Hiroshi Nakaso: Asian economy – past, present and future

Keynote address by Mr Hiroshi Nakaso, Deputy Governor of the Bank of Japan, at the Securities Analysts Association of Japan International Seminar, Tokyo, 24 April 2015.

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Accompanying charts can be found at the end of the speech.

Introduction

It is a great honor for me to speak here at the International Seminar hosted by the Securities Analysts Association of Japan.

Today's seminar is titled "Asset Management in Asia: Opportunities and Future Development." The participants here today are all engaged in financial markets business, whether directly or indirectly, and your involvement has contributed to the development of financial markets in Japan and other Asian economies. Your continued involvement in financial markets, whether directly or indirectly, has helped build the foundations for the success of the financial markets. As I will elaborate later, we, the Bank of Japan, have also been actively making efforts to develop Asian financial markets, through bilateral and multilateral cooperative initiatives with other Asian economies.

Today, under the title "Asian Economy: Past, Present, and Future," I will first look back at the growth of the Asian economy and its driving forces, and then share my views on the challenges ahead for the sustainable growth of the Asian economy.

I. Growth of the Asian economy: Past, present, and future

Asian economic growth in historical context

Let us turn back the clock and reflect on the history of Asian economic growth.

It may come as some surprise to learn that, based on studies by the renowned economic historian, Professor Angus Maddison, the Asian economy accounted for nearly 60 percent of the global GDP before the Industrial Revolution which began in the late 18th century (Chart 1). However, as the Western economies have enjoyed much higher growth since then, the share of the Asian economies has followed a downward path from that high of 60 percent, to as low as just over 10 percent by the early 1950s.

The Asian economy did not sink without trace, though. A period of strong economic expansion known as the "Asian Miracle" ensued, characterized by a "flying geese" pattern of development. This began in the 1960s, with high growth in Japan followed by take-off of the "Four Tigers," Hong Kong, Korea, Singapore, and Taiwan. In the early 1980s, Malaysia and Thailand joined these five to enjoy the high growth path. China gained momentum in the 1980s, and started to record double-digit growth after joining the World Trade Organization in the early 2000s, which made China a driving force of the Asian economy.

Of course, during the history of Asian growth over half a century, the road to success was not always smooth. Many of you will recall the 1997 Asian Currency Crisis, which followed a period of high growth in the mid-1990s. Despite the unprecedented impact of the crisis, the regional economy proved its strength and resilience, with its foundations firmly rooted in a strong manufacturing base, as many Asian economies soon regained the prosperous export-led recovery trail. Another more recent illustration of this resilience is the Lehman Shock and the subsequent global financial crisis. After the crisis, the Asian economy continued to follow a relatively high growth path.

The resilience and robustness of the Asian economy and its markets was also evident in the aftermath of the so-called taper tantrum in May 2013. The stability of financial markets in emerging economies in general was eroded, but Asian stock and foreign exchange markets remained relatively immune (Chart 2). Returning to the share in global GDP, the Asian economy today has recovered its share to over 30 percent, and is expected to continue contributing to the sustainable growth of the global economy.

Mechanism of economic growth in Asia

What then makes the Asian economy so strong and resilient? To this end, I want to elaborate on two mechanisms or the dual engines which have driven the Asian economy.

The first mechanism is Asia's position as "the factory of the world," a position achieved through continued expansion of exports driven by direct investment from abroad. Global trade volumes increased dramatically with trade liberalization and direct investment growth. Firms in advanced economies proactively engaged in strategic global allocation of production sites in order to ensure the most efficient means of production. In this way, these firms could not only cushion the effects of higher wages and saturated demand for goods in advanced economies, but also reap the benefits of growing demand in emerging economies. Significant advances in information technologies and inventory management have also contributed to these movements.

It is only natural that Asia became identified as an attractive candidate in this process, given its abundant low-cost and highly-skilled labor force and large potential for future growth. Global firms increasingly moved their production sites to Asia, and traded components and finished goods with their home or third countries, thus making their supply chains more global. Asia, as a hub of such trade networks, enjoyed employment opportunities created by the entry of foreign firms and exports increased significantly. At the same time, adoption of advances in production technology and resource management enhanced competitiveness, along with the accumulation of human resources.

The second mechanism that I want to highlight is the autonomous growth in domestic demand spurred by the development of export industries. As export industries grew, a large proportion of the labor force moved from the rural agricultural sector to take up employment in urban factory sites. As income level rose with economic expansion, the number of middle-income households gradually increased, which underpinned the strong growth in consumption. As a result, the ground was laid for an autonomous expansion of domestic demand, which, along with exports, underlined Asian economic growth. As evidenced in the recent increase in direct investment in the non-manufacturing sector, Asia is now recognized not only as "the factory of the world," but is also gaining prominence as the world's biggest "consumer base."

Middle-income trap

The question here is whether Asia can maintain its position as the world growth center in the future. According to long-term forecasts by international organizations and private-sector economists, Asia is expected to continue to enjoy relatively high growth and thus its share in the global GDP will increase steadily.

These forecasts depend largely on the implicit assumption that Asia will maintain its growth momentum without falling into the "middle income trap." The so-called follower group economies can move from low-income to middle-income status by continuing on the road to high growth, leveraging their abundant resources and importing technology. This catch-up-style growth will be short-lived though, unless it is underpinned by the gradual sophistication of the industrial structure. History shows that many economies have faced difficulties in advancing beyond the status of a middle-income economy. This is known as the "middle-income trap." A low-income economy can strengthen export competitiveness in the process of reaching middle-income status by using the abundant inflow of human resources from the rural agricultural sector, which puts downward pressure on wages. However, wages tend to rise after passing what is called "the Lewisian Turning Point" in development economics. This in turn reduces corporate profits and weakens export competitiveness, which together lead to sluggish economic growth.

