Masaaki Shirakawa: Advanced and emerging economies – two-speed recovery

Speech by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the Bauhinia Distinguished Talk hosted by the Bauhinia Foundation Research Centre, Hong Kong SAR, 23 November 2010.

* * *

I. Introduction

Good evening. Today, I am indeed honored to have this precious opportunity to give a speech here in the beautiful and dynamic city of Hong Kong. I would like to begin by expressing my heartfelt thanks to the Bauhinia Foundation Research Centre and the Chairman, Mr. Anthony T. Y. Wu for kindly providing such an honorable occasion to speak in front of our distinguished audience.

As you are well aware, financial business is the biggest industry in Hong Kong. Did you know, however, that the financial relationship between Hong Kong and Japan was forged shortly after Hong Kong appeared in modern history? In 1871, three years after the foundation of the Meiji Government, Japan began to issue its first modern currency. The government of the time acquired its minting machinery from the former English Minting Authority in Hong Kong, and invited the engineers to Japan, asking them to issue silver coins of the same weight and quality as those used in Hong Kong. While there are a variety of stories claiming to account for the origin of the name of the Japanese currency, the yen, one of these stories tells us that in fact the yen derives its name from the silver Hong Kong one yuan coin (Slide 1). Financial institutions have also been active since the very early days in helping build close associations between Hong Kong and Japan. The Hong Kong and Shanghai Banking Corporation Limited, familiar worldwide as HSBC, was established in Hong Kong in 1865. In the following year, 1866, HSBC opened its branch in Yokohama, and this contributed greatly to the development of trade finance in Japan. Among Japanese banks, the former Yokohama Specie Bank Limited, which is said to have been modeled after HSBC, opened its local office in Hong Kong in 1896.

The strong economic ties between Hong Kong and Japan are not limited to financial services but extend also to trade in goods and services. Hong Kong is currently Japan's fifth largest export partner (Slide 2). It must also be pointed out that this trade in products is not confined merely to industrial goods. Believe it or not, despite its total population of less than ten million, Hong Kong is the primary export destination for Japanese agricultural products, some of which may be re-exported to other regions, including mainland China. Japanese luxury fruits are very popular among Hong Kong's gourmet residents.

There is also a long-term relationship between Hong Kong and the Bank of Japan. The Bank of Japan opened a representative office in Hong Kong in 1957, aiming to ensure close appreciation of economic developments in the Asian region (Slide 3). Since then, our representatives at the Hong Kong office have been providing extremely valuable and enlightening reports to the Tokyo Head Office on monetary and economic developments in Hong Kong and East Asia, including those on the Asian currency crisis in 1997. We have been enjoying a very close and friendly relationship with the Hong Kong Monetary Authority, and I myself have solicited advice for today's speech from my very close friend, Mr. Norman T. L. Chan, Chief Executive of the Hong Kong Monetary Authority.

Let me now move on to the main subject. The title of my speech today is "Advanced and Emerging Economies: Two-speed Recovery," and I would like to take this opportunity to express my views on the outlook for the global economy. I will also briefly touch upon several challenges for Asia and Japan from the perspective of ensuring economic developments between the two.

II. Current state of the global economy

I will start with the current state of the global economy. The global economy has been recovering at a modest pace, following its rapid decline after the Lehman shock. The current state can most accurately be described by what has already become a rather worn-out phrase, the "two-speed recovery." According to the IMF World Economic Outlook released in October, the growth rate of the global economy was minus 0.6 percent in 2009, followed by a forecast plus 4.8 percent for 2010, and plus 4.2 percent in 2011 (Slide 4). Approximately 70 percent of the growth is contributed by emerging and resource-rich economies. Among those, the growth of Asian emerging economies stands out, and it can be said that Asian emerging economies are currently the growth center for the global economy, and have been a great driving force for its recovery since the global financial crisis.[1]

Meanwhile, Japan's economy has also benefited significantly from the growth of the Asian emerging economies. Japan's exports dropped sharply from the end of 2008 to the beginning of 2009, owing to the financial crisis. However, after the spring of 2009, exports showed a significant increase, mainly to China, the ASEAN, and other major Asian economies (Slide 5). The Japanese economy has recovered at the fastest pace among the advanced economies, and one of the main reasons for this has been the significant increase in exports to Asia.

Now, what projections can we make about future global economic developments? While the future of the global economy is fraught with uncertainty, I focus particularly on the following three points in making a projection.

The first point relates to the advanced economies, especially to an assessment of their balance sheet adjustments. The credit bubbles in the mid-2000s were on a very large scale, particularly in the U.S. and the U.K. economies, and for that reason, it may well take some time for them to recover. Assessment of the effectiveness of macroeconomic policies in advanced economies is also an important element. There is already very limited room for deployment of monetary and fiscal policy in these economies. Given these circumstances, when can we expect the advanced economies to return to a full-fledged recovery path, and how robust will this return be?

The second point I wish to raise relates to the growth prospects for the emerging economies. The growth potential of emerging economies may seem very large, but without the appropriate policy taken, the risk of a bubble cannot be ruled out. In addition, although this is not a pressing concern, the smooth transition from a high-growth economy to a mature economy will become one of the important policy challenges for the emerging economies in the longer term.

The third point, which interlinks with the above two points, is the issue of capital flows and exchange rates, or more simply, the currency conflict under the "two-speed recovery."

III. Perspectives from the experience of the Japanese economy

Japan's experience over the past few decades offers a range of ideas when considering these three points. One of the most debated topics of economic policy over the past several months has been the large-scale asset purchase program implemented by the Federal

---

[1] IMF "World Economic Outlook," October 2010. Asian emerging economies are here defined as China, India, Korea, Taiwan POC, Hong Kong SAR, Singapore, Thailand, Indonesia, Malaysia, Philippines, and Vietnam.

Reserve. Meanwhile, many commentaries by economists and policy makers suggest that the program was intended to avoid "Japanese-style deflation" or "the lost decade in Japan." Incidentally, if you search the keyword "Japanese-style deflation" on Google, the results have increased rapidly from about four hundred thousand entries during the first half of this year, to about a million during the period from July to mid-November. However, many are interested not only in Japan's experience of deflation or "the lost decade." When I talk to my friends in China, it surprises me to learn that in-depth studies are carried out on Japan's experience during the high-growth period and after the Plaza Accord.

Now, I would like to express my views on the above three points, by making reference to Japan's experience.

Balance sheet adjustments in advanced economies and their aggressive monetary easing

Let me start with the issue of balance sheet adjustments or repair in advanced economies, particularly in the United States. Balance sheet adjustments were indeed an issue that Japan struggled to resolve after the burst of the bubble. Real GDP growth in Japan after the burst of the bubble decreased significantly to an annual average of 1.5 percent in the 1990s, down from 4.4 percent in the 1980s (Slide 6). After entering the 2000s, real GDP growth picked up somewhat to an average of 1.7 percent until 2007, but dipped again owing to the Lehman shock. Average real GDP growth for the 2000s was merely plus 0.7 percent. As for the inflation rate in Japan, the consumer price index has been on a mild downward trend since 1998 (Slide 7). As such, Japan's economic performance has not been impressive in recent years, and this is why discussions in the United States often take place in the context of "avoiding the Japanisation" of the U.S. economy. However, such framing of the discussions occasionally makes me feel that Japan's experience and its lessons may be misread.

My understanding of the main causes for the decline in Japan's growth rate can be summed up in the following three points.

