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Bank of Japan

The Global Economy and the Global Financial System: In an Era of Revival and Metamorphosis

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Introduction: Ten Years On from the Global Financial Crisis

Thank you very much for giving me the opportunity to address the Spring Membership Meeting of the Institute of International Finance (IIF).

This year, we will be entering the ninth year since Lehman Brothers collapsed. That event in September of 2008 was one of the most visible flashpoints of the Global Financial Crisis, but if we count from what should be seen as the foreshock -- severe disruptions in the U.S. subprime mortgage market in 2007 -- we are marking the tenth anniversary of the Crisis. We have indeed come a long way. Since the Crisis, the global community has put considerable efforts into rebuilding the financial system, and such efforts have contributed to greatly enhancing the stability and resilience of the international financial system, compared with what we had before the Crisis.

The list of achievements regarding the reform of the international financial system since the Crisis is quite long. Basel III was introduced. The over-the-counter (OTC) derivatives market was reformed. Risk management at central counterparties (CCPs) was strengthened. The process of resolving financial institutions was improved, and so on. Of these reforms, Basel III, which applies to internationally active banks, ushered in significant changes to the existing framework of banking regulation in terms of both capital and liquidity. After almost seven years of negotiations, we are now crossing the t's and dotting the i's. The fact that we have reached this stage for a very complex framework, which must accommodate conflicting national interests, proves that financial authorities and banks, which experienced perhaps the worst turbulence since the Great Depression of the 1930s, have worked together, sharing a firm commitment not to see a repeat of the Crisis. This is a notable achievement in the annals of international financial cooperation.

Obviously, financial regulation is a means to an end. That end is financial stability, which is one of the fundamental underpinnings of sustained growth of the economy. Many of the new international prudential regulations that were agreed in the wake of the Crisis, such as the enhanced capital levels, the liquidity coverage ratio, and the countercyclical buffer, are now being introduced in steps, and more regulations, such as the leverage ratio, total loss-absorbing capacity (TLAC), and net stable funding ratio (NSFR), are on the way, again in steps.

Since all these new internationally agreed rules are part of a bigger package, they must unfalteringly come into effect as envisaged if the rules are to have the desired effects. Having said that, we also must be mindful of the danger of the means becoming an end unto itself. If compliance to rules becomes an overarching goal, there could be unintended effects on the functioning of financial intermediaries. Financial regulation must not be the Procrustean bed of Greek mythology. Accordingly, financial authorities and banks must closely monitor the effects of the new rules on the macro economy and financial markets without prejudice and from the broadest of perspectives.

I. Global Economic Developments: Adjustment Ending but Fragility Lurking

Global Recovery and the Waning of Pessimism

As the global financial system is generally returning to a surer footing, the global economy is also regaining its momentum since the second half of last year. In the World Economic Outlook (WEO) published last month, the International Monetary Fund (IMF) expects the global economy to grow by 3.5 percent this year. The developed economies -- Japan, the United States, and Europe -- are all envisaged to enjoy robust domestic demand growth, while the forecast for Chinese growth is around 6.5 percent. At the same time, with the strengthening of major economies and the bottoming out of commodity prices, nascent recovery is observed in the growth momentum of developing countries and resource-rich economies. All in all, the prevailing pessimism since the Global Financial Crisis, which fostered colorful language such as "secular stagnation" and "low growth trap," is clearly on the wane.

Such a sea change probably could be attributed in part to the anticipation over the economic policies of the new U.S. administration. Having said that, more fundamentally, I would note that the global economy has finally reached escape velocity. Support from various policies during the ten years since the Crisis is now finally bearing fruit.

Looking back, during the last few years, the global economy suffered weak corporate investment and there was talk of the C-suite losing its animal spirit. While the huge negative demand shock resulting from the Crisis inevitably depressed investment, it also seems difficult to deny that the cloud of pessimism rising from the shocks cast a pall over the economy, resulting in a negative feedback loop delaying autonomous recovery.

Cognitive psychology tells us that perception creates reality. The prevalence of skewed negativism from the damaging demand shock could have dampened investment and new hires, and that in turn could have depressed potential growth. One can interpret this as one form of hysteresis, as described in economic textbooks.

Fortunately, various measures of business and consumer confidence are on an upswing everywhere, and what I might describe as a chain reaction of pessimism is almost a thing of the past. Meanwhile, we are beginning to see active debate on the desirable policy mix for sustaining the recovery, and more generally on a possible new economic policy framework. If these discourses catalyzed by the launch of the new U.S. administration are uplifting business and consumer sentiment in one way or another, I would view this as a clearly positive development.