Several Asian economies have taken the world by surprise by achieving the "miracle" of actually escaping the shackles of the middle-income trap (Chart 3). Japan reached the Lewisian Turning Point in the 1960s, but then marked the "Izanagi" boom years from the mid-1960s to the early 1970s, growing by more than 10 percent year-on-year. The "Four Tigers" have also continued on a growth path after escaping from the middle-income trap. In these economies, there were many factors at play. On the supply-side, abundant investment in plant and equipment led to higher productivity in manufacturing and other sectors together with higher capital equipment ratios. On the demand-side, the investment in plant and equipment translated into an increase in demand, and higher competitiveness through higher productivity led to a sustained expansion of exports. The population shift from rural agricultural areas to urban areas created a sizable middle-income tier, heralding an increase in consumption.

II. Challenges for the Asian economy: Expanding productivity

So, how can Asia as a whole continue to enjoy prosperity while ensuring that those Asian economies still in the early stages of growth continue to progress without falling into the middle-income trap? I will focus on three issues that need to be addressed or the "challenges" facing Asian economies.

The first challenge is to ensure a continuous increase in productivity. In particular, there are a number of issues to be addressed if we are to strengthen the traditional Asian growth model based on a combination of both exports and domestic demand.

Staying competitive in the changing global environment

In order to remain competitive and further develop export industries, Asian economies need to keep on adapting to changes in the global competition environment.

The global trade volume has been rather depressed of late compared with global economic growth. The concept of "slow trade" is now being actively debated among economists (Chart 4). This "slow trade" phenomenon can be explained in part by the cyclical factor that investment in plant and equipment, which has a greater tendency to induce imports, is lower than in the past. At the same time, a more structural factor can also be identified. The expansion of global supply chains, which has underpinned Asian growth for some time, has reached its maturity stage, thus contributing to the "slow trade" phenomenon.

One prominent example of these structural changes can be observed in China, which has been playing a major role as the assembly and export center in global supply chains within Asia. The growth in exports to China from other Asian economies has been depressed as China, by increasingly using domestically produced parts, has become less dependent on imports. Additionally, this year will almost certainly become an epoch-making year for China when outward direct investment exceeds inward direct investment for the first time. Further expansion of production base by Chinese firms to neighboring economies is stimulating the reconstruction of supply chain networks. These developments represent a significant environmental change for Asian firms.

In addition, there has been progress toward greater integration within the region in the form of the ASEAN Economic Community (AEC). Such integration will stimulate intraregional trade as barriers to the free movement of goods and services are removed. It will also change the flow of goods and capital, and lead to increased competition.

What is required to overcome the challenges posed by such changes in the economic environment? From the experiences of those economies and regions that have already overcome the middle-income trap, it is crucial not to cling to past success, but to concentrate on adapting to the changing environment with an eye to the future direction of changes, and to keep on pushing into new frontiers. The value of investing in areas such as research and development should not be underestimated; the strategic development and advancement of the industrial structure depends upon such investment (Chart 5). If an industrial sector with competitive advantage is developed, this will translate into increased strength in the export business.

Nurturing the service sector and urbanization

Turning our attention toward the issue of domestic demand, it is clear that the key to offsetting the saturation of demand for manufactured goods is to nurture the service sector and raise its productivity. The service sector is often labor-intensive, and as a consequence, tends to yield lower productivity compared to manufacturing industry. For this reason, the Asian economies should be mindful to maintain a high level of productivity in the overall economy when they shift toward a service economy, by providing high value-added products with the active implementation of innovations such as in information technology.

Urbanization will play an important role in this regard. China and other Asian economies have been promoting urbanization as one of their policy targets (Chart 6). Concentration of the population to cities, with a larger middle-income population, will lead to greater demand for high value-added products and services.

Increasing investment in infrastructure

Increased investment in infrastructure is likewise vital to stimulating both exports and domestic demand. However, there are still some Asian economies where insufficient infrastructure is bottlenecking industrial advancement (Chart 7). For example, a stable supply of electricity is a prerequisite to persuading manufacturing firms to move their production sites. Shipping ports and roads are indispensable in order to expand exports. Supplying sufficient residential infrastructure such as housing, schools, and proper water and sewage systems is crucial to promoting urbanization.

According to a report by the Asian Development Bank (ADB), the Asian economy is expected to invest the phenomenal sum of nearly 8 trillion US dollars in the 11 years from 2010, in infrastructure such as power supply and roads. Infrastructure investment is a stimulus not only for domestic demand, but would also attract investment by foreign firms that can provide sophisticated technological expertise, which would in turn contribute to boosting productivity.

III. Challenges for the Asian economy: Adapting to changes in demographics

The second challenge facing the Asian economy is to embrace changes in demographics.

Asia is composed of a diversity of economies, and the patterns in demographics are also diverse (Chart 8). For instance, while India has some time to enjoy the benefits of the demographic bonus, the “Four Tigers,” China and Thailand are already facing an aging population and declining birth rate. It is worth mentioning that China and Thailand will be going from demographic bonus to demographic onus while they are still in the middle-income tier. Finding the appropriate response to these changes in demographics and sustaining growth poses a major challenge to the Asian economy.

We could draw lessons from the experience of Japan. One of those lessons is that demographic onus depresses economic growth through both the supply-side and demand-side factors. On the supply-side, it is widely recognized that labor constraints put downward pressure on the potential growth rate. There is empirical evidence to support this observation in the case of Japan where, since the 2000s, the labor force has been shrinking, household savings have declined, and the pace of growth in capital accumulation has slowed.

On the other hand, the demand-side factors are not so obvious, and they tend to be overlooked. In the case of Japan, the aging population and declining birth rate have, for example, induced higher demand for goods and services targeting the elderly, but not all of this potential demand has been exploited because firms have not necessarily succeeded in identifying and responding to such changes. As to social security systems, severe fiscal conditions in pension and medical insurance systems has been interpreted as heralding potential future increases in payments, which would lead to suppressed consumption.

