Toshihiko Fukui: Central banking under globalization

Speech by Mr Toshihiko Fukui, Governor of the Bank of Japan, at MAS Lecture 2007, Monetary Authority of Singapore, Singapore, 15 November 2007.

*   *   *

I am very privileged to have been invited by the Monetary Authority of Singapore to deliver its 2007 lecture. I have seen the list of prominent speakers in past lectures, and I am much honored to follow them. My topic today is the role of central banks in the context of increasing economic globalization.

I. Progress in economic globalization

As globalization proceeds, cross-border trading of goods and services as well as funds and financial products has been increasing. Although this trend had been underway for at least half a century, the pace of increase seems to have accelerated in recent years.

According to research done by the International Monetary Fund (IMF), world real GDP increased by around 50 percent over the last decade (from 1996 to 2006), indicating a high growth rate. Over the same period, the volume of world trade almost doubled, representing a growth rate around 30 percent faster than that of world GDP. This means that international trade in goods and services has outperformed the expansion in the world economy. Also, from 1994 to 2004, the growth in the global sum of overseas assets and liabilities outpaced that of world GDP by around 50 percent, and this can be considered an indication of the progress in financial globalization.

The rapid pace of globalization is closely related to advances in information and communications technology (ICT) and strong growth in Asia and other emerging economies. The progress in ICT has further eased geographical limitations on cross-border transactions of goods, services, and financial products. Against the background of these technological innovations, emerging economies, with their abundant supply of skilled labor, have established their position as global production bases. In addition, emerging economies are now regarded not only as production sites for manufacturers but also as locations for software development centers or call centers for non-manufacturers. These economies are now being brought into the business process of supply-chain management by many firms. With the accumulation of purchasing power through this process, emerging economies have also increased their presence as markets with huge potential. In the meantime, their wealth, coupled with abundant funds accumulated in oil-producing countries, has caused a significant increase in the international flow of funds. This has in turn promoted financial innovation such as the introduction of sophisticated financial products and the expansion of financial players such as managed funds.

Development of the international division of labor and progress in financial innovation have fostered efficient allocation of resources, thereby contributing to world growth. World GDP growth is likely to register around 5 percent this year, close to what we have been observing since 2003.

Another feature of current world economic growth is a reduction in the amplitude of fluctuations in the rate of growth and inflation. This is the so-called "Great Moderation," often cited by academics and economists. The stability in the world economy and prices became noticeable after the Second Oil Crisis. The inflation rate, in particular, has decreased substantially since the year 2000 in terms of its average in both industrialized countries and emerging economies, and has also been less volatile.

The current situation of the world economy, where low inflation coexists with high economic growth, seems favorable for central banks, which aim to achieve stability in prices and in economic activity. However, it is a regrettable truth that the job of central banks never gets easier, only more challenging. Let me now discuss some phenomena that have brought new challenges into being.

II. Changes in the relationship between output and prices

The first phenomenon is that the conventional wisdom regarding the relationship between output and prices is becoming increasingly inapplicable. In technical economic terms, this phenomenon could be described as a "flattening of the Phillips curve," and there is uncertainty about how flat the curve has actually become, how long this situation will continue, and whether the relationship will eventually return to its previous state.

This phenomenon has been observed in many industrialized countries, and I would like to outline the situation in Japan as an example.

After hitting bottom in 2002, the Japanese economy entered the phase of recovery, supported by strong external demand due to the expansion of overseas economies. In recent years, the annual growth rate has been around 2 percent, slightly higher than the economy's potential growth rate, and resource utilization, namely in labor and production capacity, has been increasing. However, upward pressure on prices has yet to rise markedly. The year-on-year rate of change in the consumer price index (CPI, excluding fresh food) was negative from fiscal 1998 through fiscal 2004, and has since been around 0 percent.

I think this situation, where prices do not rise despite the steady growth of the economy, is in part due to changes in the environment surrounding prices and wages amid the progress of globalization. Products made in Japan have been facing fierce competition from products imported from emerging economies. In the meantime, Japanese workers have been experiencing increased competition from their counterparts in emerging economies through growth in imports and direct investment. In the face of greater exposure to global competition and capital market discipline, Japanese firms have continued to restrain labor costs to increase corporate value, even under tighter labor market conditions. Meanwhile, employees in most cases still prefer stable employment over wage increases because of their past experience of a severe employment situation. To put it simply, prices are becoming more susceptible to global factors, while the sensitivity of prices to the state of the domestic economy has been declining.

