

NEWSLETTER

in association with the South Asian Bureau of Economic Research (SABER)

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Analysis

Bubbles and demographics: Is China following Japan and the US?

Kazumasa Iwata*

In 2005 the former Chairman Greenspan noticed the insensitivity of long-term interest rates to changes in short-term interest rates and named it the “conundrum of the long-term interest rate”. His successor Chairman Bernanke elucidated the puzzle by pointing out that the world saving-investment balance shifted to excess saving tendency after the Asian currency crisis in 1997 and 98, despite the boom of world economy after the IT bubble burst. The high growth combined with the low real long-term interest rate created the macro-economic circumstances conducive to the emergence of bubbles.

This recognition gave rise to the controversy between the U.S. and Chinese government on the cause of sequential bubbles. The then Treasurer Paulson pointed out that to the extent that the capital inflow from China tended to lower the nominal long-term interest rate in the U.S., China joined the process of generating bubbles. The Chinese government blamed the U.S. for its responsibility to allocate the flow of fund available for U.S. investors. Chairman Bernanke admitted in April that the U.S. should have used the

capital flow from abroad for a more productive way.

However, if we look at the longer-run movements of the U.S. long-term real interest rate (the interest rate on ten years government bond minus the rate of changes of consumer price), it peaked out already in the mid-1980s, and showed a secular decline until 2008.

As another background factor of sequential bubbles in the U.S. we can mention the population structure changes. The share of the U.S. working age population between 20 and 64 years old restarted to increase from the mid-1990s and reached the peak in 2007. The acceleration period virtually coincided with the period of sequential bubbles.

Usually, we observe that the age profile of life-time consumption reveals the inverted U shape with the peak of 40-50 years old. What is more interesting is the fact that the Japan’s working age population also restarted to increase since the early-1980s and peaked out in the mid-1990s. We see about ten year difference of acceleration of the share of working age population between the U.S. and Japan as well as the asset price bubbles.

To the extent that the market participants anticipate a sharp decline of the share of working age population over the future, it works to lower the real long-term interest rate. If this view were true, the bubbles in Japan and the U.S. would share the common cause.

Paper of the Month

The most downloaded paper for June 2009 is **A Rapid Appraisal of the PKPS-BBM Education Sector: School Operational Assistance (BOS)** by Widjajanti et. al.

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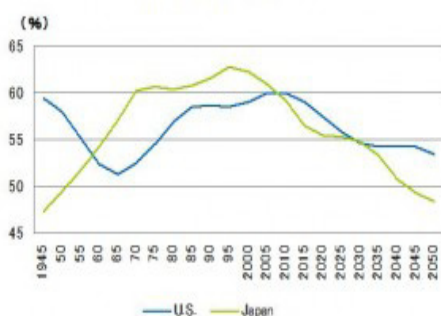
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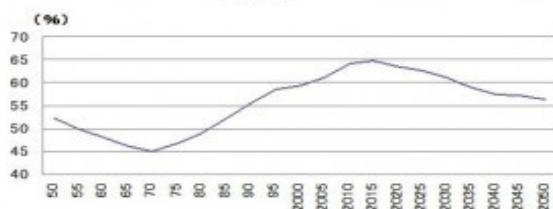
Moreover the best suited place for next bubble is likely to be China where the share of working age population will peak out in the mid-2010s. The per capita consumption accelerates until the mid-2010s, yet the real long-term interest rate will be maintained at a low level in the process of proceeding financial liberalization.

Proportion of Working Age Population
in U.S. and Japan

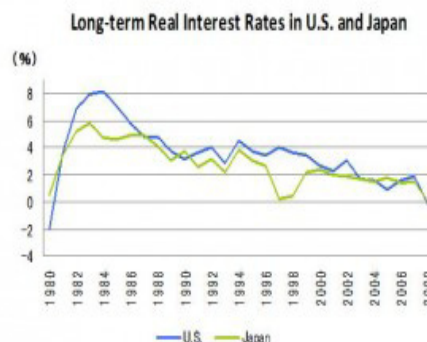


Thus, it is thoroughly possible for China to achieve high growth until the mid-2010s, mainly based on domestic demand. Actually, Japan enjoyed domestic-demand led growth in the post bubble period, where the net exports contribution to growth was virtually zero in sharp contrast to its stellar performance during the high growth period. The slow recovery in US consumer spending may also mitigate the risk of widening global imbalance.

Proportion of Working Age Population
in China



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In light of Japan's experience, China should be cautious about the mounting internal financial imbalance in view of the discrepancy between external and internal financial liberalization processes under a less flexible exchange rate regime. The lopsided financial liberalization after the establishment of the Yen-Dollar Committee in 1983, coupled with a sharp appreciation of the Yen after the Plaza Accord in 1985, provided fertile soil for the dangerous seeds of synchronized bubbles of land price and equity prices to germinate. Furthermore, the US government requested an increase in public investment of 430 trillion Yen over ten years at the US-Japan Structural Impediments Initiative in 1989-90, aiming to confine Japanese money to the domestic market. The use of Chinese money is another big policy agenda not only for the US and China, but also for the world economy.

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