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## China and Japan: A Study In Contrasts

China and Japan, Asia's two largest economies, offer a remarkable study in contrasts. Both countries play key roles in the global economy, but their current trajectories could not be more different. Despite ongoing turmoil in the global economy, China continues to enjoy strong overall growth relative to the rest of the world. Japan, meanwhile, remains mired in economic malaise that has persisted for over 20 years.

For an update on each country, *OUTLOOK* turned to two experts on Asia for their perspective.

Jeffrey Shafer is former vice chairman of global banking at Citigroup and a leading authority on China. Shafer expects China to successfully reduce its dependence on exports and transition to an economy with a significantly higher degree of internal consumption.

William Tsutsui is dean of the Dedman College of Humanities and Sciences at Southern Methodist University. A longtime student of the Japanese economy, he says Japan continues to face significant challenges as it grapples with low growth, high debt, an aging population and other intractable problems.

## China's Economy In Transition

***OUTLOOK: Give us an overview of what's happening in the Chinese economy today.***

**Jeffrey Shafer:** China has been undertaking the most remarkable economic transformation in history, starting in 1978 when Deng Xiaoping started to dismantle the communist economic system. They have been growing at more than 10 percent a year for over three decades. Right now growth has slowed a bit, but it's still growing strongly. GDP in the first quarter of 2012 was up 8.1 percent over a year earlier. The government's official five-year plan has a growth rate of 7 percent, so it's built into their thinking that China is not going to grow the way it has been. But it is still growing strongly and should continue to do so.

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**About this article**

Jeffrey Shafer is a former banker and renowned expert on Asian economies. He served as Undersecretary for International Affairs in the U.S. Treasury Department under President Bill Clinton. Later, Shafer was vice chairman of global banking for Citigroup, where he was responsible for key government and corporate client relationships in the Asia-Pacific region. Shafer also has worked for the Federal Reserve and the Organisation for Economic Cooperation and Development. He holds a bachelor's degree in economics from Princeton University and master's and doctorate's degrees in economics from Yale.

Bank lending in China is picking up now. There had been a quick policy response to rising inflation last year with monetary policy tightening. With the inflation risk rescinding, the People's Bank of China has begun to ease and this has helped to ensure that, while there's a slowdown, it's not an excessive one. Most people have forecast 8 percent GDP growth or a little more this year. If it drops below that and has a 7-handle on it, it would be no big thing. Their economy is still basically on course.

**OUTLOOK: What are the primary risks they face to growth in the near term?**

**JS:** There are some risks that they could have a bumpier landing, especially if the European downturn were to be even sharper than it now looks like it will be. Europe has gotten to be China's biggest export market – bigger even than the U.S. – so that would have an impact on them. I think it's less likely the U.S. has a real slowdown again this year, but if that happened that would have an adverse effect, too.

They face domestic risks as well. Housing had become extraordinarily strong in the Chinese economy – housing construction was 9.1 percent of GDP last year, which is 50 percent more than it was in the U.S. at the peak of the subprime bubble. If housing slows down very rapidly and they don't have the economic activity from building houses, it could become quite a drag on their economy.

**OUTLOOK: What will the Chinese government do if their economic growth falls off too sharply?**

**JS:** The government has already begun to respond with fiscal stimulus to signs of weakening growth. They both can and will do more if growth falters more. They've got a budget deficit of only 1.5 percent of GDP compared to 9.8 percent for the United States last year, so they've got lots of room to spend more and fill in for falling demand. It gives them the kind of flexibility that we just don't have. So if the downturn looks bigger than expected, there will be a response. It may be a little bit bumpier of a landing, but it won't be a hard landing.

**OUTLOOK: What about inflation in China? Isn't that a major problem?**

**JS:** It's last year's problem. The 11 percent-plus growth rates China had in 2010 and 2011 were overheating the economy, and inflation was becoming severe. It peaked in the summer of 2011, when it got up to between 6 and 6.5 percent. With the economy slowing more recently, inflation has been coming down – it was 3.0 percent over a year earlier for May, which for the Chinese is quite tolerable. The People's Bank is not under the kind of pressure that the Fed and the European Central Bank are to keep inflation at 2 percent or less. And that means their monetary policy has already begun to loosen and underpin their recovery.

They got a wakeup call when the U.S. and almost every other part of the world went into recession in late 2008 and 2009, and their export markets dried up on them.

***OUTLOOK: Chinese growth has been built around cheap labor and exports. Is that changing?***

**JS:** They got a wakeup call when the U.S. and almost every other part of the world went into recession in late 2008 and 2009, and their export markets dried up on them. They replaced the loss of export demand with domestic demand through very massive infrastructure investment.

A key gauge of an economy's dependence on exports is the "current account surplus," which is the excess of exports over imports in the trade in services as well as in goods plus net receipts on foreign investment and transfer payments. In China, the current account surplus has come down from over 10 percent of GDP in 2007, which was just a ridiculous number, to 2.8 percent last year. So they had somewhere between a quarter and a third as big of an imbalance as they had four years ago, which is quite a shift toward domestic demand.

But that shift has been based on investment rather than consumption. A lot of it is investment in housing, and part of it is massive infrastructure projects. They're investing over 50 percent of GDP. In a normal economy, investment would be 25 or 30 percent of GDP. And they are getting a relatively low return on this investment so it is hard to see how it is sustainable.

China really does need to move toward a more consumption-driven economy. And that is beginning to happen. Lots of people are buying cars, buying houses and buying furniture and appliances. They are going to restaurants and taking vacations, some abroad. Wages are rising very rapidly, which is not only shifting their export competitiveness but also equipping workers with the money to go out and buy things.

***OUTLOOK: What advantages have they gotten from their heavy focus on exports?***

**JS:** The big advantage is that they have been able to drive their economy with demand that comes from abroad and have their businesses compete in international markets, which means they have to meet international standards. If they were just producing for China behind closed trade walls they'd never learn to be world-class efficient. Some of the big Chinese companies, like Haier and Lenovo, really understand world-class competitiveness. What the Chinese need to do as they go through this

rebalancing is not to stop exporting, but to import more. As consumption grows, consumers will want things from elsewhere, and tourism will also become more and more important to them. We are also seeing China seeking to do what Japan and Korea have done before them – move up the value chain.

