Sayuri Shirai: Recent global economic developments and monetary policy in Japan – strengthening Japan's growth momentum through opportunities in emerging Asia

Speech by Ms Sayuri Shirai, Member of the Policy Board of the Bank of Japan, at a meeting with business leaders, Akita, 10 May 2012.

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I. Introduction

Good morning, everyone. My name is Sayuri Shirai, and I am a Policy Board member of the Bank of Japan. I am delighted to be speaking to you today, representing as you do the administrative, economic, and financial communities in Akita Prefecture. And as well, I feel deeply honored to be able to exchange views with you about performance and other issues related to Japanese and overseas economies, particularly with regard to the developments in this region.

First, let me briefly outline the content of my presentation. I would like to begin by summarizing recent economic and price developments. These are described in great detail in the Bank's *Outlook for Economic Activity and Prices*, which was published last month and which I will refer to as the Outlook Report. In this first part of my presentation, I also wish to discuss matters regarding Japan's monetary policy and related developments. Following that, I aim to shed light on recent economic and financial developments in emerging economies, particularly in Asia – "emerging Asia." This is because I believe that this region could provide Japanese firms with an opportunity to increase the demand for their products and services. At the same time, emerging Asia has the potential to revitalize the Japanese economy, if economic relations between Japan and this region could be enhanced – not only in terms of trade and tourism, but also through cross-border financial movements.

II. Recent developments in economic activity, prices, and Japan's monetary policy

A. International financial markets and overseas economies

As we are all aware, strains in global financial markets intensified last summer, mainly owing to concerns about the European debt problem. However, since then the strains have eased somewhat, thanks to the following factors: (1) large-scale longer-term refinancing operations (LTROs) with a maturity of 36 months conducted by the European Central Bank (ECB); (2) coordinated action undertaken by the six central banks, including the Bank of Japan, to lower the pricing on existing temporary U.S. dollar liquidity swap arrangements by 50 basis points; and (3) achievement of orderly public debt restructuring between the Greek government and private creditors – and the subsequent second-round financial assistance from the European Union (EU) and the International Monetary Fund (IMF).

Under such improved circumstances, risk aversion among global investors has weakened compared with the second half of 2011, and positive market developments have been observed, including a pick-up in stock prices around the world. In the foreign exchange market, the yen has depreciated somewhat against both the U.S. dollar and the euro compared with around the end of 2011. Nonetheless, we should continue to monitor developments in international financial markets, including foreign exchange markets, since there still remains a high degree of uncertainty related to market conditions.

With regard to overseas economies, the pace of growth began to slacken in spring 2011. In recent months, however, some positive developments have been observed. The U.S.

economy continues to recover at a moderate pace. The sluggishness in the European economy remains strong mainly due to the effects of fiscal austerity measures. More recently, however, the economy generally stopped deteriorating further as financial markets have regained some stability. In the case of emerging and commodity-exporting economies, the relatively high growth has on the whole been maintained since domestic demand has been solid, and exports to advanced economies appear to have recovered.

B. Developments in economic activity and prices in Japan: present conditions and outlook

We all recall how the Great East Japan Earthquake undermined the Japanese economy and caused serious damage to supply chains in the manufacturing sector. With the restoration of supply chains, Japan's economic activity picked up steadily, though that recovery lasted only until autumn 2011. From the second half of fiscal 2011, economic activity remained more or less flat mainly due to an adverse effect on exports and production of the slowdown in overseas economies and the appreciation of the yen. More recently, however, it has become increasingly evident that the economy is shifting toward a pick-up phase, although economic activity has remained more or less flat (Chart 1).

As for the outlook, the Japanese economy is expected to return to a moderate recovery path in the first half of fiscal 2012. This is a likely scenario, since the pace of recovery in overseas economies should pick up – led largely by the emerging and commodity-exporting economies – and reconstruction-related domestic demand after the Great East Japan Earthquake should gradually strengthen. In fiscal 2013, the economy is expected to continue to grow at a pace above its potential, as overseas economies continue to achieve relatively high growth. However, the economic growth rate is expected to be somewhat lower than that in fiscal 2012 because the positive effects from reconstruction-related domestic demand are likely to gradually diminish (Chart 2).

With regard to prices, developments in the consumer price index (CPI; for all items less fresh food) indicate that after reaching a historical trough of 2.4 percent in August 2009, the year-on-year rate of decline has continued to slow consistently since around the end of 2009. In recent months, that rate of change has been at around 0 percent. In terms of the outlook for prices, the rate of change will remain in positive territory and show a gradual increase as the aggregate supply and demand balance is expected to continue improving with the moderate recovery. International commodity prices are likely to follow a moderate rising trend owing to an expected increase in demand for food and energy in line with the growth in emerging economies. Assuming that medium- to long-term inflation expectations remain stable, the rate of change in the CPI is projected to gradually rise to a range of above 0.5 percent and less than 1 percent toward the second half of fiscal 2013. Thereafter, it will likely be not too long before the rate reaches the Bank's "price stability goal in the medium to long term" of 1 percent for the time being, as specified in the Bank's statement released in February (Chart 2).

Comparing the current projection for real GDP growth rates with that in the January 2012 interim assessment, the rate of growth for fiscal 2012 is likely to be higher than initially assessed. This reflects an improvement in the financial markets driven by the reduced tail risk associated with the European sovereign debt crisis. Comparing the current CPI projection with that in the January 2012 interim assessment, the rates of change for fiscal 2012 and 2013 are also likely to be somewhat higher than originally assessed. This is partly because the upwardly revised economic projection is expected to improve the aggregate supply and demand balance. The correction of the sharp appreciation of the yen and a rise in crude oil prices also contributed to the upward revision in the CPI projection.

C. Upside and downside risks

The aforementioned outlook is the scenario the Bank considers to be the most likely – in other words, its baseline scenario. As described in detail in the Outlook Report, the following four major risks concerning the outlook for economic activity warrant attention: (1) uncertainty related to developments in overseas economies; (2) uncertainty with regard to reconstruction-related domestic demand; (3) uncertainty associated with firms' and households' medium- to long-term growth expectations; and (4) issues related to Japan's fiscal sustainability.

Among developments in overseas economies, various challenges remain in Europe. Though the tail risk of global financial market turmoil causing a significant global economic downturn has decreased, the fundamental cause of such a risk has not been resolved. There is a possibility that strains in global financial markets will once again intensify if concerns reemerge about implementing fiscal and structural reforms, especially in the peripheral European countries. If such strains reemerge, they are likely to act as a downside risk to the global economy – and thus to the Japanese economy. Moreover, given that there is a high degree of uncertainty surrounding the progress in households' balance-sheet adjustments, the prospects for the U.S. economy also present some downside risk. It is possible that the pace of its economic recovery will remain more moderate than expected.

Regarding risks associated with prices, there are mainly two types. The first risk concerns developments in firms' and households' medium- to long-term inflation expectations; the second risk relates to developments in import prices. With this second risk, there is a possibility that crude oil prices will surge mainly reflecting geopolitical risk. If that does occur, there will be a deterioration in Japan's terms of trade, which will squeeze firms' profits and reduce households' purchasing power, ultimately having an adverse effect on the whole Japanese economy.

D. Conduct of monetary policy

The Bank is naturally concerned about the long-term prevalence of deflation in the Japanese economy. To help the economy overcome deflation, comprehensive monetary easing was introduced in 2010 by establishing the Asset Purchase Program. Subsequently, monetary easing has gradually been enhanced through expansion of the Program.

On February 14 of this year, the Bank introduced "the price stability goal in the medium to long term," which is defined as the inflation rate consistent with price stability sustainable over the medium to long term. The purpose of this action was to promote public understanding of the Bank's determination to overcome deflation. It was decided that the goal would be "within a positive range of 2 percent or lower in terms of the year-on-year rate of change in the CPI," and the goal was set at 1 percent for the time being. Moreover, the Bank made it clear that it would continue pursuing powerful monetary easing – through its virtually zero interest rate policy and continued implementation of the Program – until it judged the 1 percent goal to be in sight, on condition that it identified no significant risk to the sustainability of economic growth, including from the accumulation of financial imbalances. At the same time, the total size of the Program was raised by 10 trillion yen, from about 55 trillion yen to about 65 trillion yen (Chart 3).

On April 27, the Bank decided to increase the total size of the Program further by about 5 trillion yen, from about 65 trillion yen to about 70 trillion yen with the following changes in its composition. First, the purchase of Japanese government bonds (JGBs) was increased by about 10 trillion yen. Second, the purchases of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) were raised by about 200 billion yen and 10 billion yen, respectively. Third, the maximum outstanding amount of the Bank's fixed-rate funds-supplying operation against pooled collateral with a six-month term was reduced by about 5 trillion yen, taking into account the recent episodes of undersubscription. And fourth, the remaining maturity of JGBs to be purchased under the Program was extended from "one to two years" to "one to three years." The same treatment was applied to the remaining maturity of corporate bonds to be purchased under the Program. In addition, it was decided that the schedule for increasing the outstanding amount of the Program to about 65 trillion yen by around the end of 2012 would be maintained. It was further decided to increase the outstanding amount of the Program to about 70 trillion yen by around the end of June 2013.

Now, given that the outlook for the performance of economic activity and prices has not been adjusted downward compared with the January 2012 interim assessment, some may argue that the timing of the Bank's action at this time was questionable. On this point, I would like to stress that there remains a high degree of uncertainty surrounding the assessment, as already explained. The positive signs in economic and price developments that have emerged in recent months do not necessarily imply that the baseline scenario will be realized as projected. Even though the scenario may eventually materialize, it is still not certain how soon it may do so. Considering recent episodes, for example, there were some cases where the baseline scenario was not fulfilled, even though the economy appeared to be on the track of sustainable economic growth and prices also initially appeared to be rising steadily. Therefore, the Bank decided to seize this occasion and further enhance monetary easing to better ensure the return of the Japanese economy to sustainable growth with price stability. I believe this action also demonstrates the Bank's determination to implement its monetary policy commitment, as explained earlier.

In order to overcome deflation, however, it is important to stress the need to address Japan's long-term structural challenge of declining trend growth rates amid rapid population aging. To meet this challenge and establish a new basis for economic growth, firms need to become more innovative and competitive in an effort to add value to their activities and explore new sources of demand both at home and abroad. The government also needs to support the business community by creating a more business-friendly environment. Financial institutions should make further efforts to strengthen the foundations for economic growth by giving financial support to innovative and viable firms and providing new types of financial and other services, which are increasingly being demanded.

Meanwhile, the Bank's accommodative monetary policy will certainly support such private-sector activities through a steady decline in the cost of raising capital. By promoting longer-term economic growth, the Bank has supported the business community indirectly: it introduced the fund-provisioning measure to support strengthening the foundations for economic growth (the Growth-Supporting Funding Facility) in 2010, and it has provided longer-term fixed-rate funds to financial institutions. This facility was expanded in March and April of this year (Chart 4). It should be emphasized that the goal of overcoming deflation will be achieved through such continuous, comprehensive efforts by firms, financial institutions, the government, and the Bank within their respective roles.

