Toshihiko Fukui: The Japanese economy and Asia

Speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the Asian Affairs Research Council, Tokyo, 26 September 2003.

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It is a great pleasure to have this opportunity to address the Asian Affairs Research Council. Today, after touching briefly on the current state of the Japanese economy, I would like to share with you my thinking on the following topics: the deepening interdependence between Japan and the rest of East Asia under globalization; the implications of this deepening interdependence; and the improvement of financial and capital markets in the region as a key factor for East Asia's economic growth.

Before I start, let me note that in today's remarks I focus on East Asia, primarily the newly industrializing economies (NIEs),[1] ASEAN,[2] and China, not Asia in general, which would include India and other South Asian countries.

I. Current State of the Japanese Economy

In the Bank of Japan's semiannual economic outlook published in April 2003, the standard scenario was that as exports and production increased with the recovery of overseas economies, a self-sustaining recovery would gradually gain momentum in the second half of fiscal 2003. There were a number of uncertainties in this standard scenario. In fact, since spring 2003, the uncertainty about the economic outlook was amplified against the background of the war in Iraq, severe acute respiratory syndrome (SARS), volatile movements in the stock and foreign exchange markets, and persistent concern about financial system stability. As a result, an excessively pessimistic view on the economic outlook seemed to have spread toward the summer.

Such an excessively pessimistic view, however, has been receding since the summer. Domestic demand has begun to show some signs of improvement. Corporate profits continue to increase, and the ratio of current profits to sales for this fiscal year is likely to reach the highest level since the collapse of the bubble economy. Judging from various survey results and in light of recent machinery orders, a leading indicator, the trend of recovery in business spending, by large manufacturing companies in particular, is anticipated to become more evident. Despite continuing weakness in private consumption as shown in sales statistics, we have also begun to observe some favorable signs of change on the employment and income front. Wages and employment figures, including those for part-time workers, have stopped falling.

Overseas economies appear to be showing signs of gradual improvement. The U.S. economy is likely to pick up as private consumption remains firm partly due to the large tax cuts, and orders and shipments of IT-related goods are increasing. East Asian economies are also returning to a recovery path after a temporary decline in private consumption caused by the spread of SARS in the spring. A rebound in global IT demand, especially in the United States, seems to have given an additional impetus to the East Asian economies, which are heavily dependent on IT-related industries. Against this favorable background to overseas economies, Japan's exports are likely to return to a moderate recovery path in the second half of this fiscal year.

The Nikkei 225 Stock Average has regained the 10,000 yen level since the middle of August, reflecting improved corporate profits and better economic prospects.

In view of these developments, there is an increasing probability that the Bank's standard scenario released in April, a virtuous cycle of recovery in which an increase in exports leads to an increase in production and profits, will materialize. Yet, considering structural adjustment pressure stemming from excess debt and labor, uncertainty still exists with respect to the strength and breadth of the expected recovery.

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1 Hong Kong, Korea, Singapore, and Taiwan.

2 Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

By maintaining quantitative easing, the Bank has strived to ensure that economic recovery continues, thereby overcoming deflation and putting the economy back on a sustainable growth path. In this regard, I would like to emphasize that the Bank has made a strong commitment to continuing quantitative easing until the year-on-year increase in the consumer price index (CPI) becomes stably zero or above.

So far, I have discussed the cyclical problem of the Japanese economy, where economic activity remains below its potential due to lack of demand. But, the Japanese economy also suffers from a longer-term problem of the potential growth rate being on a downward trend amid such changes as the IT revolution, economic globalization, and an aging society. Although it is not yet clear how the potential growth rate can be raised, I believe that the keys to higher growth can be found in such traditional concepts as competition, the division of labor, free trade, education, and the capital markets. The deepening of interdependence between the Japanese and other Asian economies should be examined in this context.

More than 200 years ago, Adam Smith emphasized the advantage of the division of labor, saying that "the division of labor is limited by the extent of the market."[3] The expansion of an economy or its market size, for example, from a village to a city, or from a city to a nation, promotes the division of labor and increases production capacity. At the same time, market expansion and the associated increase in purchasing power induce new entry into the market, which leads to more intensified competition and higher efficiency. This mechanism applies equally to economic globalization. The division of labor through international trade and the efficient use of managerial resources through direct investment are indispensable for economic development.