***OUTLOOK: Culturally, are Chinese as oriented toward consumption as people in the West?***

**JS:** I meet with a lot of Chinese groups that come to New York. People say that the Chinese aren't consumers, but I know they are because when they come here they book a bus to go to Woodbury Common, the big discount mall north of the city. And they will buy thousands of dollars' worth of merchandise, each of them, to take home. It's American and French brands, but it's mostly goods that were made in China. It would be a lot better for them if those goods just stayed there and people could buy them at home. But they don't have the distribution systems set up, and there are lots of taxes and restrictions that limit availability. So I am told it can be three times as expensive for a Chinese person to buy some of these goods at home than to buy them in New York.

Obviously, this makes no sense. I think they will clean out some of the barriers. I know Hong Kong business people and others who are developing malls and big box stores in China. Some of the American stores are there too – Wal-Mart has a big presence.

I think it is a transition that will happen over several years. China will remain a big exporter, but they will buy more of their output at home and their imports will grow more rapidly. The driver of the economy will be domestic demand.

***OUTLOOK: What barriers to change do they face?***

**JS:** One handicap they have is one that we have, too, in dealing with our problems. Americans tend to think of China as a monolith – they don't have elections; it's ruled by the Communist Party as a top-down organization. But that's not really the case. The Communist Party has 30 million people within the party structure. Orders don't just flow from the top down. There is kind of a consensus that the top leaders have to reach to make changes, and there are lots of vested interests. For instance, there is an export lobby that is very powerful and it will continue to try to get a special treatment. There are other special interests as well, and those political factors may over time make it more difficult for the leadership to move as decisively as they have in the past.

**OUTLOOK: How would you describe the economy today in terms of central planning vs. free market?**

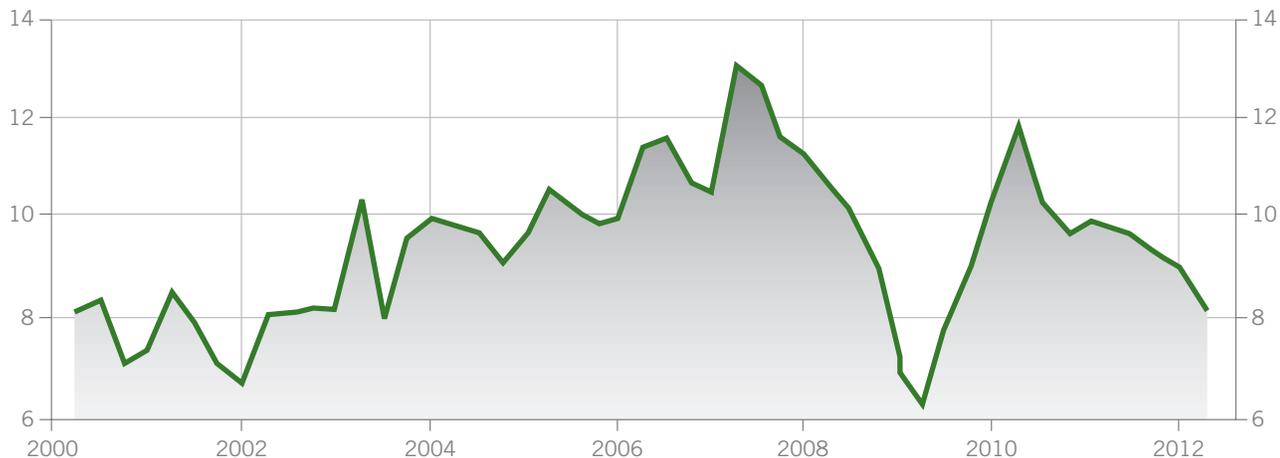
**JS:** It's not central planning in the old sense of the way they used to do it in Russia, where some guys sit down and they decide how much steel to produce and where the factories are going to be and send out the directions to meet the plan and profits be damned. China's is a market economy in that most prices are set in markets, wages are set in markets and firms are expected to be profitable.

That said, there are a lot of distortions that are generated by government policy – to keep the cost of retail distribution high, for instance, and to keep energy prices low. And many enterprises are still state-owned. They may have done IPOs and have some private shareholding, but they are still majority state-owned, and the CEOs of those organizations are put in place by the party leadership. On the other hand, these guys are motivated to make money for their company and they have to do so in an environment where they have to deal with labor markets and product markets. Their motivations aren't that different from an American CEO.

**OUTLOOK: What about their banking system?**

**JS:** China is trying to build a system that looks more like ours, despite our recent problems, and they're part way there. One thing that is different is that securities markets are relatively small and play a minor role. They're trying to change that too, but the banks are much bigger in the economy than they are in the U.S. Credit is obtained mostly through loans, not by selling bonds.

**CHINA GDP GROWTH**



Source: [www.tradingeconomics.com](http://www.tradingeconomics.com)

China is sitting on more than \$3 trillion of reserves, a large chunk of which is invested in U.S. Treasuries. That's a lousy investment for China.

The head of the Chinese central bank, Zhou Xiaochuan, is one of the smartest and best central bankers in the world. But he's not independent like Ben Bernanke. He doesn't really get to do what he wants, and you can see the political constraints on him from the party, from the Central Committee. Interest rates are closely controlled; they're really not market rates.

There's a tremendous demand for credit in China that doesn't always get satisfied at official lending rates of 5 or 6 percent. One of the distortions in the system has been that credit tends to go from the four major state-owned banks to the big state-owned enterprises, and there is a shortage of credit in the true private sector, which is the most dynamic part of the economy. Credit demand there is partly satisfied through a gray market. The big companies and some others have got the money, and they lend it at much higher interest rates – 18 or 19 percent – to other businesses.

**OUTLOOK: So you have non-bank enterprises in China serving as lenders?**

**JS:** Yes. That's common and it's growing although I can't put numbers on it. This sort of shadow banking happens any place where you've got financial over-regulation. We're going to have more of it in the U.S. when we fully absorb the impact of Dodd-Frank.