With these changes in the environment surrounding prices, the conduct of monetary policy has become increasingly difficult. In general, interest rate policy affects economic activity first and then influences prices through changes in resource utilization. As the relationship between output and prices has changed and the conventional wisdom no longer applies, it is becoming more difficult for central banks to envisage how much change in the interest rate will be needed to bring about a desired change in the inflation rate.

Since March last year, when the Bank of Japan terminated the quantitative easing policy and reinstated an interest rate regime, we have raised the policy rate at a moderate pace, even though the year-on-year rate of change in the CPI has remained stable at around 0 percent. A factor behind this conduct of monetary policy is the changes in the relationship between economic activity and prices I have just discussed. With these changes, the pace of growth in Japan's economy needed to raise the inflation rate in a short period of time would have to be quite high. In addition, significant uncertainty remains as to the exact rate of growth that would be desirable. Monetary policy aimed at such a high level of growth in the economy could bring about larger swings in the economy and risk the sustainability of the economic expansion. The alternative, safer and more prudent route is to focus on securing sustained economic growth and minimizing swings, generating a gradual rise in the inflation rate.

In the NIEs and ASEAN economies, reductions in both the rate of inflation and its amplitude of fluctuations have also been observed. Given the relative openness of their economies and their geographical proximity to the fast-growing Chinese economy, the NIEs and ASEAN economies seem to have been significantly influenced by ongoing globalization. Of course, the attainment of price stability is a major achievement of monetary policy conducted by central banks in these economies with their main focus on prices since the Asian currency crises, and this has greatly contributed to the growth and stability of the global economy.

If I may add, prices of international commodities such as crude oil have recently risen substantially despite the stability in prices on a global basis. This will inevitably impair terms of trade for oil-consuming countries, but what is important, in terms of the price situation, is its influence on inflation expectations. There is a risk of a rise in inflation expectations in the longer term under tight demand and supply conditions given that recent rises in commodity prices are due in part to continued high growth in the world economy, especially in emerging economies. This implies that the Phillips curve may shift upward. Although inflation expectations so far seem generally contained in many countries, appropriate monetary policy designed to achieve price stability and sustained economic growth is becoming increasingly important.

III. The conduct of monetary policy from a medium- to long-term perspective

Next, I would like to take up the recent disruptions in global financial markets stemming from the subprime mortgage problem in the United States. Although recent events could be considered from various points of view, I think they were intimately related to the benign conditions of the world economy and financial markets that continued for many years under economic globalization, as I have just described. The crux of the problem, as I understand it, is that risk evaluation had become too lax under those benign conditions and this has led to a correction through market forces.

If we look back historically, we can see many cases where excessive financial and economic activities continued for a certain period based on optimistic profit assumptions, and eventually resulted in large fluctuations in economic activity and prices or in financial crises through a later reaction. The Great Depression of the 1930s, Japan's asset price bubble in the 1980s, the Asian currency crisis in the late 1990s, and the IT bubble of the early 2000s are examples. The common feature shared by all of these was that imbalances in the economy and prices had grown under seemingly favorable and stable conditions in the economy and prices.

If expectations take hold that a low interest rate environment will continue indefinitely, the rate for discounting expected future returns in the determination of asset prices will be likely to decline, bringing about a rise in asset prices. A similar situation could also come about as a result of optimistic assumptions about profits when an economy has enjoyed continuous high growth for a considerable time. For example, there was the rise of influential concepts such as "transformation to domestically led economic growth" in Japan during the 1980s and the "Asian miracle" in the 1990s prior to the Asian currency crisis. These concepts led economic agents to lower their awareness of risks and to overestimate their future profitability.

Given these dangers, it has become more important for us to respond to risks that may bring about larger swings in economic activity and prices in the longer run, since central banks have a mission to conduct monetary policy to achieve price stability in the medium to long term. To be more specific, it is essential to carry out careful assessment of risks that may be relatively unlikely to materialize but, if they did, would have a large impact on the economy and prices, such as an asset price bubble. It is also essential to assess financial conditions and inflation expectations that may influence the economy and prices in the medium to long term.

