Toshihiko Fukui: Reflections on what is happening in the global economy today

Summary of a speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the 2005 IIF Annual Meeting, Washington DC, 25 September 2005.

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Introduction

It is a pleasure to appear before you this morning and share my thoughts on what is happening in the global economy today.

Before I go any further, let me express my deepest condolences for the great suffering caused by Hurricane Katrina just a few weeks ago.

My remarks will be divided into three parts. In the first, I will comment on the currents of structural changes in the global economy from a long-term perspective. Against the backdrop of these changes, I would then like to say a few words on the changing role of the International Monetary Fund (IMF)--a medium-term issue for all of us in this room. Finally, I will comment briefly on a conjunctural issue--the state of the Japanese economy and the monetary policy of the Bank of Japan. I hope to answer a few questions, if we have time before I have to head to Dulles Airport to catch my plane to Tokyo.

Structural changes in the global economy

The global economy has undergone significant structural changes in the last decade. Of those changes, in my view, three are most important. The first is the entry of emerging market economies into the market-based economic system. The second is the progress we have observed in information, communications, and telecommunications (ICT) technology. The third is the aging of the population, especially in mature industrialized economies. Let me take up these developments in turn.

Since the 1990s, emerging market economies--China, India, and countries in Central and Eastern Europe--have progressively been integrated into the market-based economic system. Taking advantage of their relatively low wages and foreign direct investment (FDI) and technology transfers from mature industrialized economies, these countries have increased their supply of goods and services to the global economy. In this process, these countries have broadened their exports as well. They are now exporting not only light industry products, such as textiles, but also heavy and high-tech industry products. Exports now also include services, such as operating call centers.

The advances in ICT technology, such as the widespread use of the Internet, have significantly reduced the costs of processing and transmitting information. This has, in turn, enabled firms to expand their operations globally. Production of goods and services is now spread out over many economies. At the same time, ICT technology has also enabled firms to enhance efficiencies of so-called middle-management functions, resulting in the flattening of corporate organizations. The confluence of these developments with the integration of emerging markets into the market-based economic system has reduced the costs of doing business worldwide, and enhanced competition in the global marketplace.

Meanwhile, the importance of the third structural change that I just mentioned--the rapid aging of the population especially in the industrialized economies--is just beginning to sink in. We now realize that the shift in demographics may have profound effects on various aspects of the global economic system. For example, it may change the savings-investment balance; it may change flows of money through financial intermediaries; and it may influence asset allocation among investors.

Today, I have chosen to focus on these issues, because various developments in the global economy--sometimes puzzling developments--flow out from these changes. One is the subdued rate of consumer inflation, which has defied extremely elevated price levels of commodities and raw materials such as crude oil. Another is the relative stability of long-term interest rates.

At the end of August, crude oil prices reached US$70 a barrel. Though prices have come off the peaks, this starkly illustrates the rapidly rising prices of commodities and raw materials. Factors such as political unrest in producer countries and bad weather have certainly influenced such developments. Looking at crude oil, production capacity for petroleum products is constrained, because not enough money was invested in exploration, extraction, and refining in the wake of collapsing prices after the Second Oil Crisis. Nevertheless, the most significant factor seems to be the tightness in supply and demand conditions caused by strong demand. In particular, the combination of relatively high growth and relatively inefficient energy use in emerging market countries seems to be contributing to higher than expected growth in crude oil demand.

As I noted a few moments ago, emerging market countries are now being integrated into the market-based economic system. Being new members of the system, however, their economies are still evolving. There remain rigidities, such as price controls. Consequently, they are not able to use resources as efficiently as mature industrial economies. Given this environment, it seems we will have to live with higher prices of commodities and raw materials, at least for the time being.

While input prices are thus rising, pass-through to output prices is rather limited. In fact, since the 1990s, we are observing significantly lower rates of consumer price index (CPI) inflation around the globe. Productivity growth in the corporate sector is providing some cushion. However, the most important factor behind this development is again the integration of emerging market countries into the market-based economic system. With increasing integration, more goods are brought onto the market. In turn, competition is enhanced globally, producers' pricing power is weakened, and consumers benefit from downward pressures on prices.

Lower inflation is accompanied by smaller fluctuations of the economy. Not only are we seeing lower inflation rates, we are also seeing lower inflation volatility. The volatility of growth is also declining. The increasing importance of services, the demand for which is less volatile than that for goods, is one contributing factor. As individual firms take advantage of ICT in managing their output, economic activity at the macro level may see less fluctuation. At the same time, greater flexibility in products and labor markets may help firms adapt smoothly to changing business conditions.

Obviously, factors other than structural changes have also lowered inflation and volatility of inflation and growth. Central banks have also contributed to enhancing stability. Independent central banks, pursuing price stability through monetary policy, have successfully tamed inflation. This has enhanced the credibility of monetary policy, and, in turn, stabilized inflation expectations.