So, with an eye to these potentially serious negative effects of the demographic onus, it would be wise to recognize and assess these effects without delay, and to take action to alleviate them in a forward looking manner.

On the supply-side, labor participation of women and the elderly will need to be increased in order to address the decline in the working population. In general, the participation rate of women and the elderly tends to be lower in Asia than in advanced western economies. There is an urgent need to establish a working environment that is receptive to women and elderly workers, so as to make the most of their potential contribution. On the demand-side, firms need to step up efforts to identify and exploit the potential demand of the elderly, adjusting their product lines to cater to targeted needs in areas such as travel, nursing care, and user-friendly electronic appliances.

IV. The challenges for the Asian economy: Enhancement of resilience

Capital flows and the Asian economy

The third challenge is how to make the Asian economy more resilient to global shocks.

Asia has successfully maintained its high economic performance so far by attracting and effectively utilizing the capital flowing into the region. The capital inflow first came primarily in the form of direct investment, which helped establish Asia's position as "the factory of the world." Later, portfolio investments joined the capital inflows, resulting in more volatility in capital flow in and out of Asia, which then developed into the Asian Currency Crisis of the late 1990s.

This experience prompted Asian economies to review their policy frameworks flexibly so as to become more resilient to global shocks. For instance, in terms of foreign exchange policy, the de facto fixed exchange system pegged to the US dollar was replaced by a more flexible system. Foreign reserves were accumulated at a rapid pace. To make financial systems more resilient, Asian economies adopted macroprudential policies well in advance of other regions. On the financial market front, policy initiatives have been introduced to encourage the development of local currency bond markets. These efforts combined have led to a strengthening of Asian markets, as proven by the fact that Asian markets were not as seriously affected by the negative effects of the global financial crisis that followed the Lehman Shock.

However, we should also recognize the fact that capital flows to and from Asia will inevitably become more volatile as the Asian financial markets become more integrated into global financial markets with the irreversible progress of globalization. With this in mind, a major challenge facing the Asian economy is to further strengthen its resiliency against global shocks, and I want to share three ways through which this might be achieved.

Making use of the region's abundant savings

The first way is to further promote financial intermediation mechanisms which enable effective use of the abundant savings in Asia. Traditionally, Asian economies have relied mainly on the banking sector for financial intermediary services, and this may have been at the expense of development of the capital markets. Against this background, the abundant savings in Asia have not been utilized within the region, but have flowed out to the advanced economies, only to return to Asia as capital flows from advanced economies. In this process of global capital recycling, even small changes in the risk appetite of global investors have caused the rewinding of capital inflows, and that has had a disproportionately large impact on relatively small emerging markets.

In order to resolve this issue, it is essential to work simultaneously on strengthening the banking intermediary channel and nurturing alternative financial intermediation channels. In particular, each economy should continue to focus on promoting the development of its local currency bond market, so as to ensure a more diverse range of investment choices into which Asian domestic savings can flow.

In this regard, bond markets in Asia have grown significantly since the mid-2000s (Chart 9). This is largely thanks to the invaluable efforts of market participants like the audience today to make the market environment more conducive, including making improvements in soft infrastructure such as enhanced disclosure by Asian firms and standardization of accounting systems. Looking at data by currency, the share of foreign currency-denominated bonds has declined overall. A look at the most recent data, however, paints a somewhat contradictory picture of this trend, with a small increase in foreign currency-denominated bonds as funding costs have declined against the background of unconventional easing policies in advanced economies. Due attention should be paid to the influence that the imminent normalization of the monetary policies in the United States might have on the debt servicing capacity of Asian firms.

Regional integration and pickup in cross-border trade

The second way to boost resilience to global shocks is to accelerate regional financial integration, which has been lagging behind the integration of trade and other real economic activity. Together, these efforts are expected to encourage more activity in the flow of funds, with a pick-up in cross-border transactions, both inter-regional and intra-regional. Over-dependence on capital from outside the region would expose Asia to sudden withdrawal of credit provision and sharp unwinding of capital triggered by shocks not directly related to the region. Expansion of intra-regional cross-border transactions would broaden and deepen the investor base, contributing to higher resilience of Asian markets.

The financial markets in Asian economies are in various stages of development. This poses a serious impediment to regional integration, unlike in Europe, which stands as a forerunner case in regional integration. Even so, it is not farfetched to expect a surge of activity in terms of cross-border transactions, once market practices and the relevant laws and regulations are further harmonized.

In this connection, one topic which needs to be duly considered alongside the promotion of cross-border trades is payment and settlement systems. Central banks, including the Bank of Japan, are making joint efforts to ensure and enhance smooth cross-border settlements. As part of these efforts, there is ongoing discussion among the ASEAN economies, Japan, China, and Korea to establish cross-border linkage between the securities settlement systems and central banks' payment systems. This would most likely stimulate an increase in capital transactions within the region, as intra-regional cross-border payments and settlements will become safer and more efficient. Once this initiative is established, for instance, Japanese banks would be able to smoothly and effectively obtain funds in Asian currencies on a Delivery Versus Payment (DVP) basis against Japanese Government Securities (JGSs) collateral (Chart 10).

Strengthening the regional safety nets

The third way to ensure resilience is to strengthen the regional safety nets. It is especially important to prevent spillover and contagion triggered by a temporary liquidity shortage in terms of the balance of payments or funding by financial institutions.

Bilateral swap agreements have already been established among the economies in the region to deal with any liquidity crisis related to balance of payments. Furthermore, the economies of ASEAN, Japan, China, and Korea have agreed on the expansion and strengthening of the Chiang-Mai Initiatives, which help finance short-term US dollar liquidity among participating economies (Chart 11).

