Klaas Knot: Dutch financial stability in the Asian era

Speech by Mr Klaas Knot, President of the Netherlands Bank, at the symposium "The future of the Netherlands in the Asian era", Center for Japanese Studies, University of Groningen, 31 August 2012.

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With thanks to Jeroen Hessel.

INTRODUCTION

Ladies and gentlemen, it is always a pleasure to be back here in Groningen. I find the two buildings on the conference invitation very well chosen. They symbolise the common fears about the rise of Asia. The Dutch Euromast was modern and imposing when it was built in1960, but now looks small and outdated compared to the brand new Sky Tree in Tokyo, the second-tallest building in the world at a height of 634 meters.[1] The Euromast would also be dwarfed by the 492 meter Shanghai world financial center or the 509 meter Taipei 101. Does this indeed show that advanced economies like the Netherlands are not able to compete with the larger and more efficient Asian countries?

I tend to be optimistic. I will discuss the rise of Asia with a focus on financial stability. Indeed, the rise of Asia implies profound changes for advanced countries. But as long as countries face the challenge and adjust their economies, this need not be problematic. On the contrary, Asia also provides many opportunities. This applies especially to the Netherlands, with our centuries of experience in international trade and finance. After all, our *Verenigde Oostindische Compagnie* had the only western trading post with Japan for over 200 years. Until 1859, a number of Dutch settlers lived on Deshima, a tiny island just off the coast of Nagasaki. And already in the 1920s, banks like the *Nederlandsch-Indische Handelsbank* and the *Nederlandsche Handelsmaatschappij* had offices in Singapore, Shanghai and Bombay.

INFLUENCE OF ASIA ON THE REAL SIDE

The rise of Asia is not new. In fact, Asia accounted for over half of world GDP for centuries, and only started to lag behind in the 20th century. In a way, Asia is now restoring the old balance of power. We saw the rise of Japan in the 1960s and 70s, and the rise of Korea, Singapore, Hong Kong and Taiwan in the 1980s and 90s. But the recent ascent of large countries like China and India dramatically increases the scale and speed of the shift. The share of emerging Asia in the world economy increased from 8% in 1980 to 26% in 2012.

The rise of Asia primarily affects advanced economies on the real side of the economy. Trade and international competition have intensified. Trade with low wage countries has quadrupled the effective global labour supply since 1980.[2] Companies more easily offshore stages of their production to these countries. Our iPhones were designed in the US but are assembled in China. So comparative advantages have not disappeared, but they are changing more quickly than before. The Dutch trade monopoly with Japan lasted for two centuries. By contrast, the top position in the mobile phone market has already changed several times in the last decades. It switched from

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[1] After the Burj Khalifa in Dubai, which is almost 830 meters high.

[2] This measure of the effective global labour supply comes from the IMF (WEO April 2007) and is measured as the size of national labour forces scaled by trade openness (export-to-GDP ratio's). More trade openness means a larger effective labour supply as more people work in the tradable sector worldwide.

Nokia in Finland via Blackberry in Canada to Samsung in Korea. It is vital that Western countries become flexible enough to accommodate such more frequent changes, and to prevent structural problems like long term unemployment. This would also help them benefit from Asia's fast- growing domestic markets. Germany's strong exports to China show that Chinese people enjoy driving an Audi or BMW as much as we do.

The rise of Asia also affects inflation in advanced economies – an important theme for a central banker. Inflation is lower because consumers directly profit from cheap imports like camera's, computers and clothing. More indirectly, domestic producers also keep prices low because they are afraid of losing market share to Asian competitors. The rise of Asia has therefore contributed to the decline of inflation over the last decades, alongside other factors like better monetary policy. In recent years however, this was partly offset by the strong increase in food and commodity prices, which is driven by demand from emerging markets. China for instance accounted for 30% of the growth in oil demand between 2002 and 2005.

INFLUENCE OF ASIA ON THE FINANCIAL SIDE

While the rise of Asia has clear effects on the real side, the effects on the financial side are more controversial. Some people claim that Asia had a large influence on the exceptionally loose financial conditions that led to the financial crisis. In their view, the strong increase in global liquidity was largely driven by the *savings glut* in Asia, particularly in China. Asian countries had increased their current account surpluses after the Asian crisis in 1998. This was partly to reduce their vulnerability and partly due to export-led growth strategies. These savings were mostly held in official reserves, which increased six fold to around five trillion dollars in only a decade. Because financial markets within Asia are underdeveloped, the reserves were invested in advanced economies, for instance in US treasuries. This may have reduced long-term interest rates and fuelled the credit boom.

While the savings glut did contribute to global liquidity, it is not the only explanation. After all, Asia still plays a relatively modest role in financial globalisation. Asia, like many other emerging markets, is not so financially integrated. The average size of foreign assets and liabilities is only around 70% of GDP in emerging markets, against a much larger 220% in advanced economies. Emerging markets usually have smaller financial sectors, less developed financial markets, and often a more domestic orientation. China has some of the largest banks in the world, but this is because of China's enormous domestic market. Their international activities are relatively limited, if only because China still has a closed capital account. Capital flows from emerging markets therefore mainly consist of foreign direct investment, which is relatively stable and not so harmful for financial stability. By contrast, the volatile international portfolio and banking flows are dominated by advanced economies.