III. Changing economic features of advanced and emerging economies

As already mentioned, I believe that overcoming deflation in Japan requires policies and private-sector initiatives to promote economic growth in addition to the Bank's accommodative monetary policy. In line with this view, I would like to explain the importance of emerging economies as a potential source for generating economic growth in the Japanese economy.

A. Growing presence of emerging economies

The Japanese economy has confronted a series of large-scale shocks in recent years. Among them, the global financial crisis of 2008–09 presented the greatest shock to both the global and Japanese economies, causing a rapid shrinking in production and trade around the world. In response, it was agreed at the G20 Summit that coordinated policy actions would be conducted to quickly stabilize financial markets and prevent the global recession from deepening further. Thus, central banks and governments collectively reacted to the crisis with liquidity injections into the financial sector, bailouts, and fiscal stimulus packages. Since these accommodative policies helped stimulate both domestic and overseas demand, the global economy succeeded in avoiding a deep recession like that of the Great Depression in the 1930s, and the average rate of global growth dropped by only 0.7 percent in 2009.

What has become evident after the global financial crisis is that the overall economic performance of emerging economies has been better than that of advanced economies. Advanced economies were formerly viewed by emerging economies as role models. They were highly respected and deemed worthy of emulation, because advanced economies had already achieved a higher level of living standards and produced numerous firms with advanced skills, management styles, and knowledge. Their macroeconomic performance also used to be regarded as relatively stable, as exemplified by low, stable inflation and sound government fiscal positions. Advanced economies were also equipped with well-developed legal and judiciary systems and mature democratic societies. Most of these features are unchanged today, but there is a growing view among emerging economies that the path toward economic and social development need not be the one adopted by advanced economies: alternative approaches can be explored according to a particular country's conditions and history.

B. Features of emerging economies

I would now like to highlight four features that have developed in emerging economies since the occurrence of the global financial crisis.

B-1. Impressive growth-generating power

The economic size of emerging economies is rapidly expanding. As a result, they are increasingly functioning as an engine of global growth. Based on IMF data, for example, the purchasing power parity (PPP)-adjusted share of global GDP of advanced economies dropped from a high level of 63 percent in 2000 to 51 percent in 2011. By contrast, that of emerging economies rose from 37 percent to 49 percent over the same period (Chart 5). China stands out among the emerging economies. It has exhibited an impressive performance, having doubled its share of the global GDP from 7 percent in 2000 to 14 percent in 2011. India follows China, with its global GDP share having jumped from 3.7 percent to 5.7 percent over the same period. Brazil ranks third in terms of economic size after China and India, but its global GDP share was unchanged at around 3 percent over that period. Thus, it can be stated that emerging Asia has made more impressive progress than emerging economies in other regions.

The rapid growth of emerging economies implies that their growth-generating power is greater than that of advanced economies. This can be grasped by considering historical movements in real GDP growth rates. Here, the period of 2000–11 will be divided into two sub-periods – before and after the 2007 global financial crisis – namely, 2000–07 and 2007–11. It is evident that the difference in average growth rates between emerging and advanced economies increased from 3.9 percent in 2000–07 to 5.3 percent in 2008–11.[1]

[1] It is true that the growth rate for emerging economies has declined during this period, but their average growth rate decreased only modestly – from 6.5 percent in 2000–07 to 5.6 percent in 2008–11. Among them, China's growth rate declined only from 10.5 percent to 9.6 percent over that period, and it still exhibits one of the highest economic growth rates in the world. In the case of India, its rate showed an increase of 7.1 percent to 7.7 percent over this period. Like India's, the growth rate of Brazil rose from 3.5 percent to 3.8 percent during this period. Overall, the growth performance in emerging economies, particularly those of Asia, is impressive.

This growing gap is mainly attributable to the decline in the average growth rate of advanced economies. Their average rate of growth almost reached minus 4 percent in 2009; though their subsequent growth became positive, it has remained modest (Chart 6). In Japan, the average growth rate in the pre-crisis period reached 1.5 percent, but it dropped to minus 1 percent following the crisis. In particular, its economic activity plunged by 5.5 percent in 2009. Japan managed to achieve a 4.4 percent growth rate the following year, but the country then suffered further blows in 2011: the Great East Japan Earthquake and flooding in Thailand caused serious damage to supply chains in the manufacturing sector mainly through a sharp curtailment of production and exports. In the United States, the average growth rate dropped from 2.6 percent in the pre-crisis period to 0.2 percent following the crisis. The U.S. economy experienced its sharpest decline of 3.5 percent in 2009, though it has since displayed modest but positive growth.

B-2. Favorable fiscal performance

Emerging economies enjoy a relatively favorable fiscal position, and in sharp contrast to advanced economies they have continued to show an improvement in this regard. This may indicate not only that the likelihood of succumbing to a sovereign debt crisis in the near future has declined for emerging economies, but also that they have some room to adopt an accommodative fiscal policy in the downturn phase of the economic cycle. According to IMF data, the fiscal deficit as a share of GDP jumped from 1.5 percent in 2001 to 6.5 percent in 2011 among advanced economies; among emerging economies, however, this deficit was reduced from around 2.8 percent to under 2 percent over the same period (Chart 7). Similarly, the public debt-to-GDP ratio for advanced economies rose from 73 percent in 2000 to 104 percent in 2011, but emerging economies managed to reduce the size of this ratio from 49 percent to 36 percent over the same period (Chart 8).

Above all, China's fiscal position has remained relatively solid: its fiscal deficit-to-GDP ratio dropped from 3.3 percent in 2000 to 1.2 percent in 2011, and its public debt-to-GDP ratio rose from only 16 percent to 26 percent over the same period.[2] Despite its prolonged fiscal deficit performance, India also managed to reduce its deficit ratio from 10 percent in 2000 to 8.7 percent in 2011; it decreased its public debt ratio from 72 percent to 68 percent over the same period.[3] By contrast, Japan's fiscal position deteriorated: its deficit ratio grew from around 7.5–8.0 percent in 2000 to 10 percent in 2011, and its public debt ratio increased from 140 percent to 230 percent over the same period. This debt figure is the largest among advanced economies.

B-3. Rising capital inflows from the rest of the world

From a consideration of cross-border capital flows, it is notable that private-sector capital flows to advanced countries in the EU have dropped, while those to emerging Asia and Latin America have grown (Chart 9). Private-sector capital inflows consist largely of foreign direct investment (FDI), portfolio investment, and such other forms as loans and deposits. Private-sector capital inflows to emerging economies are concentrated in portfolio investment, followed by FDI. In recent years, there has in addition been an increase in capital inflows in terms of other items.

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[2] The National Audit Office of the People's Republic of China reported that the country's local government debt accounted for around 27 percent of GDP last year. Some observers believe that China's actual public debt is greater than the officially reported figure and that the debt-to-GDP ratio should stand at around 55 percent. However, this ratio still remains well below that of advanced economies.

[3] As for other emerging economies, it has been reported that upgradings of Indonesia's sovereign debt by some credit-rating firms to investment grade around the end of 2011 has attracted the attention of global investors, including pension and insurance funds.

Asian emerging economies face a more rapid pace of capital inflows than emerging economies of other regions. From 2000 to 2011, the amount of capital inflows to emerging Asia showed an 8.8-fold expansion. This growth is greater than that for emerging Latin American economies, whose capital inflows showed only a 4.6-fold increase over the same period. As a result, capital inflows to emerging Asia as a share of total capital inflows to emerging economies rose impressively from 32 percent in 2000–02 to 48 percent in 2011. Latin America lost its leading position in terms of total capital inflows, with its share dropping from 37 percent to 29 percent over the same period.

An increase in capital flows to emerging economies indicates that these economies are becoming important capital importers. This trend can be attributed to their continued high economic growth, as well as the presence of a large number of potential investment projects and high demand for credit, which reflects the development stage of their economies. This explanation is supported by the fact that returns on investments to emerging economies have been higher than those on investments to advanced economies (Chart 10).

B-4. Gradually evolving external investment activities

While it is true that emerging economies are major importers of private-sector capital inflows from around the world, one feature is becoming increasingly evident in emerging Asia: once figures on overseas investment by the monetary authorities and government are added to cross-border capital flow data, it is seen that these economies are also becoming important capital exporters. This suggests that the amount of capital outflows exceeds that of capital inflows in emerging Asia, thereby transforming it into a net capital exporter.

In the past, advanced economies played the role of net capital exporters as a result of abundant capital and relatively limited domestic demand for credit. By the middle of the 2000s, however, this situation had changed, as some emerging economies shifted from being net capital importers to exporters. In particular, it is remarkable to note that China has become the largest net capital exporter in the world, followed by Japan and Germany. In other words, China – even though its per capita income is below 8,000 U.S. dollars and thus its income level is regarded as medium – exports more capital than Japan and Germany, whose per capita income of over 30,000 U.S. dollars marks their status as high-income nations. In addition, China is becoming a major financier of advanced economies, such as the United States. In Asia, many economies – including Hong Kong, Indonesia, Malaysia, Singapore, the Philippines, and Thailand – have, like China, also become net capital exporters.

IV. Strengthening Japan’s growth momentum through growth opportunities in emerging Asia

A. Deepened economic relations between Japan and emerging Asia

I have pointed out that emerging Asia has many favorable features relative to advanced economies. I would now like to emphasize how Japan has already begun deepening its economic relations with these economies. Indeed, Japan’s trade value with emerging Asia exceeds that with the United States and Europe. Specifically, China has become Japan’s top trade partner. At the same time, Japan’s trade relations with the Association of Southeast Asian Nations (ASEAN) and South Korea have been rapidly developing. I would like to stress that emerging Asia is not only important to Japan as a trade partner, but also is becoming essential as a tourism partner. According to data released by the World Tourism Organization (UNWTO), Germany, the United States, and China are among the countries with a large overseas tourism expenditure. These days, Chinese tourists are commonly encountered in many places in Japan. There is no doubt that China is becoming one of the most important importers of Japan’s tourism services.

In addition to trade and tourism, cross-border capital flows have quickly expanded between Japan and emerging Asia, especially in the form of FDI. Therefore, I would like to address now the possibility of making use of rising growth opportunities in emerging Asia by activating cross-border capital flows with a view to increasing trend growth rates and revitalizing the Japanese economy. This presentation will proceed with the issue of FDI, followed by portfolio investment and banking activities.