Preventing liquidity crises among financial institutions is another important task for central banks. The Lehman Shock and the ensuing global financial crisis reminded central banks around the world of the importance of fostering a sound financial system with a resilient funding environment for financial institutions and deep and liquid interbank markets. We have also observed that banks have been increasingly expanding their presence in other economies in the region. This is one of the reasons why Asian central banks are progressively making efforts to enhance environments for the funding of local currencies. The Bank of Japan has already agreed to establish cross-border collateral arrangements with many Asian central banks (Chart 12). These are arrangements in which, for instance, Asian central banks provide local currency liquidity to Japanese financial institutions against yen-denominated assets as collateral, in a situation where the Japanese financial institutions encounter funding difficulties in the Asian currencies. The Bank of Japan has agreed to establish such arrangements as a backstop with central banks in Thailand, Indonesia, and Singapore. In February 2015, the Bank of Japan and Bangko Sentral ng Pilipinas (BSP) agreed to establish a cross-border liquidity arrangement where Philippine pesos are provided against yen cash.

In establishing and managing regional safety nets, authorities in the region should recognize and acknowledge the policy issues that each country faces, and be prepared to cooperate in addressing any sudden and serious changes in international financial markets. From this perspective, the Bank of Japan, in cooperation with other central banks in Asia, has been contributing proactively to the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP).

Concluding remarks

I have talked briefly today about the history of Asian economic growth, and I have highlighted three challenges ahead. These challenges will test whether the Asian economy will be able to realize a sustainable growth path. I believe that Asia has high potential to overcome these challenges, and, we should be able to celebrate the 21st century as the "Asian Century."

Another important question is how Japan can contribute to sustainable growth in the region, as well as enjoying the benefits of this growth. I would like to add a few words on this issue.

As Asia becomes more than just "the factory of the world," but also a globally important market, many changes are being observed in the demand structure in the Asian economy, such as rising demand for goods in local markets and the shift towards a service economy. If Japan is to enjoy the full benefits of the region's growth, it needs to adapt appropriately to such changes. Japanese firms have nurtured strong product lines and business expertise within a competitive domestic business environment. In order to cultivate local demand, I think it would be very effective to take advantage of such high-quality products and expertise with due consideration to the local cultures and customs of each economy. For Japanese financial institutions, it is essential to focus not only on efforts to support Japanese firms operating in Asian countries, but also to contribute to local economic development by supporting local business firms. These efforts are already underway.

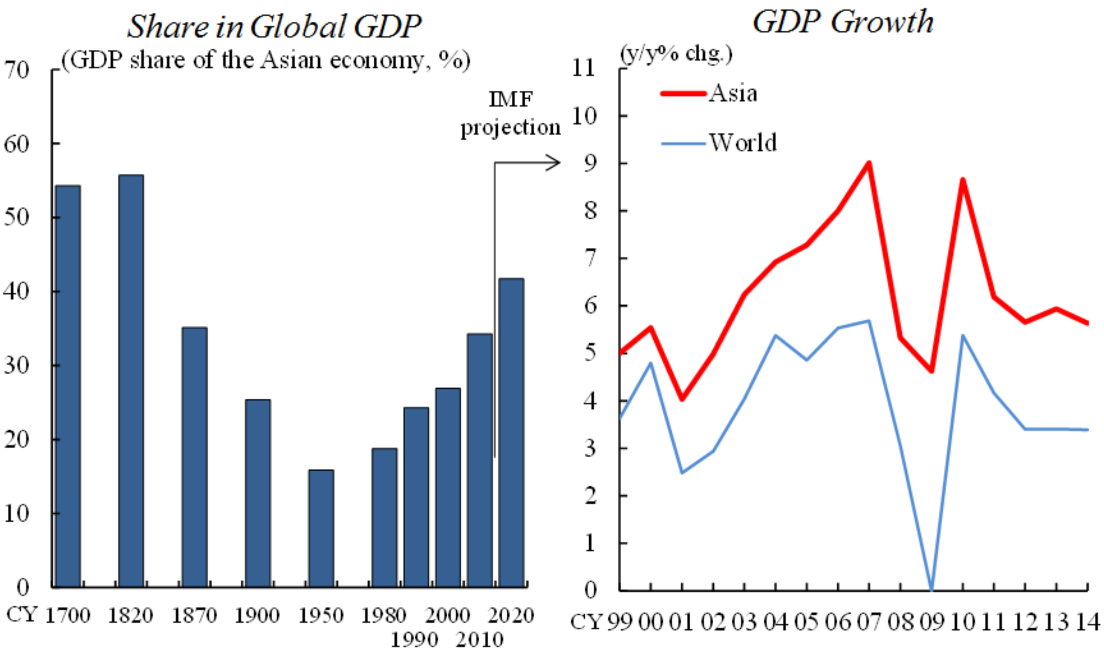
Japan has already experienced many of the challenges that other Asian economies will be facing in the near future, such as environmental and energy issues. We could say Japan is "in the vanguard of addressing global issues." Japan can use this front-runner advantage as a business opportunity in providing skills and expertise in these areas, and through this, can contribute to underpinning sustainable growth in the region.

The Bank of Japan, for its part, has been pursuing aggressive monetary easing, or quantitative and qualitative easing (QQE), with the aim of achieving a price stability target of 2 percent. Leading Japan's economy out of persistent deflation and putting it on a solid recovery path should also contribute to upholding the sustainable economic growth of the Asian economy. I would like to conclude my remarks by adding that the Bank of Japan is determined to play an active role in enhancing the financial infrastructure in Asia, through such means as refining payment and settlement systems and strengthening safety nets.

Thank you.

