## Toshihiko Fukui: Global imbalances and exchanges

Speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the Annual Meeting of the World Federation of Exchanges, Tokyo, 13 October 2004.

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### Introduction

Ladies and gentlemen, it is an honor as well as a pleasure to be invited to the annual meeting of the World Federation of Exchanges, to offer some thoughts on recent developments in the international financial system. Taking this opportunity, I would like to congratulate you on the tremendous success exchanges around the world are achieving in promoting trading of various financial instruments, and on the role your association has played in facilitating such developments.

Today, having just chaired this month's first Monetary Policy Meeting, I would like to briefly comment on the monetary policy of the Bank of Japan. The Japanese economy continues to recover steadily, but mild deflation persists, reflecting factors such as increasing productivity. Against this background, the Bank of Japan decided to maintain the so-called "quantitative easing" framework.

For the rest of the evening, I would like to focus on a medium term structural issue that never seems to go away - global imbalances, and offer my views on what role exchanges will be able to play in meeting this challenge.

### Global imbalances

Let me begin by briefly laying out how unbalanced the world is.

At the beginning of this month, I attended a series of meetings in Washington. Those meetings were held in conjunction with the annual meetings of the International Monetary Fund and the World Bank Group, and included the meeting of the finance ministers and central bank governors of the Group of Seven countries. A common theme running through those meetings was surprisingly robust growth in 2004. The global economy is expected to grow by 5% this year, which is the highest growth in 30 years. The above-potential growth would probably have to slow down next year, but the estimate given in the World Economic Outlook by the International Monetary Fund is 4.3%, still somewhat higher than the potential. Against this relatively favorable outlook, we have identified some risks. After all, central bank governors are paid to worry.

One risk is obviously the high prices of oil. I will not go into details of this issue today, because so much is written about it.

Another risk is global imbalances. The current account deficit of the United States reached 542 billion dollars last year. This is almost 5% of the nominal GDP of the United States. For this year, we have seen no sign of this deficit shrinking to any significant extent. If we look back to the middle of the 1980's, the last time global imbalances were considered to be a problem of the world economy, the current account deficit of the United States peaked at 3.5% of GDP.

Looking at the details, however, there are some interesting differences between 2004 and the middle of the 1980s. First is the size of the imbalances, which I have just mentioned. The second is who are in the deficit club. In the mid-eighties, not only the United States but also many other countries were running deficits. On the other hand, today, most of the deficits are concentrated in the external account of the United States. Third, related to the point I have just mentioned, the emerging Asian economies are now in the black instead of being in the red.

Having said this, I must make this clear: I am not saying that imbalances per se are bad. As a matter of simple arithmetic, if there were no trade in the first place, there would be no imbalances. When we start trading, unless everyone is balanced, imbalances are inevitable. We are certainly better off trading than not. More conceptually, an economy with abundant investment opportunities relative to its savings, most notably a developing economy, is likely to run a deficit. In this sense, some imbalances are a reflection of enhanced economic welfare. Furthermore, the size of the imbalances is not necessarily disruptive, either. At present, the United States is financing a current account shortfall amounting to 542 billion dollars, the size of the economy of Netherlands, with no visible difficulties.

You may perhaps remember the concerns voiced in the market some twelve months ago. There were worries that the U.S. dollar might fall sharply, were it not for continued and heavy currency market interventions by Asian monetary authorities. That has not been the case so far. In the case of the yen, even in the absence of official interventions in the foreign exchange market since mid-March, the dollar has held up well against the yen. This suggests that private capital flows are now playing a more important role in determining market dynamics. I might even say that we should be proud of ourselves in allowing the international financial markets to develop into such a resilient system.

If this is so, why are we saying that global imbalances risk the stability of the international financial system and the global economy?

Large imbalances are worrisome, because imbalances cannot grow forever. In fact, the imbalances we saw in the middle of the 1980s led to a rather painful correction of the dollar. As one accumulates more dollars, he or she would begin to worry about the danger of putting all his or her eggs in one basket. Alternatives are there. It can be the euro, the yen or any other currency or a physical asset. If sentiment shifts suddenly in such an environment, there would be a rush to convert dollars into alternative assets. With the large accumulation of deficits to start with, the resulting flows could be quite large. They might be of a magnitude that could impair the smooth functioning of the international financial system. Though unlikely, that is still a risk we must not ignore. In order to reduce such risks, we must think about how to adjust the imbalances to more comfortable and manageable levels.

