

## **Toshiro Muto: Dynamism and diversity of Asia – a central banker's view**

Remarks by Mr Toshiro Muto, Deputy Governor of the Bank of Japan, at "Emerging Opportunities in the Global Economy" the 29th Annual Joint Meeting of the Japan-US Southeast Association and Southeast US-Japan Association, Tokyo, 17 October 2005.

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### **I. Introduction**

Good morning, ladies and gentlemen. It is a great pleasure to join you at this special gathering.

Asia is undergoing tremendous changes. Links between the countries in this region are getting closer. Two big countries, China and India, are growing on a global platform. These changes are taking place not only in economic terms but also in the political and diplomatic arenas. Against this background, changes in Asian dynamics are beginning to reshape the contours of the US-Asia relationship.

With these things in mind, I will address four facets of today's Asia: booming economies, rising regional cooperation, looming challenges, and evolving relations with the US.

### **II. Booming economy**

Following the economic crisis in 1997-98, the economies in south-east Asia have made a strong recovery. Indeed, countries in this region have exhibited impressive resilience in restoring their economic vitality. When the world economy slowed in the wake of the bursting of the IT bubble in 2002-03, Asia's solid growth helped avert the global recession. China's economic expansion is particularly remarkable as it has sustained an average growth of 8-9 percent per annum for the past decade.

If you take a closer look at the current economic dynamism in Asia, you will not fail to see a stark difference from the past economic booms. In the past, trade in this area was simple. Industrial countries like Japan and Korea imported raw materials from their Asian neighbors to export final products to the US and Europe. In contrast, trade patterns within Asia are now much richer on the basis of the sophisticated vertical division of production processes. Countries are specializing in the optimal parts of the supply chain on the basis of their resource endowment and comparative advantage. This process is being propelled by foreign direct investment (FDI) coming from both within and outside the region. For example, Japan exports intermediate and capital goods to China and other Asian countries, and these countries assemble what they import from Japan in order to make final products for the global markets. Consequently, the proportion of intra-regional trade in Asia has climbed to 54 percent, which lies between NAFTA's 46 percent and the EU's 62 percent.

Asia's export-led growth has increased its absorption, thereby stimulating its imports from abroad. This is particularly true of China where huge domestic demand has yet to be saturated. Because of its large population, China presents itself as both an international production hub and a big consumer market. For instance, China accounted for 7 percent of global trade in 2004. Combined with Hong Kong and Taiwan, it captures 11 percent, only slightly below the US. Against this background, China is exerting a strong influence on the global economy. Also note India, which is becoming the major off-shoring destination for foreign multinationals, particularly in the service sector.

This strong performance of Asian economies might possibly be affected by the recent spike in oil prices. In fact, some Asian currencies, like the Indonesian rupiah, came under pressure when oil prices reached a record high this August. However, the economic fundamentals of most Asian countries are much stronger than in the 1970s when they were hit by the worst oil market turmoil ever. In addition, Asian countries responded swiftly this time by raising interest rates or slashing public fuel subsidies. These prompt actions have helped them minimize potential disruptions to their economies. Furthermore, Asian countries have large volumes of foreign reserves and only a small amount of external debt in comparison to both their own past and developing countries in other parts of the globe. For mutual liquidity assistance in times of external stress, countries in this region are working toward an expanded network of bilateral swap arrangements, to which I will come back in a few minutes. In short, Asian economies are better equipped with both the will and capability to fend off sources of disturbance to their sound economic growth.

### **III. Rising regional cooperation**

Under these circumstances, we have seen increasing drive for regional cooperation in Asia, especially among the "ASEAN+3 nations" consisting of the ten ASEAN countries plus Japan, China, and Korea. As I said earlier, these countries are strengthening their trade links. But similar attempts are being made in other fields as well where progress has been less impressive, such as finance, environment, energy, and scientific technology. Collaboration in these areas is proceeding in a functional and pragmatic manner.