Chart 1

GDP Share of the Asian Economy



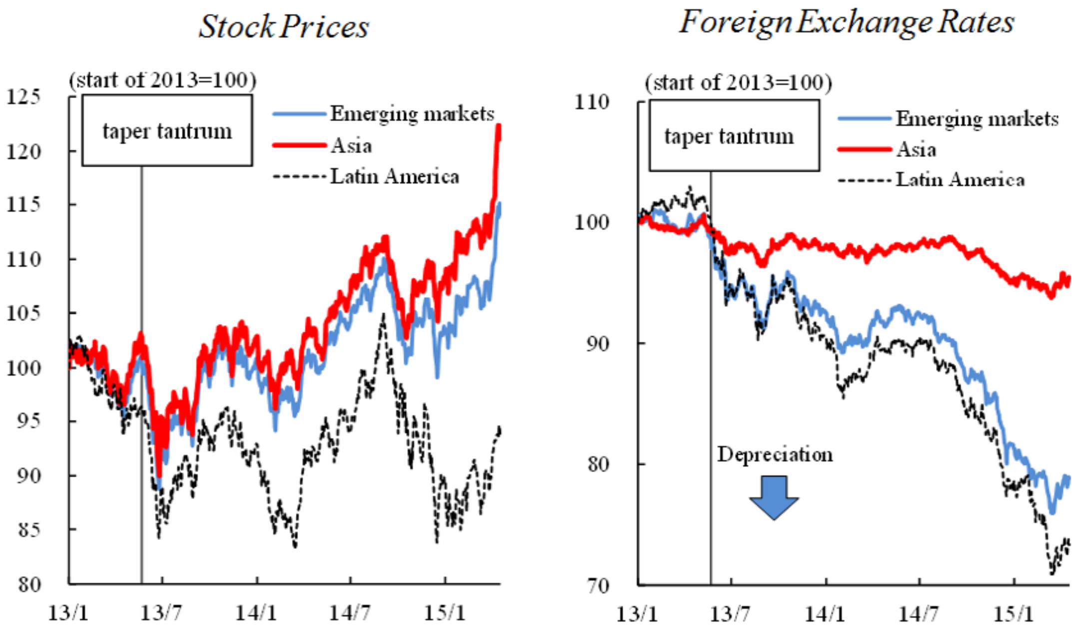
Notes: 1. Figures up to 1980 are based on Maddison. Figures from 1980 are based on IMF data.
2. Asia here includes the following 16 economies: Bangladesh, China, India, Japan, Myanmar, Nepal, Sri Lanka, the four NIEs (Hong Kong, Singapore, Korea, and Taiwan), and the ASEAN-4 (Indonesia, Malaysia, Philippines, and Thailand).

Sources: IMF, Angus Maddison "Statistics on World Population, GDP and Per Capita GDP, 1-2008 AD."

1

Chart 2

Asian Financial Markets



Source: Bloomberg.

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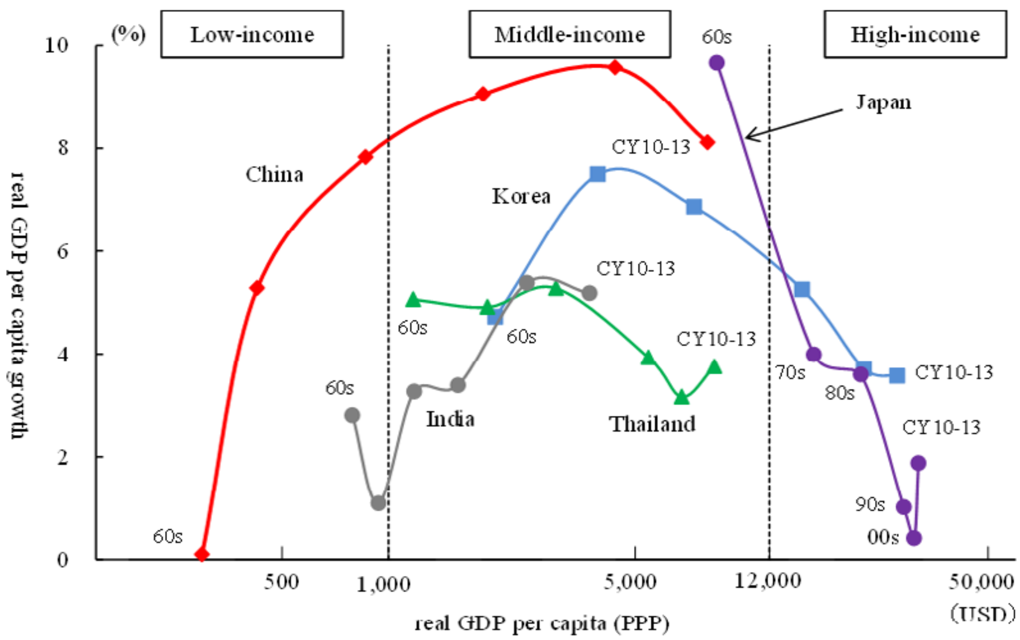
Chart 3

Economic Growth of Asian Economies



Note: Annual averages. X-axis represents logarithmic value of Real GDP per capita.
Sources: World Bank, Penn World Table.