I think such awareness is shared by most central banks, but policy frameworks differ on how to incorporate this in the actual conduct of monetary policy.

In the case of the Bank of Japan, the current monetary policy framework was introduced when the quantitative easing policy framework was terminated last year. Under the new framework, (1) we examine the most likely outlook for economic activity and prices for one to two years ahead, and (2) we assess risks considered most relevant to the conduct of monetary policy from a longer-term perspective.

The recent disruptions in global financial markets seem to show that under the continuing favorable conditions of healthy world growth and low inflation, financial imbalances can accumulate, which will be followed by corrections, posing a risk to economic stability. In more general terms, recent events could be regarded as a reminder of the importance of progress in which financial and economic activities remain in harmony. Recent events have strengthened my belief that it is important for a central bank to assess various factors that may have negative consequences for the situation of the economy and prices in the medium to long term.

IV. Market stabilization and central bank activities

Central banks can also learn a lesson from the recent market disruptions from a rather different standpoint. It is a central bank's role to stabilize the market when it is under pressure. The recent market disruptions occurred when there were growing uncertainties about the location of risks due to the complexity of the international flow of funds under economic globalization. Risks have been dispersed and re-accumulated in various markets through the medium of advanced financial products whose risks are not easy to evaluate. At the same time, given the wide range of financial players, including hedge funds and private equity funds, the identity of risk-taking parties and the scale of risks have become blurred, masking the nature of the risks the financial system is exposed to.

The problem stemming from the rise in housing mortgage loan delinquencies has crossed the Atlantic to the European markets through a decline in the credit ratings of securitized products such as asset-backed commercial paper (ABCP) with mortgage loans as collateral. With uncertainty regarding the location and the scale of risks, the functioning of credit markets including securitized markets has deteriorated overall. Conditions in money markets in the United States and European countries turned volatile because of increased counterparty risks among financial institutions, and central banks have aggressively supplied funds to these markets.

The Japanese money market, however, has been generally calm, with our policy interest rate, the overnight call rate, remaining close to our target level. The most significant factor that kept the Japanese money market stable was the limited exposure of Japanese financial institutions to subprime mortgage-related products. The stability could also be attributed to the ability of the Bank to accurately grasp financial market situations and perform money market operations, developed through a variety of past experiences including financial crisis. To be more specific, the following seem to have contributed: (1) an accurate grasp of the money market conditions through daily monitoring of transactions by market participants; (2) disclosure of information concerning money market operations through, for example, daily release of shortage and surplus of funds in the money market, both projections and actual results; and (3) flexible use of money market operation tools covering maturities from overnight to three months, depending on market conditions.

These are part of our normal modalities of money market operations and nothing special. It is necessary for a central bank to accurately grasp the daily liquidity needs of market participants as well as overall market conditions because monetary policy works through influencing money market conditions and the behavior of market participants. In addition, understanding each financial institution's soundness, thereby contributing to the soundness of the financial system, is an important element of central banking.

The ability to closely monitor the liquidity condition of financial institutions should be finely honed in normal times. After all, a central bank is a "bank." Recent actions by central banks to calm market turbulence seem to have highlighted the simple fact that it is through its banking business that a central bank plays a principal role. Faced with increasing complexity in the international flow of funds, which may bring about sudden stress in the working of financial markets, it is becoming ever more important for a central bank to accumulate further knowledge about financial conditions through its daily activities.

V. Concluding remarks

I sometimes describe central banking in terms of the role of the goalkeeper in a football team. It is rare for goalkeepers to score a goal themselves, but what they do is support their teammates in their efforts to score by defending their goal from the enemy's attacks. In defense, it is vital to read the enemy's offensive strategy; in the conduct of monetary policy, it is essential to accurately assess the risk profiles of economic activity and financial market conditions. When on the offensive, good teamwork is important; in monetary policy terms, it is important to facilitate the efficient allocation of resources and stimulate innovation. The dynamic progress of economic globalization brings with it challenges for central banks such as I have discussed today, but we intend to grapple with them and bring victory to the team by supporting players in the globalized economy.

Thank you.