Closer trade links in Asia, as symbolized by the web of free trade agreements (FTA), are likely to promote trade liberalization and catalyze FDI flows in and out of the region, thereby providing a boost to economic globalization. In other words, regional trade arrangements are not aimed at creating an exclusionary economic bloc. To the contrary, such trade networks can make the Asian economies more open and prosperous. On the financial front, cooperation among Asian countries is gathering pace. Its prime motivation is to avert a financial crisis like the one we went through in 1997-98. Efforts in this field are producing tangible results around two pillars: 1) the establishment of bilateral swap arrangements, and 2) the development of regional bond markets.

As some of you might know, there is a collegial group of central banks in this region. This group, called EMEAP, an acronym for the Executive Meeting of East Asia Pacific Central Banks, has eleven members. From its inception in 1991, EMEAP comprises nine east-Asian central banks plus two central banks from Australia and New Zealand. EMEAP is very active in three key areas, namely, financial markets, banking supervision, and settlement/payment systems. To give you a picture of what EMEAP is doing for bond market development, allow me to digress a little bit.

EMEAP has engaged itself in the project known as ABF, or Asian Bond Fund. In this fund, eleven EMEAP central banks jointly set up their foreign reserves to place investment funds composed of Asian sovereign bonds. The purpose of ABF is to stimulate turnovers in the bond market in this region. In June 2003, the central banks launched ABF1, the first stage of the ABF project, to invest in dollar-denominated sovereign bonds issued by Asian countries. In May 2005, EMEAP went a step further by announcing the start of ABF2. ABF2 invests in sovereign bonds issued in Asian local currencies. Although led by the EMEAP central banks, ABF is not an "Asia-only" project. Actually, Western financial services companies take part in this project as a fund manager and custodian. From what I have said, you can sense the pragmatic spirit of Asian regional cooperation. In fact, pragmatism is the hallmark of joint initiatives in this region.

Another point is that these cooperative endeavors are largely market-driven. Put differently, Asian cooperation is an "autonomous" process. It is in sharp contrast to the EU integration where member nations have agreed to transfer some of their sovereignty to Brussels, Frankfurt, and other European cities to operate supra-national governance. Therefore, Asian regional collaboration does not have a lead player a priori. Instead, a variety of players are involved. In fact, Asia has several groups of different stripes, like EMEAP, ASEAN, ASEAN+3, Asian Development Bank (ADB), each with its own unique membership. Such an "open-ended" modality for regional cooperation reflects Asia's diversity in ethnic, historical, religious, and linguistic backgrounds.

Some say that Asia's diversity could weaken its regional unity. There is some truth in this view, but diversity has its own advantages as well. It can create an environment in which people appreciate different values and ideas, develop a sense of tolerance to others, and become more innovative through such cross-cultural interaction. This is a unique advantage for Asia to maximize, and I believe Asian cooperation should move ahead in this direction.

The first East Asian Summit meeting is slated for this December. The summit will be attended by the leaders of ASEAN+3 nations, India, Australia, and New Zealand and will be the first of its kind. This gathering of countries attests to the flexibility of Asia's cooperation. Given the prospect for energy development in east Siberia or Sakhalin, the attendees to the East Asian Summit may even include Russia in the future. But this is anyone's guess, of course.

### **IV. Looming challenges**

Despite the collective progress so far made, Asian countries are facing new challenges. In my judgment, response to these problems will define the path of Asian cooperation going forward.

There is no doubt that high growth has enabled Asia to savor better economic welfare. However, I see four challenges to further prosperity in Asia;

- accelerate financial market integration
- establish sound socioeconomic infrastructures like intellectual property right protection, transparent corporate governance, and impartial judiciary
- tackle transnational problems like regional epidemics, natural calamities and environmental disruptions
- formulate sustainable energy policy

First, financial market integration. Financial markets in Asia are still ring-fenced by national borders. That makes it hard to link savings with investment opportunities within the region efficiently. As I said, the financial authorities in Asia are working together to develop liquid bond markets, as they expect such markets to facilitate the marriage of savings and investment in the region. Organic linkage of savings and investment would underpin sustainable growth in Asia, thereby contributing eventually to the adjustment of global payment imbalances.