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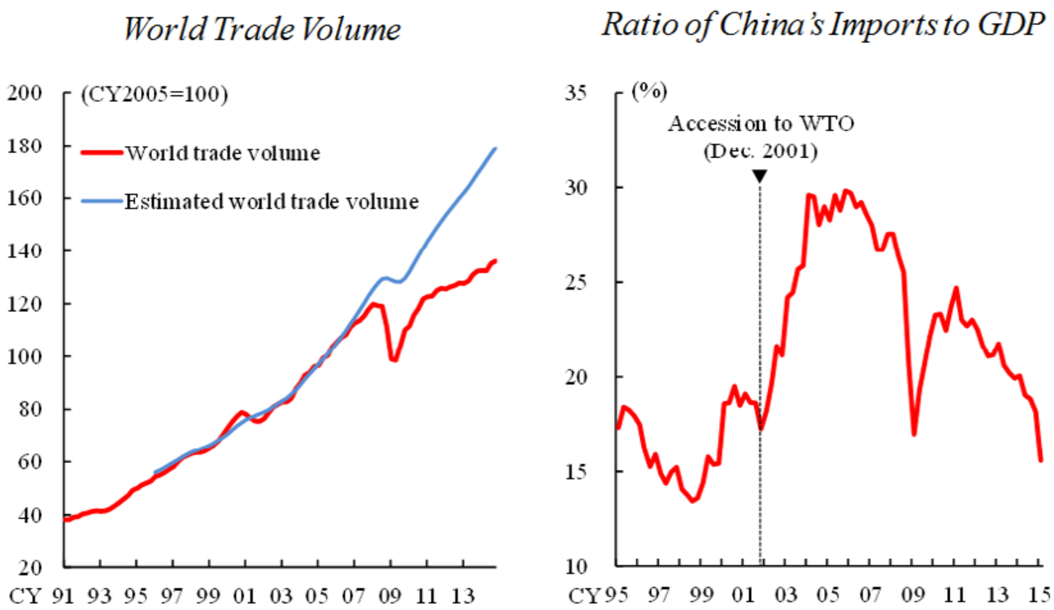
Chart 4

Changes in Global Trade



Note: Estimated world trade volume is derived from world trade volume and world GDP in 1996-2007 time span by a simple linear regression, and is extrapolated after 2008.
Sources: CPB, HAVER.

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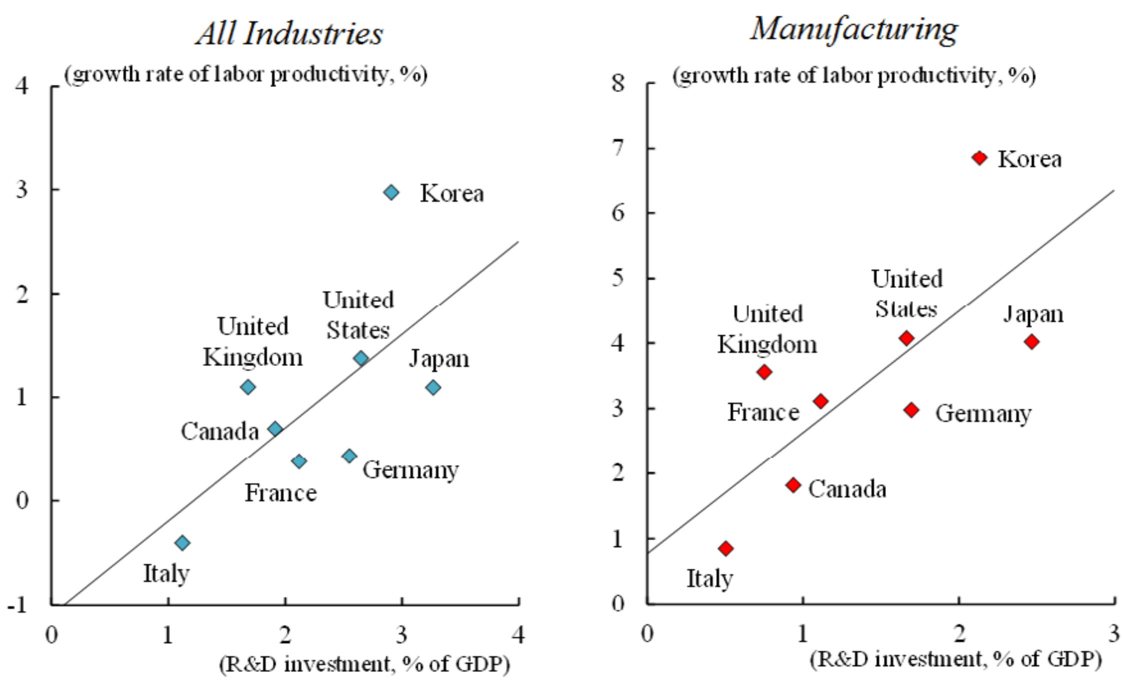
Chart 5

R&D Investment and Labor Productivity



Note: Average of 2000-2012. Figures of R&D investment on the right-hand side are base on "Business."
Sources: OECD, United Nations, ILO, HAVER.

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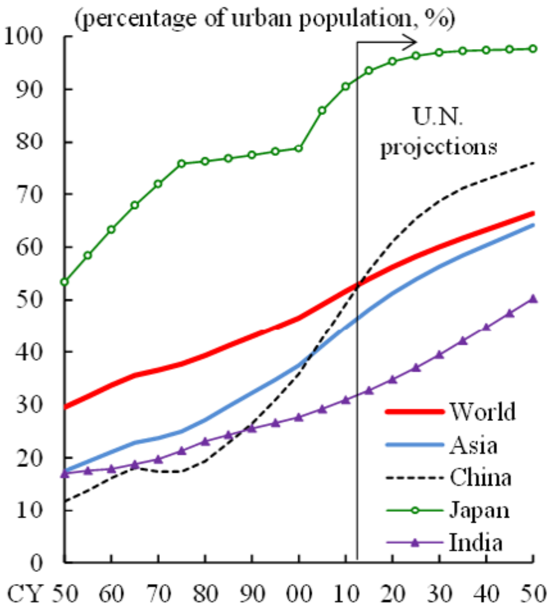
Chart 6