Policy makers cannot adopt benign neglect in this context. I believe many things are best left to the market and the government should keep out of its way. We cannot, however, always say that the market would take care of itself. If left to the market, there is a risk, however remote, of a sudden shift in sentiment over the dollar. Policy makers must reassure the market that they are not letting imbalances get out of hand.

We need to have a good mix of policies.

To begin with, we need to ensure flexibility in the financial system and the economy. In many cases, unleashing market forces is a key to efficient adjustment, and flexibility is essential to the financial system and the economy to withstand shocks arising from adjustments.

Beyond this, there are basically two routes to reach a level of imbalances that would be more comfortable and manageable in the long run: realigning exchange rates and rethinking policies that influence absorption in economies. Adjusting imbalances entirely through exchange rate realignments is neither practical nor desirable. Meanwhile, policy choices can influence absorption. If dissavings by the government are resulting in current account deficits, consolidation of fiscal expenditure would be necessary. Governments of deficit-running economies might also review any policies that are discouraging private savings or adopt policies that encourage private savings. Surplus-running economies can adopt policies to encourage domestic absorption. For example, enhancing confidence in social security systems would persuade households to avoid excessive savings. It is responsibility of policy makers to formulate and implement an appropriate mix of policies.

## Imbalances and Asia

Adjusting imbalances, however, is easier said than done. The United States now imports 50% more than it exports. If imports are to grow by 5% per year, exports must grow by 7.5% just to keep the dollar amount of current account deficits at present levels. Viewing from a slightly different angle, even if the income elasticity of U.S. imports to U.S. demand growth were to suddenly drop to zero while exports continued to grow at 5%, it would take nearly 5 years before the deficit halved.

How then could we realize this significant adjustment? What should Asian economies, which are running surpluses, do in the context of global imbalances?

First of all, economies should, in principle, accept adjustment through market forces. Rigidity can lead to a build-up of stress in the system. Many words have already been spent on this subject, and I will not repeat them. I would just note that, in our recent meetings with central bank colleagues from Asia, they were fully aware of the need for flexibility and the challenges facing them in pursuing that goal.

In addition to enhancing flexibility, today I would like to explore another option: the possibility of Asian economies enhancing absorption in their economies.

For Japan, demography would aid the adjustment process. Academic literature tells us that the rate of savings tends to decline in an aging society. In our case, as baby-boomers begin to retire in the next few years, they would start drawing down their savings. This should gradually influence the overall rate of savings and hence the level of external surplus. In this context, one important element would be rebuilding confidence in the social security systems that are now under pressure from the rapid aging of the population.

In many non-Japan Asian economies, the government does not provide a sufficient social safety net. This is one area where a quick action is needed.

In a financial context, one challenge is to explore a better use of capital. Emerging Asia collectively earns about 150 billion dollars a year in surpluses. These dollars are often invested in the United States. Meanwhile, as developing economies, emerging Asia has an almost insatiable appetite for capital. There are still numerous investment opportunities out there in the region. Today, these ventures are often financed by overseas investors, often from the United States. At a risk of oversimplification, I would say that dollars earned by emerging Asia are invested in the United States, which are, in turn invested in emerging Asia. We should ask if there are better ways for capital to flow.

Having put this question on the table, let me spend a few minutes on investment opportunities in emerging Asia.

Emerging Asia has a huge population. China alone has 1.3 billion people. If one adds India with 1.1 billion, there are almost three billion people in the region. These people are not just inexpensive sources of labor for goods and services exported to markets in industrialized economies. These people will become happier if they enjoy material wealth like we do.

You can see vending machines virtually at every corner in Tokyo, peddling one-dollar cans and bottles of soft drinks. If the three billion people in emerging Asia can each drink just one can or bottle a day, the sales add up to three billion dollars. In a year, it will become more than one trillion dollars. To put this into perspective, the annual revenue of the Coca-Cola Company was 21 billion dollars in 2003. Of course, this is not yet a plausible story because many of these people are living on just a couple of dollars a day. For example, 3 dollars in China, 2.6 dollars in Indonesia and 1.5 dollars in India. Today, not every one can afford to spend one dollar for the pleasure of drinking a refreshing can of soft drink. However, if jobs are created for these people, huge untapped demand could be unleashed.

