Haruhiko Kuroda: Asia's contribution to the global economy – prospects and challenges for the transition to domestic demand-led growth

Speech by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at the 4th Bank of Thailand Policy Forum, Bangkok, 24 July 2014.

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1. Introduction

Governor, distinguished guests, ladies and gentlemen,

Thank you for inviting me to the 4th Bank of Thailand Policy Forum. It is a great honor to address such distinguished guests who are leading the Thai economy. I would like to extend my heartfelt gratitude to Governor Prasarn Trairatvorakul for giving me this valuable opportunity.

Thailand was the first Southeast Asian nation to establish diplomatic relations with Japan, and the year 2017 will mark the 130th anniversary of this significant event. The two countries have been engaged in active cultural exchange at least since the Ayutthaya dynasty. In more recent years, our two nations have established close ties as important economic partners, providing support to each other in times of difficulty. The Bank of Japan received generous donations from the Bank of Thailand and the Bank's staff to help the victims of the Great East Japan earthquake in 2011. All of us at the Bank of Japan remain deeply grateful for this kindness. I learned about these donations immediately after I became Governor of the Bank and felt deep reverence for and strong gratitude to our friends in Thailand. I would like to take this opportunity to renew our thanks.

Thailand is a key base in Southeast Asia for the economic activities of Japanese firms, of which more than 1,500 are members of the Japanese Chamber of Commerce in Bangkok. Last year, Japan was Thailand's largest importing trade partner, and its third largest export destination. The very close ties between the two countries are shown in the results of a survey conducted by the Ministry of Foreign Affairs of Japan, where 97 percent of the people in Thailand regarded Japan as a friendly nation.

Today, I would like to share with you my views on Asia's contribution to global economy. These views are based on my 16 months' experience as Governor of the Bank of Japan, and my 8 years as President of the Asian Development Bank before that.

I. A change in growth model for the Asian economies

Even when growth in the major advanced economies slowed considerably following the global financial crisis, the Asian economies continued to register solid growth. Moreover, the region's economies have contributed significantly to the recovery and subsequent growth of the global economy. The Asian economies accounted for two-thirds of the recent growth of the global economy (Chart 1).

The Asian economies have benefited greatly from sophistication of global supply chains and trade liberalization. Exports have played a leading role in the region's high economic growth. Asia's industrial base was built upon the combination of foreign capital and a plentiful, diligent, well-educated labor force. This industrial base has boosted export-led growth in Asian economies. In recent years, however, domestic demand, primarily consumption, has also begun to play an increasingly important role. This is not only China, India, and Indonesia, with the largest populations in the world, but other Asian economies too. Asian economies have enjoyed rising income levels and have seen the emergence of a middle consumer class that actively purchases goods and services from around the world. A virtuous cycle among production, income, and spending in the region has given rise to growing domestic demand, which has contributed to the growth of the global economy. This suggests that a more balanced growth model is emerging in Asia, to replace the conventional model of export-led growth that depended on demand from advanced economies (Chart 2).

II. Fundamental background to the expansion of domestic demand

Rising domestic income levels created an affluent and aspiring middle class during the phase of demographic dividend with an increase in the proportion of the working-age population. This is the fundamental background to the expansion in domestic demand in the Asian economies.

First, many rural residents moved to more developed urban areas. This increase in labor supply led to an increase in aggregate supply capacity and to improved export competitiveness. The improvement in household incomes, especially for residents in urban areas, has led to a rise in consumption and an increase in aggregate demand.

Second, the growth of the middle class boosted demand for higher value-added goods and services. In response to this increased demand, there was parallel progress in the supply side. Wider use of foreign technology in production facilities of domestic industries, for instance, brought improvements in productivity.

However, some medium- and long-term challenges need to be addressed to ensure a smooth transition to a well-balanced economic growth that combines both exports and domestic demand. These challenges include demographic changes, as well as the risks of excessive credit expansion under high economic growth and destabilization of the financial system. Let us consider some possible countermeasures to these challenges, based on Japan’s experience.

III. Demographics and domestic demand: Japan’s experience

Japan is in the midst of dealing with some significant demographic challenges of an ageing population and a decline in the overall size of the population. In Asia, China and Korea are next in line to phase out of demographic dividend into demographic onus. Thailand is not far behind. Let me talk about the experience of Japan.