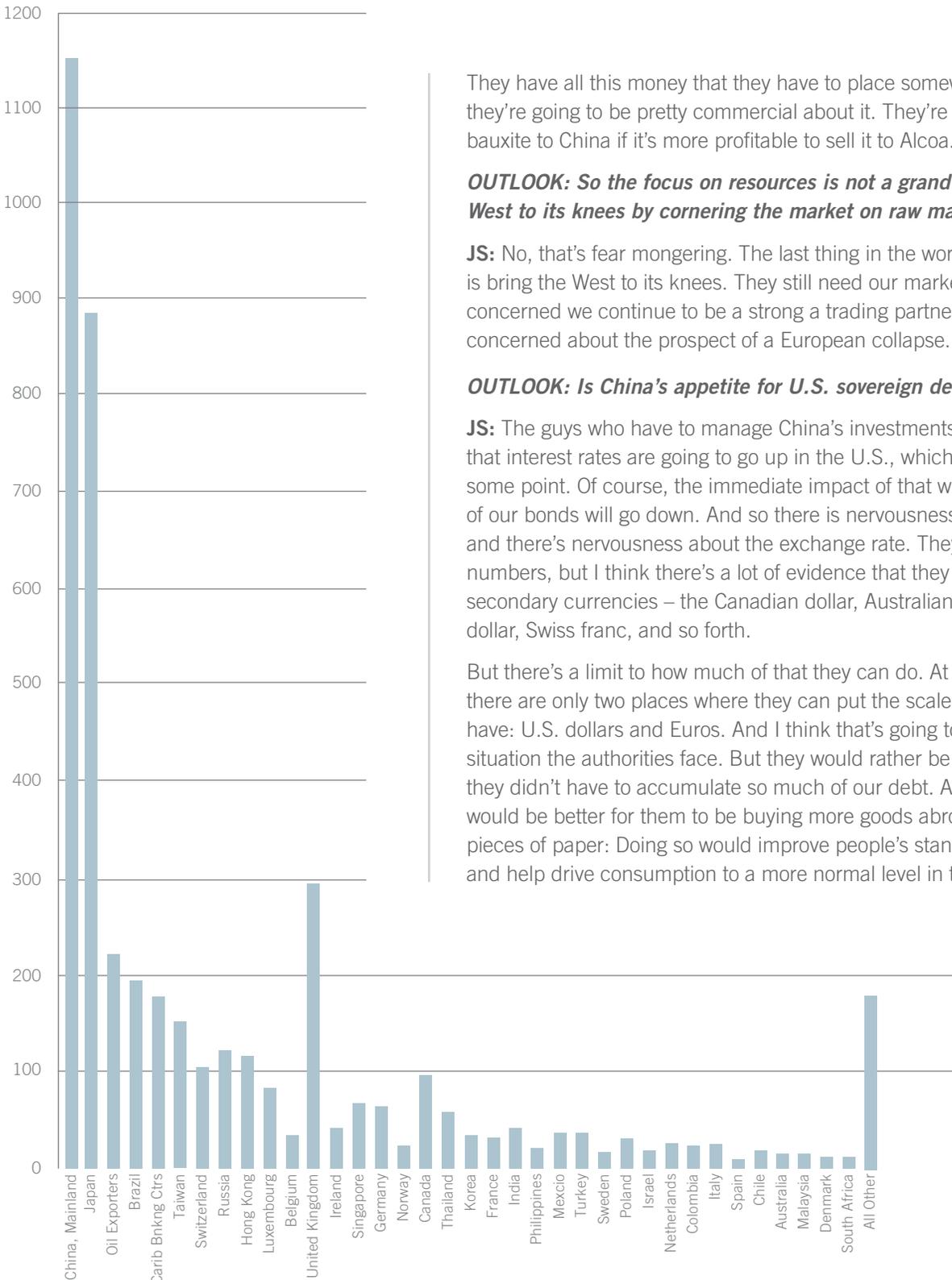
**OUTLOOK: One hears a good deal about China investing abroad, especially in ways that secure their long-term access to oil and other resources. Is that something we should be concerned about?**

**JS:** They are looking to move upstream or downstream from where they are in the production chain, either to get the raw materials or buy the distribution channels where their products can be sold. Right now, Europe doesn't look so interesting to them. But Latin America does, and so does Africa. They're also investing in Thailand, Vietnam and the other areas in southeast Asia. They are acquiring oil, bauxite, iron ore – all kinds of resources as well as manufacturing plants. They are small and the Chinese have been low key about it, but there have been a number of Chinese investments in U.S. manufacturing that preserve or create jobs here.

A lot of this activity is simply seeking a higher rate of return. China is sitting on more than \$3 trillion of reserves, a large chunk of which is invested in U.S. Treasuries. That's a lousy investment for China. Interest rates are low, and the dollar is going to depreciate against their currency, the renminbi, over time.

## MAJOR FOREIGN HOLDERS OF U.S. TREASURY SECURITIES

Holdings as of February 2011, in billions of dollars



They have all this money that they have to place somewhere, and I think they're going to be pretty commercial about it. They're not going to bring their bauxite to China if it's more profitable to sell it to Alcoa.

**OUTLOOK: So the focus on resources is not a grand scheme to bring the West to its knees by cornering the market on raw materials.**

**JS:** No, that's fear mongering. The last thing in the world they want to do is bring the West to its knees. They still need our market. They're very concerned we continue to be a strong a trading partner. They are extremely concerned about the prospect of a European collapse.

**OUTLOOK: Is China's appetite for U.S. sovereign debt declining?**

**JS:** The guys who have to manage China's investments are very afraid that interest rates are going to go up in the U.S., which they will have to at some point. Of course, the immediate impact of that will be that the value of our bonds will go down. And so there is nervousness about that in China, and there's nervousness about the exchange rate. They don't give out the numbers, but I think there's a lot of evidence that they are investing more in secondary currencies – the Canadian dollar, Australian dollar, New Zealand dollar, Swiss franc, and so forth.

But there's a limit to how much of that they can do. At the end of the day, there are only two places where they can put the scale of money that they have: U.S. dollars and Euros. And I think that's going to continue to be the situation the authorities face. But they would rather be in a position where they didn't have to accumulate so much of our debt. And they recognize it would be better for them to be buying more goods abroad rather than just pieces of paper: Doing so would improve people's standard of living in China, and help drive consumption to a more normal level in their economy.

Source: Department of the Treasury/Federal Reserve Board

I have a Chinese friend in Beijing who said to me recently, “You know, we’re going to buy all the pork the U.S. can produce.”