The first cause can be attributed directly to the burst of the bubble. During the formation of the bubble, driven by excess optimism about the future, firms expanded their business capacity and employment, and increased their debt. After the eventual bursting of the bubble, the so-called "three excesses" remained, namely excesses in business capacity, employment, and debt. The economy continues to suffer downward pressure as long as "such excesses" remain. It was not before the resolution of these "three excesses" in 2003 that Japan returned to a full-fledged recovery path (Slide 8).

The second cause is the failure of Japanese firms in adapting to the changes in overall trends that took place globally from the late 1980s through the 1990s, namely deregulation, globalization, and the information and technology revolution. During this period, global markets were further integrated, and divisions of labor in production processes were extended on a global scale. Foreign firms increased their value added by optimally re-arranging their production base and sales channels, and reduced costs by effectively expanding outsourcing. On the other hand, it was a significant challenge for Japanese firms to adapt to such circumstantial changes, since their business models were based on centralized control and integrated team production. The industrial model in Japan was supported by a highly skilled domestic labor force under the lifetime employment system. However, since Japanese firms were trapped in the memory of their past successes, they were left behind in adapting themselves to the major trend changes in the global economy.

The third cause is the aging and declining population (Slide 9). There are a variety of channels through which demographic changes affect the economy. However, with other conditions being equal, domestic demand will naturally decrease in line with a decrease in population. Likewise from the supply side, a decrease in labor supply will reduce the growth rate. Owing to Japan's rapidly aging population, the growth rate of productive population turned to be negative in 1995, and was minus 0.9 percent in 2009 on a year-on-year basis. The decline in population will also increase the fiscal burden on the working generation.

How should we assess the risk of deflation, a question which relates to the debate on “the lost decade”? In fact, Japan has experienced a mild price decline of about 3 percent on a cumulative basis over a decade. However, the country has not experienced a deflationary spiral, where a decline in prices induces a decline in economic activity, thereby leading to a further decline in prices. This deflationary spiral is the strongest reason for fearing deflation. Instead, in terms of length, Japan experienced its longest post-war period of sustained recovery from 2002 to 2007, though not necessarily spectacular. Hong Kong has also experienced an increase and decline in prices in recent years. For every jurisdiction, it is not appropriate to isolate the issue of deflation from economic structure, in particular from wage setting. If we compare consumer price inflation between Japan and other advanced economies, the rate difference is mainly attributed to the development in the price of services (Slide 10). As the inflation rate declined, wages were set in a more flexible manner in Japan. This flexibility in wage setting was attained not only through a reduction in bonus payments and an increase in the number of non-regular workers, but also through the downward revision of fixed remuneration for regular workers in a flexible manner. Since services are more labor-intensive than the production of goods, the flexible adjustment of nominal wages resulted in a decline in the price of services, which became a cause of the deflation. Since the latter half of the 1990s, corporate management and employees in Japan have given priority to ensuring employment, and a decline in wages has therefore been accepted by the workers. As a flipside to a decline in wages and mild deflation, Japan has experienced an increase in its unemployment rate which is currently at 5.0 percent, but this increase has been much smaller than in the U.S. and European economies.

Let me summarize the above argument by highlighting the implications for the current U.S. economy.

First, it takes a significant time after the burst of a large bubble for an economy to complete its balance sheet adjustments and return to the path of full-fledged recovery. In this regard, the current U.S. economy may require some more time to repair its balance sheets. Aggressive monetary easing could reduce some of the pain arising from on-going balance sheet adjustments, but it will not extinguish the need for those adjustments.

Second, even during the process of balance sheet adjustments, it is essential not to forget paying attention to the importance of the supply side of the economy. Although accommodative monetary policy is important so as to avoid sharp declines in demand, prolonged low interest rates may hinder the growth of productivity by devitalizing economic regeneration. In the longer term, the trend in economic growth rates is determined by supply side factors, namely the growth of the labor force and productivity. On this point, the United States seems to have the advantage over Japan in terms of its more flexible economic structure as well as higher population growth of approximately 1 percent, which is higher than that of Japan in the post-bubble period. However, during the prolonged economic downturn period after the burst of a bubble, policies that may harm long-term efficiency are often introduced in the climate of accumulated social frustrations. Preventing a decline in growth potential appears to be the key to avoiding “the lost decade” situation, although this is not an easy task for any economy.

How long will the high growth of emerging economies be sustained?

The above are my views on the balance sheet adjustments in advanced economies, which is the first point I wish to make in projecting the future developments of the global economy. My second point is on the sustainability of economic growth in emerging economies. Emerging economies have achieved remarkable growth in recent years. If we mathematically extrapolate from the average growth rates of the global economy and BRICs economies for the last ten years, the global share of the BRICs economies will reach more than 80 percent in 2040, although this is considered to be unrealistic. Even these high-growing economies will mature at some stage. Let me now make a simple comparison of Japan's high economic growth in the past and China's economic growth in recent years. Roughly speaking, China's population is ten times greater than that of Japan, China's per capita nominal income is one-tenth of that of Japan, and, accordingly, the nominal GDP for the two countries is about the same. Japan's high economic growth era started in the mid-1950s, and ended in the early 1970s. The average annual growth rate for this fifteen-year period reached about 10 percent (Slide 11). On the other hand, China's high growth era began in the early 1990s, and the average annual growth rate for the first fifteen years was roughly the same as that of Japan during its high growth era. The difference between the two is that China is still continuing its high growth at an average of more than 10 percent. During a period of high growth, the supply of labor from rural agricultural areas is one of the key factors. If we compare the urban population ratios of Japan and China from this perspective, the current ratio for China is about the same as that of Japan during high growth era of the 1960s.[2] The automobile diffusion ratio for China has also reached about the same level as that of Japan in the 1960s, which indicates a consumption boom owing to improvements in income level. Based on such simple comparisons, China's high economic growth is likely to continue for the time being.

However, one of the important prerequisites for maintaining high growth is to avoid the formation of a bubble. The authorities in China are well aware of this. I would then like to share my understanding on how the bubble was formed in Japan in the latter half of the 1980s. It was a phenomenon that arose from the complicated interaction of the following factors.

The first factor was the overconfidence that became so pervasive throughout Japan. Japan's growth rate gradually declined after its high growth era ended in the early 1970s, and yet growth rates remained far greater than those of other advanced economies up until the 1980s. Inflation rates were quite subdued, and therefore, Japan boasted of itself being an honor student. It may sound like a joke, but there were even calculations in the late 1980s that the land value of the Tokyo metropolitan area alone was sufficient to purchase the whole United States. This economic background fostered overconfidence, and increased the aggressive behavior of many economic entities.

The second factor was the lack of a sufficiently prudent financial supervision. Financial institutions considerably increased their lending to the real estate, construction, and non-bank sectors, and loosened their underwriting standards on loans, including collateral evaluation. As a result, the exposures of the financial institutions' portfolios became extremely vulnerable to fluctuations in land prices.

The third factor was the prolonged accommodative monetary policy. However, it is not so meaningful to simply state that monetary easing was one of the factors that contributed to the bubble. We need to examine in depth the social and economic background as to why monetary easing was continued for such a prolonged period. One of the reasons is the continuance of the low inflation rate. Another reason is that Japan had been under strong external pressure to squeeze its current account surplus. In order to reduce its current account surplus, Japan needed to expand domestic demand, and strong arguments developed around implementing accommodative monetary policy. Even after the economy had improved, concerns were often expressed, mainly by exporting firms, regarding the appreciation of the yen. These factors stood in strong opposition to withdrawing the accommodative monetary policy.

---

2 For the comparison of development phases in Japan and China, for instance, see Muto, Matsunaga, Ueyama, and Fukumoto (2010), "On the Recent Rise in China's Real Estate Prices," *Bank of Japan Review Series*, No. 10-E-3.