II. Interdependence between Japan and the Rest of East Asia

East Asian economies are the high-growth center of the world, with an average annual growth rate of more than 7 percent during the past ten years, which is significantly higher than that of industrialized countries. The NIEs first achieved high growth in the second half of the 1970s, closely following Japan. Then, from the mid-1980s, East Asia as a whole exhibited remarkable economic growth as the ASEAN and Chinese economies joined the advance.

The mid-1980s were the period when Japanese companies took major steps toward globalization. At that time, many of them struggled to find new opportunities in their overseas business strategies such as building factories abroad and undertaking foreign direct investment to cope with the rapid appreciation of the yen and intensifying trade friction with the United States. In expanding into NIEs, Japanese companies aimed at substantially reducing production costs, and maintaining or enhancing their competitiveness by taking advantage of the inexpensive and abundant local labor force in their processing and assembly bases. These activities of Japanese companies contributed significantly to the creation of employment opportunities in East Asia as well as the region's economic growth.

In the 1990s, companies from all over the world, including Europe and the United States, boosted their direct investment in East Asia. They first invested in the ASEAN countries, and then expanded to China. In terms of industries, IT-related companies made significant inroads into the region as the IT revolution progressed. Although direct investment was temporarily halted by the Asian currency crisis in 1997-98, it resumed as regional growth regained momentum.

Recently, Japanese companies, not only manufacturing but also nonmanufacturing companies such as retailers, distributors, trading houses, and financial institutions, are actively engaged in businesses in East Asia, particularly those related to China. These businesses include not only the relocation of labor-intensive production but also the expansion of new business aiming at technology transfer, marketing, and sales enhancement. Such business expansion promotes the further globalization of Japanese companies.

These developments are reflected in trade. For example, the total amount of trade by the NIEs, the four major countries of ASEAN,[4] and China increased 2.3 times from 1991 to 2002. And, East Asia's share in the world trade increased from 14 percent to 17 percent over the same time span, exceeding

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[3] Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations, Book 1, Chapter 3, 1776.

[4] Indonesia, Malaysia, the Philippines, and Thailand.

that of the United States. The salient feature of East Asia's trade expansion is the rise in the trade of IT-related goods. In fact, IT-related goods account for about 30 percent of the exports of East Asian economies, which is higher than the figure for traditional export items such as clothing. In terms of the share in the world trade of IT-related goods, Asia, excluding Japan, accounts for more than 30 percent, which is higher than that for Japan, the United States, and Europe. East Asia plays an important role as the global supplier of IT-related goods.

Trade between Japan and the rest of East Asia is also on an upward trend. From 1991 to 2002, exports from Japan to the rest of East Asia increased 1.6 times, and imports from the rest of East Asia to Japan 1.9 times. In particular, trade with China posted a significant increase. Both exports to and imports from China rose more than fourfold from 1991 to 2002. In terms of Japan's exports and imports classified by region, the rest of East Asia now accounts for more than 40 percent, up from about 30 percent in the first half of the 1990s, which is significantly higher than that for the United States and the European Union.

With the increasing trade volume, the trade items between Japan and the rest of East Asia have changed. A significant part of exports from Japan consists of capital goods and intermediate goods shipped to production and processing bases in East Asia. Among such exports, those of IT-related electronic parts to China have recently displayed a marked increase. A large part of imports from the rest of East Asia to Japan used to consist of labor-intensive goods, including clothing and light manufactured products. But, lately, imports of these labor-intensive goods have been leveling off, and instead those of high value-added goods such as IT-related and capital goods have been on an increasing trend. The rise in IT-related goods in both exports and imports indicates that Japan and the rest of East Asia are in the process of establishing a vertical international division of labor under ongoing economic globalization.

III. Implications of a Deeper Interdependent Relationship

As I mentioned, Japanese companies need to open themselves further to global competition and transform themselves to enhance their vitality under globalization. Given that Japan and the rest of East Asia have already established significant economic interdependence, I would like to consider further the implications of deeper regional interdependence in the context of the transformation of Japanese companies.

Under globalization, countries and regions naturally deepen their economic linkages with each other. With the advance in transportation and IT, it is a global economic trend that people, goods, money, and information move freely across borders, and that countries and regions deepen their mutual dependence by promoting the international division of labor based on their comparative advantages. In light of this trend, it is very important for Japan and the rest of East Asia to further deepen the already established interdependence, for the following reasons.