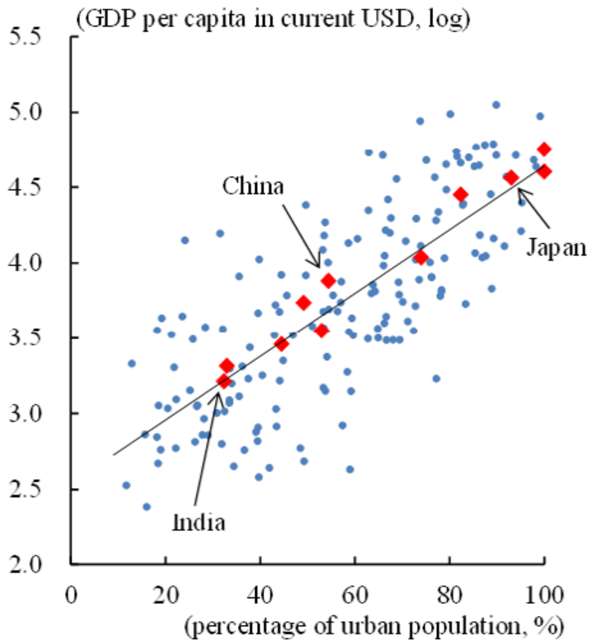
Progress in Urbanization

Urbanization in Asian Economies



Sources: United Nations, IMF.

Urbanization and Growth



Note : CY 2014 data.

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Chart 7

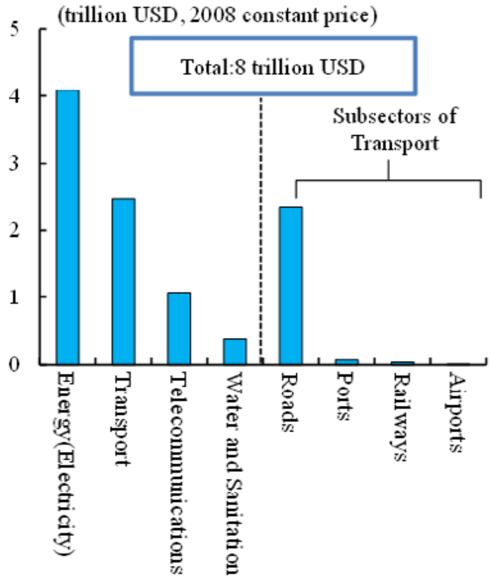
Business Environment and Infrastructure Needs

Business Environment

(ranking based on 189 economies)

	Ease of Doing Business	Starting a Business	Dealing with Construction Permits	Getting Electricity
Singapore	1	6	2	11
Hong Kong	3	8	1	13
Korea	5	17	12	1
Malaysia	18	13	28	27
Taiwan	19	15	11	2
Thailand	26	75	6	12
Japan	29	83	83	28
China	90	128	179	124
Philippines	95	161	124	16
Indonesia	114	155	153	78
India	142	158	184	137

Asia's Infrastructure Needs



Note: The projection of infrastructure needs covers 30 economies in Asia and the Pacific for the period 2010-2020.
Sources: World Bank, Asian Development Bank.

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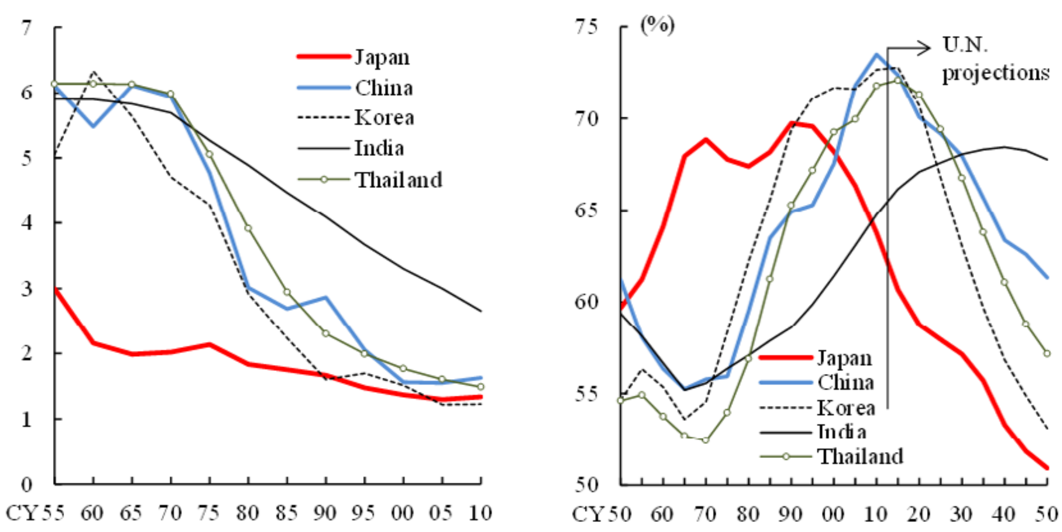
Chart 8

Demographic Transition

Fertility Rate | *Working-Age Population Ratio*



Note: Fertility rate refers to total fertility rate.
Sources: United Nations, HAVER.

