Overview

The crisis overshadows the G8 summit

The British Prime Minister found it hard to rejoice after the G8 meeting in Northern Ireland on Monday and Tuesday. Of course, he did manage to get the ten British overseas territories and Crown dependencies to sign an international treaty on banking transparency (see Overview of 31 May: "G8: a very global equation). But no other major advances were made on trade issues, despite the fierce battle and last minute compromise between G27 trade ministers concerning the European Commission's mandate to negotiate with Washington. This seemed to announce the imminent opening of trade talks on a US-EU Free Trade Agreement (FTA). But that was before President Obama warned about any cultural exceptions and Manuel Barroso, President of the European Commission, lambasted France's position on the subject barely after arriving at Lough Erne. Most importantly, renewed volatility in the financial markets helped focus the attention of the heads of state on the main challenges that must be met to promote world growth, employment and long-term prosperity.

For the past several weeks, we have seen investors react nervously to Ben Bernanke's statements suggesting that the Fed could begin to slow the pace of its QE3 monetary easing programme in the near future (see The Week in the United States, 14 June: "The Fed and the bathtub"). The chairman's press conference following the FOMC meeting of 18 and 19 June was widely awaited. The chairman confirmed that the pace of asset purchases (currently maintained at $85bn a month) would gradually slow over the months ahead in such a way as to exit QE3 by the middle of next year, once the unemployment rate had dropped to about 7%. Ben Bernanke added that interest rates would remain low as long as the unemployment rate had not fallen below 6.5% (although this triggering point could be revised lower) and inflation prospects from a 1 to 2-year horizon did not exceed 2.5% (see The Week in the United States). The Fed chairman has never been so explicit about the pace of changing monetary policy, which will closely hinge on macroeconomic data trends. The markets did not take long to react. The S&P 500 lost more than 1% and US 10-year yields rose nearly 20 basis points to 2.36%, the highest level since March 2012. The dollar strengthened against all currencies, with its effective exchange rate up 1%.

The Japanese Prime Minister, Shinzo Abe, tried hard to convince the heads of state gathered in Lough Erne of the merits of his economic policy and to reassure them about its impact on the yen. Recent data on industrial production, prices, household consumption and the job market in April seem to confirm that the economy is recovering and that the government's new strategy is beginning to pay off. The Abe government's economic strategy combined with a new stimulus plan (JPY10,000bn, i.e. 2% of GDP), massive monetary easing (the monetary base will be doubled in 2 years, with a higher inflation target) and structural reforms (for more information on "Abenomics", see the Q2 issue of EcoPerspectives: "Abenomics: a dangerous cure"). Yet there is still a lot of doubt about the long-term sustainability of the recovery. First, fiscal consolidation efforts will have to be maintained, above and beyond the increase in the VAT rate. Second, although Japan's participation in talks about a Transpacific Free Trade Agreement is a major step towards greater deregulation of the country's markets for goods and services, the Prime Minister cannot forego further structural reforms. Along these lines, the Prime Minister's cabinet adopted three major reforms in mid June that aim: 1) to increase the female participation rate (71.6% in Japan vs. 74.7% in the United States), 2) reinvigorate research in the medical sector, notably in the field of stem cells, and 3) develop Tokyo, Nagoya and Osaka as attractive "Special Economic Areas" in order to tap into abundant foreign investment flows.

Lastly, Mr. Abe Abe is still persuaded that the entire global economy would benefit from a reinvigorated Japan, esteeming that during the four years following the collapse of Lehman Brothers, the yen served as the adjustment variable for the global crisis. The yen's recent depreciation is thus nothing more than the return to normal, (see chart). All he has to do now is convince his main trading partners, beginning with South Korea.

JPY: Nominal effective exchange rate*

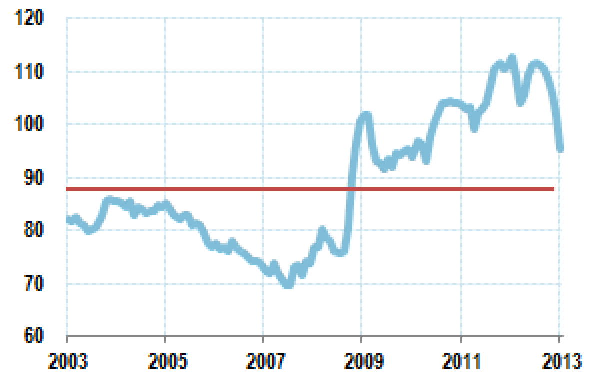

Chart 1 Source: BIS

* : Narrow definition, trade-weighted average with 27 economies: Germany, Australia, Austria, Belgium, Canada, South Korea, Denmark, Spain, the United States, Finland, France, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, Portugal Norway, New Zealand, Portugal, the UK, Sweden, Singapore, Switzerland, Taiwan, eurozone