Toshihiko Fukui: Growth, integration and monetary policy in East Asia

Opening speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at the 14th International Conference hosted by the Institute for Monetary and Economic Studies, Bank of Japan, Tokyo, 30 May 2007.

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I. Introduction

Good morning, ladies and gentlemen. It is my great honor to address the 14th international conference hosted by the Institute for Monetary and Economic Studies. On behalf of my colleagues at the Bank of Japan, I welcome all the distinguished guests from central banks, international organizations, and academia. The theme of this year's conference is "Growth, Integration and Monetary Policy in East Asia."

II. East Asia's growing integration into the global economy

Over the past decades, East Asia has been one of the most rapidly growing regions in the world economy. Although the region suffered from a temporary setback owing to the financial crisis of the late 1990s, it has exhibited an impressive economic recovery. The average annual growth rate of East Asian emerging economies since 2000 reached 7 percent, substantially exceeding that of industrialized economies. Since the crisis, there has been a considerable improvement in economic fundamentals in the region. Large stocks of foreign exchange reserves have accumulated, balance sheets of both the corporate and banking sectors have improved, and structural reforms in various areas have proceeded, all of which have contributed to making East Asia more resilient to external shocks. It is highly likely that East Asia will continue to play a major part in the sustained growth of the world economy.

East Asia's high growth has been accompanied by its deepening economic integration with the world. The integration is taking place at both the inter-regional and intra-regional levels. It is reported that Asia's share of world trade more than doubled during the past three decades. Intra-regional trade in East Asia also increased considerably. The share of East Asia's intra-regional trade is comparable with the NAFTA, although it is slightly lower than that of the EU. The increasing trade is a reflection of developments in the supply chain wherein each country specializes in the optimal parts of the global production network based on its resource endowment and comparative advantages.

Meanwhile, it is notable that the rapid emergence of China is adding further momentum to the growth dynamism of the world economy in various ways. First, China's buoyant domestic demand provides more business opportunities for the rest of the world. China's role in the world economy has gone beyond a mere production base. It is increasingly a source of final demand as well. Second, China's integration into the global economy is promoting transformation of trade, investment, and production patterns of other economies. Previously, China maintained its comparative advantages mainly in production of goods and services that were intensive in the use of unskilled labor. In recent years, however, it has attracted sizable foreign direct investment from developed countries and thereby strengthened its competitiveness in production of capital-intensive or knowledge-intensive goods and services. Such changes on the part of China have affected comparative advantages of other East Asian economies as well and required them to reallocate domestic resources accordingly.

The efficient reallocation of resources could, in principle, lead to higher growth of the region as a whole. At the same time, however, the adjustment process sometimes entails certain costs. If domestic markets and institutions are not flexible enough to facilitate reallocation of labor and financial resources from unproductive sectors to productive sectors smoothly, the cost might appear in the form of stagnant growth and unemployment. In this regard, it is of utmost importance for policymakers to continuously pursue reforms to ensure that their domestic systems remain responsive to structural changes in the economy.

On the financial front, East Asia's integration with the international financial system has also advanced steadily in recent years. The integration brings benefits to the economies in the region. With more funding options available, borrowers in the region can raise funds on more favorable terms. With more global investment options available, investors can improve the risk profile of their portfolio through diversification. However, as financial integration deepens and international capital flows become more active, negative shocks originating from one country or region are easily transmitted to another country or region. Such transmission of shocks is not only from developed economies to emerging economies, but also vice versa. Asset prices, in particular, stock prices, are closely correlated both globally and regionally. It should be noted that, in such circumstances, asset prices tend to overshoot economic fundamentals from time to time, causing excessive volatility, which could in turn negatively affect the developments in the real economy.

III. Issues for discussion at the conference

Whereas East Asia's integration could bring substantial benefits to both the global and regional economies, possible side effects should be monitored carefully. It will be a challenge to reap maximum benefits from deepening economic and financial integration while minimizing costs that could possibly arise from such integration. Keeping these broad viewpoints in mind, let me raise several questions that I hope are discussed at the conference.

First, what are the implications of East Asia's growing economic and financial integration on the global business cycle and price movements? The mechanisms through which integration affects various economic variables are complicated. Among these, the relationship between global economic integration and the inflation process is of particular interest to central bankers. Integration of emerging economies including East Asian economies appears to have exerted downward pressure on wages and prices through intensified competition among firms. Whether this trend will continue into the future will have important bearings on the conduct of monetary policy.

Second, what issues are raised for central banks of industrialized economies and East Asian emerging economies by growing external imbalances? It has been argued that global economic and financial integration has contributed to making large current account imbalances more sustainable. East Asia has been a beneficiary of a substantial amount of private capital flows from developed economies, and at the same time, an exporter of an even greater amount of capital in the form of foreign reserves. This is not consistent with the prediction of traditional economic theory that capital flows from developed economies to emerging economies where the marginal productivity of capital is higher. A question naturally arises as to whether the phenomenon has been driven by the fundamental misallocation of global savings and investment. In any case, disorderly unwinding of the imbalances and accompanying capital flows would have detrimental impacts on global financial stability. It is critical for us to carefully examine the factors underlying the imbalances and the desirable policy for both surplus and deficit economies.

Third, what kind of monetary and exchange rate regimes are appropriate for East Asian emerging economies to pursue sustained economic growth under price stability? In the world of highly open capital accounts, the effectiveness of monetary policy depends on the exchange rate regimes in place. After the crisis, there has been a tendency in emerging economies to abandon exchange rates as a nominal anchor. As a matter of fact, a growing number of economies have moved away from pegged exchange rate regimes toward relatively more flexible exchange rate regimes. So far, it seems that the benign international market environment for emerging economies in recent years has made such a transition more or less smooth. Nevertheless, the extent to which exchange rate fluctuation should be tolerated remains a challenging question. Looking ahead, the appropriate policy regimes could change over time. It is important for central banks to review the appropriateness of the policy regimes in light of the changes in their economic and financial structure and the state of the international financial system.

IV. Conclusion

To conclude, East Asia has been in the process of dynamic transformation. We are still a long way from fully understanding the policy implications of East Asia's integration into the global economy. I am looking forward to learning from both prominent scholars and central bankers their analyses and perspectives on the issues. I would be delighted if all of you could take away some insights from the discussion.

Thank you for your attention.

Note: "East Asia" or "East Asian emerging economies" is defined as comprising of People's Republic of China, Hong Kong, Korea, Singapore, Taiwan, Indonesia, Malaysia, the Philippines, and Thailand.