B. Expanding FDI flows between Japan and emerging Asia

With the growing number of middle- and high-income consumers, emerging economies have experienced an increase in domestic demand, and thus the markets for goods and services have expanded. Japanese firms have made efforts to provide such goods and services. They are able to meet such demand if they modify their production capacity to satisfy the specific needs and conditions that exist in various emerging economies by establishing locally based production, marketing, and sales networks. In this regard, Japan's outward FDI has rapidly expanded over recent years. Data released by the United Nations Conference on Trade and Development (UNCTAD) indicate that Japan's outward FDI grew by 105 percent year on year to 115.6 billion U.S. dollars in 2011.[4]

By region, FDI to emerging Asia grew by 63 percent year on year to 3 trillion yen in 2011 (Chart 11).[5] In very recent years, Japan's outward FDI to the ASEAN countries – especially to Thailand, Indonesia, and Vietnam – has exceeded that to China. Japan's FDI to Thailand has been concentrated in the areas of electrical machinery, general machinery, and iron and nonferrous metals. After the severe flooding in Thailand at the end of last year damaged production facilities in a number of Japanese-operated industrial zones, Japanese firms have boosted FDI into Thailand to restore their production and export capacity. Japan's FDI to Indonesia has been increasing in the transportation machinery sector thanks to Indonesia's rapidly growing demand for automobiles. In the case of Vietnam, where labor costs are lower than in neighboring emerging economies, Japan's FDI has undergone expansion in the electrical machinery sector. Regarding China, Japan's FDI has traditionally centered on the manufacturing sector; however, recently it has grown in the wholesale and retail sectors, as well as the real estate sector, mainly in provincial cities in the process of urbanization. In India, Japan's FDI has not undergone a rapid increase despite strong interest on the part of Japanese firms; this is because the slow administrative approval process for investment projects and a shortage of industrial sites are believed to act as obstacles.

In addition to Japan's outward FDI, it is equally important to examine its inward FDI with a view to making use of rising growth opportunities in emerging Asia. Inflows of FDI to Japan may provide the opportunity to promote innovation and thus revitalize the domestic economy. The level of Japan's inward FDI from emerging Asia has been positive over the past five years, although the value declined moderately in 2011 compared to the previous year (Chart 12). Singapore, whose FDI is concentrated in the construction sector, is the largest supplier of FDI to Japan. In addition, FDI from South Korea has maintained positive growth rates since 2005. Investment from Hong Kong and China to Japan has also remained solid. A major Japanese electronics producer sold some of its electrical appliance operations to a

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4 Over half of this figure reflects large-scale M&A activity conducted by a major Japanese pharmaceutical firm. Therefore, outward FDI may not continue at this magnitude in the future.

5 Some observers have pointed out that expansion of outward FDI promotes the hollowing-out of Japanese industry and reduction of employment opportunities in Japan. However, it is equally possible that outward FDI will lead to an increase in production and employment in Japan if establishing global-level production and sales networks increases demand for goods and services produced by Japanese firms. In addition, achieving a global-level division of labor and increased sophistication of domestic industry as a result of reorganizing firms may enhance the international competitiveness and revenue-generating power of those firms.

large Chinese electronics firm this year. Last year, a Chinese computer manufacturer formed a personal computer joint venture with a Japanese computer-manufacturing firm.

Such moves may reflect cross-border M&A activities in the face of tougher global competition and the need to promote corporate restructuring and reorganization. FDI inflows to Japan have also been witnessed in the area of medical and welfare services – where the potential demand is high due to the rapidly aging society – as well as in energy-saving and environment-friendly businesses. Nonetheless, the scale of Japan's inward FDI remains roughly one-tenth of its outward FDI to emerging Asia. Since firms in emerging Asia are swiftly growing and becoming multinational, it is likely that the scale of inward FDI to Japan will expand.

C. Gradually expanding portfolio investment between Japan and emerging Asia

I would now like to examine recent trends in cross-border portfolio investment. At one time, the securities market in emerging Asia was underdeveloped, and the banking sector dominated the financial system. This situation has changed in recent years with the rapid growth of the securities market.

Regarding bond markets, it used to be the case that Asian economies had difficulty in issuing domestic currency-denominated bonds internationally, because foreign investors did not want to bear exchange rate risks and thus preferred U.S. dollar-denominated assets. This prevented the market from developing. However, as their macroeconomic performance has stabilized and become more favorable, and their governments have begun to liberalize their financial markets, emerging economies have become increasingly capable of issuing bonds denominated in both foreign and domestic currencies. If East Asia, including Japan, collectively makes further progress in terms of improving each economy's financial infrastructure – for example, in clearing and settlement institutions and securities depository institutions – as well as standardizing securities regulations, cross-border investment is likely to prosper.

With regard to the stock market, the number of listed firms is rapidly increasing in emerging Asia. As a result, the number of initial public offering (IPO)-related listed firms currently accounts for over half of the world total. In addition, the share of stock market capitalization in East Asia and the Pacific region now accounts for over 30 percent of the world total.

The development of securities markets in emerging Asia provides a revenue-enhancing opportunity for Japanese investors. But as well, Asia's growing savings could be utilized on a global scale for a wide range of firms, including those of Japan. Given that investors in each economy generally have different investment patterns and risk attitudes, some Japanese firms may be able to make use of such funds in the process of exploring new business models and strategies.

Over the past decade, securities markets have become increasingly synchronized at the international level. In general, securities markets among Japan, the United States, and Europe have shown a relatively high degree of synchronization. This is because cross-border investment has long been carried out through well-developed institutional investors and a large number of multinational firms. In addition, Japan has historically enjoyed a strong economic relationship with the United States. Therefore, the prices of Japanese stocks and bonds tend to be highly correlated with those of the United States and Europe (Chart 13).[6]

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[6] It is well known that Japan has been the world's largest net external creditor, reflecting its considerable external assets. Generally, Japan's portfolio investment is centered on medium- and long-term bonds (such as Treasury securities, agency bonds, and corporate bonds in the United States and bonds in Europe). Although some investment had been made in stocks in the United States and Europe, the global financial crisis has promoted a shift of Japanese investors' preference from stocks to medium- and long-term bonds. Meanwhile, overseas securities investment in Japan is generally concentrated on medium- and long-term bonds and

Though there remains a strong one-way influence from the United States to Japan and other Asian economies, there are growing signs that integration of securities markets is steadily taking place between Japan and emerging Asia. In particular, their stock markets have shown increasingly greater integration since the early 2000s. This may be associated with the establishment of region-wide production and trade networks in Asia. Japan has been exerting a strong influence on other Asian stock markets. In recent years, the influence of China on stock markets in this region has increased. And this is consistent with the growing importance of China in the post-crisis period.[7] The greater synchronization in Asia suggests that stock markets are more prone to common shocks, rather than country-specific shocks, and therefore investors may benefit less from diversifying their portfolios across the Asian region. At the same time, however, greater cooperation in macroeconomic policies and financial infrastructure may contribute to stabilizing stock markets, and thus encourage their further development (Chart 14).

There is also a high degree of synchronization in the bond markets of Japan, the United States, and Europe (Chart 15). However, it is likely that with further development of bond markets, financial integration will deepen in the Asian region in the near future (Chart 16). One contributing factor to an increase in capital inflows to bond markets in emerging Asia is interest rate differentials between emerging and advanced economies. Since interest rates are generally higher in the former than in the latter, global investors tend to engage in carry trade investment – investment in search of higher yields without hedging foreign exchange risk, which is thus highly speculative – in periods of high appetite for risk. Therefore, it should be noted that capital flows to emerging economies tend to become highly volatile, as do their bond prices.

D. Increasing cross-border banking activities between Japan and emerging Asia

Finally, I would like to consider cross-border banking activities. As mentioned earlier, the financial system in emerging Asia has traditionally been characterized as bank-dominant. In this region, foreign-owned financial institutions are prominent in the fields of long-term finance, such as project finance, and trade credit, some of whose services require sophisticated skills and experiences. With the worsening of the European sovereign debt problem, some financial institutions in Europe have begun to withdraw from those fields.

In the case of Japan, overseas lending activities by Japanese-owned financial institutions began to decline sharply in the 1990s, mainly as a result of nonperforming-loan problems. In recent years, there has been a shift in this trend as these financial institutions have begun to actively extend credit overseas again (Chart 17). Lending activities to emerging Asia have undergone a particularly brisk expansion through both Japanese- and non-Japanese affiliated firms. While the presence of European banks has declined in this region, Japanese-owned financial institutions have been swiftly extending credit to such countries as China, Indonesia, South Korea, Malaysia, and Thailand, thereby mitigating the adverse impact of

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stocks. There was a short-lived but rapid increase in investment from overseas in Japanese short-term sovereign bonds from the autumn of 2011 to the beginning of 2012, when a worsening of the European sovereign debt problems aggravated strains in the global financial markets and increased demand for Japanese sovereign bonds as safe assets.

7 For example, *the Progress of Asian Economic Integration Annual Report 2012* compiled by the Boao Forum for Asia reports the correlation of stock market index returns between countries. From 2002 to 2006, Japan was positively correlated with all other Asian economies. After the global financial crisis, there has been a trend of increasing stock market synchronization in Asia. In particular, China has become increasingly important as its correlations with India, Japan, South Korea, Malaysia, the Philippines, and Singapore have grown. Some studies indicate that Singapore, India, and Japan have stronger impacts on Asian stock markets (for example, see Meric et al., "Co-Movements of and Linkages between Asian Stock Markets," Business and Economics Research Journal, 2012).

deleveraging by European banks. In an increasing number of cases, Japanese financial institutions act as leading banks in arranging syndicated loans and project finance.

Most economies in emerging Asia still lack basic infrastructure, including systems of transportation, energy supply, information and communications, and water supply and sewerage. A deficiency of adequate long-term funds hinders infrastructure development in this region. This points to the large potential demand for such long-term credit. It is estimated that the scale of this credit demand will amount to 8 trillion U.S. dollars between 2010 and 2020, according to data from the Asian Development Bank (ADB). Public funds are insufficient to meet such credit demand, and this signifies the need for private-sector initiatives and funds in the form of long-term loans and bond finance. There are thus growing business opportunities for Japanese financial institutions.

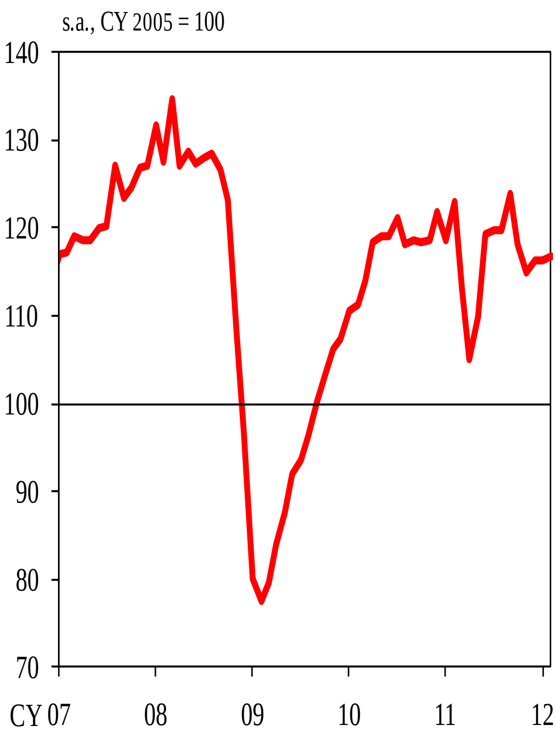
At the same time, it is important for Japanese financial institutions to make greater efforts to support entrepreneurial new businesses that endeavor to supply goods and services in areas of potentially high demand. Those areas include medical treatment and welfare, environment, and energy. Under these circumstances, financial institutions are expected to provide innovative, demand-responsive financial services. Such efforts are likely to bolster the competitive advantages of Japanese financial institutions, since the skills and experiences gained from such activities in Japan may lead to greater business opportunities in other Asian economies. It should be noted that some of these Asian economies are also expected to face growing aging populations in the near future.