If there are lessons for high-growing emerging economies to learn from Japan's experience, which might help them avoid a bubble, these can be summarized in the following three points. First, society, as a whole, needs to maintain a sense of discipline in order to avoid overconfidence, particularly in times of high growth. Second, I put an emphasis on the importance of the financial regulation and supervision. Especially given that each bubble is different, it is absolutely essential to have a supervisory framework from the perspective of macro-prudence to accurately grasp the overall risk. Third, monetary policy has to aim at domestic stability, which amounts to sustainable economic growth under price stability. We must bear in mind that focusing on foreign exchange rates and current accounts can be detrimental to the stability of the domestic economy.

Financial and capital market developments under the "two-speed recovery"

Let us now move on to my third point in making projections for the global economy. The third point relates to issues arising in financial and capital markets owing to the "two-speed recovery." Currently, advanced economies, including Japan, are conducting extremely accommodative monetary policies to ensure their economic recovery. On the other hand, emerging economies are experiencing increasing capital inflows from advanced economies (Slide 12). These capital inflows mainly reflect the high growth prospects of emerging economies, together with the influence of interest rate differentials between advanced and emerging economies. A number of Asian emerging economies have observed their stock prices reaching new historical peaks (Slide 13). Real estate prices have increased at a substantial pace, and the rising trend in global commodity prices is also observed. In terms of the increase in asset prices, Hong Kong is no exception.

Given these circumstances, emerging economies have been expressing concerns over the accommodative monetary policy in advanced economies, as it could lead to overheating in their domestic economies and the emergence of a bubble, and further to a possible reversal of capital flows in the future. Advanced economies are, on the other hand, expressing concerns that the foreign exchange rates of emerging economies are less flexible, and this may eventually threaten global sustainable growth by enlarging global imbalances. For reference, the foreign reserve assets of Asian emerging economies dropped slightly immediately after the Lehman shock, but recovered again and increased dramatically (Slide 14).

How should we address this currency issue? Textbooks provide clear-cut answers, but have never sufficiently covered the variety of dilemmas that we have actually experienced in recent years, including carry trades, where low interest rate currencies are borrowed as a funding currency and invested in the financial assets of high-yield currencies. Even if the textbooks did provide us with clear-cut answers, these would not instantaneously help resolve the problems we face, as there are no binding powers to ensure their policy implementation across jurisdictions. In this regard, I would like to emphasize that a deep understanding of the textbook principles is important, but at the same time, thinking in a textbook manner alone is not sufficient.

Allow me now to confirm a very basic principle from the textbooks. Central banks in every jurisdiction bear the ultimate responsibility for the price stability and economic stability of their jurisdiction. Whether an advanced or an emerging economy, it is natural and legitimate for central banks to take accommodative monetary policy to be strengthened further or otherwise corrected, depending on each economic situation. In relation to exchange rate fluctuations, under the free movements of international capital, fixing the exchange rate would inhibit autonomous monetary policy. Therefore, if the capital inflows to the emerging economies are causing overheating, the textbook answer for them would then be either to accept the appreciation of the currency, or to tighten monetary policy in response to the extent that it affects domestic prices and economic activity.

This principle is indeed important. However, the textbooks we have do not consider the important economic reality at this moment, namely the zero interest rate bound and balance sheet adjustments. Given the zero interest rate bound, and given also that there are many economic entities exposed to balance sheet adjustments, it may be more difficult than in other circumstances for monetary easing policy to take effect through domestic economic entities. Rather, it tends to take effect through external channels, such as capital outflows and currency depreciation. The reality for those emerging economies receiving capital inflows is that, although the growth of their financial and capital markets may indeed have been remarkable in recent years, their markets are still small and less liquid compared with those of advanced economies. Hence, when there are large uncovered capital flows into the local currency stock and bond markets of emerging economies, the exchange rate and the price of securities tend to rise simultaneously. This further accelerates the inflows in a self-fulfilling manner, as speculative money seeks the capital gains of currency as well as securities. Such superfluous capital inflows force down domestic bond yields, creating downward pressure on the lending rates of domestic banks, and may lead to a rise in asset prices. Allowing the currency to appreciate may help to deter capital inflows, but if inflationary pressures were suppressed by such currency appreciation, the low interest rate period may be extended owing to the apparent stable price conditions, resulting in the inability to prevent the overheating of the economy and the creation of a bubble. This would suggest that currency appreciation is also not a panacea. In either case, if emerging economies experience the formation and the burst of a bubble, the influence will also rebound to advanced economies.

Several years ago, when Japan was implementing its quantitative monetary easing policy, there were criticisms from Asian colleagues that such a policy was promoting carry trades. There have been similar arguments, expressed even more vigorously, since the Federal Reserve recently implemented its large-scale asset purchase program. Although it is understandable for advanced and emerging economies to have their different views, what is essential for us is to acknowledge that we are all in the same boat when it comes to the globalized economy. There is as yet no clear-cut answer to these difficult issues, but I believe it is important that each jurisdiction embraces the following approach when implementing monetary policy.

First, advanced and emerging economies need to rethink the meaning of domestic stability of both prices and economic activity, before actually implementing monetary policy. Every central bank aims at ensuring domestic stability for its jurisdiction at any time. However, in order to attain this objective under circumstances of economic and financial globalization, it is becoming important for central banks to take into account the impact that their own monetary easing or lack of flexibility on foreign exchange rates might have overseas, as well as the feedback effects on their jurisdictions.

Second, it is also important to implement measures from a prudential policy perspective. In this regard, the Hong Kong Monetary Authority (HKMA) has sounded a warning since last year about the rapid increase in real estate prices, implementing a variety of policy measures, such as the lowering of the Loan-to-Value (LTV) ratio. These macro-prudential measures are particularly essential for Hong Kong, where a fixed foreign exchange rate regime has been adopted. An issue currently of global importance is how to design macro-prudential measures appropriate to the situation of each domestic economy and to the degree of development in financial markets.

IV. Economic development in Japan and other Asian economies

So far, I have expressed my views on the outlook for the global economy. Next, in the little time remaining, I would like to change the topic and talk briefly about economic developments in Japan, with particular reference to the economic relationship with other Asian economies.

The Japanese economy is facing a number of difficult challenges, as indicated by the declining trend of GDP growth rate. We, Japanese people, often tend to be rather self-reflective, which is also considered a virtue, but I feel that this tendency has been going too far recently. We should avoid being excessively either optimistic or pessimistic.

Therefore, I will start by emphasizing the strengths of Japan's economy. First, the growth rate of real GDP per worker in Japan, namely the growth rate of productivity, still bears comparison with that of the United States, although it is no longer what it once was (Slide 15). Second, Japan's financial system is sound. Looking back at the time of the Lehman shock in the fall of 2008, Japan's financial system was relatively more stable than those of the U.S. and European economies (Slide 16). Third, Japan has high technological competitiveness. For instance, Japan is at the global forefront of advances in environmental technology. Japan has also made advances, during the process of urbanization for example, in areas of high technology associated with infrastructure, including water supply, roads, railways, and harbors. Fourth, Japan has strong economic and historical ties with, and is geographically close to East Asian economies which together currently enjoy the most rapid growth in the world. Recent experience of the global economy suggests that, even in the age of globalization, the importance of geographic closeness still counts.

After highlighting these strengths of Japan's economy, I have to admit that it nonetheless faces many challenges. The most pressing challenge is, I think, coping with its demographic changes. Japan's working population has been declining since the latter half of the 1990s, and the number of workers has also shown a declining trend since 1998. Under these circumstances, I believe, the particularly important issues we have to deal with are maintaining a sustainable fiscal balance, and increasing the rate of participation in the elderly and female workforce.