The first is geographical proximity. Simply put, Japan adjoins the rest of East Asia, and vice versa. Despite the significant advances in transportation, geographical proximity and a small time difference still offer substantial advantages in terms of the movement of people and goods. The IT revolution enables inventory control without actually having to carry a large amount of inventories. In addition, the prompt and timely delivery of goods from suppliers to customers becomes important in responding swiftly to changes in demand. The merits of such geographical proximity have been shown clearly in Europe as well as North and South Americas, where mutual dependence with neighboring countries is first strengthened.

The second is the large economic size of East Asia, excluding Japan. In fact, in terms of nominal GDP, it is about 70 percent of Japan's economy as measured in current foreign exchange rates. The economic size of Latin America is a little less than 20 percent of the United States, and that of Eastern Europe is less than 10 percent of the Euro area. Such a comparison clearly shows the huge advantage for Japan to have an enormous and fast-growing market such as East Asia as a neighbor. A further expansion of the markets in East Asia is expected, especially China. Currently in China, a rise in income is enlarging consumer demand. Moreover, we now observe an increase in investment demand for enhancing production and product development capacity as well as construction investment demand related to the Beijing Olympic Games and the Shanghai Exposition.

The third is the complementary nature of the relationship between Japan and the rest of East Asia. East Asia is endowed with an abundant labor force that is diligent and relatively inexpensive. It is thus quite an effective strategy for Japanese companies shouldering high labor costs to make use of such a labor force to strengthen their competitiveness. Accordingly, many Japanese manufacturing firms have moved their production and processing bases to East Asia which has been welcomed by the host countries as these moves create employment and increase income. Furthermore, they look forward to the transfer from Japan of production and product development techniques as well as managerial expertise that will help them move to a more sophisticated industrial structure.

It is clear that all these reasons lead naturally to the formation of interdependent relationships between Japan and the rest of East Asia. In fact, I see it as an encouraging trend that momentum is growing among Japanese companies to seize a variety of new and challenging business opportunities in East Asia, in China in particular.

Having said this, there is concern in Japan that the expansion of Japanese companies to East Asia engenders a hollowing-out of Japanese industry, which adversely affects domestic production and employment. There exists a deeply embedded view that rapid growth in East Asia, especially in China, may constitute a threat to the Japanese economy.

However, faced with intensifying global competition, due partly to the increased consolidation of East Asia in the global economy, Japanese companies must strive to increase their ability to create high value-added goods and services, while raising productivity and correcting their high cost structure. Not only companies expanding their overseas operations, but also those remaining in Japan, need to enhance their competitiveness through innovation and the reallocation of resources. In addition to people, such intangible assets as information, knowledge, and expertise move freely across borders. By effectively utilizing these assets and human resources, Japanese companies should be able to generate a self-sustained virtuous cycle of creating high value-added goods and services in Japan.

As economic globalization progresses, deeper interdependence between Japan and the rest of East Asia is of great significance. One of the driving forces behind this interdependence is the prevalence of free trade agreements (FTAs) in East Asia. FTAs expand trade and direct investment by eliminating trade barriers among the parties to such agreements. Although recognizing such merits, we should bear in mind the exclusiveness of FTAs to parties outside the agreements. Thus, in the "Basic Policies for Economic and Fiscal Policy Management and Structural Reform 2003" announced in June 2003, the Japanese government emphasizes the need to promote the current round of World Trade Organization (WTO) negotiations as well as FTAs.

IV. Improvement of Financial and Capital Markets in East Asia

With the deeper interdependence between Japan and the rest of East Asia through business and trade, there is a growing need to improve the financial infrastructure to underpin these activities. Under globalization, money travels across borders much faster than people and goods do. To take advantage of the market mechanisms and enhance competitiveness, developing convenient and efficient financial and capital markets is indispensable.

The importance of a healthy financial infrastructure is one of the valuable lessons learned from the Asian currency crisis of 1997-98. During the crisis, companies in East Asia suddenly faced difficulties in their funding as they relied heavily on U.S. dollar-denominated short-term debt. Concerns about financial stability developed into a serious economic crisis. As a result, many economies in the region suffered negative economic growth. With this experience in mind, after the crisis East Asian governments reformed the banking sector, and companies in the region switched their funding to long-term debt and direct investment as well as to domestic currency-denominated debt.