The recent literature therefore suggests that the loose liquidity conditions before the crisis largely came from financial sectors in advanced countries themselves. The *great moderation* fed the perception that large fluctuations were a thing of the past, and this has reduced risk premia and increased leverage. This was reinforced by low policy interest rates, which were possible thanks to more credibility in monetary policy and because globalisation contained consumer price inflation. Credit growth was fuelled further by financial innovations like securitization, and by the internationalization of banks. Banks increasingly relied on foreign wholesale funding, which enabled them to expand credit much further than if they had only relied on domestic deposits. The US housing bubble, for example, was partly financed by European banks that bought mortgage- backed securities. The *banking glut* in advanced economies seems at least as important as the savings glut from Asia.

CRISIS ACCELERATES THE SHIFT IN BALANCE OF POWER

In retrospect, we should have been aware of the risks. The world became more financialised than ever, as the size of financial sectors and capital flows grew strongly. History shows that these financial factors may lead to recurrent patterns of booms and crises, as the famous book by Kindleberger reminds us. Recent examples are the Japanese crisis in 1991 and the Asian crisis in 1998. Still, most policymakers failed to notice the development of an almost global credit boom since the mid-1990s. Many advanced countries witnessed a strong increase in credit and house prices. Housing bubbles developed in countries such as the US, the UK, Spain and Ireland. In the euro area, the boom interacted with inflexible product- and labour markets, leading to strong wage growth and a severe loss in competitiveness. Especially southern European countries had not adjusted their economies to the loss of exchange rates in the monetary union. Yet all these imbalances largely went unnoticed. Major changes in the economic landscape, such as globalisation, often make it difficult to spot vulnerabilities. We are lead to believe that we are in a new era, while in fact we are close to a new crisis.

The consequences are familiar. Almost four years after the collapse of Lehman Brothers, most advanced economies are still struggling. We are reminded that financial crises may lead to a longer period of relatively low growth, with Japan's lost decade as the most pronounced example. Growth is reduced because banks remain fragile and hesitant to lend, households are saving to reduce debt, and governments are consolidating in order to counter the surge in public after the crisis. In the euro area, the situation is complicated further by the sovereign debt crisis. Sovereign bonds in southern Europe are under severe financial market pressure, while some countries are also experiencing capital outflow from the banking sector.

Meanwhile, emerging Asia has remained surprisingly resilient. Many Asian countries had improved their economic fundamentals after the Asian crisis. Their exposures to the current crisis were also limited, because of lower financial integration and because their reserves were invested in safe assets. While the business cycle in these export-oriented economies is affected by demand from the West, their trend growth has clearly decoupled. Emerging Asia recorded an average annual growth of 8.5% per year over the last decade, against only 1.7% for advanced economies. The financial crisis has only accelerated the shift in the economic balance of power in the world, which has important consequences. It for instance changes the composition of international organisations like the IMF and the BIS. Asia is seeking a greater say at the expense of advanced economies, especially in Europe. The recent decision to merge the Dutch and the Belgian constituencies at the IMF is a direct consequence of this.

CHALLENGES FOR EUROPE AND THE NETHERLANDS

The rise of Asia therefore poses important challenges for advanced economies, and especially for Europe. Industrial countries must restore financial stability, prevent new instability in the future, and implement structural reforms to compete against low wage countries. The required adjustment is not easy, but is necessary to fully reap the benefits of real and financial globalisation in the Asian era. I see four policy priorities.

The first is a further reduction of public debt, which this year stands at a staggering 108% of GDP on average in advanced economies. Lower debt reduces refinancing risks and the vulnerability to shocks. It also helps to calm financial markets in the euro area. Further debt reduction is absolutely necessary, even if it will probably reduce growth in the short run. After all, delays only require an even larger adjustment further down the road. Moreover, there is increasing evidence that high public debt levels reduce growth themselves. High debt may for instance crowd out domestic private investment or deter foreign direct investment.

A second priority is therefore to increase the growth potential in advanced economies via reforms. Structural reforms of product- and labor markets are especially urgent. The southern European product and labour markets belong to the most rigid in the world. A higher growth potential makes it easier to reduce debt. Wage and price flexibility helps to restore competitiveness and reduce current account imbalances within the euro area. Finally, flexibility also facilitates adjustment to the more frequent shifts in comparative advantages due to trade globalization that I described before.

The third priority, related to the first two, is a lasting solution for the European debt crisis. In the short run, a credible financial backstop should give countries under pressure sufficient time to achieve a lasting adjustment. In the longer run, it is also vital that Europe repairs some of the design flaws in the monetary union that the crisis has revealed. The report by EU president Van Rompuy provides a good starting point, although much will depend on the exact design of the various elements. European countries should also realize that further integration is the only way to preserve our position in a world where Asia is gaining importance. This requires a strong and credible commitment from European politicians.

A final priority is to prevent financial instability in the future. This requires a large number of different measures, such as the strengthening of banking sectors via the Basel III framework, and the development of macro prudential policy frameworks. As the challenges of financial globalization only became apparent recently, these policies still require time and analysis. Moreover, booms have been missed many times in the past. This should remind us that even new solutions may not always be bulletproof.

CONCLUSION

Allow me to conclude. Despite these challenges, the fears about the rise of Asia should not be exaggerated. Rotterdam's Euromast may not be able to compete with Asian buildings, but its harbor is thriving thanks to trade with China. And meanwhile, Amsterdam's buildings from the time of the *Verenigde Oostindische Compagnie* increasingly attract Asian tourists.