A Caveat regarding the Global Financial System: Circularity of Offshore Dollars

Even as the global economy improves, there are still fragilities that should not be overlooked. One that I would like to point out is the dollar-denominated debt of some emerging economies, which has been repeatedly called to attention by observers including economists at the Bank for International Settlements (BIS). These economies -- especially firms in these economies -- have increased the levels of dollar-denominated debt under the accommodative global monetary environment following the Global Financial Crisis. Now, as the United States embarks on monetary policy normalization, we now need to monitor the debt dynamics of these economies from two perspectives: increasing interest payment burden and exchange rate depreciation.

Mentioning the dollar-denominated debt of emerging market economies calls to mind the 1980s debt crisis in Latin America, which shook the world and led to the establishment of the IIF to deal with the problem. The origins of the debt crisis could be traced back to the recycling of excess dollars at oil-producing economies, which ballooned in the 1970s, to Latin American economies through U.S. and European banks. When the United States began monetary tightening and the dollar began appreciating under the new Reagan administration in 1981, the Latin American economies suffered deteriorating debt dynamics and soon fell into arrears on their external payments.

Reflecting on their experiences during the Asian Monetary and Banking Crisis of the 1990s, many emerging market economies today have adopted flexible exchange rates, strengthened risk management at banks, and built up firewalls such as foreign exchange reserves. Accordingly, emerging economies are generally more resilient in the face of stress. Nevertheless, with the increased capital mobility across borders and ever more complex geopolitical risks, we should continue to pay attention to the issue of dollar-denominated debt and currency mismatch at emerging market corporates.

If I may add a few more words here, currency mismatch is also an issue that cannot be ignored by financial institutions of the major economies. For example, over the last few years, Japanese financial institutions have taken pains to ensure stable funding of dollars as they expanded their overseas activities. Even so, they still depend on foreign exchange swaps for some portion of their dollar funding. The foreign exchange swap market has been described as the black box of the international financial market, because it was difficult to pin down the details of its structure.[1] The increasing level of interest rates in the United States would result in higher dollar funding costs through swaps. Furthermore, if emerging market economies reduce the investment of dollar reserves in anticipation of currency support operations, financial institutions would also experience tighter dollar financing conditions in terms of availability.[2]

The issues of repaying dollar-denominated debt by emerging economy corporates and of stable dollar funding at non-U.S. financial institutions are, in a sense, two sides of the same coin. They are the manifestation of the circularity and recursivity of the dollar as the exceptional reserve currency. In view of the sometimes extreme fluctuation of dollar demand and supply in the offshore markets, we should perhaps not forget a comment by a former U.S. Treasury Secretary: "The dollar is our currency but your problem."[3]

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[1] Nevertheless, recent efforts -- for example, by various foreign exchange market committees -- have resulted in enhanced data collection regarding this market.

[2] See Hiroshi Nakaso (2017), "Monetary Policy Divergence and Global Financial Stability: From the Perspective of Demand and Supply of Safe Assets."

[3] Attributed to John Connally, U.S. Treasury Secretary (February 1971-June 1972).

II. Financial Business Environment: Profitability and Digital Innovation

Profitability of Financial Institutions

Under these conditions that I have just described, how is the environment evolving for financial institutions in the major economies?

During the last few years, U.S. and European financial institutions, which bore the brunt of the Global Financial Crisis, had to slim down and restructure their balance sheets in response. However, this is not the end of the story for financial institutions in the developed economies. Since well before the Crisis, these economies have been confronted with long-term structural challenges, such as stagnating potential growth and changing demographics. More recently, risks arising from climate change have been added to the list. These challenges are forcing financial institutions to fundamentally review their business strategies.

In this context, if I may touch upon the situation in Japan, changes in business models at Japanese banks have been less visible compared with U.S. and European banks, reflecting to an extent the relatively limited impact of the Crisis. Nevertheless, the low interest rate environment that has persisted for a quarter of a century and accelerating aging of the population are significantly weighing down on domestic interest margins and loan-to-deposit ratios, and pressure from these two directions is reducing the underlying profitability of Japanese banks. In response, Japanese banks have been actively attempting in recent years to enhance profitability through measures such as expanding overseas business, shifting assets and taking non-yen and equity risks, and diversifying non-interest revenues.