**OUTLOOK:** *A major complaint the U.S. has had is that China has kept its exchange rate with the dollar artificially high, which makes it very difficult to export our goods to the Chinese market. Talk about that issue.*

**JS:** It has been a real issue, but it is receding. For most of the last decade, China was holding down its exchange rate. And you could see the effects in terms of very strong exports and not such strong imports. The U.S. was on the other side of that, and we couldn’t export much to them competitively; we were only importing their cheap goods.

That dynamic did a couple of things. It helped to keep inflation down in the U.S. The Chinese were buying our Treasury bills, and we were not having to buy those Treasury bills ourselves, so we had the room in our portfolio to buy all the subprime mortgages instead. We fueled the U.S. economy by putting people to work in areas where we didn’t have to compete with the Chinese, namely housing. And so we way overdid that and it all came apart. Now we are getting back on track. There has been some renminbi appreciation, and rapid wage increases in China have contributed to a competitiveness rebalancing. As I noted earlier, the Chinese current account surplus has shrunk a lot.

**OUTLOOK:** *Do you believe China will continue to grow as an export market for U.S. goods?*

**JS:** I have a Chinese friend in Beijing who said to me recently, “You know, we’re going to buy all the pork the U.S. can produce.” The Chinese public is losing confidence in its own pork suppliers, and one of the responses is they’re going to buy pork from Iowa. Not just the soybeans to feed to their own pigs, but the pork itself. I think that same thing could happen too with chicken, milk and a lot of other products as well. There’s real potential. If they’re going to become a more consumption-based economy, it’s going to mean moving up the food scale. Instead of eating rice, they’re going to eat meat. Part of that process is going to be to look to the U.S. for more agricultural goods.

**OUTLOOK:** *What are some of the pressing problems in China?*

**JS:** Many local governments have borrowed heavily for infrastructure investments, and they don’t have the cash flows in those areas to make the debts good. There’s a pretty sizeable cleanup that’s going to have to take place there. What will probably happen is, in one form or another, the central

**INFLATION IN CHINA**

Annual Change on Consumer Price Index



Source: [www.tradingeconomics.com](http://www.tradingeconomics.com),  
National Bureau of Statistics of China

government will just take over those debts. But even if it does, the total amount of debt of the government would not be that much more than their holdings of foreign exchange reserves. So they've got the latitude to deal with those problems.

Another very serious problem for them is pollution of both air and water. And as China becomes more of a middle-class society, public unhappiness with pollution is rising. There are environmental laws in place from the central government, but the local governments still aren't implementing them. If you're a provincial governor, you're going to get rated by the people in Beijing on how fast your provincial economy grows. And so you cut corners, and you don't want to do anything to the big polluters because it may slow growth down. They're working very hard to try to change how people are evaluated, but it's a long slow process.

**OUTLOOK: What about corruption?**

**JS:** Corruption is a big problem – it's a problem in any emerging country. And the leaders are concerned about it. Recent news about Bo Xilai and his family have highlighted how senior officials may be engaged in corruption. But it's not such a problem that it takes all the efficiency out of the economy, the way it did in Indonesia in the 1990s. I think there's a view among global businessmen that a 10-percent "corruption tax" you can tolerate, and 20 percent you can't. China's level of corruption is tolerable, and in the range that you would expect for its level of development. Public tolerance seems to be declining. This will be good if it forces a higher standard of behavior. But Chinese leadership fears of political instability may lead them to engage in cover-ups and allow corruption to grow. This would eventually put both economic growth and political stability at risk.

***OUTLOOK: As China develops a wealthier and more independent middle class and business class, will the government come under pressure to grant citizens more liberty and freedom?***

**JS:** There is already a lot of individual freedom, in terms of how you live your life. If you're entrepreneurial and want to go out in the private sector, you can. Yes, there isn't the political freedom to denounce the government. But the government doesn't weigh on people's personal lives in the way it did in Russia in the old Soviet days. And I think most Chinese are quite content with that.

But there is an underlying problem that's going to get sharper, which is that there is a two-class system. The Communist Party represents 30 million people out of a total population of 1.2 billion. If you're a member of the Party and you get in trouble you're tried in different courts. You have a lot of special privileges, you've got good jobs, and you make good money. There have been major public demonstrations when sons of party officials have been found to have been involved in hit-and-run accidents with their cars and have not been held responsible. And corruption scandals such as the one involving Bo Xilai can also raise public dissatisfaction with the political regime. Whether the leadership will solve this two-class problem by making everybody members of the Communist Party or finally adopting some kind of pluralistic political system, I don't know. The most senior people in the government are very aware that the status quo isn't sustainable forever. But they don't know how they're going to get out of it yet either.

***OUTLOOK: Fundamentally, though, you seem optimistic about the ability of the Chinese to manage these difficult problems and transitions.***

**JS:** They're well-equipped to deal with problems as they arise. They have been masters of just-in-time policy making. They've got lots of problems that they can't solve immediately, but when one's about to overwhelm them they do respond effectively and deal with it. There is always a risk that they could lose this capacity. With a change in leadership over the coming year, we will see a test. But their record of economic management for more than 30 years of rapid change has been extremely good. ■

## Stagnation In Japan

**OUTLOOK:** *Japan built what seemed to be one of the strongest economies in the world in the decades after World War II. Since 1989, the country has been in a period of almost continuous economic malaise. Remind us of what happened to Japan and why its economy reversed course so sharply.*

**William Tsutsui:** The origins of the bursting of the bubble really go back to the Plaza Accord of 1985, where a deal was hammered out in which the Japanese agreed to appreciate the yen vis-à-vis the U.S. dollar. The dollar had been strong, and there was a growing sense of crisis about the trade balance with Japan, so the Japanese agreed to pump up the yen.

The impact of that domestically in Japan was recessionary. The Bank of Japan responded by easing monetary policy, and easing it quite aggressively. This led to a speculative boom both in equities and in the real estate market.

So we saw a bubble develop with a rapid run-up in asset prices in the late 1980s until everything blew apart in late 1989.

**OUTLOOK:** *What specifically caused the bubble to burst?*

**WT:** By 1989 it was clear to everyone that the Japanese economy was severely overheated. And probably the last people to notice this – and the people who should have been watching the closest – were the folks at the Bank of Japan.