In financial markets, low and stable rates of inflation have led to lower long-term interest rates around the world. Since I do not wish to repeat Chairman Greenspan, I will merely say that the structural changes I have touched on today are definitely influencing interest rate developments.

The three broad trends--globalization, ICT, and aging--will be sustained for some time. Considering that there are still millions if not billions of underemployed workers in emerging market countries, the integration process will probably continue for many more years. Since human ingenuity is unlimited, we will find new and innovative uses for ICT in the years ahead. Institutional changes to mitigate the effects of rapid aging have only just begun.

As a result of the interactions between these trends, we are sure to see economic developments that we would never have imagined before. We have no crystal ball to accurately identify the changes ahead of us or their consequences. This means that our well-being will only be maintained if we can efficiently and effectively adapt to the changing environment. We must monitor events closely as they unfold, and be ready to respond flexibly. I am optimistic that central banks can adapt to changing economic conditions, as they have done so over many years.

The changing role of the IMF

Structural changes are not confined to the real economy. The forces of globalization are influencing the international monetary system as well.

Yesterday, at the meeting of the IMF Council, we discussed the results of the Strategic Review of the IMF, initiated by Managing Director, Rodrigo de Rato. Rodrigo's project was extremely helpful, drawing up a comprehensive list of issues that we have to address. The consensus on where we stand was already described by Gordon Brown yesterday, and I will not repeat it here.

The Strategic Review was necessary and useful in defining what needs to be done today. It is, however, the first step.

Sixty years ago, the Fund was created to maintain a network of exchange rates anchored on the U.S. dollar backed by gold. There was also a mechanism to facilitate adjustments. Member countries were obliged to enter into annual consultations. In this process, the Fund identified economic policies that would undermine the network of fixed exchange rates. The Fund then suggested remedies, and lent money if necessary to buy time for policy adjustments to take effect. If exchange rates really fell out of line with economic fundamentals, it was possible to tweak the rates.

Fast-forward to today, and we no longer have fixed exchange rates, particularly between systemically important countries. As a result, policy advice from the Fund is losing the force and urgency it once had. At the same time, we are witnessing increasingly stronger and more mobile private capital flows. These flows are, of course, generally beneficial. Though it is hard to measure precisely, private capital has played a significant role in the robust investment-led growth of many countries.

Private flows are not only getting bigger, they are getting more nimble. In the seventies and eighties, banks were the main financiers for emerging market economies. On the other hand, much of today's private capital flows are in the form of bond issues. Compared with banks, bondholders tend to react very quickly. Bankers cannot call a loan until it is due. On the other hand, when bondholders sense a problem brewing, they can sell their bonds immediately. If everyone heads for the exit at once, bond prices will collapse and exacerbate problems for the issuing country. There will also be coordination problems. You can cram a few dozen bankers into one room and cut a deal, but we cannot do the same for bondholders.

No wonder that emerging market and developing countries tapping the international financial market sometimes feel so insecure and helpless. The welcome rug could be pulled quickly from under their feet, as many of them found out in the late 1990s. They can turn to the Fund for help, but private flows could even overwhelm the Fund. Fund quotas, essentially equivalent to paid-in capital, total about US$330 billion. This is only a fraction of global financial flows.

In our recent efforts to reform the international monetary system, we have tried to deal with these changes. As I said a few minutes ago, the Strategic Review is an important milestone. Nevertheless, the recommendations will soon be overtaken by developments in the international financial landscape. The three trends I mentioned in the first part of my talk--globalization, ICT, and aging--will continue. This means that capital movements between economies will accelerate, broaden and expand. The Fund must continue to evolve, if it is to remain relevant in tomorrow's international monetary system.

Though we cannot predict the exact consequences of the structural changes, a general idea of what we can expect seems to be clear enough. If private flows become increasingly important, we should emphasize private solutions as well as public interventions. There are two significant developments in this context.

One is the collective action clauses (CACs) in bond covenants, advocated by the G-10 countries in September 2002. Now almost all new international bond issues are governed by CACs. In the near future, when bonds without CACs are all retired, CACs would govern the resolution of sovereign debt crises. A typical CAC allows the terms of a bond issue to be changed with the consent of 75% of bondholders. This means that if a country cannot pay its debts in full, it needs to come up with a restructuring plan that satisfies 75% of the lenders. The clear and transparent rules also reduce the chances for holdouts or rogue investors to disrupt an orderly workout process. In turn, the market can more appropriately price the risks and costs of defaults.

Another notable development is the "Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets," released about a year ago. I know that Managing Director, Charles Dallara and his colleagues at the IIF worked hard to see its publication. The Principles offer a framework for enhancing flows of information between borrowers and lenders. They also provide guidance for productive engagements between them. These improvements should enable lenders to assess and price risks more precisely, enhance the stability of flows to developing and emerging market countries, and facilitate resolution of problems when they occur.

