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Bank of Japan

Global Economy: Challenges and Policy Responses

Keynote Speech at the T20 Summit

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Introduction

It is a great honor for me to deliver this keynote speech at the T20 Summit. This year, Japan assumes the G20 presidency for the first time. The G20 Finance Ministers and Central Bank Governors Meeting in Fukuoka is fast approaching. I will be co-chairing the meeting with Deputy Prime Minister and Finance Minister Aso. We will be discussing various key issues regarding the global economy and finance. The T20, as an international forum for think tanks, has also debated a wide range of issues on the global economy, along similar lines to the G20 discussions, and has provided policy proposals. I believe those proposals from think tanks, with their expertise and unique viewpoints, provide valuable input for public sector policy management. Needless to say, it is important that the private and public sectors exchange views, learn from each other, and engage in constructive dialogue, in order to provide and implement better policies. Today, I would like to talk about the challenges and policy responses to the current situation in the global economy, hoping that my speech will contribute to the discussions at the T20 Summit.

Specifically, I would like to elaborate on the medium-term challenges such as global imbalances and international financial architecture. Before going into those issues, let me begin with recent developments in the global economy.

I. Recent Developments in the Global Economy

The global economy registered high growth up to the first half of last year, but it has decelerated since then, particularly in China and the euro area. Several factors account for this deceleration.

First, there has been increased uncertainty regarding economic policy on a global level such as trade tensions and the Brexit negotiations. This has put downward pressure on corporate investment and international trade in capital goods. Second, at the same time, the so-called silicon cycle has entered a downturn, something we have observed many times in the past. Until the first half of last year, there was a claim that the "super-cycle" in demand for semi-conductors was on a rising trend. According to the claim, semi-conductor demand would increase steadily over the medium term. However, as was seen in the past, there have been some cancellations of multiple orders for parts and capital goods, together with downward revisions to final goods such as smartphones.

In addition to these two global factors, region-specific factors have contributed to the recent deceleration in the global economy. The Chinese economy has shown some weakness due to the lingering impact of deleveraging policy measures, together with trade tensions. In the euro area, exports have decelerated, automobile production has been hampered by delays in adjusting to new emissions regulations, and business sentiment have deteriorated due to heightened uncertainty regarding political and economic conditions.

In short, these several factors have contributed to the slower pace of growth in the global economy.

What then are the prospects for the global economy? The most recent *World Economic Outlook* from the International Monetary Fund (IMF), published in April, indicates that the global economy will regain positive momentum during the second half of this year. First, economic policy measures in China and other regions will gradually begin to take effect. China has decided to implement or has already implemented a range of policy measures since the second half of last year, including fiscal and monetary policies. Some Asian emerging economies are also expected to increase fiscal expenditures. In emerging economies in general, monetary policy space has increased as the Federal Reserve has adopted a patient stance regarding its policy normalization. Concerns over capital outflows, currency depreciation, and heightened inflation have also eased relative to last year. Second, production adjustments are likely to show progress in IT-related goods. Manufacturers in Asia, including those in Japan, are now in an adjustment phase, but production of electronic parts is expected to turn around and increase gradually in due course.

However, there remains a high degree of uncertainty regarding these prospects, and the downside risks are large. Among them, I will touch upon four risk factors here.

The first is the impact of trade tensions. Although trade negotiations seem to have progressed somewhat, a number of issues remain to be resolved. Due to the widening range of tariff increases, trade costs may rise, and corporate activity could be subdued due to reconsideration of production sites and global value chains.

The second risk is the effects of economic policy measures, such as those in China. China has implemented a range of tax reduction measures, together with an increase in infrastructure investment. The effect of these tax reductions, however, depends on the extent to which households and firms increase their spending. Households' and firms' spending is affected by their sentiments and prospects for the economy. Since we have seen heightened uncertainty regarding, for example, trade tensions, we should be cautious about the effectiveness of these policy measures.

The third risk comes from political factors. In addition to Brexit and political uncertainties in Europe, political destabilization due to increasing income inequality could affect the global economy through a decline in confidence and instability in financial and capital markets.

The fourth risk is vulnerability arising from accumulated debt in the private and public sectors. The accumulation of public debt is the result of an increase in public expenditure after the Lehman shock and rising social security payments. There is no doubt that such expenditures have had a positive impact on the economy. However, securing long-term fiscal sustainability is a precondition for maintaining economic stability. While accumulated private debt may be the result of positive investment, such as corporate and housing investment, it does increase the financial vulnerability of firms and households, making them susceptible to changes in interest rates and financial market conditions. We therefore need to be vigilant about such risks.

At each G20 meeting, we share our understanding on global economic conditions and associated risks, and we discuss the necessary policy measures. Of course, the global economy is changing continuously. In the run-up to the June G20 meeting in Fukuoka, we will remain vigilant about these changes, while gathering all the necessary information. As president of the G20, we will lead policy discussions at the meeting with all the relevant information and appropriate evaluations of global economic conditions.

II. Global Imbalances

Among the G20 policy agendas, let me focus on two medium- to long-term issues: global imbalances and international financial architecture.

First, on global imbalances. Although the issue has long been a topic for discussion at G20 meetings, we have had limited opportunity in the recent past to discuss it in great depth. We have therefore decided to put the issue on the table of G20 meetings again this year. We will analyze the trend and background of global imbalances and discuss the appropriate policy actions.