Although these efforts have been gradually bearing fruit, it is vital to further develop financial and capital markets to respond to growing credit demand and achieve the efficient allocation of resources.

To this end, it is useful to strengthen the functioning of bond markets in East Asia. Deep and liquid bond markets can satisfy various funding and investment needs in the region. Furthermore, the fair assessment of credit risk in bond markets contributes greatly to strengthening the financial intermediation function of the banking system. Japan has made a variety of contributions to the development of Asian bond markets. I will return to this subject later when I discuss the role of the Bank of Japan.

Strengthening the functioning of Japan's financial system also helps to stimulate and diversify capital flows in East Asia. Recently, however, loans by Japanese banks to the region have been declining, and companies in East Asia do not issue a large number of bonds in the samurai bond market. To improve the situation, it is necessary to revitalize the Japanese securities market, and at the same time, to strengthen the intermediation function of the Japanese financial institutions.

Let me touch briefly upon the foreign exchange rate system in East Asia. For companies vigorously engaged in business in East Asia, the stability of East Asian currencies is a prerequisite for expansion. As I have often stated elsewhere, foreign exchange rates should be determined in a stable manner reflecting economic fundamentals. In an open economy, we cannot simultaneously achieve a fixed foreign exchange rate, free capital flows, and independent monetary policy. For example, many industrialized countries, including Japan, enjoy free capital flows and independent monetary policy at the expense of having floating foreign exchange rates. On the other hand, China seeks a de facto fixed foreign exchange rate and independent monetary policy at the expense of regulated capital flows. Although China is gradually easing regulations on capital outflows, the deregulation of capital flows may cause instability if unaccompanied by reform of the domestic banking system, as the experience of the Asian currency crisis shows clearly. One orthodox way to achieve sustainable economic growth is to gradually remove capital controls and make the foreign exchange rate system more flexible in tandem with reform of the domestic banking system and strengthening of the financial system.

V. Role of the Bank of Japan

Finally, let me discuss the role of the Bank of Japan in the context of deeper interdependence between Japan and the rest of East Asia. In brief, what the Bank can do is to provide Japanese companies with a stable financial and economic environment to support their innovative business activities under globalization. Let me elaborate.

First, needless to say, the sound development of the Japanese economy is one of the most important prerequisites for stable economic growth in East Asia. To this end, the Bank is working to overcome deflation and put the economy back onto a sustainable growth path by maintaining the current quantitative easing policy.

Second, the Bank is strengthening regional financial cooperation with central banks in the rest of East Asia. Such a direction has gained further momentum since the Asian currency crisis of 1997-98. In the wider context of ensuring the stability of the international financial system, the importance of establishing a collective and regional financial support system has been widely recognized among East Asian economies. In this regard, Japan has already entered into currency swap agreements, in the form of liquidity support, with Korea, Thailand, the Philippines, Malaysia, China, and Indonesia.

Discussion on developing bond markets in East Asia is underway in various international forums. The Bank has taken an initiative in such discussions in close cooperation with the Japanese government. Recent examples include the Bank's decision to participate in the Asian Bond Fund, which is a fund for investment in U.S. dollar-denominated East Asian sovereign bonds. This is part of central bank cooperation to further develop Asian bond markets, which was discussed at the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP). The initial size of the Asian Bond Fund is only about U.S.$1 billion. We hope that with an increase in trading volume and liquidity as well as an expansion in the number of investors not only from the region but also from all over the world, the Asian Bond Fund will generate momentum for the further expansion of Asian bond markets. This would certainly contribute to facilitating funding by Japanese companies in East Asia. We also strongly hope that such cooperation among central banks in East Asia will strengthen financial systems in the region.

Third, the Bank is further improving the quality of information and analysis relating to economic and financial developments in East Asia. Particularly noteworthy are the rapid development of the Chinese economy and the expansion of Japanese companies into China-related businesses. In light of such developments, the Bank is preparing to establish a representative office in Beijing by the end of the year. Through this office, the Bank aims to gather more detailed information about the East Asian economy.

Bearing in mind the relationship between Japan and the rest of East Asia that I have described, we will make our utmost efforts to meet the challenges facing the Japanese economy in the broader context of ongoing globalization.