Meanwhile, it is also vital that Japan continues to make efforts towards realizing the potential strengths that I mentioned earlier. Strengthening our cooperation with Asian economies is likewise crucial for this issue. Looking at the weight of East Asian economies in exports from Japan, it has increased from 30 percent in 1990 to 40 percent in 2000, and further up to 51 percent in 2009 (Slide 17). The weight of Asia in foreign direct investment from Japan has also been increasing steadily. As such, Japan's relationship with Asian economies has been deepening further. Economic strategy in Asia is one of the important pillars in the Japanese government's "New Growth Strategy" which was recently issued. As an example, I would like to mention again environmental technology. Japan was once plagued by low energy efficiency, which resulted in large fluctuations in the real economy as the energy price changed. This also caused serious environmental problems, including air and water pollution. In order to overcome these problems, mainly after the first oil shock, Japan made strenuous efforts to develop energy-efficient and environmentally-friendly technologies by bringing together both public and private sectors. As a consequence, energy unit efficiency in Japan has improved dramatically, and has become the most efficient in the world (Slide 18).[3] This has reduced the impact of resource price changes on domestic prices and the real economy while at the same time bringing environmental benefits, as there are now far fewer environmental disruption problems. The Asian emerging economies have much to improve in terms of environment, and I think there are many areas in which Japan can make a contribution.

In terms of cooperation with Asia, finance is an equally important area. In fact, one of the recent key strategies for major Japanese financial institutions has been the strengthening of their business activities in East Asian economies. Developing financial markets in the region is also an important policy issue. According to a BIS survey as of April 2010, global foreign

[3] According to the Agency for Natural Resources and Energy of Japan, the efficiency of Japan's energy consumption has improved by 37 percent during the past thirty years, and as a consequence, its total primary energy input per GDP became the lowest in the world.

exchange transactions increased by 20 percent compared with that of three years ago. Among them, the share of Asian currencies in foreign exchange transactions is only less than 4 percent (Slide 19). However, given the significant presence of Asian economies in trade in goods and services, this share is expected to increase much further. As such, developing financial markets is important for the Asian region. For instance, there are still limits on the number of Asian currencies that can be settled via the international foreign exchange settlement system called Continuous Linked Settlement (CLS). It is also our task to introduce cross-border collateral arrangements in the region that would enable central banks to supply local currency liquidity against collateral which are financial assets in other jurisdictions. In Asia, there are distinct international financial markets, including Hong Kong, Singapore, and Tokyo. What is expected of the market participants and monetary authorities in those financial markets is to support the overall efficiency and stability of the financial intermediary by being competitive and cooperative with each other. In this regard, I have the deepest respect for one of the HKMA's missions to promote and develop Hong Kong's financial market into an international financial center, and for the innovative policy stance the HKMA has taken.

V. Closing remarks

As time is running out, I would like to conclude my speech. The future of the global economy is currently fraught with uncertainty, and we are facing a variety of challenges. For both Hong Kong and Japan, whether our economies will be able to take a desirable path depends significantly on global economic developments. From the perspective of the outlook for the global economy, I have raised three issues today, namely balance sheet adjustments in advanced economies, growth potential of emerging economies, and debates on currency conflict. The exact nature of these issues will change considerably, depending on the policy responses of each jurisdiction. It is therefore important for policy authorities around the world to promote better understanding and to cooperate closely with each other.

Over the past decades, the world economy and financial markets have in fact been moving steadily towards globalization. However, at the same time, it is also true that we are still far away from perfect globalization. As typically observed in debates on currency conflict, the variety of challenges we are facing may reflect the complex reality of the global economy. Nevertheless, we need to make efforts to resolve these challenges. In this regard, the growing number of voices calling for reform of the international currency system seems to me a welcome development. At the same time, however, it is unrealistic to expect that such difficult challenges can be resolved in a short period of time. What is most important at this moment is the sincere commitment of each jurisdiction to learn the lessons of what others have experienced. There is much to be learned from this experience, particularly on issues relating to the formation and the bursting of bubbles, and on policy responses to financial crises.

Moreover, it is important for us to exchange frank views on the challenges we are facing. While listening to recent debates on currency conflict, I am often reminded of the word "sympathy" as used by a great economist Adam Smith in his first but continuously revised book, "The Theory of Moral Sentiments." What we need most fundamentally at this juncture is "sympathy" with each other, in Smith's meaning of the term, bearing the situation of other economies in mind. I believe the current "two-speed recovery" presents a perfect example of the importance of such "sympathy." We, the Bank of Japan, cooperating with other central banks and monetary authorities, should put all our efforts into ensuring sustainable economic growth under price stability, and the stability of the financial system.

Thank you very much for your attention.

Slide 1

Japan's "Silver Yen" and Hong Kong's "Silver Yuan" in the 19th century

Japan's Silver Yen

Hong Kong's Silver Yuan

Source: Currency Museum, Institute for Monetary and Economic Studies, Bank of Japan.

Slide 2

Hong Kong as an Important Trading Partner for Japan

Share of Japan's Exports by Country and Region (2009)

(%)

1	China	18.9
2	US	16.1
3	Korea	8.1
4	Taiwan	6.3
5	Hong Kong	5.5
6	Thailand	3.8
7	Singapore	3.6
8	Germany	2.9
9	Netherlands	2.3
10	Malaysia	2.2

Share of Japan's Exports of Agricultural, Forestry and Fishery Products by Country and Region (2009)

(%)

1	Hong Kong	22.2
2	US	16.4
3	Taiwan	13.1
4	China	10.4
5	Korea	10.3
6	Thailand	4.1
7	Singapore	2.8
8	Vietnam	2.7
9	Australia	1.2
10	Philippines	1.1

Source: Ministry of Finance, *Trade Statistics*.

Slide 3

Bank of Japan Representative Office in Hong Kong

Slide 4

IMF World Economic Outlook (October 2010)

Contribution to World GDP Growth (%)

	2009	2010	2011
World GDP growth (yoy)	-0.6	4.8	4.2
United States	-0.5	0.5	0.5
Euro area	-0.6	0.2	0.2
Japan	-0.3	0.2	0.1
Emerging Asia	1.5	2.4	2.2
Other countries	-0.6	1.4	1.3

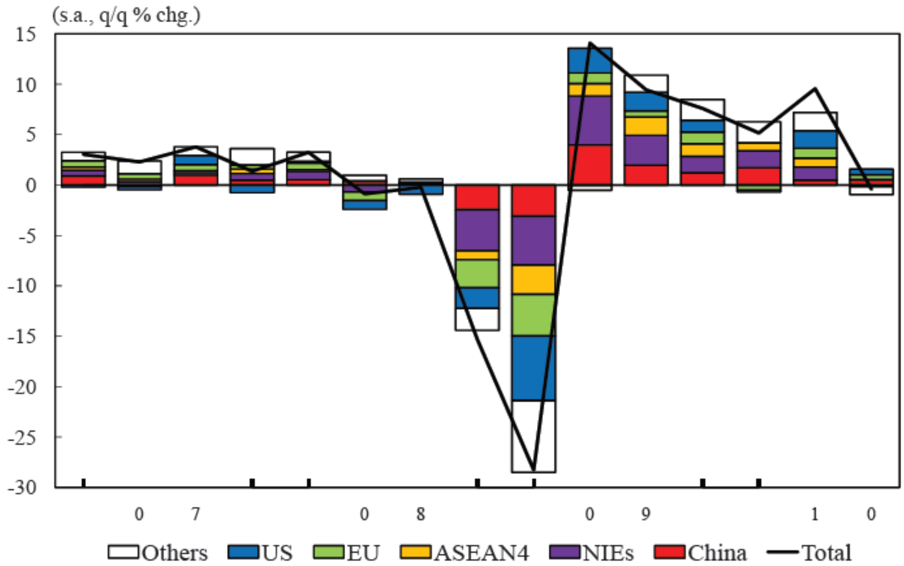
Notes: 1. Contributions to world GDP growth are calculated by the Bank of Japan staff.
2. Emerging Asia is here defined as China, India, Korea, Taiwan POC, Hong Kong SAR, Singapore, Thailand, Indonesia, Malaysia, the Philippines, and Vietnam.