Given the variety of business models for financial institutions, there is no single panacea that could improve profitability. There are good, rational reasons for how various models have evolved. For example, in the United States, where there is a deep capital market, investment banking has evolved, and in Europe, where firms and households are relatively more dependent on banks, there is a preference by tradition for universal banking or bancassurance.[4] Having said that, with due respect to the differences in weighting of factors between economies, attempts by financial institutions to sustainably enhance their profitability must clear higher hurdles that now exist, such as the low-for-long environment, increasing compliance costs, and intensifying competition. Financial institutions must build business models that can flexibly accommodate any changes in environment and at the same time enable them to proactively take risks supported by strong capital foundations. This is a common challenge for all financial institutions in every economy.

As a footnote, I would like to note that, from the perspective of maintaining the stability of the financial system, authorities are paying close attention to the profitability of financial institutions, because higher profitability is one route for financial institutions to organically generate their capital. At the same time, authorities need to closely monitor the robustness of risk management at financial institutions so that these institutions do not take excessive risks in pursuit of profits; in other words, not endanger financial stability via an overheating channel.

FinTech: A New Wave of IT Innovation

In such an environment, FinTech, which is fast emerging worldwide, could potentially be an "enabler," opening up new business frontiers and allowing financial institutions to free themselves from the yoke of low profitability.

Looking at the current state of the global economy, we find the rise of "connected businesses," which tie together information and services almost instantly over a wide horizon, against the backdrop of advances in digital communications technologies and epitomized with terms like "the fourth industrial revolution" and the "Internet of Things (IoT)." "Sharing economy" is one example of such development that is gaining traction everywhere, and broadly speaking, FinTech can be understood in the same context.

[4] A business model where banks develop and sell insurance products. It became popular in Europe (France, Italy, and Spain in particular) from the 1990s onward, involving mainly life insurance products. However, there have been signs of deemphasizing this model recently, reflecting doubts on synergies achieved.

This trend is probably changing the nature of innovation from the longstanding emphasis on improving individual products to an emphasis on transforming how services are provided; in other words, the distribution channel of services. In adapting to such a change, firms that can perform meticulous customer analytics will be able to more appropriately and promptly provide individual customers with services that are tailored to their attributes and preferences.

Such "personalization of services," as it often is called, is making rapid inroads, especially in fields such as healthcare and development of new drugs.[5,6] It also could become more prevalent in finance, leveraging on advances in FinTech, in areas such as retail payments, remittances, and lending, as well as in less capital intensive areas such as transaction banking and wealth management.[7] Here, it is interesting to note that trends in the two of the most heavily regulated activities -- medicine and finance -- are pointing in the same direction with the personalization of services.

Meanwhile, financial institutions cannot shy away from improving their cost structure in meeting their profitability goals, and here again, FinTech can make significant contributions. For example, it is a well-known fact that the return on equity (ROE) of financial institutions is materially higher in the Nordic economies, where online banking is prevalent and branch network density is generally low. Furthermore, while financial institutions have been spending more on compliance with various regulations following the Global Financial Crisis, we are now seeing efforts to apply IT technologies in this area, which are referred to as RegTech, following FinTech. The use of RegTech is still in its infancy, but I must say that it was a groundbreaking endeavor by the IIF to release a report on this issue as early as it did.[8]

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[5] "Personalization of services" could be regarded as a tailoring of services at a more granular level than previously possible.

[6] For example, in everyday application, monitoring of physical conditions through censor-based wearable devices, and in a more rarefied setting, gene therapy taking account of individuals' DNA readings.

[7] Examples of transaction banking are cash management, trade finance, and supply-chain finance.

[8] IIF (2016), "RegTech in Financial Services: Technology Solutions for Compliance and Reporting."

Circumspection and Innovation at Financial Institutions

Although there are opportunities, some leading thinkers argue that banks should distance themselves from innovation and return to a simpler business structure focusing on deposit taking and lending. Such a view is one reflection of the situation that existed before the Global Financial Crisis, at which time banks were jokingly described as "too complex to succeed." In fact, in places like Europe following the Crisis, we can observe trends in banks' lending and funding, which might be described as back to retail. Nevertheless, I cannot buy the idea that banks should be dull, boring, and far removed from innovation. Such a view seems too extreme and ignores, among other things, the extensive information gathering ability of banks.

If banks distance themselves from cutting-edge innovations, that could affect their business models. For example, if retail deposits begin to move around more frequently due to FinTech, intermediary services performed by banks, for which funding is reliant on relatively sticky deposits, would be forced to change. In the United Kingdom and the United States, debate is now underway on the appropriateness of granting banking licenses and central bank access to FinTech enterprises, and this shows that a new horizon of cooperation and competition is being opened up between banks and FinTech enterprises.