The transition from demographic dividend to demographic onus brings with it a series of problems. Perhaps the most pressing of these problems are a decline in the potential growth rate, a deterioration in the fiscal balance, and intergenerational income transfers. These problems put downward pressure on the growth of domestic demand.

In Japan, the potential growth rate has been pushed down by a decline in labor input. There are two reasons for this decline. First, the number of workers has declined due to demographic changes. Second, working hours have become shorter as the economy has matured. Firms’ slow response to demographic changes has contributed to sluggish growth in aggregate capacity to supply goods and services that reflect the changing environment. The demographic onus has also led to deterioration in fiscal deficits, impairing the pension and health-care insurance systems. Delays in reforms to these social security systems have increased the burden on future generations and raised the issue of intergenerational income transfers.

There has been a growing consensus in Japan that greater efforts are needed to address the adverse effects of demographic changes. These efforts are expected to provide new growth momentum for Japan’s economy. For example, there has been progress in initiatives to raise the labor participation rate of women and the elderly, to address the decline in the number of workers. There have also been initiatives to attract more highly-skilled foreign workers. Firms are also making headway in areas such as retail, tourism, medical and nursing services in an effort to provide goods and services for the elderly and families with small children.

While demographic changes can be predicted quite accurately, reversing them is extremely difficult. However, as is often the case when problems seem too serious or difficult, initiatives to address those problems tend to be put off. Although Japan's working-age population started to decline in the mid-1990s, concrete action was taken only after the total population started to decline in the latter half of the 2000s. Japan's experience thus suggests that it is crucial not only to debate the challenges posed by the demographic onus, but also to take the necessary action at an early stage. Prompt action is needed to preserve the growth momentum of the domestic demand-led economy in Asia.

IV. Global monetary accommodation and domestic credit growth

High economic growth is often associated with an increase in domestic credit. The current growth in domestic demand in Asian economies is mainly driven by domestic structural factors such as the increase in the middle consumer class. But, it has also been reinforced by a combination of global monetary accommodation and the concomitant expansion in domestic credit.

History tells us that bubbles often arise when people's expectations become bullish due to the experience of continued high growth and domestic demand expansion. Examples of such situations where domestic demand growth became excessive and ill-balanced are now all too familiar. We saw this in the bubble economy in Japan, in the housing bubble in the United States, and in the overheating in real estate markets in peripheral European countries. These economies eventually fell into financial crises. And the symptoms were common in each case: a rapid increase in credit and an emergence of euphoria based on the belief that the country had entered a new phase.

There is also the danger of an unsustainable increase in domestic credit reliant on short-term foreign borrowings. This is due to the lack of deep domestic financial markets. The current global accommodative financial conditions raise the possibility of unhealthy global capital flows into Asian economies. Such capital flows could result in the build-up of distortions and risks in the financial systems of these economies. For example, several economies have seen considerable increases in real estate prices partly due to foreign capital inflows. Needless to say, if there were a substantial decline in real estate markets, nonperforming assets could pile up in the financial sector. Such a scenario could hamper growth substantially and for a prolonged period, depending on the magnitude of the problem.

To prevent such distortions and risks from building up, commercial banks and financial supervisory authorities need to enhance their credit risk management capacity. They need to instill a *credit culture* in which credit is proactively managed in response to changes in the environment. These actions could be effective throughout Asian economies.

Another possible course is to use macroprudential policy. While discussions on macroprudential policy continue, particularly in the United States and Europe, some Asian economies have already gone ahead and introduced them. For instance, the Bank of Thailand has implemented policy measures such as LTV limits for mortgage loans.

Further improvements in financial infrastructure are also crucial; for example, in accounting practices, corporate governance, and the judicial system. At the same time, authorities should make efforts to further develop domestic financial markets so that financial intermediaries can make effective use of domestic savings.

The appropriate mix of these policy measures may differ from country to country, depending on each country's policy objectives and financial system. Still, it is important for any economy to pursue sound macroeconomic policies as well as efforts to enhance the robustness of its domestic financial system.

