OFF THE NEWS

When Interest Rates Are Too Low

As the Japanese economy continues to shift away from manufacturing industries, it should more closely align itself with capital-intensive, highly productive non-manufacturing industries that will generate the greatest value for the overall economy. Japan is well-positioned to start this structural transformation because its services industries are underdeveloped (a result of decades of over-regulation). According to OECD labor statistics for 2009, the service sector represents only 69 percent of total employment in Japan, compared to 77 percent for France, 79 percent for the United Kingdom, and 81 percent for the United States.

Transforming the economy from manufacturing to services is the most important part of Japan's growth strategy. But in order to achieve this transformation, interest rates need to be normalized. As long as interest rates remain near zero, unprofitable companies can survive and discourage new investment. Consumers also suffer because zero interest rates erode household interest income. According to national income statistics, interest payments represented 34 percent of national income in 1991. In 2009 they had tumbled to a mere 13 percent of income. In Japan's ¥500 trillion economy, this 20 percent drop represents a ¥100 trillion shift in income from households (savers) to borrowers such as non-financial corporations and the government. As interest income is eliminated, retirees, who are the primary savers, are left with only their pensions. This is the main reason for the prolonged slump in consumption over the past two decades. In order to achieve demand-led growth, interest income needs to be revived. This is especially so for the elderly as they hold a vast majority of Japan's ¥1,100 trillion of net private financial assets and are the biggest consumers of medical and nursing-care services.

Ultra-low interest rates are even more destructive now.

Ultra-low interest rates, which were introduced as a temporary emergency measure after the economic bubble burst in the early 1990s, hurt the economy then and are even more destructive now. The policy needs to be stopped. It has propped up zombie companies for far too long and postponed a much-needed elimination of excess supply capacity, which has been the main cause of disinflation and the biggest obstacle blocking new investment for more than fifteen years—the so-called lost years. There will be more lost years if this measure is not reversed.

—Tadashi Nakamae

Mindboggling Change

"Office space in Rio de Janeiro now costs more in dollar terms than midtown Manhattan, according to real-estate firm Cushman & Wakefield."

—Wall Street Journal

Why There Are So Few New Jobs

Today roughly 15 percent of start-up companies backed by venture-capital firms eventually go public. In the early 1980s, the rate was 90 percent.

—National Venture Capital Association

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Remembering a Friend

For nearly a quarter century, Harry Freeman, who died on June 6, was a close advisor and spirited force behind this magazine. Harry was a one-man think tank/public policy dynamo. A man of great intellect, dedication, and passion, he transformed Washington thinking on trade at a critical moment when the U.S. economy was in transition to a largely services economy. Harry predicted this development and helped reposition the U.S. government to reflect this new reality.

Harry Freeman, *financial services champion, died on June 6, 2011.*

Harry's accomplishments were impressive. He coined the term "financial service sector," which ultimately led the Bureau of Labor Statistics to change its monthly trade balance figures to acknowledge the impact of goods and services. As a result, *Fortune Magazine* began an annual list of the top 500 service companies.

Along with other prominent members of the financial services community, Harry conceived of the Coalition of Service Industries to promote the contributions of the service sector to the U.S. economy. He was a catalyst for the creation of the Financial Services Coalition for the purpose of recognizing the collective importance of the various segments of the banking, securities, and insurance industries.

One of Harry's greatest achievements was in helping craft the U.S. negotiating strategy for the Uruguay Round to break down international barriers against services. As an active trustee for the Committee for Economic Development, Harry promoted campaign finance reform. He also fought for prudential financial regulation reform long before banks became too big to fail.

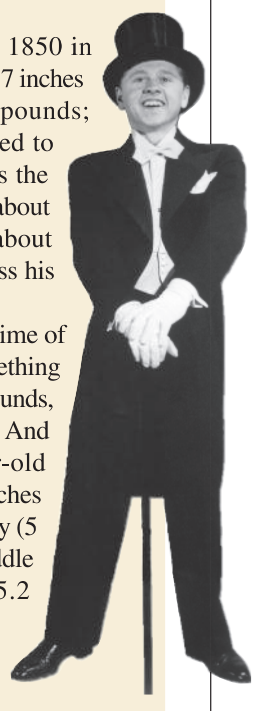
Harry Freeman will be remembered for these extraordinary accomplishments … and for being a good friend to so many throughout the global economic policy community.

Why Greece Is in Trouble

"According to a remarkable presentation that a member of Greece's central bank gave last fall, the gap between what Greek taxpayers owed last year and what they paid was about a third of total tax revenue, roughly the size of the country's budget deficit. The 'shadow economy'—business that's legal but off the books—is larger in Greece than in almost any other European country, accounting for an estimated 27.5 percent of its GDP (In the United States, by contrast, that number is closer to 9 percent.) And the culture of evasion has negative consequences beyond the current crisis. It means that the revenue burden falls too heavily on honest taxpayers. It makes the system unduly regressive, since the rich cheat more. And it's wasteful: it forces the government to spend extra money on collection (relative to GDP, Greece spends four times as much collecting income taxes as the U.S. does), even as evaders are devoting plenty of time and energy to hiding their income."

—*The New Yorker*

Supersize Me



"The average adult man in 1850 in America stood about 5 feet 7 inches and weighed about 146 pounds; someone born then was expected to live until about 45. In the 1980s the typical man in his early 30s was about 5 feet 10 inches tall, weighed about 174 pounds and was likely to pass his 75th birthday.