Japan's central bankers made two mistakes. One was waiting too long; they probably should have put on the brakes a year if not two years earlier. And then when they did put on the brakes, they put them on too hard. They jacked up interest rates too much. And that deflated the bubble far too quickly and led to a crisis that could and should have been averted. Real estate prices plummeted, the stock market plummeted. In the early 1990s something like \$2.5 trillion in assets just disappeared in a matter of two and a half years.

People called the early 1990s the era of Japan's "disappearing wealth" because Japan, which had seemed like an economic juggernaut headed for global economic domination, all of the sudden was bleeding red ink.

The peak of the Nikkei index was the last trading day in 1989. If you look at the Nikkei you'll see it's only a small fraction of that even today.

### About this article



William Tsutsui is dean of the Dedman College of Humanities and Sciences at Southern Methodist University. He is considered a specialist in modern Japanese business and economic history and has written books that examine topics ranging from banking policy to the film icon "Godzilla." He is the author of "Banking Policy in Japan: American Efforts at Reform During the Occupation" and "Manufacturing Ideology: Scientific Management in Twentieth-Century Japan." Tsutsui received a master's and a doctorate in history from Princeton University. His bachelor's degree in East Asian Studies is from Harvard University.

By the turn of the millennium Japan's highways were gorgeous, every city seemed to have a new train station, there were new airports, new dams out in the countryside. Of course all this led to huge increases in public debt.

**OUTLOOK: What was the policy response following the crash?**

**WT:** It was very much a textbook response for dealing with a situation like this, where all of a sudden the carpet is yanked out from underneath an economy. In terms of fiscal policy the Japanese government was pumping money strongly into the economy through much of the 1990s. This was especially true in public works spending. For the better part of the decade, the central government was essentially writing blank checks to build infrastructure. By the turn of the millennium Japan's highways were gorgeous, every city seemed to have a new train station, there were new airports all over the country, new dams out in the countryside. Of course all this led to huge increases in public debt.

**OUTLOOK: Why wasn't the stimulus more effective?**

**WT:** It kept the economy from keeling over, but the fact of the matter is the Japanese government did not address fundamental problems, including the bad loans on the books of Japan's major banks. They were carrying a huge load of bad debt, and rather than clearing off that debt and recapitalizing the banks, the government chose a less drastic (and ultimately less effective) policy of economic life support. It kept money flowing into the system through easy monetary policy, it kept fiscal spending going to keep employment up and the people happy, and there was no real adjustment. Those bad loans were not written off. So-called "zombie corporations" that no longer were doing business were kept at least nominally functioning by money flowing through the system. And the reckoning that needed to take place from the bubble was delayed by a good 15 years. It was only really in the early part of the 21st century – in 2004 and 2005 – that the Japanese government really became serious about pumping cash into the banking system and getting those bad loans scrubbed from the books.

**OUTLOOK: Why was Japan so hesitant to deal with bad debt?**

**WT:** Japan has never had the kind of faith in market mechanisms that we have in the United States. The "creative destruction" that we associate with capitalism is not part of Japanese business culture. The idea of institutions going out of business, especially large institutions that would be the equivalent of Lehman Brothers, simply was not conceivable to people in the

## The Japanese economy has been more or less treading water for over 20 years now.

Japanese business world. And frankly through most of the 1990s, people in Japan at all levels just couldn't believe that things weren't eventually going to right themselves. It was taken almost as an article of faith that real estate in Japan was so valuable that even though the bottom had fallen out from underneath the market, it was going to come back and be as strong as it once was. And almost everyone bought into the mythology of the great Japanese corporations – that Toyota would always be Toyota and Sony would always be Sony. And it really took them a long time to get around to the idea that, “Boy, you know this thing isn't going to come back like we thought, and we're going to have to drink that harsh medicine.”

### ***OUTLOOK: Talk about the Japanese economy and where it stands today.***

**WT:** The Japanese economy has been more or less treading water for over 20 years now. There have been some more promising moments and some more desperate moments during that time.

Just before the financial crisis in 2008, Japan was on a roll and I think a lot of people thought Japan was beginning really to pull out of this long dry period. And much of the optimism at that time was due to the increasing integration of the Japanese economy and the Chinese economy. As China was doing better, Japan was doing much better as well. But the financial crisis shook Japan badly, and Japan slipped into deflation in late 2008 into 2009. So that was hit number one.

Hit number two was the earthquake last year. The earthquake arguably solved the deflation problem for the time being, just because the amount of money that's been going into relief efforts has tended to buoy the economy. Nonetheless, from quarter to quarter, Japan is right around zero growth. I don't see too much change in that in the near term future.

### ***OUTLOOK: What about the Japanese trade balance?***

**WT:** For a very long time Japan had a strongly positive balance of trade. But after the earthquake, with the need to import more gas and oil because so many nuclear plants are offline, Japan's trade balance has sunk badly into the red. If those nuclear plants don't get started again, this is a very worrisome development for the long term.

**OUTLOOK: What about employment?**

**WT:** Unemployment by our standards doesn't look very bad. Officially it's something like 4.5 percent in Japan right now. But that hides a lot of underemployment and discouraged workers. The real unemployment rate in Japan is probably closer to 9 percent or 10 percent.

By historic standards that's just huge. For most of the post-World War II period, Japan essentially was a full-employment economy. So the situation since 1989, where there has been substantial and sustained unemployment in Japan, has been a shocking change to many Japanese, especially to youth.

**OUTLOOK: Has Japan been able to hold onto its manufacturing base?**

**WT:** Wages have been stagnant, or have perhaps even fallen slightly, in Japan over the past 20 years. So as China's labor costs have gotten higher, Japan's become a more competitive place for manufacturing again. In the 1980s one saw a lot of what the Japanese called "hollowing out" – the movement of manufacturing industries into China and Southeast Asia. But that process has largely stopped now because in a number of sectors, especially in more capital intensive industries, Japan can compete pretty well against its Asian neighbors.

The question is how long this is going to continue. Many of the prominent Japanese brands that powered the nation's spectacular post-war growth, especially in electronics – Sony, Hitachi, Toshiba – are in severe crisis right now. These big companies have been completely outstripped by Samsung and increasingly by Chinese competitors as well. There's been a lack of innovation, a lack of risk taking, and a curious kind of complacency in those firms. And there's the real worry now that they've simply fallen too far back to compete successfully.