There are some key factors to pursue so that Asian economies can continue to enjoy domestic demand-led growth. The first is efforts to prevent any excessive expansion of credit with help of appropriate prudential policies. The second is actions to ensure that the financial system remains sufficiently robust to withstand any economic shocks. The third is to maintain the resilience of the financial system to be restored after any damage from such shocks.

V. Initiatives to improve regional safety nets

Such strengthening of the domestic financial system will also help to prepare for shocks generated abroad. Concerns have been expressed regarding the impact of monetary policy in advanced economies on international capital flows. There was a period of market volatility after May last year due to heightened speculation about a withdrawal of monetary easing measures in the United States. During that period, some countries suffered large capital outflows. These are countries where structural vulnerabilities such as current account or fiscal deficit were a concern. This highlights the importance of addressing structural weaknesses from a medium- to long-term perspective.

It is also important to establish regional safety nets to prepare for possible external shocks. Regional safety nets increase confidence in a country's financial system and economy, and reduce the threat of a financial crisis. A prime example of such a regional safety net in the Asian region is the Chiang Mai Initiative Multilateralisation (CMIM). This initiative, involving the ASEAN countries, together with China, Japan and Korea, has been expanded to provide a backstop in case any of the countries faces a short-term liquidity shortage.

The role that safety nets play may also be affected by changes in the activities of firms and financial institutions in Asia. With Asia no longer serving as a production base for exports only, but also representing a major consumer market, global firms have been actively expanding in Asian markets and have been localizing their businesses. For instance, in order to capture the growing domestic demand in Asian economies, Japanese manufacturing firms have been increasing local production. Japanese firms also have been focusing on local consumers in a wide range of businesses, including retail and other services. In response to these developments, Japanese banks have been making efforts to further localize their Asian business.

For firms expanding their businesses in Asia, securing stable funding in the local currency is becoming a challenge. To meet this challenge, it is important to establish ways in which firms can obtain local funds from banks. Development of domestic financial markets can provide banks with stable access to liquidity and underpin their provisioning of funds to firms. This will not only contribute to stabilizing the domestic financial system in Asian economies, but also create a virtuous cycle encouraging the entry of more global firms and the localization of their businesses.

The challenge for central banks is to nurture a sound banking system that ensures secure funding and fosters liquid interbank markets. The availability of local currency funding differs across countries, depending on the stage of development of money markets and of funding tools using collateral. The Bank of Japan has agreed on cross-border collateral arrangements with other Asian central banks as one of the backstops for developing financial markets in this region (Chart 3). For example, with the Bank of Thailand, the Bank of Japan has already established a framework providing Thai Bahts to financial institutions against Japanese government securities and Japanese Yen as collateral.

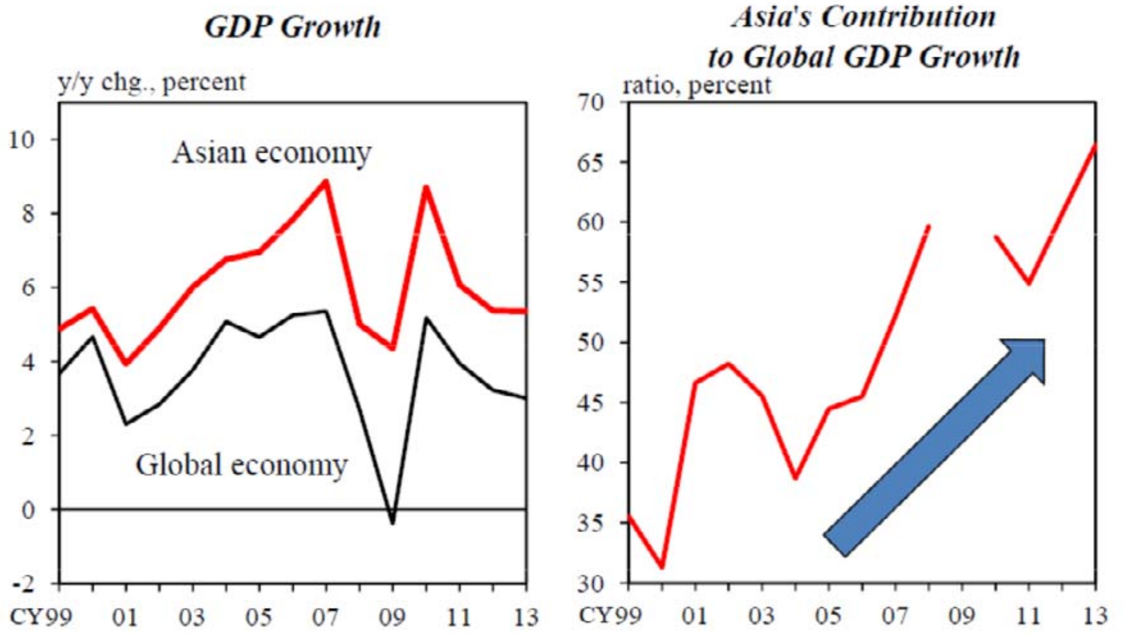
In running a regional safety net, it is important to monitor carefully the regional financial and economic conditions. It is also necessary to share relevant information among the region's countries in a timely manner. Information on macroeconomic policies and the challenges that each country faces should be exchanged on a regular basis. At the same time, it is essential to create a network of swift information sharing and rapid response to sudden changes in international financial markets. To help strengthen such cooperation among central banks, the Bank of Japan has been actively participating in the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), together with the Bank of Thailand and other Asian central banks.