Looking back on the global trend before the Lehman shock, we saw excess consumption and investment on the back of soaring asset prices in the United States, and an expansion in current account deficit as the mirror image of these domestic excesses. On the other hand, emerging economies took a cautious approach to investment, partly because of the trauma of past balance-of-payment crises, and as a result, their current account surplus accumulated. When asset prices plunged and domestic demand shrank in the United States, the saving-investment balance subsequently recovered. The expanding trend of U.S. current account deficit stopped. Meanwhile, emerging economies experienced a deterioration in trade balances due to the slowdown of the global economy triggered by the global financial crisis. The increasing trend of their current account surplus stopped.

It is not necessarily true that deficit is bad and surplus is good with regard to global imbalances. As textbook macroeconomics tells us, the current account is equivalent to the domestic saving-investment balance. It is not appropriate to judge whether it is in a good situation or not merely by seeing if there is a deficit or surplus. For example, it is better for emerging economies with high growth potential to borrow abroad, invest at home, and realize higher economic growth. On the other hand, for countries with limited growth opportunities, it is better to invest abroad and earn higher returns. In these circumstances, countries with abundant investment opportunities are more likely to see investment exceed savings, resulting in a current account deficit. Meanwhile, countries with limited growth opportunities see savings exceed investment, hence a current account surplus. Optimal saving-investment balances and associated current account balances differ from country to country, depending on individual circumstances. What we need to determine is whether the actual saving-investment balances and current account balances have diverged from the optimal levels that reflect economic fundamentals. If the balances do not reflect economic fundamentals, we then need to examine whether or not this divergence is the result of disequilibrium of the economy and finance and inappropriate policy measures.

In order to realize sustainable and balanced economic growth, we cannot overlook excess current account imbalances that are not in line with fundamentals. Bilateral trade measures will not help resolve such imbalances. These are primarily issues for multilateral and macro saving-investment consideration.

Global imbalances will be discussed intensively at the G20 meeting this year. In particular, we will promote understanding that we need to examine whether the current levels of global imbalances are appropriate or excess, taking into account the importance of structural factors such as aging.

III. International Financial Architecture

Along with global imbalances, international financial architecture has also long been on the agenda at the G20 meetings. The global economy has suffered the enormous negative impact of financial and economic crises such as the Asian crisis in the late 1990s, the global financial crisis after the Lehman shock, and the subsequent European sovereign debt crisis.

To prevent such crises from occurring again, each country must implement the appropriate economic policies to avoid accumulating economic and financial sector imbalances. Looking back on history, we have seen how asset bubbles in stocks and real estate, as well as excessive lending by financial institutions, have contributed to overheating the economy, and vice versa, and how current account deficits and accumulated external debt have become the source of crises. One lesson history teaches us is that, by helping to stem the source of crises, appropriate economic policy management is definitely the first line of defense in crisis prevention. Rigorous monitoring of the global economy and financial conditions is crucial to detecting the early signs of crisis. With this in mind, we intensively examine global economic and financial conditions at every G20 meeting.

Of course, experience has taught us the difficulty of prior detection of excessive activities and imbalances. That is why we also need to prepare crisis management policy tools to prevent crises from spreading. The IMF's lending facilities play a crucial role in such crisis management. One of the important functions of the IMF is to provide short-term lending to a country with a balance-of-payments crisis. The IMF's role in times of crisis has become even more important as international trade and financial transactions have expanded.

Besides the IMF lending in times of crisis, regional financing arrangements (RFA) are also expected to be used. In Asia, the Chiang Mai Initiative Multilateralization (CMIM) is one such arrangement. Japan, China, Korea, and the ASEAN countries participate in the initiative. Once a crisis occurs, each country is expected to provide the funds necessary to prevent the crisis from spreading. In order to mobilize funds promptly, there is the so-called de-link portion of the fund. This portion comprises 30 percent of the total funds, and is not directly linked to the lending from the IMF. We have also seen an expansion in bilateral swap agreements. When a crisis occurs, countries can use a swap agreement to exchange their currency for another in order to obtain the funds needed for international transactions.

In short, we now have multiple layers of measures to cope with global financial crises, with IMF lending playing the central role, supplemented by regional financing arrangements and bilateral swap agreements.

Thanks to this enhancement of international financial architecture, together with the strengthening of financial regulations following the global financial crisis, it is fair to say that the resilience of the global economy and financial system has been increased. Nevertheless, it is important to remain vigilant as global financial and economic conditions continue to evolve dramatically. A key element of surveillance is ensuring that no potential sources of crisis have been overlooked. We have seen rapid and revolutionary innovations in information and communication technologies in particular, and financial activities could expand beyond the scope of current regulatory and surveillance frameworks. We have also seen the migration of financial activities to the non-banking sector as regulations on the banking sector have been tightened. To address such non-traditional flows of funds, it may be necessary to expand the tools used and the range of data subject to surveillance in order to detect signs of a crisis.

The policy actions of individual countries and international coordination to tackle the imbalances identified by such surveillance are also important issues for discussion. In addition to monetary and fiscal policy, macroprudential policy measures are increasingly used to address these financial imbalances. Macroprudential policy measures such as countercyclical capital buffers, stress testing, and regulatory measures on lending are all valuable areas for the exchange of ideas and mutual learning. To enhance crisis management in international finance, we need to continue discussing the appropriate modalities for the facilities provided by different entities.

Concluding Remarks

As I have mentioned, there are a number of important issues to be considered regarding the current state of the global economy. We will be discussing these issues at the G20 meetings this year. The analyses and policy proposals from think tanks provide invaluable input for our discussions, especially considering the wide range of issues related to the global economy. I would like to conclude my speech with the hope that today's T20 Summit will prompt further collaboration between the private and public sectors.

Thank you very much for your attention.