Second, socioeconomic infrastructures. In a nutshell, Asia has yet to establish its credentials as an economic area where the rule of law receives due respect. This is particularly crucial since Asia derives enormous benefits from FDI flows via foreign multinationals. In order to sustain FDI inflows, it is of vital importance to provide legal protection of patents, brands, and copyrights. Asia also needs to consolidate a law-abiding and corruption-free business culture to help legal frameworks function effectively.

Third, transnational problems. These problems have global dimensions, but they have some Asian features as well. The nightmare of the tsunami disaster is still vivid in our memory, but this region has other weather-related anomalies, including tropical cyclones, floods, droughts, and dust storms, some of which are exacerbated by desertification and deforestation. It is easy to see how these natural disasters decimate our economies. In addition, given the high population density and still-poor sanitation infrastructures in Asia, systematic steps should be taken to contain the spread of lethal epidemics such as avian flu, HIV/AIDS and SARS before they become a global pandemic. The spread of these contagious diseases will virtually halt the cross-border movement of goods and people, thereby causing fatal damage to our economies.

Both natural disasters and public health crises call for rapid intervention by the relevant authorities. In order to formulate effective emergency response, we may as well study swiftly a possible region-wide mechanism for surveillance, early warning, and information sharing. Concerted efforts by countries in this region would also make it easier to obtain badly needed international funding for the prevention and mitigation of such human emergencies.

Fourth, energy policy. Asian emerging countries are big consumers of energy, while they have little natural resources to count on. This means that, to sustain the present economic rise, these countries need to secure stable sources of energy while developing alternative energy supplies as well. Equally important is a demand-side effort to curtail energy intensity. Better energy efficiency is also helpful in reducing air pollution and green house gas emission.

I said earlier that Asian regional cooperation should proceed without rigid boundaries regarding membership. As geography is relative, boundaries should be "open-ended." As far as financial markets are concerned, however, membership can be defined by the time zone. The majority of East Asian countries are located within the 3-hour time band from Sydney to Bangkok. Thus, it is of little surprise that the countries in this zone constitute the core of numerous regional groups. But it will be too naive to assume that Asia alone can handle all the challenges I have described. For instance, we should learn more from the US and Europe when it comes to transparent governance, biomedical technology, public hygiene, and environmental conservation. Being "open-ended" will continue to be an essential element for Asian cooperation.

## **V. Evolving relations with the US**

Now let me conclude by adding a few words on US-Asia relations.

The trans-pacific economic space, spanning Asia and the US continent, explains roughly half the global GDP. In regard to cross-border money flows, the vast portion of Asia's savings are invested in US financial markets, and then recycled back to Asia in the form of FDI by multinationals. The ongoing RMB (renminbi) reform could lead to a substantial change in the monetary landscape between Asia

and the US. Given these and other elements I do not cover today, Asia and the US will most likely continue to assume shared responsibility for the smooth functioning of the global economic architecture.

Besides the economic issues, Asia's cohesion is as evident as that of Europe. Unlike Europe, however, Asian countries are divided or "linked," I would say, by the sea. Therefore, the safety and stability of sea routes are vital for the cross-border movement of goods, services, and people. With respect to culture, ethnicity, and religion, Asia remains an area of immense diversity. Also, Asia is undergoing profound changes as I said at the outset. Dynamic and diversified perspectives, instead of linear and stereotyped views, help us understand what is going on in Asia, upon which productive US-Asia relations develop.

As the US-Asia relationship evolves into a multi-layered nexus like a tapestry, it is essential for leaders on both sides of the Pacific to interact closely through prominent forums like the one we are attending today. Let us hope that our trans-pacific ties will continue to be solid on this basis.

Thank you for your attention.