That brings me to the end of my presentation. Thank you very much indeed for your kind attention.

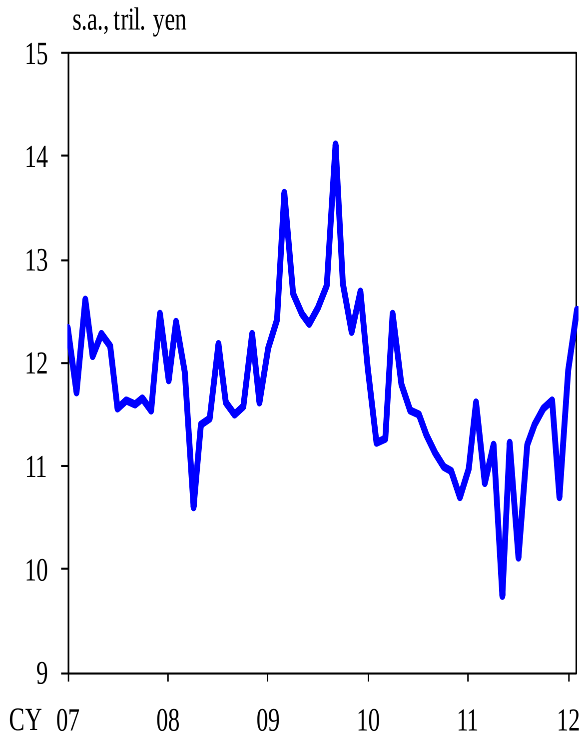
Chart 1

Recent Developments in Japan’s Economy

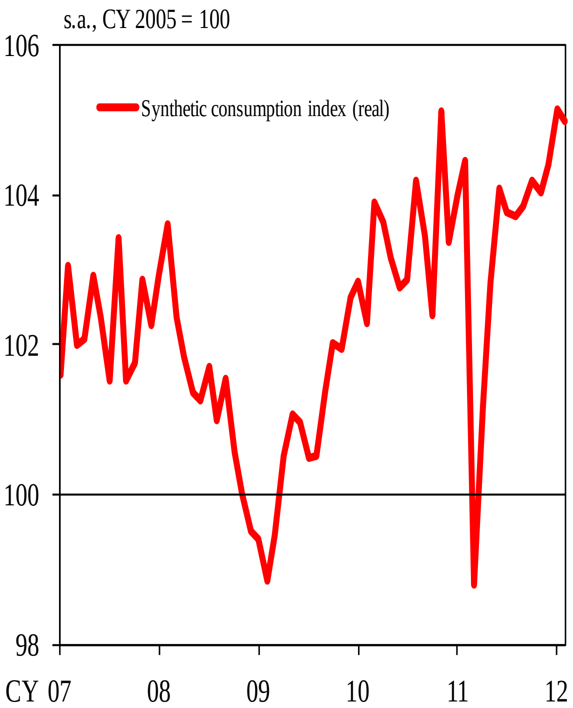
(1) Real Exports



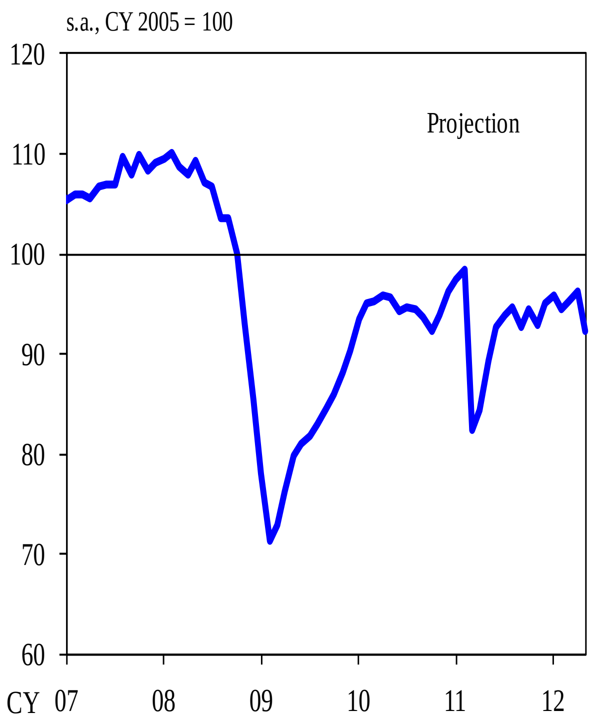
(2) Value of Public Works Contracted



(3) Private Consumption



(4) Industrial Production

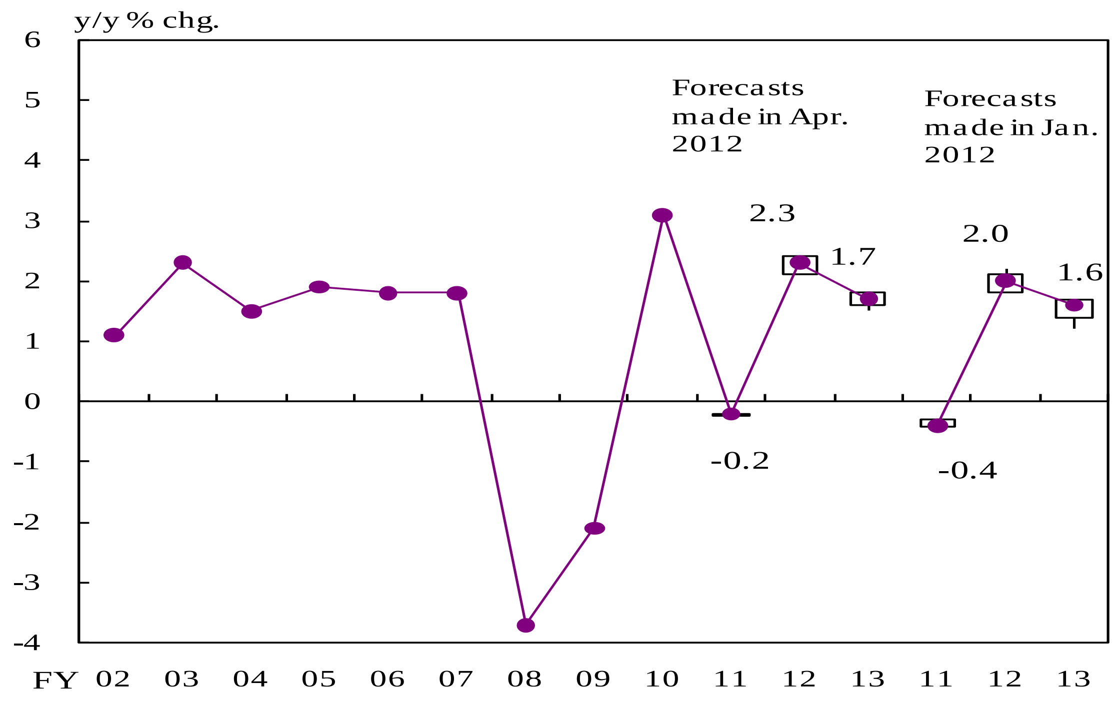


Sources: Cabinet Office; Ministry of Economy, Trade and Industry; East Japan Construction Survey; Bank of Japan.

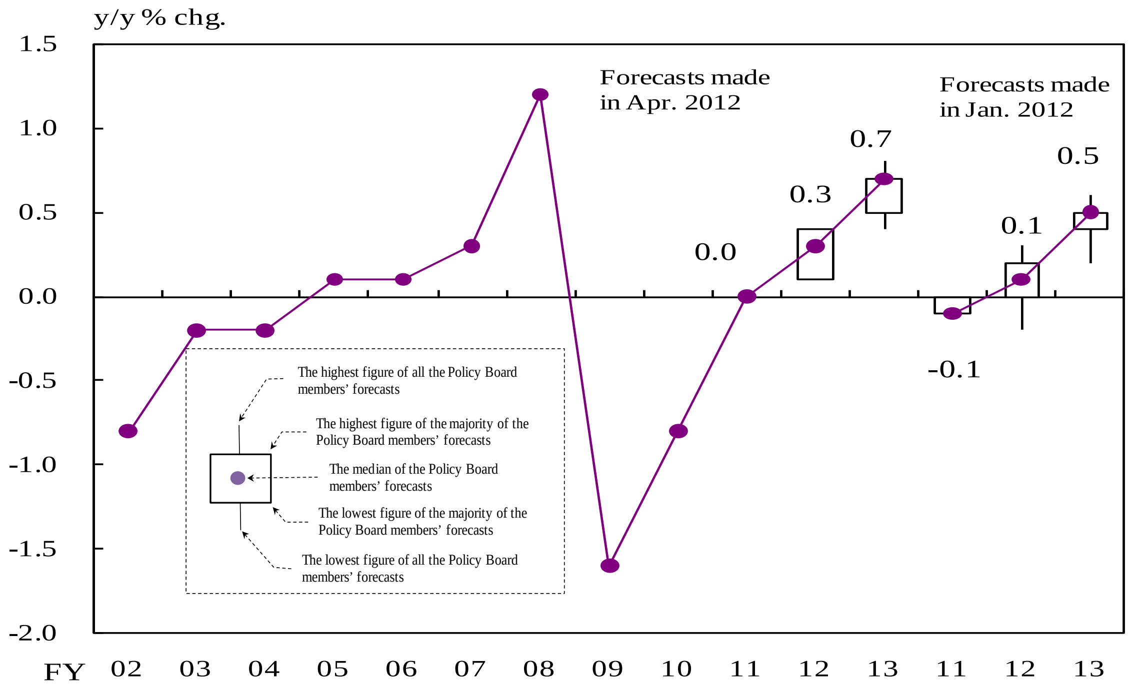
Chart 2

The Bank of Japan's Economic and Price Forecasts

(1) Real GDP



(2) CPI (all items less fresh food)



Note: The figures for real GDP for fiscal 2011, 2012, 2013, and the CPI (all items less fresh food) for fiscal 2012 and 2013 are the Policy Board members' estimates.
Source: Bank of Japan, "Outlook for Economic Activity and Prices."

Chart 3

The Bank of Japan's Conduct of Monetary Policy

1. Introduction of "the Price Stability Goal in the Medium to Long Term"

- ✓ The inflation rate consistent with price stability sustainable in the medium to long term.
- ✓ A positive range of 2 percent or lower in terms of the year-on-year rate of change in the consumer price index (CPI). A goal of 1 percent is set for the time being.

2. Clarification of the Bank's Determination to Pursue Monetary Easing

- ✓ Aiming at achieving the goal of 1 percent in terms of the year-on-year rate of increase in the CPI.
- ✓ Pursuing powerful monetary easing by conducting the Bank's virtually zero interest rate policy and by implementing the Asset Purchase Program mainly through the purchase of financial assets until the Bank judges that the 1 percent goal is in sight.
  - ➢ On condition that the Bank identifies no significant risk to the sustainability of economic growth, including from the accumulation of financial imbalances.