Once upon a time, the U.S. economist William J. Baumol noted that the number of musicians needed to play a Beethoven string quartet was four in the 19th century and remained so in the 20th century. That illustrated the Baumol effect, which observed that it was difficult to raise productivity in labor-intensive service industries. However, such a view as Baumol's is now beginning to be a thing of the past, reflecting the widespread deployment of technologies such as artificial intelligence (AI) and robotics in many industries, not only in transportation and logistics but also in medicine and care-giving.

While we must not forget that there are still issues with FinTech in areas such as customer protection and security, we also should recognize its value as a "sandbox," where financial institutions can test innovations according to their respective competitive advantage. We should not let ourselves fall into complacency. After all, as the saying goes, "the stone age did not end for the lack of stone."

III. Conclusion: the Changing Face of Globalization and Multilateral Engagement

Up to now, I have discussed recent developments in the global economy and financial institutions. For the remaining few minutes, let me offer some personal observations on the bright and the not-so-bright sides of globalization, on which debate is now raging in every direction, drawing in part on my experiences at the Asian Development Bank (ADB), where I served as its president until a few years ago.

Increasing Uncertainty in a Multipolar World

Over the last few years, we have seen growing momentum around the world for anti-globalism, which argues that the globalization of the economy is exacerbating income inequality. However, such a view overlooks the unmistakable fact that global economic integration is mitigating global poverty, most obviously in places such as China and East Asian economies. It also is safe to say that access to financial services is improving significantly in emerging economies, as a result of developments such as the widespread adoption of mobile banking. Therefore, it is slightly ironic to find that anti-globalism is becoming more acute in the developed economies. I believe that there is no future in an inwardly obsessed movement turning its back on globalization.

Economies of the world are now strengthening their mutual ties through many channels, including the establishment of value chains transcending national borders. Digital innovations taking place in cyberspace are also accentuated by openness to the outside world. Any ring-fencing attempt that ignores such global interdependencies is inconsistent with the reality of the 21st century in both the real and virtual worlds.

It is true that, in today's world, people's values are fragmenting, leading to increased uncertainty in politics and economic activities, as attested to by anti-globalization movements. Just as a degree of stress is useful in maintaining our personal health, uncertainty will act as a brake on our unwarranted optimism or complacency. Nevertheless, that is true only up to a point. If everyone is saying, as in today's financial markets, that the only certainty is uncertainty, it is not difficult to imagine that decision making is becoming increasingly difficult for economic agents.

The Importance of Multilateral Cooperation

As the world becomes more and more fragmented and uncertain in a mutually reinforcing cycle, we must maintain the stability of the global financial system in the face of inescapable international flows of capital. For this purpose, economies must overcome their narrowly-defined self-interest so as to cooperate and coordinate from a broader perspective. This is to mitigate to some extent the so-called financial trilemma, through multilateral cooperation, and it requires a well-functioning institutional framework such as the IMF, multilateral development banks (MDBs), and the G20.[9] The financial reforms that I have referred to earlier would not have been possible without confidence building among stakeholders through various international fora, including the G20, the Financial Stability Board (FSB), and the IIF.

Since the IIF came into being in the first half of the 1980s, its membership has expanded more than tenfold and now covers more than 70 economies. This underscores the fact that financial institutions were both the driver and beneficiary of globalization. Building on the experiences of the most extreme financial crisis of the last decade, central banks around the world have strengthened their defenses against acute liquidity problems involving foreign currencies, through cooperative measures such as multilateral swap lines. Obviously, reinforcing the safety net like this takes into account the fact on the ground that financial institutions now operate more broadly and deeply across borders.

For the last 30 years, the world economy was engulfed by a strong homogenizing current of globalization. Having said that, I must also note that every trend has an inflection point. As polarization and fragmentation are becoming more evident, globalization may have reached a turning point of sorts. I would thus like to conclude my remarks today with the sincere hope that every one of you gathered here in this room, who are the leaders in international finance, will continue to play the role of inspirators regarding the direction of the global economy.

Thank you very much for your attention.

[9] Financial trilemma is the term for noting that it is impossible to pursue the following three policy objectives alongside one another: financial stability, global financial integration (free movement of capital across borders), and domestically oriented financial policy. For a more detailed explanation, see D. Schoenmaker (2011), "The Financial Trilemma," *Economic Letters*, 111, pp 57-59.