**OUTLOOK: What is the reason for that complacency?**

**WT:** People in Japan talk about something called the "Galapagos Syndrome," as in the Galapagos Islands of the South Pacific. It refers to an inward-looking tendency, in Japanese society at large but particularly among Japanese corporations. Japan, it is said, is evolving independently of the rest of the world (like the animals of the Galapagos Islands) and the Japanese seem satisfied with their growing isolation.

A great example of this Galapagos Syndrome is cell phones. The Japanese were true innovators in developing cell phone technology, and the first Internet-enabled cell phones were available in Japan. They were out in

front of the curve on so many of the innovations we now take for granted internationally. But they didn't manage to sell these anywhere beyond Japan. The Japanese have been able to be complacent, at least in part, because the domestic market has been of significant size. They use different engineering standards, different networks, and so forth. And so the Japanese, despite their head start in cell phone technology, have allowed manufacturers elsewhere – in Asia, Europe and North America – to dominate the world market. Firms in a place like South Korea have a relatively much smaller home market, so they've had to think in global terms.

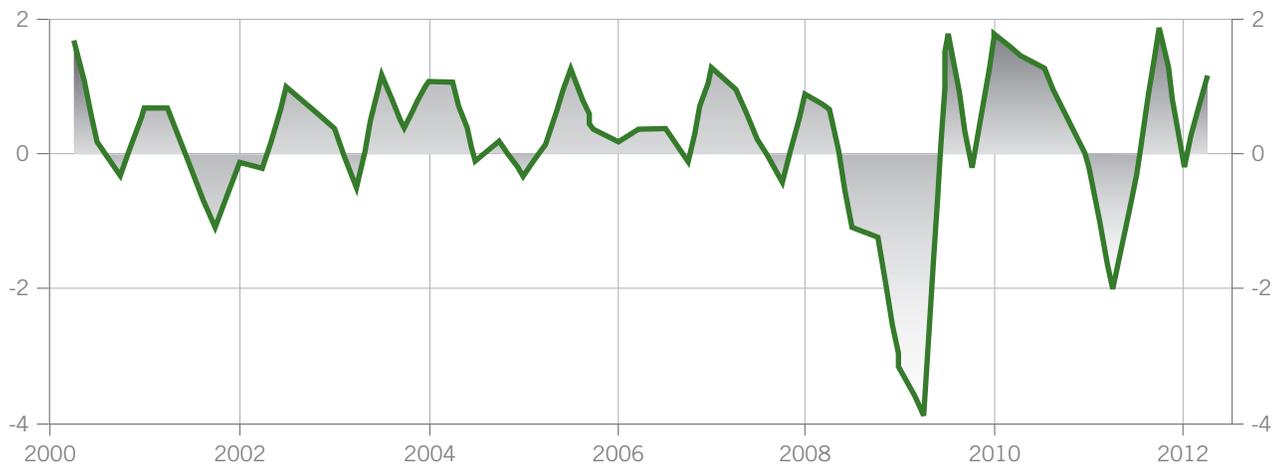
People are familiar with the image of Japanese tourists in Waikiki or Manhattan. But the reality is the Japanese are traveling much, much less. Study abroad from Japan to the outside world, and especially the United States, has declined substantially. The number of students in Japan studying English has also shrunk considerably. It really does seem that with this ongoing economic downturn the Japanese are very much turning inwards.

**OUTLOOK: What policies is the government implementing today to lift Japan out of the doldrums?**

**WT:** Right now the Japanese government is out of tools. They've tried just about everything and they have, at least, kept the Japanese economy from slipping into a truly profound crisis. Japan is not Greece. But the economy has not responded positively to any of the standard tools for inducing recovery. At this point I think the biggest handicap the government is working under is the huge debt burden. Japan has the heaviest debt burden as a proportion of GDP of any nation in the world. It is stunning, much higher than

**JAPAN GDP GROWTH**

Percent Change in Gross Domestic Product



Source: [www.tradingeconomics.com](http://www.tradingeconomics.com)

in any of the places that have recently caught the world's attention – Iceland or Greece or Spain or Italy. The Japanese have been able to hold it together, so far. But the party can't continue much longer.

***OUTLOOK: How high is public debt as a percentage of GDP?***

**WT:** It's over 200 percent – perhaps as high as 225 percent. And rising. And the reason it is rising is because of the earthquake relief.

The government has said that they have to get this under control. Of course austerity is relatively easy as lip service but difficult in reality. It's unclear to me how they're going to accomplish that, but essentially the political authorities have said that Tokyo has got to turn off its taps of money. There has been discussion of increasing the consumption tax pretty substantially in Japan. The current prime minister has proposed doubling it over a period of several years.

Of course last time the Japanese did this was in the mid-1990s: They increased the consumption tax to get the debt burden under control and promptly sent the economy into a tailspin. That almost triggered a deflationary spiral. So I have to say I'm pretty concerned about too much belt-tightening right now.

But if fiscal policy no longer becomes an option for stimulating the economy, that leaves it up to monetary policy, and frankly at this point there's not much more the Bank of Japan can do. They've opened the taps to the extent they can. It's been zero discount rates for as long as anyone can remember, and that's just essentially just staved off crisis.

***OUTLOOK: What about the Japanese consumer?***

**WT:** Japanese consumers aren't spending. Japanese citizens have always been prodigious savers. One of the important outcomes of the bursting of the bubble was that the Japanese became even more miserly in their spending. And they stuff increasingly large parts of their paychecks under their mattresses or into their savings accounts. As easy as money is in Japan, consumers aren't interested in using it, and companies don't seem eager to invest it.

**OUTLOOK: How did they get to public debt at 225 percent of GDP?**

**WT:** Japan is not a big place, but it's terrifying to see how much of those islands are coated in concrete. The construction industry has been Japan's biggest boondoggle for a very, very long time. There's been an incredible amount of money spent on infrastructure, and a lot of government funding has also gone to protect and assist rural areas. Since World War II, wealth has been generated in the cities, and agriculture has been in quite steep decline. It really doesn't pay to be a farmer anymore, but to keep rural income levels at least close to the national average the government has had to invest heavily in providing services to the countryside, and in creating jobs there through construction projects.