3. Increase in the Asset Purchase Program

- ✓ About 55 trillion yen → about 65 trillion yen (Feb. 2012)→ about <u>70 trillion yen (April 2012)</u>
  - ➢ In addition to purchases under the Program, the Bank regularly purchases Japanese government bonds at the pace of 21.6 trillion yen per year.

Chart 4

Enhancement of Fund-Provisioning Measure to Support Strengthening the Foundations for Economic Growth

The Bank decided to substantially enhance the fund-provisioning measure to support strengthening the foundations for economic growth both in terms of the yen and a foreign currency.

Provision of funds to financial institutions, equivalent to the actual amount of lending and investment carried out with a view to strengthening the foundations for economic growth, over a long term (maximum duration of four years) and at a low rate (currently 0.1 percent)

1. Main Rules

- ✓ 3.0 trillion yen⇒ 3.5 trillion yen (eligible investments and loans: 10 million yen or more)

2. Special Rules for Small-Lot Investments and Loans

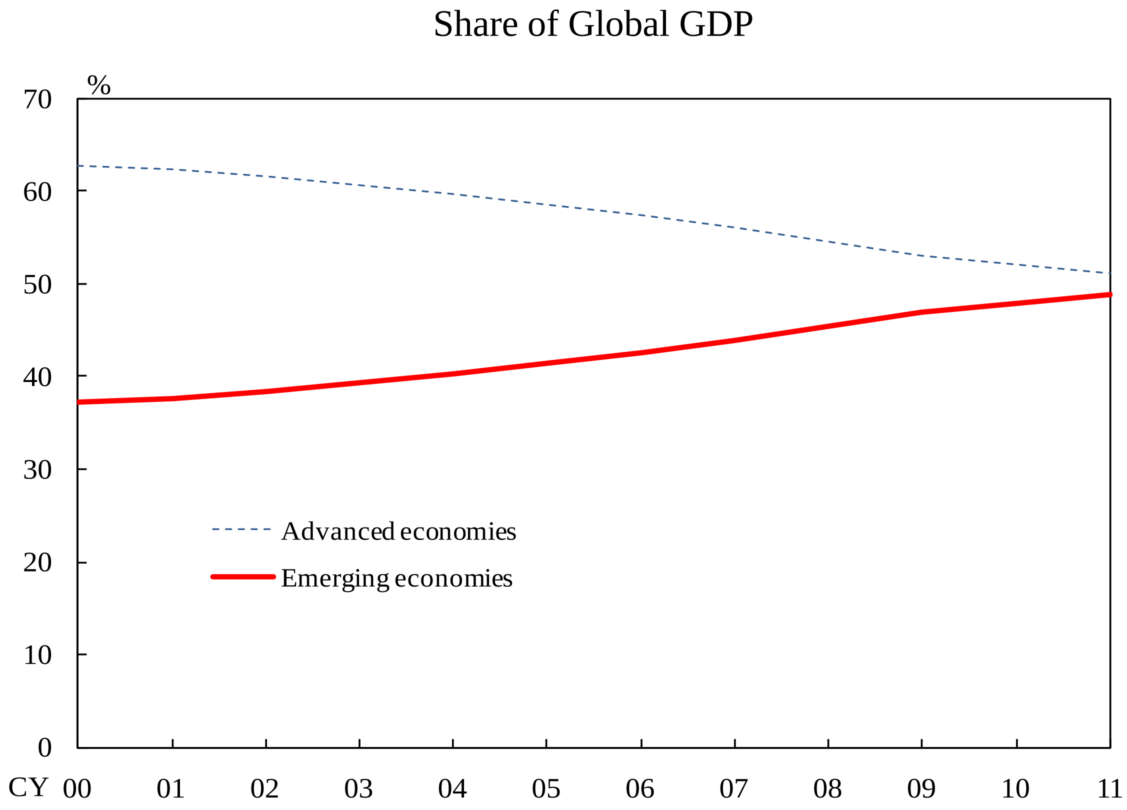
- ✓ 0.5 trillion yen newly added (eligible investments and loans: 1 million yen or more but less than 10 million yen)

3. Special Rules for a New U.S. Dollar Lending Arrangement (April 2012)

- ✓ 1.0 trillion yen (12 billion U.S. dollars) newly added (eligible investments and loans: denominated in foreign currencies)

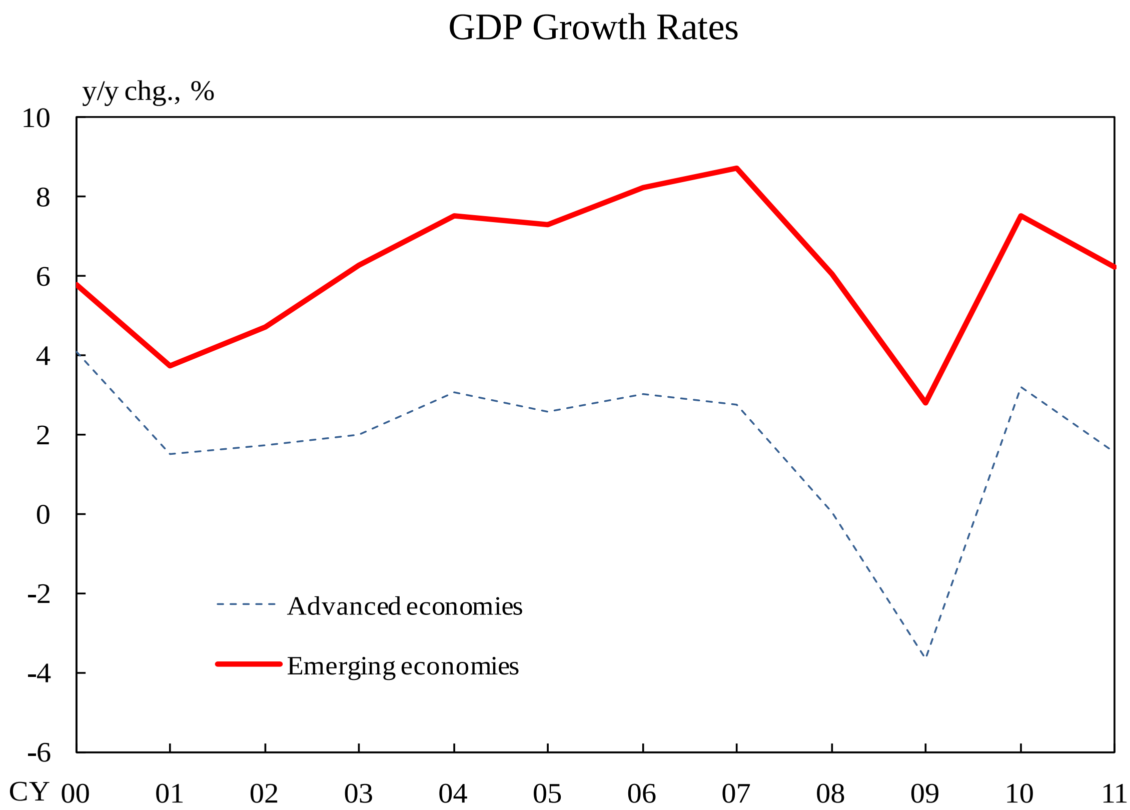
With special rules for asset-based lending (ABL) (eligible investments and loans: equity investments and ABL), the total amount is 5.5 trillion yen. The deadline for applications for new loans is March 2014.

Chart 5



Source: IMF, "World Economic Outlook."

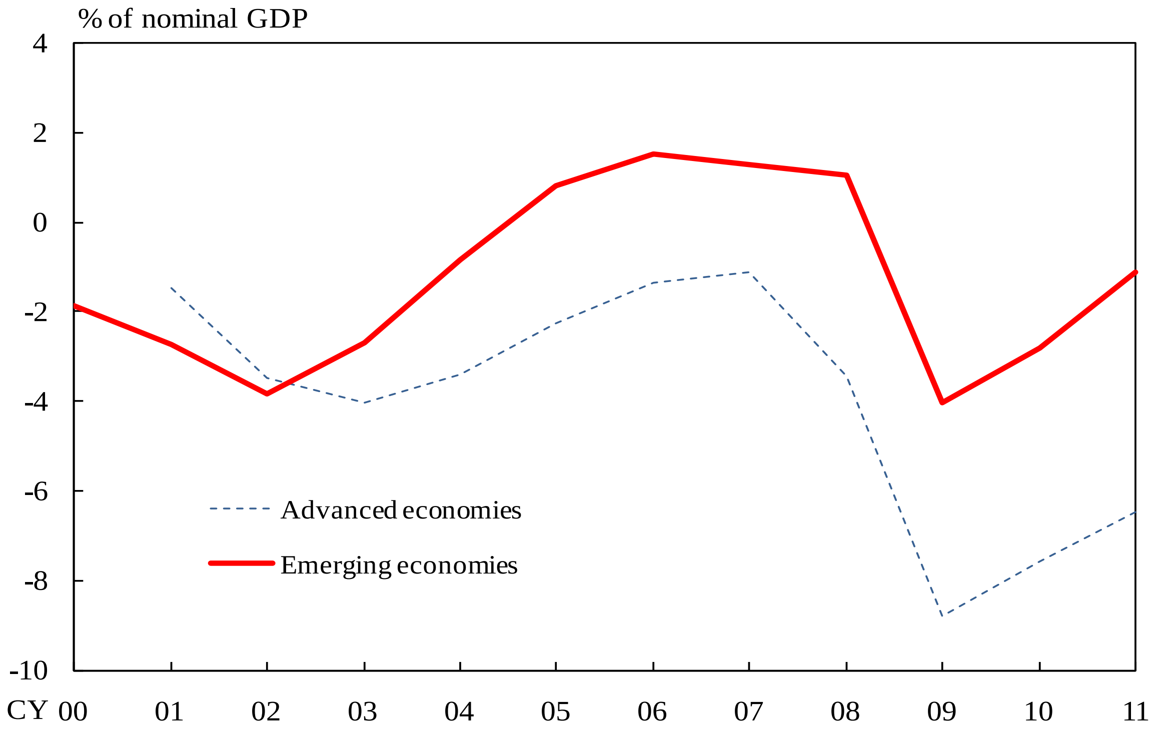
Chart 6



Source: IMF, "World Economic Outlook."