Source: International Monetary Fund, *World Economic Outlook, October 2010*.

Slide 5

Japan's Real Exports

The recovery of Japan's real exports is mainly driven by Asian economies.

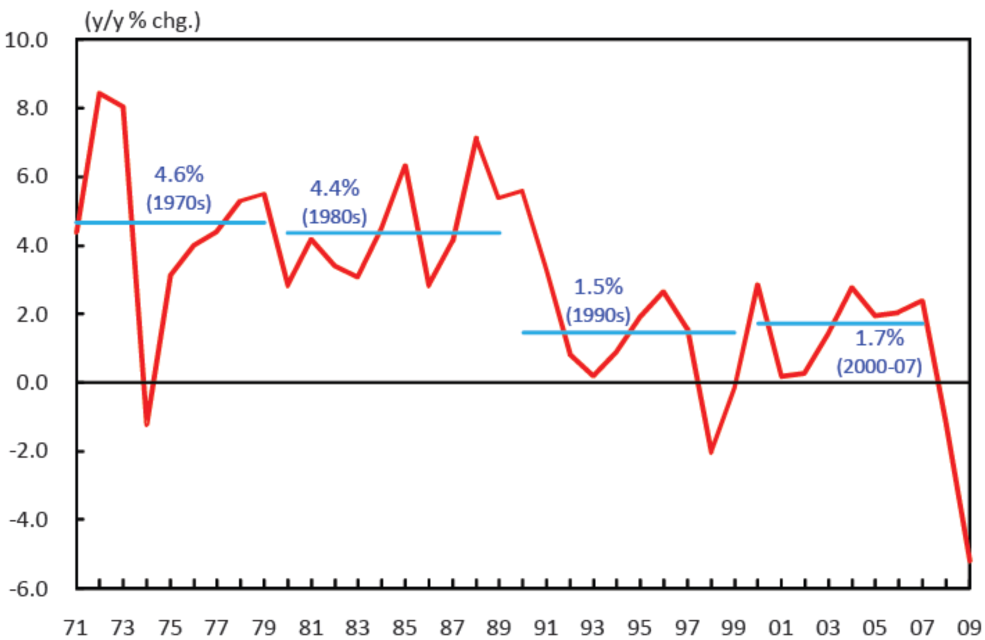


Note: NIEs includes South Korea, Taiwan, Hong Kong, and Singapore. ASEAN4 includes Thailand, Malaysia, the Philippines, and Indonesia.
Source: Ministry of Finance, *Trade Statistics*.

Slide 6

Japan's Economic Growth

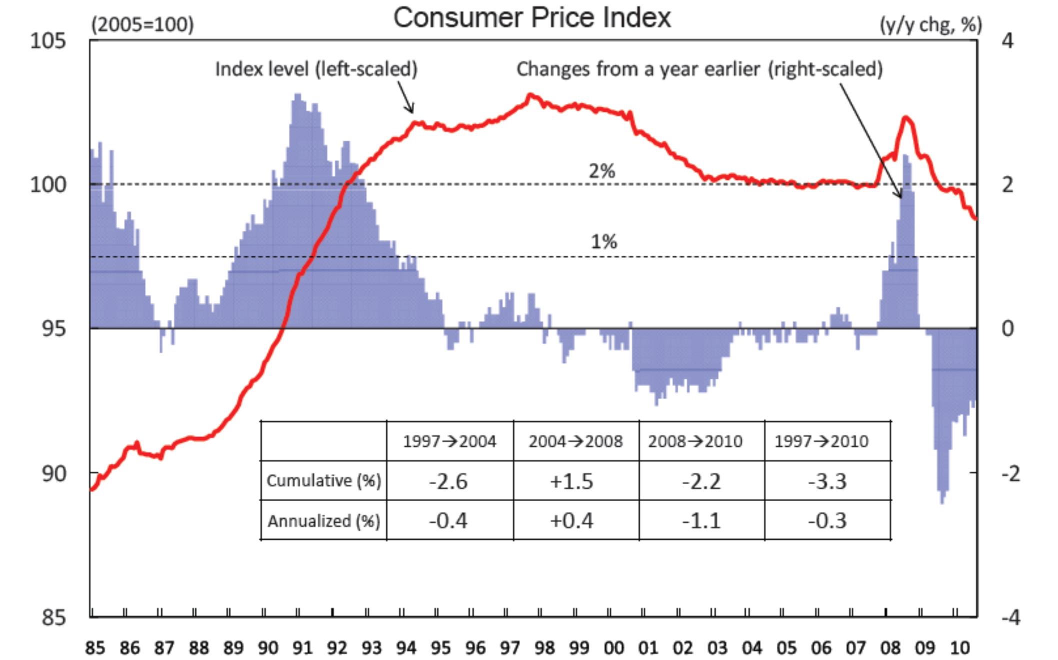
Economic growth decelerated significantly in the 1990s, called "Lost Decade."



Source: Cabinet Office, *Annual Report on National Accounts*.

Slide 7

Japan's Mild Deflation since 1998



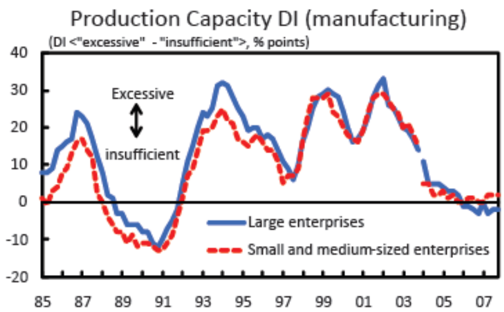
	1997→2004	2004→2008	2008→2010	1997→2010
Cumulative (%)	-2.6	+1.5	-2.2	-3.3
Annualized (%)	-0.4	+0.4	-1.1	-0.3

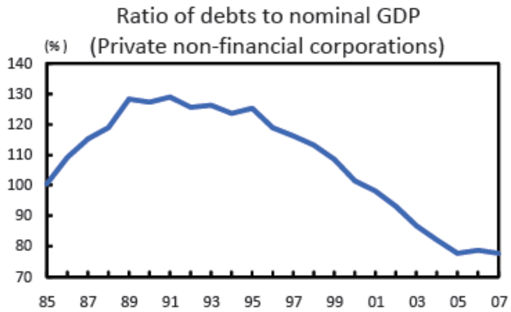
Note: Figures are adjusted for the impact of consumption tax, which was introduced at 3 percent in 1989, and raised to 5 percent in 1997.
Source: Ministry of Internal Affairs and Communications, *Consumer Price Index*.

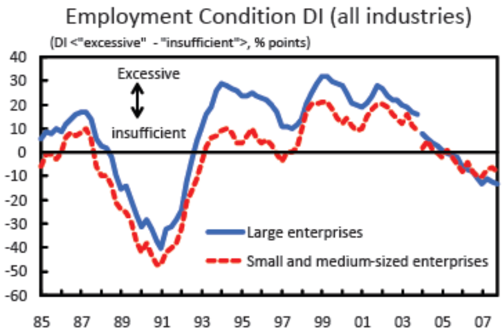
Slide 8

"Three Excesses"

Resolution of "three excesses" led to the full-fledged recovery.