These developments, especially the Principles, would strengthen market discipline. Borrowing countries would be encouraged to improve their institutions and adopt sound economic policies. As a result, we should see fewer international financial crises. In the unfortunate and hopefully rare event that problems do arise, a borrowing country and private lenders can negotiate orderly settlements, under the framework of CACs. The public sector, including the Fund, would only be called on in the rarest cases, where the speed and magnitude of the problems might overwhelm efforts to formulate private solutions.

What does this mean for the Fund?

In terms of giving out policy advice, the Fund's role would be more relative. If private lenders become more important, borrowing countries would be inclined to listen to what the market wants. The Fund is facing formidable competition, but I think it can build on its excellent reputation. I am especially looking forward to the efforts currently underway to enhance the Fund's work related to financial issues.

Meanwhile, as I noted a moment ago, Fund lending will be necessary only when there is a rapidly unfolding crisis of considerable magnitude. We should, therefore, consider if the current rules for releasing Fund resources could appropriately cope with such a situation. In the jargon of the Fund, this is a question of improving the rules for exceptional access. To say that the Board is responsible for approving such lending is sidestepping the question. Can the Board form a consensus quickly enough? Is the Board representative enough so that members can subscribe comfortably to its decisions? Who is going to be held accountable if something goes wrong? Answering these questions will tax our imaginations to the fullest extent, but we must not dodge them. Disasters do happen.

Recent developments in the japanese economy

Before closing my remarks, let me briefly speak on the Japanese economy and the monetary policy of the Bank of Japan.

If we put aside quarter-to-quarter fluctuations in the rates of growth, the Japanese economy has been on a recovery track for three and a half years, since the beginning of 2002. Nevertheless, from the summer of 2004, we had a period of sluggish growth in exports and industrial production. This pause in growth was brought about by the global adjustment in the ICT sector.

The Bank of Japan stated all along that slower growth was temporary, and that the Japanese economy would eventually regain momentum. There were, however, concerns that Japan had slipped back into recession. Fortunately, recent developments seem to indicate that the pause in growth is finally over: the adjustment in the ICT sector is almost complete; domestic demand components, private capital investments, and household consumption in particular, are generally showing firm growth; and exports, which were flat for some months, seem to be regaining traction.

I believe that this trend will be sustained for some time. The Japanese economy should remain on a moderate but enduring growth path, supported by both domestic and external demand. There are two particularly encouraging factors.

The first is that Japanese firms are at last seeing the end to structural adjustments necessitated by the bursting of the bubble economy. For more than a decade, the Japanese economy was under the yoke of "three excesses"--excess capacity, excess employment, and excess debt. Japanese firms worked very hard to get rid of these excesses. They are now adopting new strategies that enhance efficiency and competitiveness. As a result, they are becoming more profitable. In fact, measured by the profits-to-sales ratio, Japanese firms are more profitable than they were in the end of the 1980s, at the peak of the bubble economy. Against this background, the growth of capital investment is relatively strong, not only at large manufacturing firms but also at manufacturing small and medium-sized enterprises (SMEs) and at non-manufacturing firms.

The second encouraging factor is that households are increasingly benefiting from the recovery in the corporate sector. Employment is growing, and the jobless rate has dropped to a seven-year low of 4.4%. Looking past the headline numbers, we see even more encouraging signs. Until recently, Japanese firms hired part-time and temporary workers in order to keep labor costs in check. Today, firms are stepping up their efforts to hire permanent workers, against the background of improving profitability and thus business confidence. Consequently, employee income, which was depressed by the rising proportion of part-time and temporary workers, is rising moderately. The promising employment and income environment is firmly supporting personal consumption, in both goods and services. These trends in employment, income and consumption are expected to continue for the time being.

Coming back to the broad trend, the Japanese economy grew by 2.7% in 2004 and is expected to grow by 2.0% in 2005 according to the Fund's World Economic Outlook (WEO). This is not as spectacular as the United States, which grew by 4.2% in 2004 and whose WEO growth forecast is 3.5% for 2005. Nevertheless, it is a respectable growth path compared to some other mature industrialized economies. I believe that this moderate growth trend can be sustained for some time.

What does this mean for monetary policy?

The Bank of Japan is maintaining the policy framework of quantitative easing. As you know, under this framework, the Bank supplies liquidity far in excess of required reserves, creating an environment where short-term interest rates stay very close to zero. Another element of our present policy framework is a firm commitment to maintaining that environment until year-on-year inflation, as measured by core CPI, is stably zero or above.

Currently, Japanese core CPI is still declining slightly, and the Bank of Japan steadfastly adheres to the commitment I have just explained. By doing so, we are supporting the Japanese economy's return to a stable and sustainable path of growth.

Thank you for your attention. It has been a pleasure speaking to you.