Chart 7

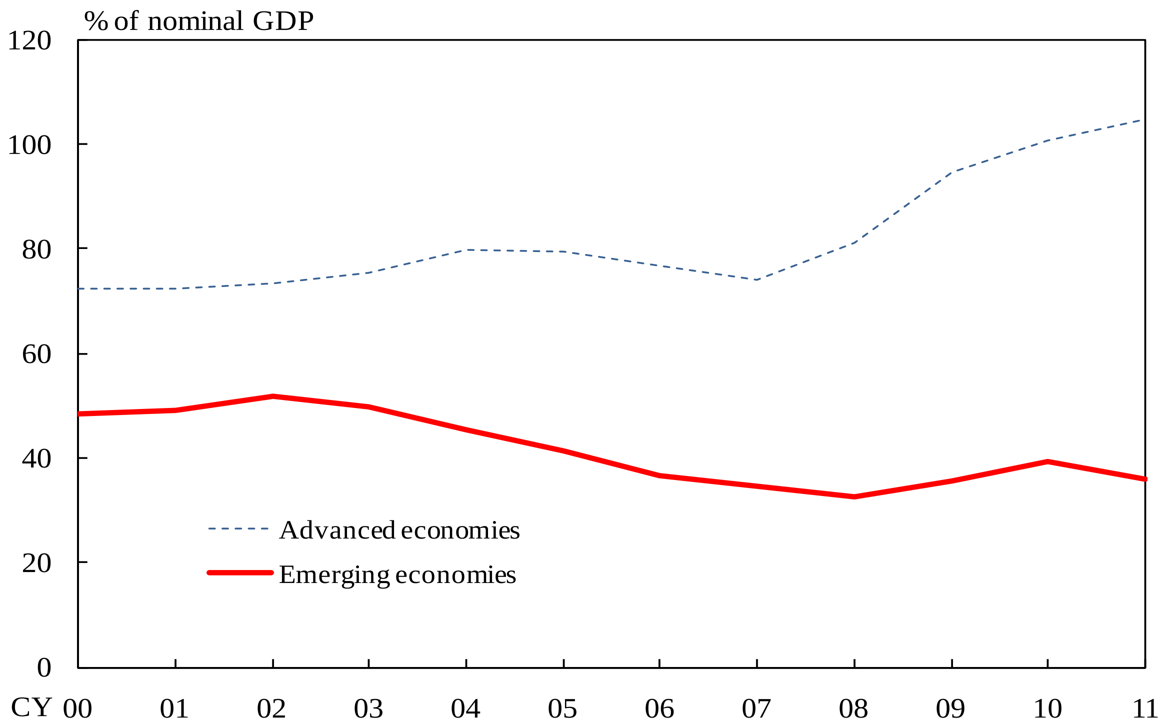
Fiscal Balance



Source: IMF, "World Economic Outlook."

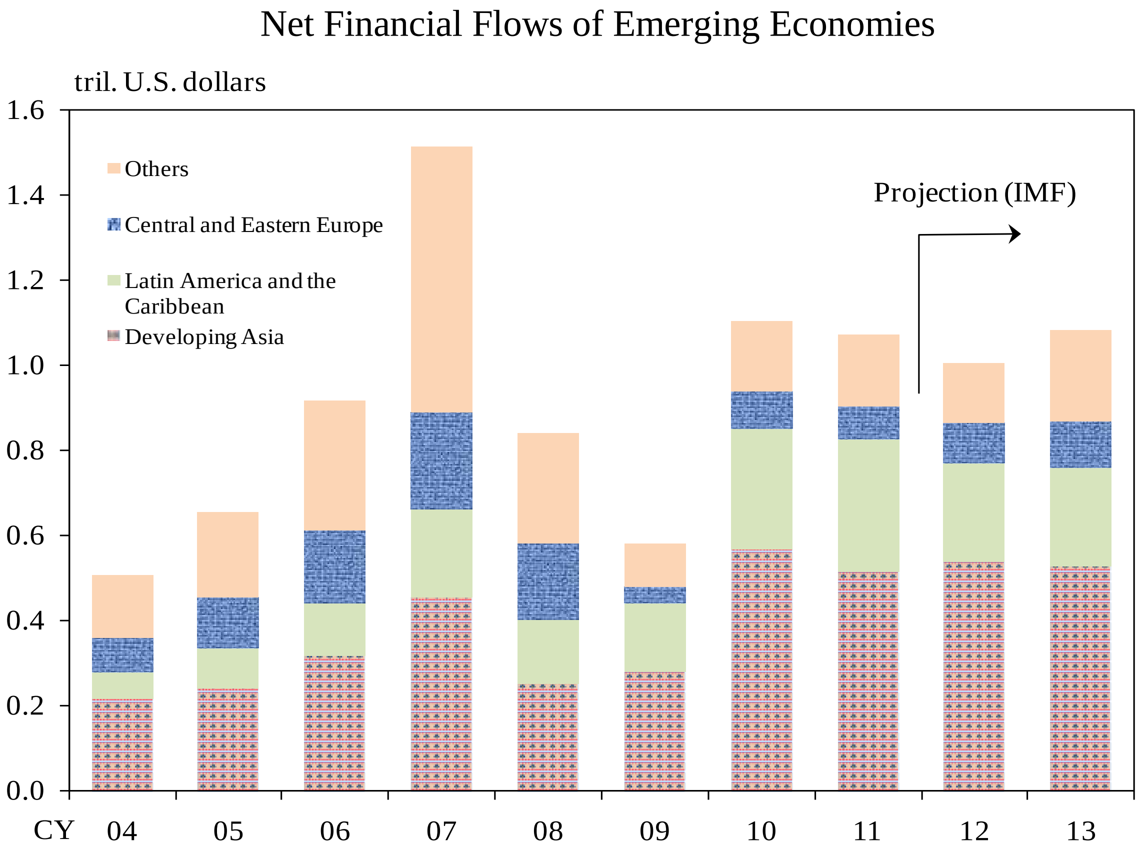
Chart 8

Government Debt



Source: IMF, "World Economic Outlook."

Chart 9

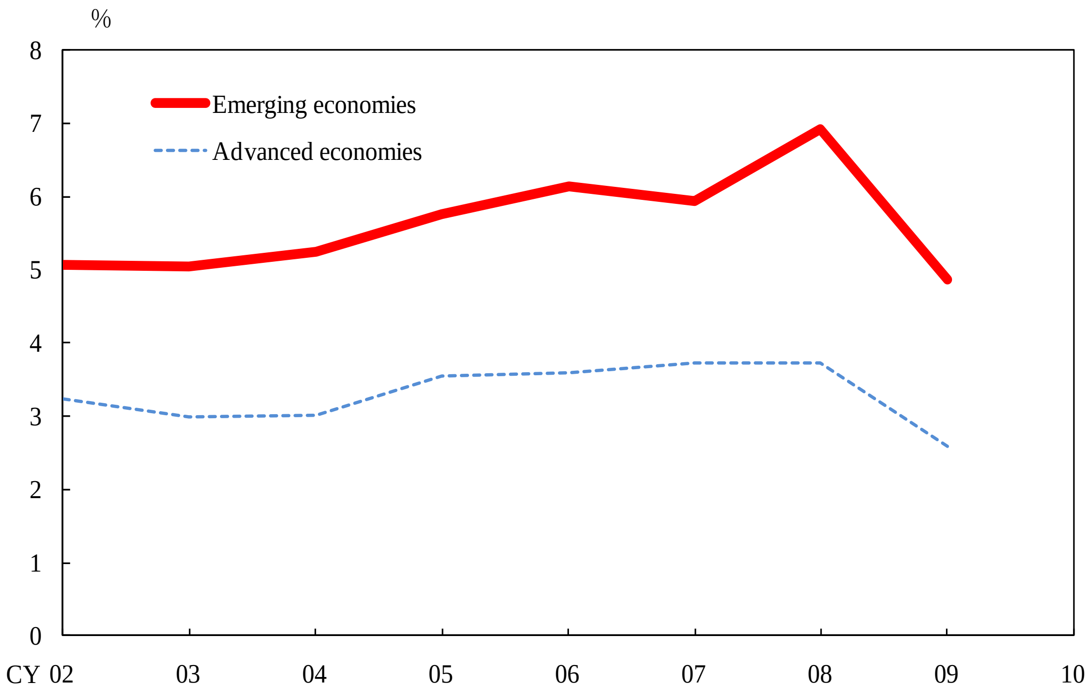


Source: IMF, “World Economic Outlook.”