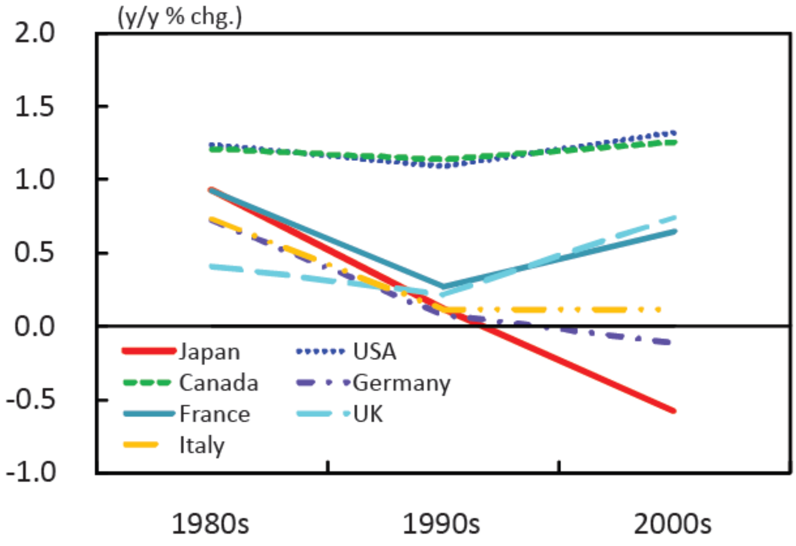
Notes: 1. The Tankan has been revised from the March 2004 survey. Figures up to the December 2003 survey are based on the previous data sets. Figures from the December 2003 survey are on a new basis.
2. Debts is the sum of loans and securities (other than equities) in private non-financial corporations.

Sources: Cabinet Office, *Annual Report on National Accounts*; Bank of Japan, Bank of Japan, *Tankan*, *Short-Term Economic Survey of Enterprises in Japan*, *Flow of Funds*.

Slide 9

Labor Force Growth

Japan's declining trend in labor force growth is significant among G-7 countries.

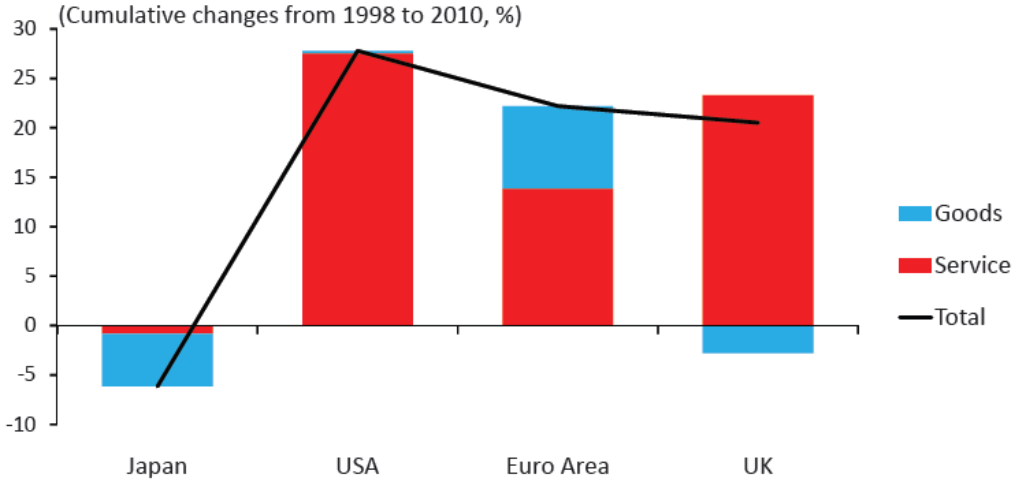


Source: Organisation for Economic Co-operation and Development.

Slide 10

Consumer Price Index in Terms of Goods and Services in Advanced Economies

Most of the distinction between Japan and other advanced economies can be explained by the difference in service prices.



Sources: Ministry of Internal Affairs and Communications, *Consumer Price Index*; Bureau of Labor Statistics, *Consumer Price Index*; Eurostat, *Harmonized Indices of Consumer Prices*; Office for National Statistics, *Consumer Price Index*.

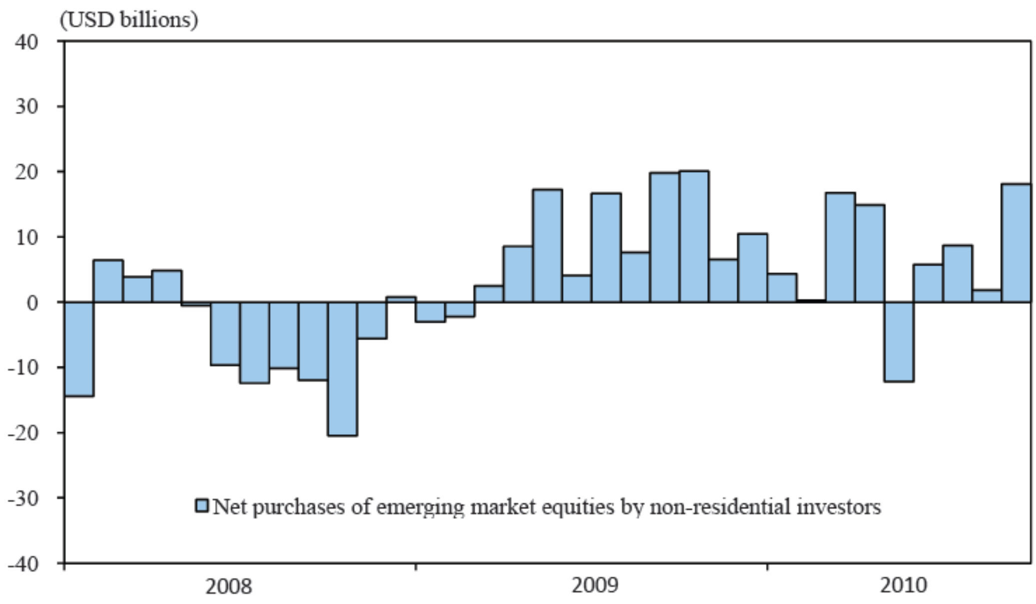
Slide 11

High Growth Era in Japan (mid 1950s-early 70s) and China (1990-2010)

Sources: Cabinet Office, *National Accounts*; National Bureau of Statistics of China, *National Accounts*.