It's discouraging to think about where alternate investments could have been made. The Japanese educational system has been highly vaunted internationally, and honestly Japanese high-schoolers do have great skills in math and science and reading and so forth. But Japan has not made the investments in its university system and, in particular, in research activities in higher education that we see in the United States and in Europe. Japanese universities tend not to be competing at the very highest level, and all the spending over the past 20 years that's gone into concrete could have been much better spent on building the educational foundations of innovation in Japan.

**INFLATION IN JAPAN**



Source: [www.tradingeconomics.com](http://www.tradingeconomics.com)

***OUTLOOK: Japan's population is aging rapidly. Talk about the country's demographic trends.***

**WT:** This is the ticking time bomb for Japan. I was just reading a quotation from the governor of the Bank of Japan and he said, "You know, the central bank can't solve structural problems." And the main structural problem he was talking about was demographic change in Japan. The Japanese population is now declining and is going to keep declining for the foreseeable future. It's already a very old population, but the number of people in the workforce supporting the number of retirees is truly sobering going forward. One estimate that I've seen from the United Nations suggests that Japan would have to add 700,000 new immigrants a year for the next 50 years just to compensate for the natural decline of its population.

***OUTLOOK: How much immigration is there today?***

**WT:** Right now there are about 15,000 new naturalized Japanese citizens every year. To go up to 700,000 is just inconceivable for Japan. That is just not a part of the culture or the political discourse.

The government has been caught flat footed on the nation's demographic problems and policy has been inconsistent so far. Japanese women have been caught in the middle. On the one hand the government has been saying to women, "Stay home and have children." On the other hand, because the labor force has been getting smaller, Tokyo has been advising women, "Get educated, stay in the labor force and work." And considering that social support mechanisms like child care really aren't in place in Japan, it's made it impossible for young women to negotiate a family and career. Consequently many of them are opting out. The average age at which women get married in Japan has been increasing extremely rapidly. More and more women are simply concluding, "I don't want to get married. I'm just going to stay at work."

***OUTLOOK: How have the Japanese responded to all this, psychically?***

**WT:** It has been very difficult to watch Japan over the past 20 years, not least because I have such huge respect for the Japanese people and their culture. The world gained some sense of the fortitude of the Japanese spirit in the wake of the earthquake and tsunami last year: the Japanese are, without doubt, some of the most resilient, patient, cohesive people in the world. It's a remarkable society, built for stability, built for coming together in tough times.

Japan's tenacious economic downturn has not led to anger, unrest and activism, but instead to a kind of passivity among the Japanese people and a pattern of widespread social withdrawal.

Japan's tenacious economic downturn has not led to anger, unrest and activism, but instead to a kind of passivity among the Japanese people and a pattern of widespread social withdrawal. This is particularly obvious among the younger generation, who in most countries are the people on the front lines, who are out there pushing for change.

In the decades after World War II, the "Japanese dream" was to go out, get a good education, land a job in a big company or the government, work as a "salaryman," have a family with two kids, and perhaps ultimately aspire to a home of one's own. In many ways it was similar to the American dream. After 1989, however, that dream just evaporated. Education was no longer a guarantee of stable employment. Jobs were hard to find, even for the most highly qualified. Homeownership was increasingly out of reach for most young people. But rather than protesting, rather than going to the streets, rather than demanding more from the politicians and business interests, the Japanese people have tended to look inwards. One sees more and more Japanese youth choosing to detach themselves from the economy, from politics and from social life.

The most famous manifestation of this is something called hikikomori. These are people who essentially live as hermits. They mainly live with their parents, but they go into their rooms and they simply don't come out, often for years at a time. There may be a million of such hikikomori in Japan today who don't have jobs, who don't interact with the world except perhaps through the Internet, who are fed and cared for by their parents and whose future is entirely unclear. And unfortunately they are a good metaphor for society as a whole. At time when the Japanese people might well be on the streets demanding better from their leadership, most have chosen instead just to suck it up, do the best they can, not complain loudly, and try to ride the hard times out.

**OUTLOOK:** *The same characteristics that are their strength may also be a weakness.*

**WT:** That's it exactly. And, as much as anything, if I look back over the past 20 years, I am struck by just how badly the Japanese people have been let down by their political leadership. There have been 17 prime ministers since 1989, which means the average term in office has been just over a year. There have been very few inspiring politicians who can speak to the Japanese people and provide anything like a vision for what Japan could do to get its arms around its economic and social problems.

**OUTLOOK:** *What do you see as possible scenarios for Japan looking ahead over the next five to 10 years?*

**WT:** The best case scenario is that we begin to see some change in Japan. And looking out five to 10 years I don't think one can see more than the beginning of reform over that time, because the society and the political system are generally so resistant to change.

I would hope we start to see some real loosening on immigration in Japan. And to see more political leadership. That we begin to see some people with vision really stepping up and inspiring the people. We need to see youth brought back into the equation, and the active empowerment of youth to take a place on the public stage. Right now Japan is very much run by and for the gray hairs; the elderly and their interests have largely set the national agenda. But we really need to see the young step forward.

And, as much as anything, what I would like to see is a new entrepreneurial energy in Japan. Traditionally Japan has been dominated by large corporations and the government, and it has been a tough place for entrepreneurs to make a start. "Risk" is a dirty word in Japan. Going it alone is not something most Japanese feel comfortable with. But we see some glimmers of entrepreneurship in Japanese industries like video games and animation, where there is real creativity and daring. If society would ease up a little bit, and if the government would back off a little bit, I really think we could see more dynamism from the grass roots of the Japanese economy.

The ultimate worst case is a sovereign debt crisis in Japan, which would make Greece look like nothing.

**OUTLOOK: What's the worst case scenario?**

**WT:** The worst case is pretty nasty, I'm afraid. The ultimate worst case is a sovereign debt crisis in Japan, which would make Greece look like nothing.

I don't think it's going to get that bad, however. I suspect the realistic worst case scenario is that Japan continues to tread water like it has for two decades. That Japan five years from now looks very little different from Japan today. That the population continues to decline. That GDP growth keeps fluctuating around zero. And that all the fundamental problems in Japanese society, Japanese politics and the Japanese economy just don't get dealt with. What would be particularly devastating in such a scenario would be that those companies that have remained in Japan and been fairly successful in Japan finally decide that the Japanese labor market and political situation and educational system are really not good bets for the long term. And those companies begin to pull out. In that case, Japan's slow descent could accelerate quickly.