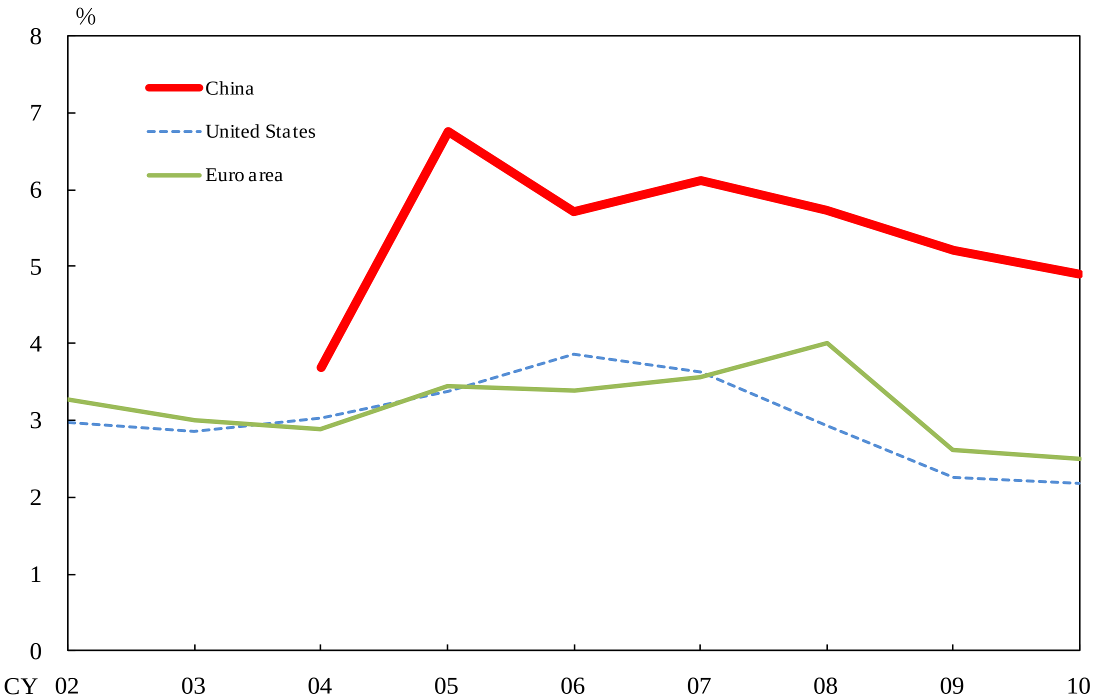
Chart 10

Rates of Return

(1) Advanced Economies and Emerging Economies



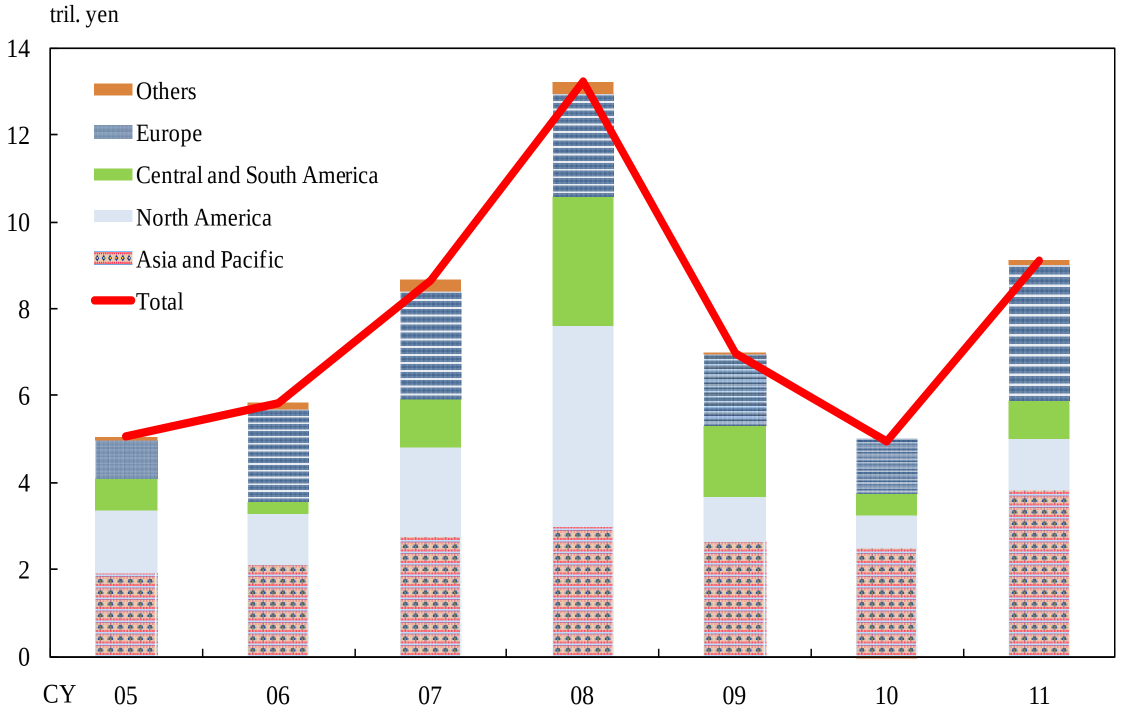
(2) Major Economies



Note: Rate of return = financial outflows/external liabilities
Source: IMF, "International Financial Statistics."

Chart 11

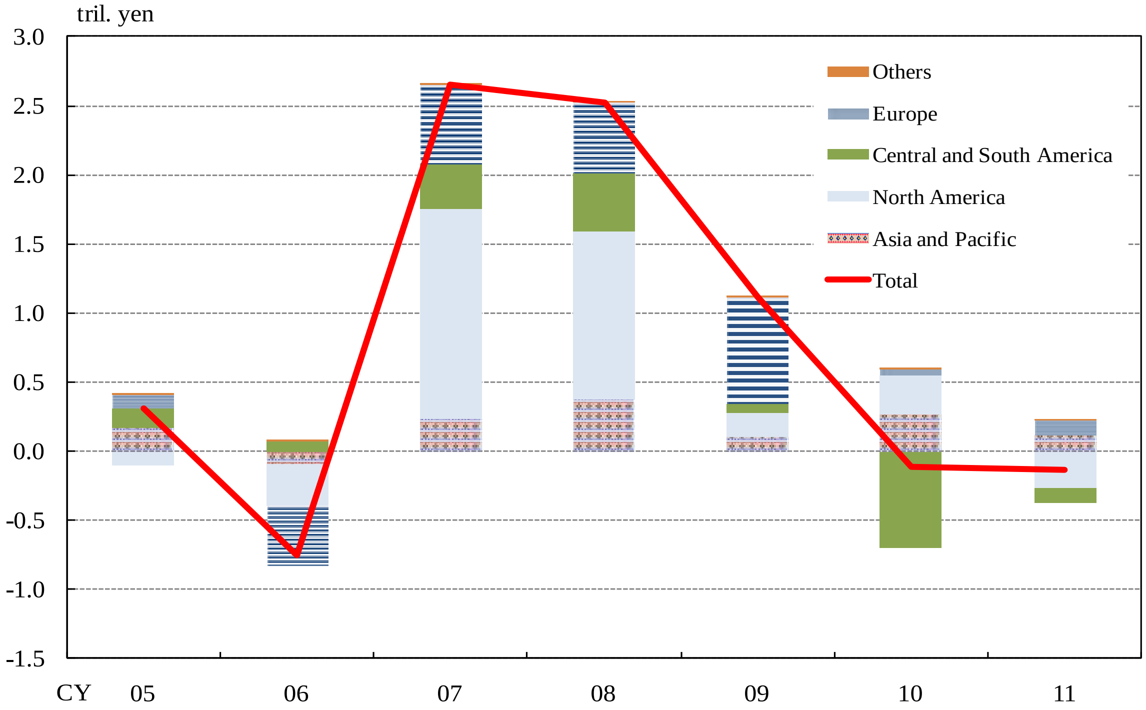
Japan's Direct Investment Abroad



Source: Ministry of Finance, "Balance of Payments."

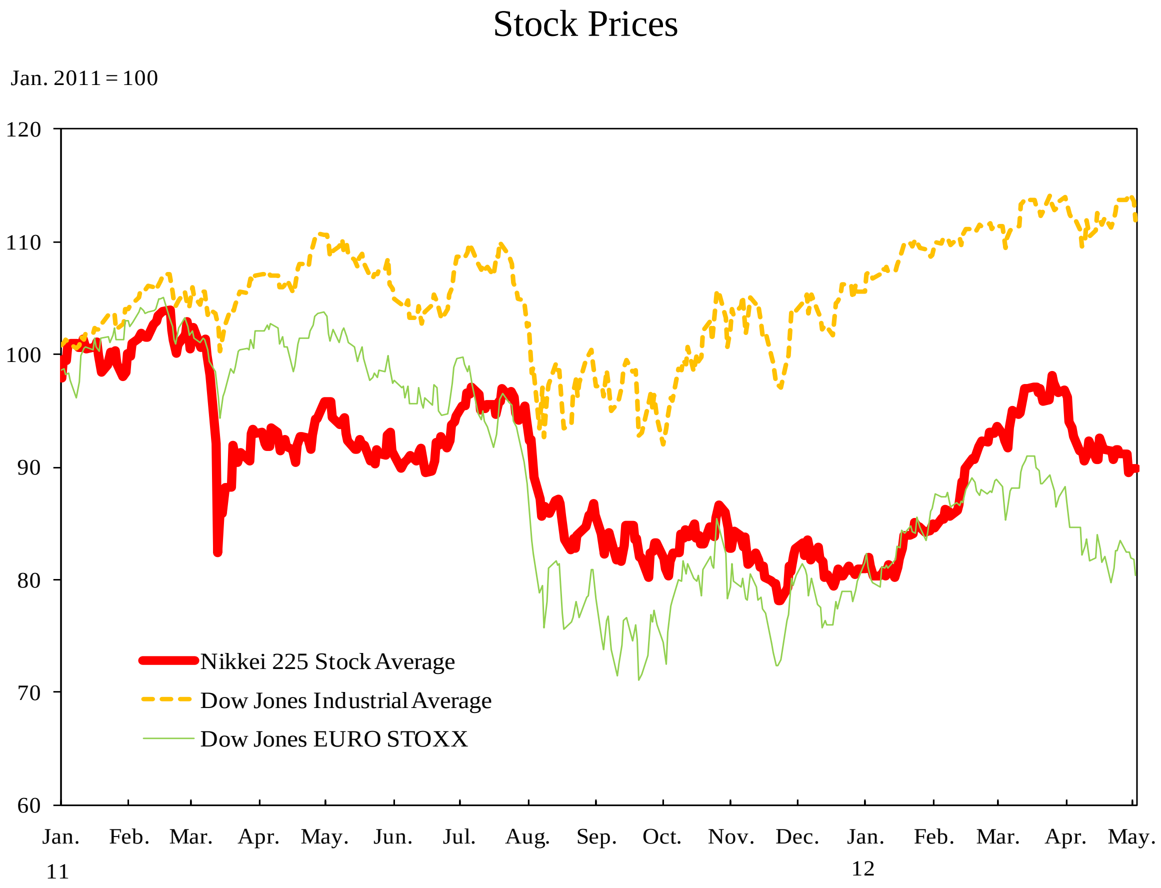
Chart 12

Direct Investment in Japan



Source: Ministry of Finance, "Balance of Payments."

Chart 13

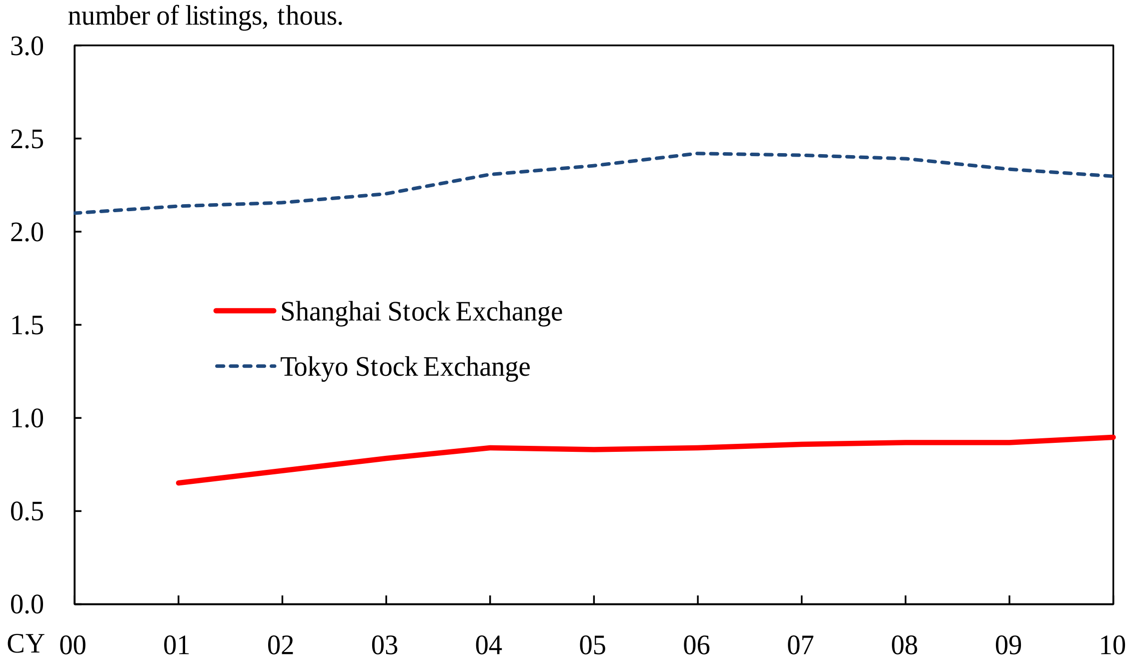


Source: Bloomberg.