Slide 12

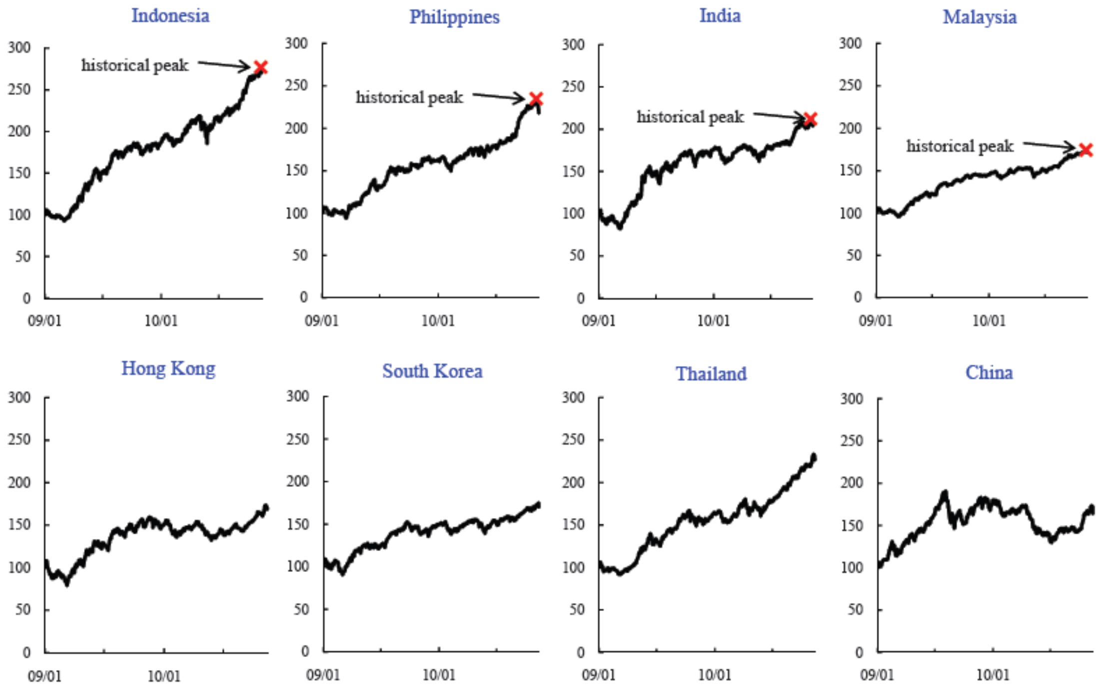
Equity Flow into Emerging Economies



Note: The figure above is the sum of net purchases of emerging market equities in India, South Korea, Taiwan, Indonesia, Thailand, the Philippines and Brazil.
Sources: Bloomberg, CEIC.

Slide 13

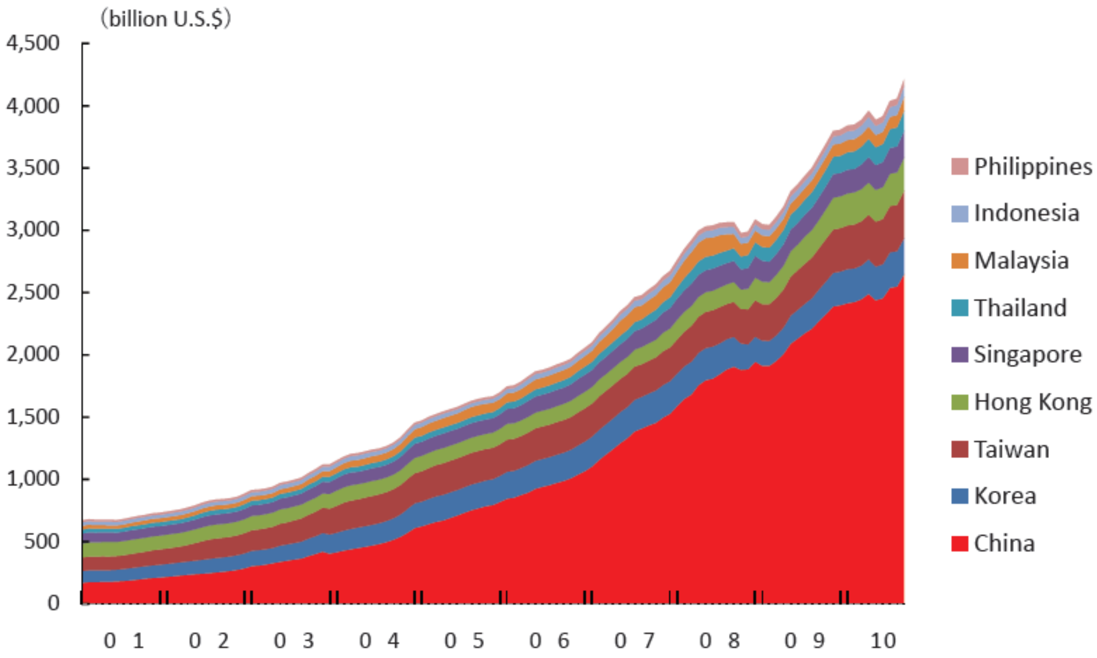
Stock Prices in Asian Emerging Economies



Source: Bloomberg.

Slide 14

Foreign Reserves in Asian Emerging Economies

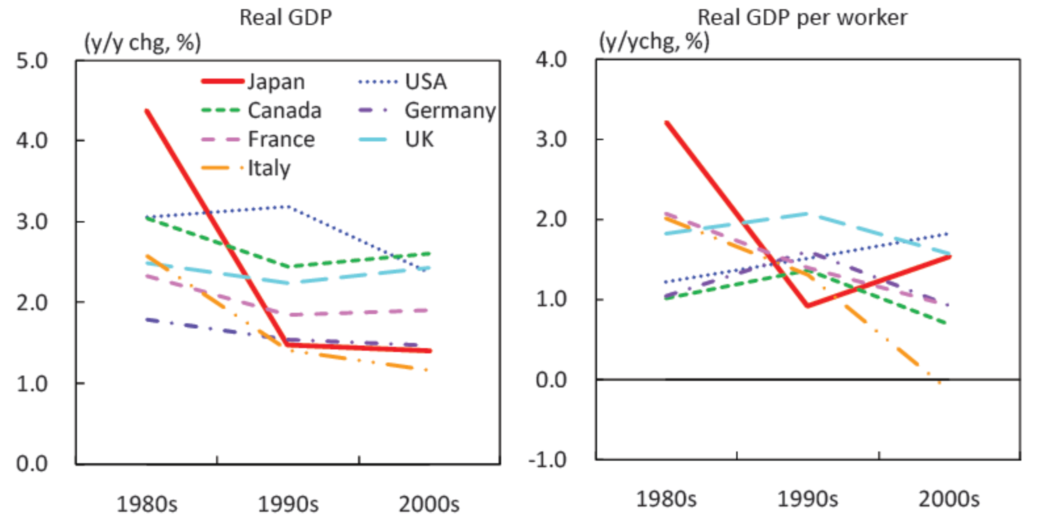


Source: CEIC.

Slide 15

Economic Growth in G-7 Countries

For real GDP growth, Japan slipped down to a lower-class in G-7 in the 1990s. Nevertheless, in real GDP growth per worker, Japan shows comparable performance to the US, even decelerated rapidly in the 1990s.

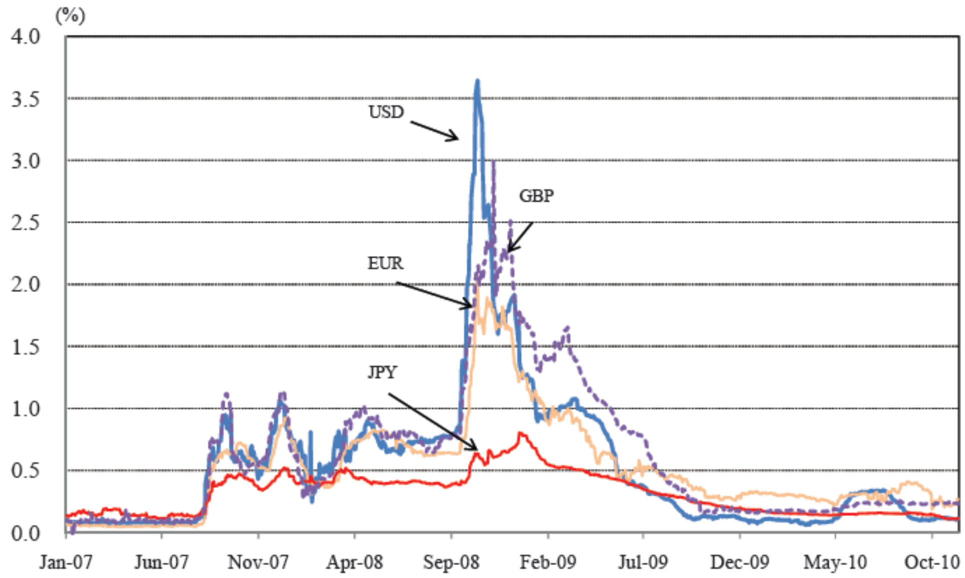


Notes: 1. The figures for Germany of the 1980s are those of West Germany. The figures for Germany for the 1990s are the average from 1992 to 1999.
2. The figures for the period 2000s are from 2000 to 2008.
Sources: Organisation for Economic Co-operation and Development and other governmental sources.