"Across the Atlantic, at the time of the French Revolution, a 30-something Frenchman weighed about 110 pounds, compared with 170 pounds now. And in Norway an average 22-year-old man was about 5 and one-half inches taller at the end of the 20th century (5 feet 10.7 inches) than in the middle of the 18th century (5 feet 5.2 inches)."

—*New York Times*

Trouble in Paradise

"As municipal projects play out across China, spending on so-called fixed-asset investment—a crucial measure of building that is heavily weighted toward government and real estate projects—is now equal to nearly 70 percent of the nation's gross domestic product. It is a ratio that no other large nation has approached in modern times.

"Even Japan, at the peak of its building boom in the 1980s, reached only about 35 percent, and the figure has hovered around 20 percent for decades in the United States. …

"By Beijing's estimate, total local government debt amounted to $2.2 trillion last year—a staggering figure, equal to one-third of the nation's gross domestic product. A wave of municipal defaults could become a huge liability for the central government, which is sitting on about $2 trillion in debt of its own.

"And Beijing's estimate of what the cities owe might be too low, in the view of Victor Shih, a professor of political economy at Northwestern University who has studied China's municipal debt. He says that by now, after even more borrowing in early 2011 and some figures hidden from government audits, total municipal debt in China could be closer to $3 trillion."

—New York Times

XINHUA

Why Are These Men Smiling?
Chinese Premier Wen Jiabao (front right) attends the launching ceremony of Beijing-Shanghai High Speed Railway in Beijing.

Dodd-Frank Uncertainty

In the United States, an attempt at comprehensive reform of financial markets was embodied in the Dodd-Frank legislation approved by Congress in 2010. Although the Obama Administration tried to take credit for much of these "reforms," Senate leaders repeatedly denied that the Administration had a primary influence in the drafting of that legislation. Taking up thousands of pages, this legislation essentially outlines "objectives," and delegates to regulators the tasks of interpreting the intentions of Congress, writing new rules, and establishing appropriate monitoring and enforcement mechanisms. As with any legislation, the new legal language has generated further controversies and revealed unintended consequences. Regulators have had to postphone implementation in the face of intensive lobbying against their proposed actions.

Based upon past experience with complex "reform" legislation, it seems virtually certain that Dodd-Frank will be followed by a massive "technical corrections" bill introduced in the next session of Congress after the national elections of 2012. Rather than admit that all or most of the Dodd-Frank reforms were mistaken, a technical corrections bill will be crafted that will negate or dramatically alter many provisions of Dodd-Frank. In the meantime, Republicans in Congress have already succeeded in denying or diminishing funding for implementation of some of the regulatory reforms stipulated in Dodd-Frank or recommended by executive branch officials and regulators. Thus, the legislative rules of the game that will prevail over banking and financial markets after 2012 are yet to be determined.

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—Hal Malmgren

White House Jobs Advisors

President Obama

"In 2000, 30 percent of GE's business was overseas; today, 60 percent is. In 2000, 46 percent of GE employees were overseas; today 54 percent are."

—*Wall Street Journal*

Africa Calling

NOKIA

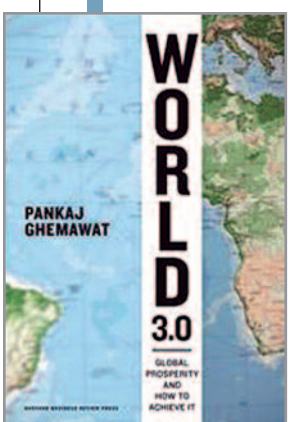
"From almost none a decade ago, there are now half a billion mobile phones in Africa, roughly one for every two Africans, according to industry analyst Informa Telecoms & Media. The economic effect has been just as dramatic. According to studies by the London Business School, the World Bank, and consultants at Deloitte, for every ten additional mobiles per 100 Africans, GDP rises 0.6 percent to 1.2 percent."

—*Time*

What Globalization?

"The world is just not as flat as pundits would have us think. More than half of global trade, investment and migration still takes place within regions—much of it between neighboring countries. Canada is the United States' biggest trading partner. In his very smart book *World 3.0,* Pankaj Ghemawat, a professor at the IESE Business School in Spain, tallied up a few telling numbers. Some 80 percent of global stock-market investment, for example, is in companies that are headquartered in the investor's home country. Exports make up only about a quarter of the global economy. Only 2 percent of students attend a university outside their home country. Less than 20 percent of Internet traffic crosses national borders, and so on."

—*Time*



World 3.0 *by*
Pankaj Ghemawat

Taxation in Perspective

"It's true that the economy was able to absorb the Bush 41 and Clinton tax hikes and still grow at a very rapid pace. But what the soak-the-rich lobby ignores is how different the world is today versus the early 1990s. According to the OECD, over the past two decades the average highest tax rate among the 20 major industrial nations has fallen to about 45 percent. Yet the highest U.S. tax rate would rise to more than 48 percent under the Obama/Democratic tax hikes. To make matters worse, if we include the average personal income tax rates of developing countries like India and China, the average tax rate around the world is closer to 30 percent, according to a new study by KPMG. What all this means is that in the late 1980s, the U.S. was nearly the lowest taxed nation in the world, and a quarter century later we're nearly the highest.

"The Tax Foundation recently noted that in 2009 the U.S. collected a higher share of income and payroll taxes (45 percent) from the richest 10 percent of tax filers than any other nation, including such socialist welfare states as Sweden (27 percent), France (28 percent) and Germany (31 percent)."

—Stephen Moore, *Wall Street Journal*