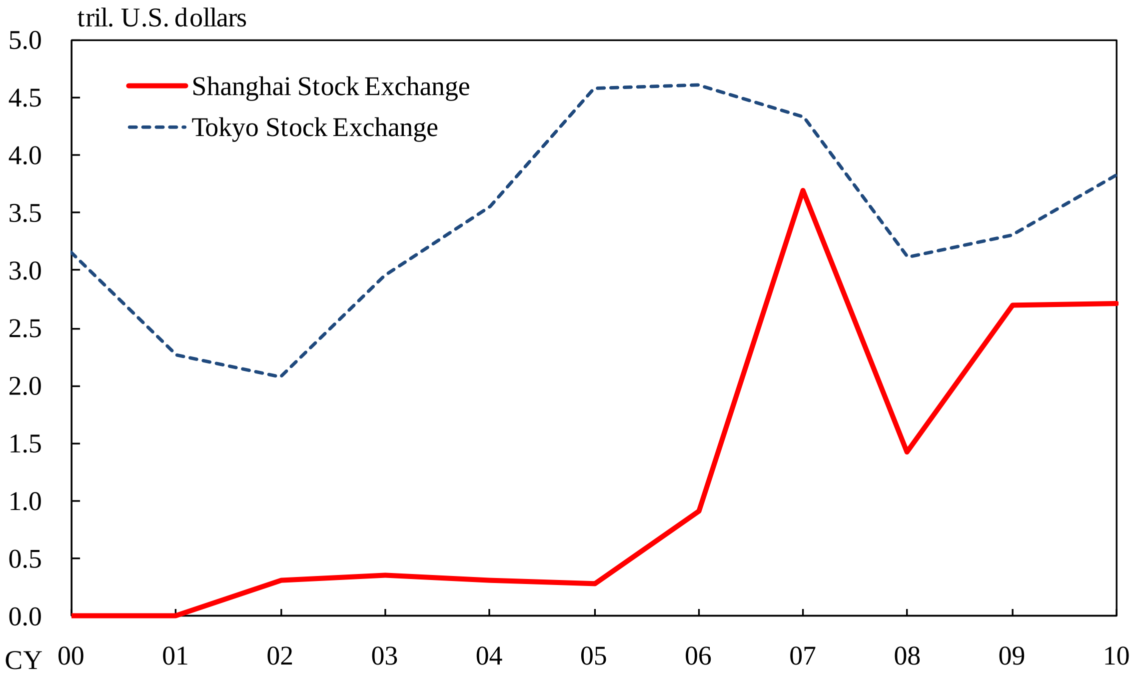
Chart 14

Stock Exchange Listings and Market Capitalization

(1) Number of Companies Listed

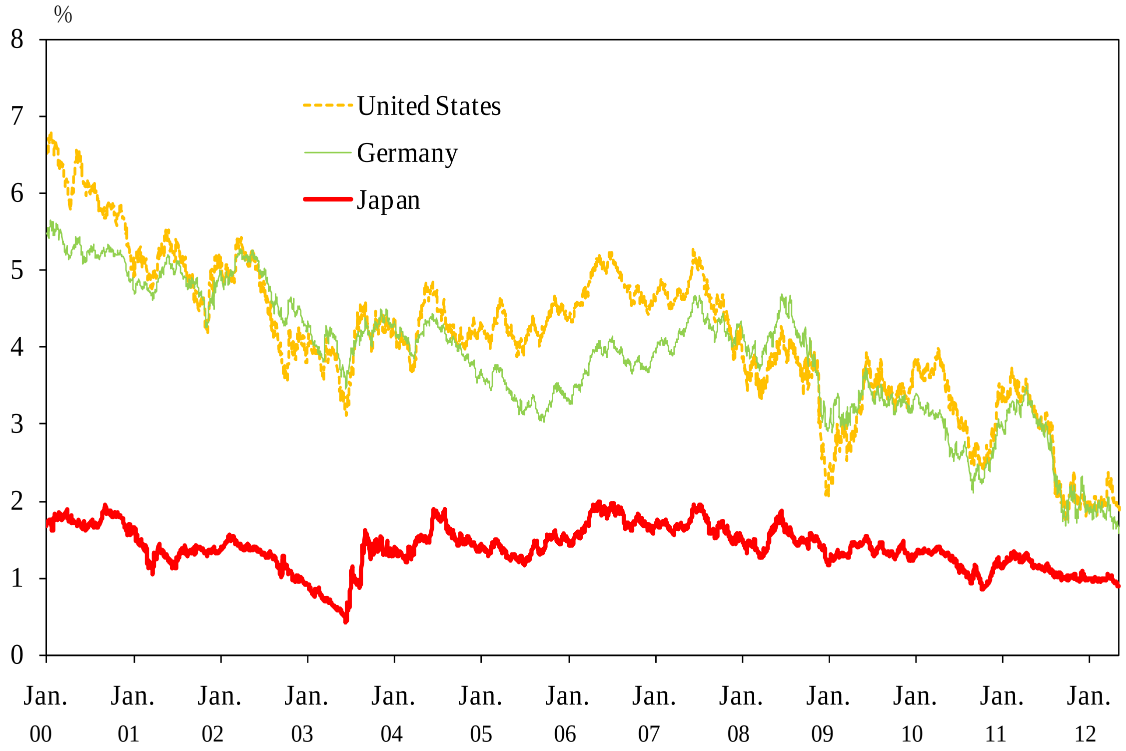


(2) Market Capitalization



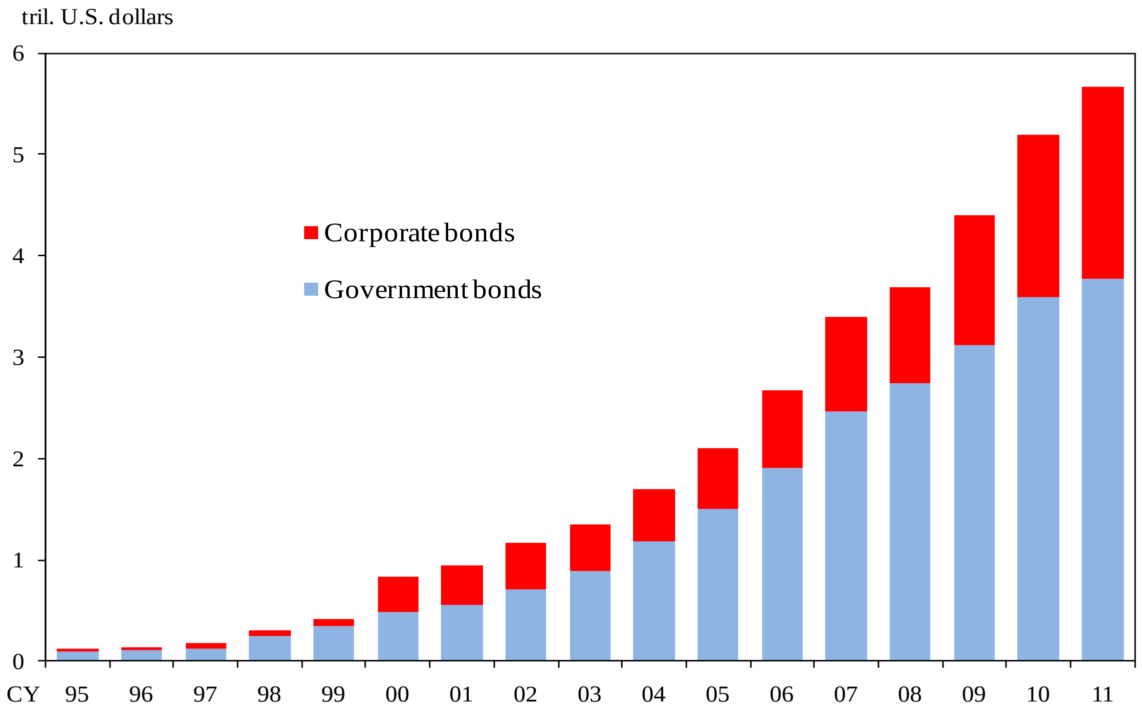
Note: The data are as of the year-end.
Source: World Federation of Exchanges.

Chart 15
Long-Term Interest Rates



Source: Bloomberg.

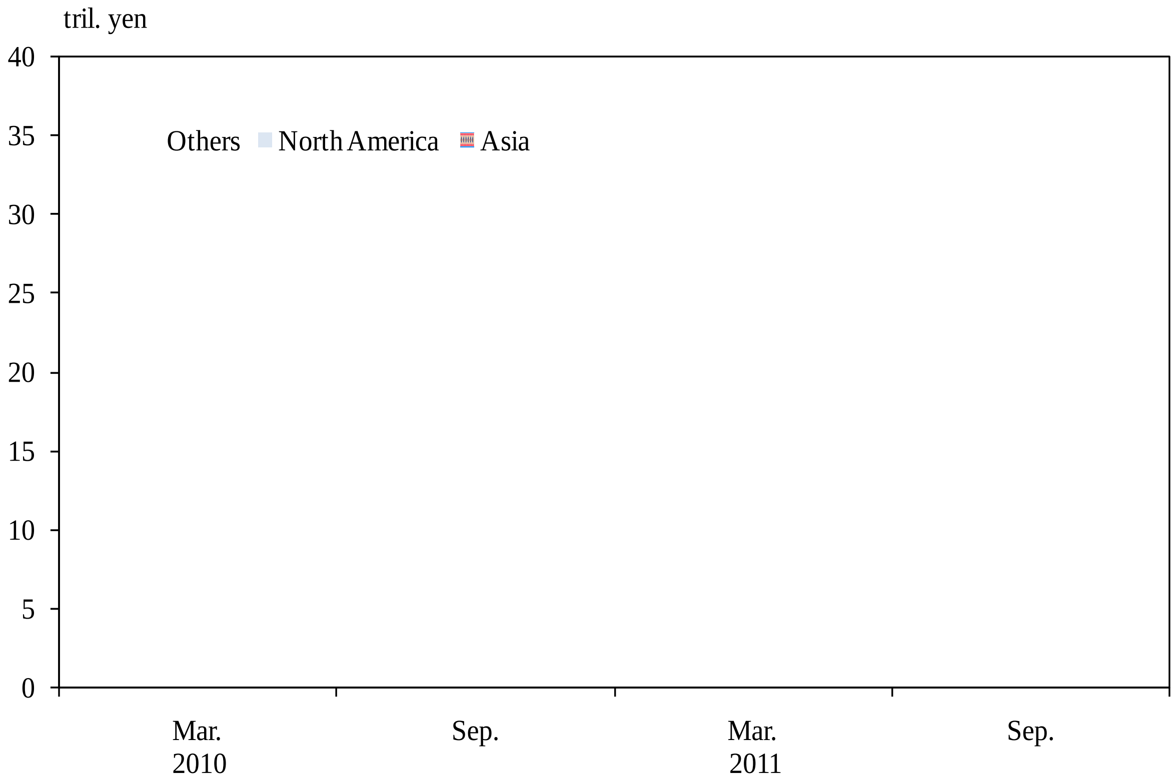
Chart 16
Outstanding Amount of Local Currency Bonds in Asia



Note: The data are as of the year-end.
Source: Asian Development Bank.

Chart 17

Overseas Loans of the Major Japanese Banks



Notes: 1. Figures are the sum of the three major financial groups (non-consolidated basis).
2. The data are as of the month-end.
Sources: Published accounts of each group.