**OUTLOOK: What lessons does the Japanese experience hold for the United States and the rest of the developed world?**

**WT:** Some of the same demographic and economic problems that Japan is facing – an aging population, increasing welfare demands on government and so forth – are global realities right now. Japan's demographic situation is not that different from South Korea's or Italy's or Germany's. Japan today looks a lot like what other developed economies are going to in the not-too-distant future.

What's interesting is that Japan now has a chance to be the pioneer. The Japanese have always been marvelous followers. They've been great at emulating Europe and the United States – taking the best from abroad and then really perfecting it. But the Japanese really haven't been in this situation before, where it's up to them to chart a course for the rest of the world. I hope Japan will rise to the challenge and set the example for what a 21st-century capitalist liberal democracy can be. ■

# Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 05/31/12. They are intended to provide rate or cost indications only and are for notional amounts in excess of \$5 million except for forward fixed rates.

## KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

## ECONOMIC AND INTEREST RATE PROJECTIONS

Source: Insight Economics, LLC and Blue Chip Economic Indicators

### US Treasury Securities

2012	GDP	CPI	Funds	2-year	10-year
Q2	2.20%	2.20%	0.15%	0.30%	1.90%
Q3	2.40%	2.20%	0.15%	0.30%	2.00%
Q4	2.60%	2.10%	0.20%	0.40%	2.10%
2013	GDP	CPI	Funds	2-year	10-year
Q1	2.20%	2.10%	0.25%	0.50%	2.20%
Q2	2.60%	2.10%	0.25%	0.60%	2.30%

## PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

## IMPLIED FORWARD SWAP RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	0.48%	0.57%	0.68%	0.99%	1.34%	1.72%
0.25	0.51%	0.61%	0.74%	1.07%	1.41%	1.78%
0.50	0.61%	0.64%	0.79%	1.14%	1.48%	1.84%
0.75	0.65%	0.65%	0.85%	1.22%	1.55%	1.90%
1.00	0.65%	0.66%	0.90%	1.30%	1.62%	1.96%
1.50	0.66%	0.71%	1.07%	1.46%	1.77%	2.08%
2.00	0.73%	0.78%	1.25%	1.64%	1.89%	2.20%
2.50	0.93%	1.01%	1.47%	1.82%	2.05%	2.31%
3.00	1.13%	1.23%	1.68%	1.99%	2.21%	2.42%
4.00	1.60%	1.71%	2.07%	2.30%	2.45%	2.60%
5.00	2.00%	2.11%	2.36%	2.53%	2.65%	2.75%

## HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

## FORWARD FIXED RATES

### Cost of Forward Funds

Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	5	5	5	5
90	5	10	10	12
180	5	14	17	20
365	15	29	34	39

Costs are stated in basis points per year.

## SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

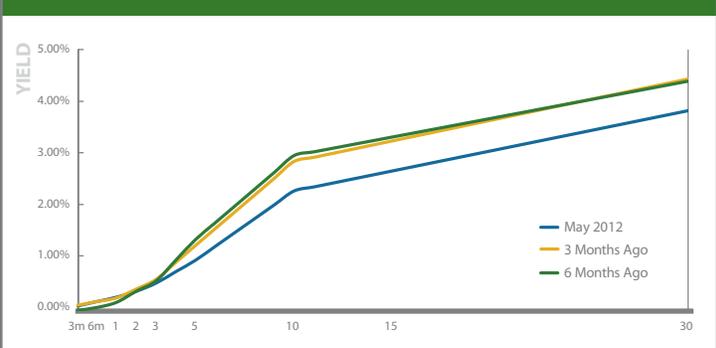
## 3-MONTH LIBOR



## RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

## TREASURY YIELD CURVE





## 2012 CoBank Board Elections

Ballots for CoBank’s 2012 board of directors election will be distributed to shareholders in July.

A total of nine seats on the board are open this year, partly as a result of the new governance structure adopted by the bank in conjunction with its recent merger with U.S. AgBank. The bank’s independent Nominating Committee has qualified two candidates for each open seat. For some seats, the initial term is shorter than the standard four-year term in order to accommodate term staggering.

The names of the candidates, along with their place of residence and seat type (one-member-one-vote or modified equity), are listed in the table below.

### About CoBank

CoBank is a cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving more than 70,000 farmers, ranchers and other rural borrowers in 23 states around the country.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation’s rural economy. Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore.

For more information about CoBank, visit the bank’s web site at [www.cobank.com](http://www.cobank.com).

SEAT	CANDIDATE	RESIDENCE	SEAT TYPE
East Region (four-year term)	James A. Kinsey*	Flemington, WV	One-member-one-vote
	Donald P. White	Bangor, ME	
South Region (one-year term)	George B. Kitchens	Decatur, AL	One-member-one-vote
	Robert W. Leavitt, Jr.	Sunset Beach, NC	
South Region (four-year term)	Robert M. Behr	Lakeland, FL	Modified equity
	Steven A. Harmon	Greenville, AL	
Central Region (two-year term)	James R. Magnuson	Sully, IA	One-member-one-vote
	Larry A. Swalheim	Stoughton, WI	
Central Region (four-year term)	Robert B. Fifield	Hastings, NE	One-member-one-vote
	David J. Kragnes*	Felton, MN	
Mid Plains Region (two-year term)	John R. McClelland	Holcomb, KS	One-member-one-vote
	Clint E. Roush	Arapaho, OK	
Mid Plains Region (four-year term)	Joseph Pandey Jr.	Granby, CO	One-member-one-vote
	Scott H. Whittington	Burlington, KS	
West Region (one-year term)	Jon E. Marthedal	Fresno, CA	One-member-one-vote
	Keith C. Murfield	Chandler, AZ	
Northwest Region (two-year term)	Erik N. Jacobson	Bend, OR	One-member-one-vote
	Thomas P. Stokes, II	Selah, WA	

\*Incumbent

Voters will have approximately 60 days to return the ballots after receiving them in mid-July. Election results will be announced in September. ■

*Commentary in Outlook is for general information only and does not necessarily reflect the opinion of CoBank. The information was obtained from sources that CoBank believes to be reliable but is not intended to provide specific advice.*