Concluding remarks

Compared with European countries, Asian countries are much more diverse in terms of their economic and social makeup, so that the challenges of managing the economy vary significantly. At the same time, however, Asian economies face challenges similar to those of other economies, including the advanced economies. Therefore, active discussion in the region to share the experience and wisdom in Asian economies can also be beneficial to other regions. Asian countries can make a substantial contribution to the global economy not only by achieving sustainable growth that balances both domestic and external demand, but also by playing an active role in discussions toward global challenges.

Thank you for your attention.

Chart 1. Asian Economies as Drivers of Global Economic Growth

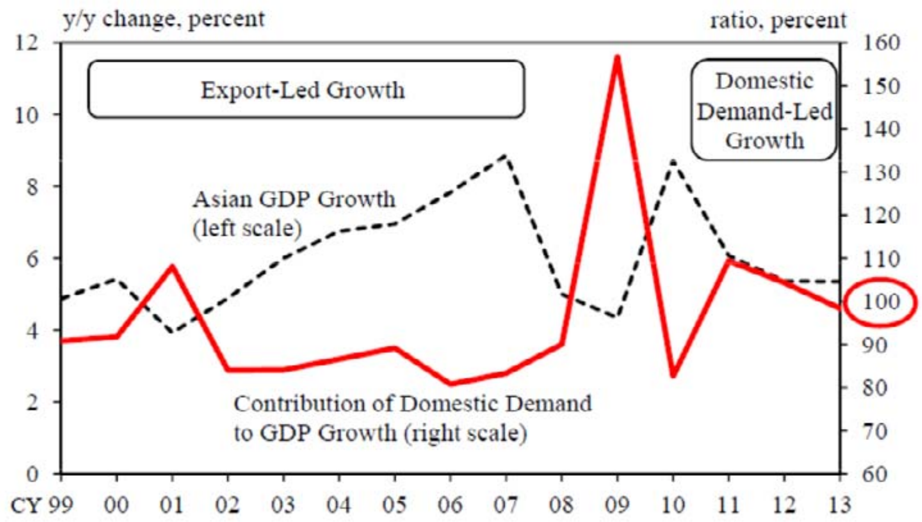


Notes: 1. Asian here includes the following 16 economies: Bangladesh, Cambodia, China, India, Japan, Laos, Myanmar, Vietnam, the four NIEs (Hong Kong, Singapore, South Korea, and Taiwan), and the ASEAN-4 (Indonesia, Malaysia, the Philippines, and Thailand).

2. Data for 2012 were used where data for 2013 are not available.

Sources: IMF, World Bank, United Nations, national statistics.

Chart 2. Transition Toward Domestic Demand-Led Growth



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Sources: IMF, World Bank, United Nations, national statistics.

Chart 3. Cross-Border Collateral Arrangements (CBCA) between Asian Central Banks and the Bank of Japan

	Year of Establishment	Eligible Collateral
Bank of Thailand	2011	Japanese Government Securities, Japanese Yen
Monetary Authority of Singapore	2014	Japanese Government Securities
Bank Indonesia	Agreed in principle in 2013	Japanese Government Securities