Slide 16

LIBOR-OIS spreads

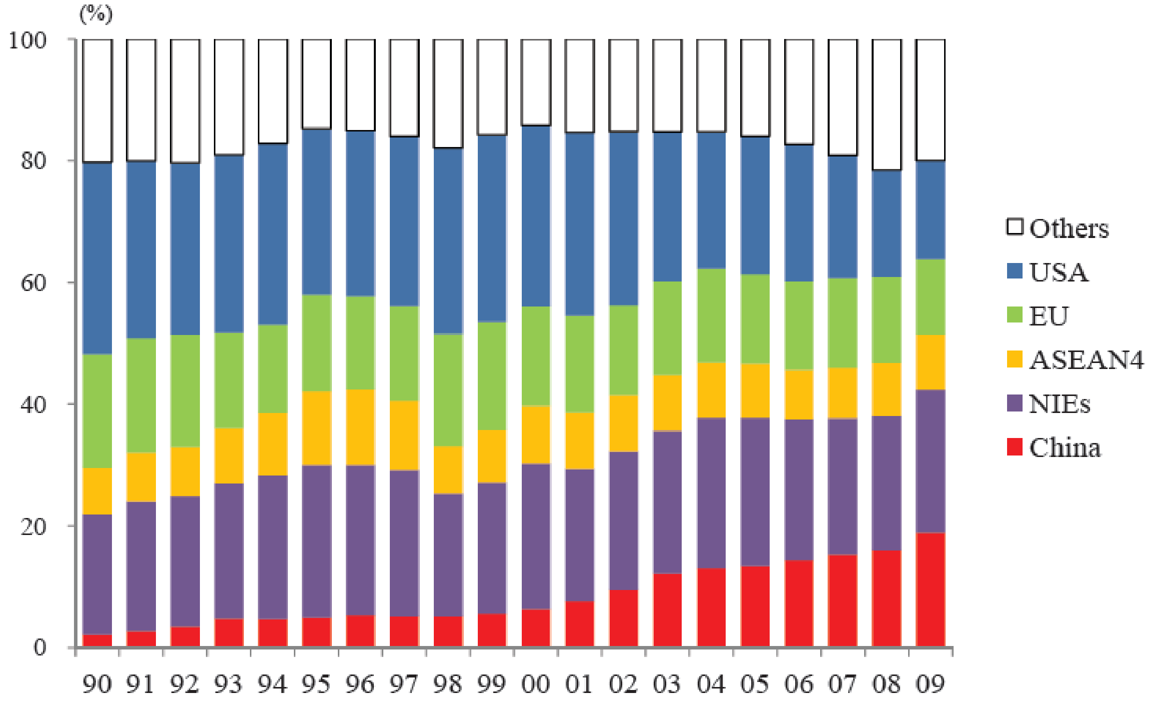
Japan's financial system was relatively stable during the financial crisis.



Note: 3 months.
Source: Bloomberg.

Slide 17

Shares in Japan's Exports by Country and Region

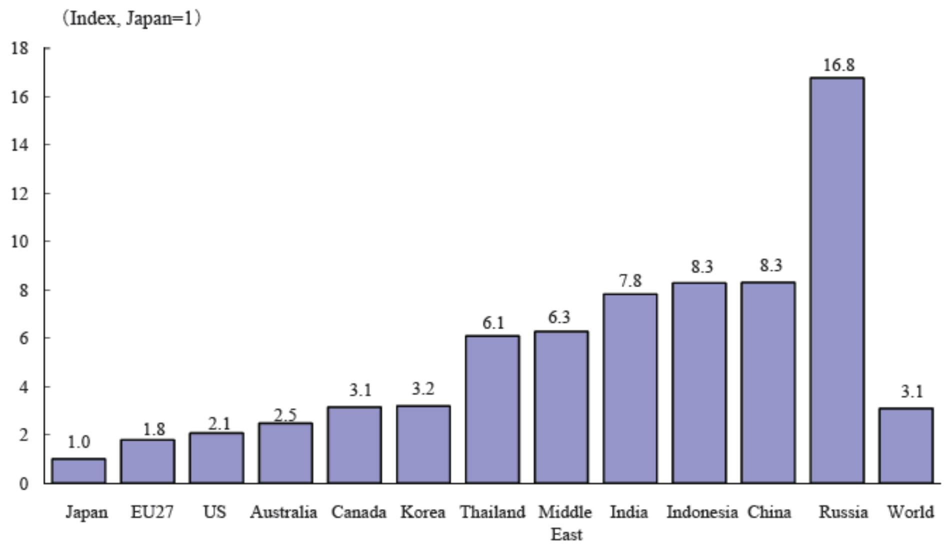


Note: NIEs includes South Korea, Taiwan, Hong Kong, and Singapore. ASEAN4 includes Thailand, Malaysia, the Philippines, and Indonesia.
Source: Ministry of Finance, *Trade Statistics*.

Slide 18

Total Primary Energy Input per GDP

Japan's energy efficiency is the highest in the world.

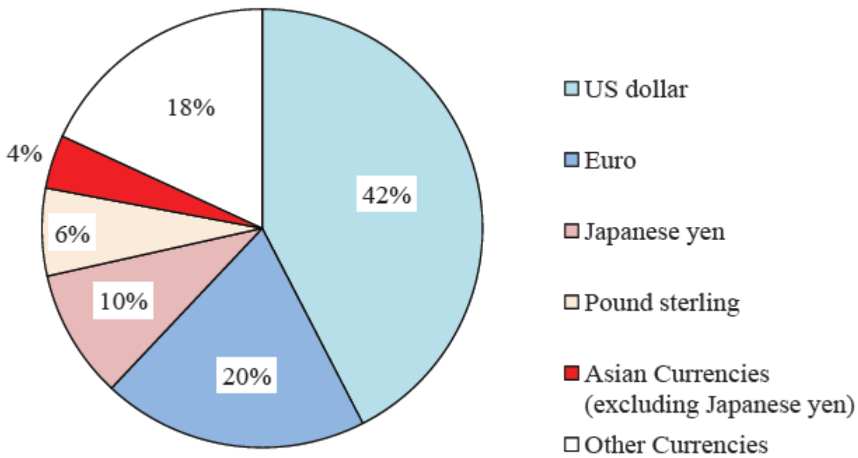


Sources: International Energy Agency, *Energy Balances of OECD Countries 2009 Edition*, *Energy Balances of Non- OECD Countries 2009 Edition*; Agency for Natural Resources and Energy, *Annual Energy Report FY 2010 (Japanese version)*.

Slide 19

Global Foreign Exchange Market Turnover

(Percentage shares of currency as of April 2010)



Note: Asian currencies include Hong Kong dollar, Korean won, Singapore dollar, Indian rupee, New Taiwan dollar, Chinese renminbi, Malaysian ringgit, Thai baht, and Indonesian rupiah.

Source: Bank for International Settlements, *Triennial Central Bank Survey*.