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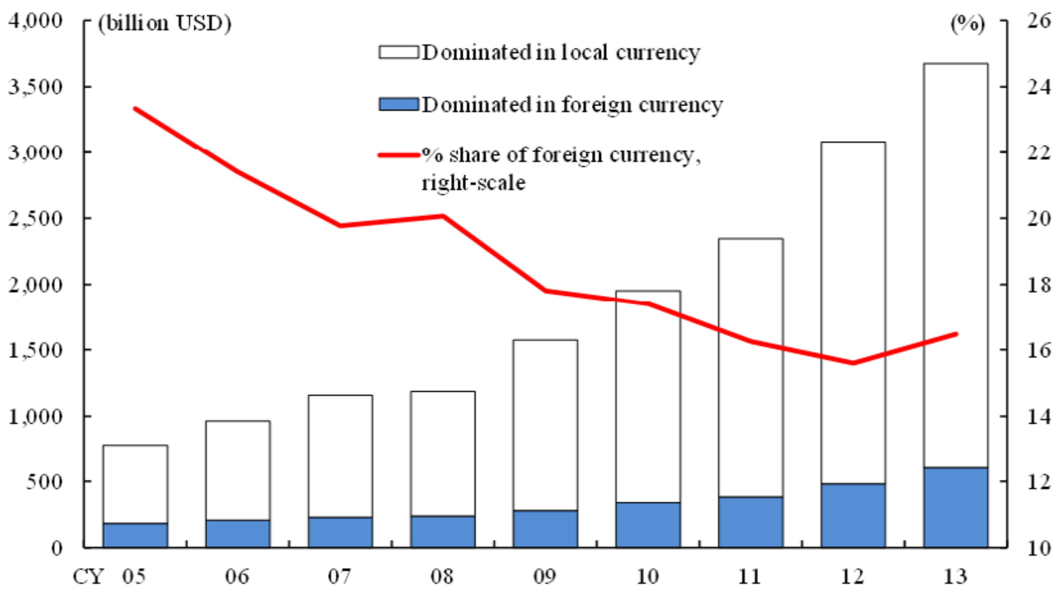
Chart 9

Corporate Bonds Outstanding in Asia



Note: Aggregate of nine Asian economies, excluding Japan.
Source: Asian Bonds Online.

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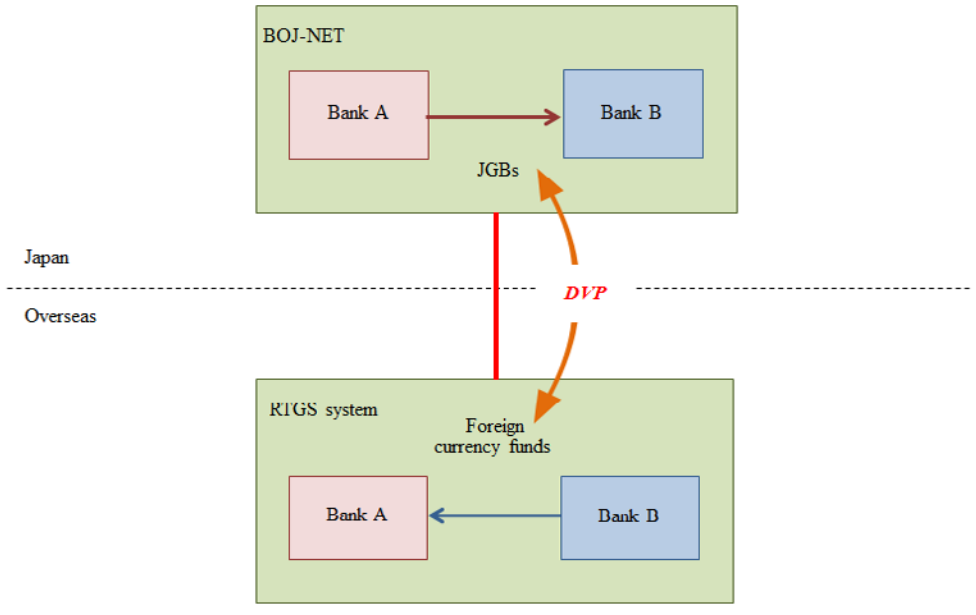
Chart 10

Cross-Border DVP Linkage: Illustration



Note: DVP (delivery-versus-payment) is a mechanism in which a delivery of securities takes place if, and only if, payment occurs.

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Chart 11

Chiang Mai Initiative Multilateralisation (CMIM)

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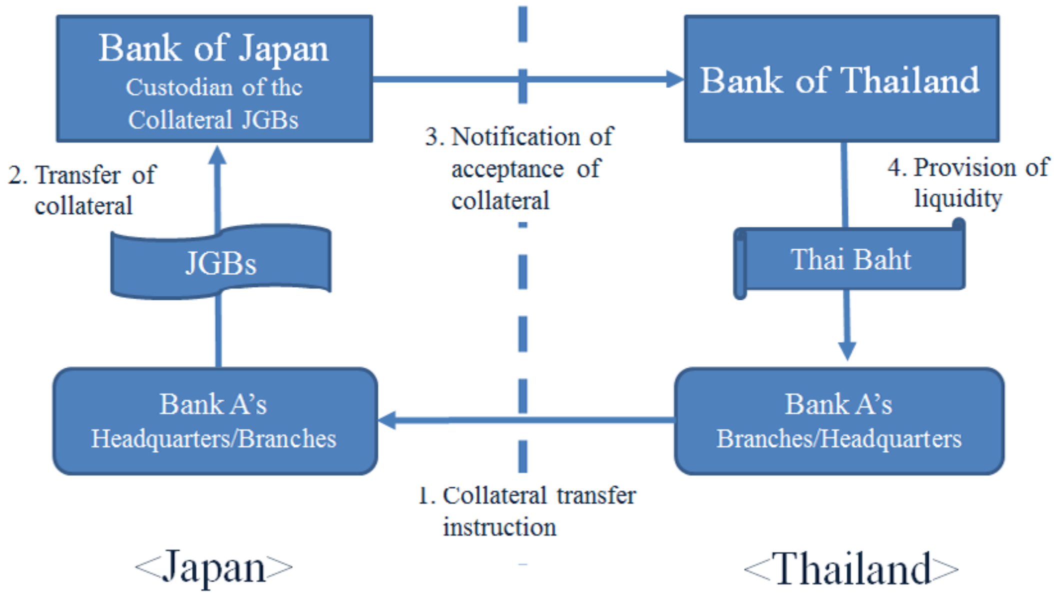
Chart 12

Cross-Border Collateral Arrangement

Case between Bank of Japan and Bank of Thailand



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