Workers are at the same time consumers. Investments in goods and services targeted for intra-regional consumption can create jobs and, in turn, the market for those goods and services. If and when this happens, domestic absorption will increase in emerging Asia. Global imbalances will be alleviated.

This scenario is not a pipe dream. In many parts of emerging Asia, consumer demand is picking up. From Myondong in Seoul to Nanjin Lu in Shanghai to Siam Square in Bangkok, consumers are flocking to fashionable shops and cafes. This demand is creating a favorable cycle by creating new jobs and hence greater consumer demand. For this model to work, however, a thorough understanding of the region and the needs of the people is essential. The deepening of regional integration will, I hope, give birth to a new breed of intra-regional investors, who will focus on these opportunities.

In connection with this scenario, an interesting question is how to finance the efforts of the region’s entrepreneurs. A key issue here is how can we mobilize the region’s rich reservoir of savings to finance regional investments. Financial institutions in this region must enhance their ability to intermediate between savings and investments. I also find it important to strengthen the financial infrastructure of the region.

There are many important initiatives now underway. Since I have recently had a chance to explain them, I will not repeat them here.

I would just like to draw your attention to ongoing efforts, such as the launch of the Asian Bond Fund by EMEAP central banks and the Asian Bond Market Initiative by ASEAN+3 countries. These efforts attempt to become catalysts for developing the bond market in the east Asian region, which still remains in an infant stage. In the case of the Asian Bond Fund, the seed money provided by central banks ought to strengthen confidence among investors contemplating to enter the market.

### Imbalances and exchanges

Let me now turn to possible roles that exchanges can play in this world with imbalances.

You know more than I do that exchanges are important channels to distribute funds for various investment opportunities. Exchanges facilitate the flow of funds in the market. Since financial markets are interconnected, efficiency gains accorded by exchanges contributed to the expansion of global capital flows. In this regard, exchanges are part of the international financial system that helps finance global imbalances.

Before moving on, I would like to discuss one important efficiency-enhancing feature of exchanges. Exchanges are highly transparent form of connecting sellers and buyers of financial assets. In the over-the-counter market, a seller must search for buyers. The seller does not know precisely at what price the asset traded. The seller does not have an idea of the depth or the liquidity of the market. Exchanges bring together sellers and buyers in one place to maximize the chance of a seller finding a buyer. Prices are available and the distribution of bids and offers could also be seen in some cases. In short, exchanges facilitate the trade matching process through its transparency.

Exchanges can also be a mitigating factor of imbalances.

In the context of Asian economies, one should look at a common structural problem in the domestic financial systems of emerging Asian economies. In these countries, much financing still moves through the banking channel. Strengthening of capital markets is therefore a common goal. The initiatives related to the bond market, which I referred to a few moments ago, should be seen in this light. Exchanges can play a role here as well. Providing a full range of financing options to entrepreneurs is a key element in the mobilization of the region’s rich reservoir of savings to finance regional investments.

Another contribution that can be made by exchanges is enhanced transparency. In some cases, investors are said to be discouraged from investing in the emerging Asian market, partly because transparency is so low. With their transparent trading systems, which I have just mentioned, exchanges may help overcome this problem.

Finally, exchanges could be linked across borders. Such linkages would create additional efficiency. In the context of emerging Asia, it is important to strengthen the intra-regional as well as extra-regional linkages between exchanges. Listing of overseas assets, cross-listing of products and trading links between exchanges can all be designed to enhance intra-regional capital flows. I hope the distinguished leaders of established exchanges assembled here today would assist their emerging Asian colleagues to achieve these goals.

## Concluding remarks

Central banks operate in the markets to achieve its policy goals. As a result, the effectiveness of monetary policy depends on the sound development of financial markets. In this context, central banks have more than a passing interest in enhancing market infrastructure. Exchanges are important building blocks of this infrastructure.

I should stress that in a globalizing world supported by information technology, the certainty of transactions is a crucial factor for sound development of the financial system. Central banks provide certainty through the finality of payments effected through their accounts. Exchanges provide certainty through its settlement arrangements. In light of these common roles, I believe that we can cooperate in many ways to enhance the efficiency and soundness of the financial system. I look forward to working together with you in this regard.

Thank you for your kind attention, and good evening.