Economic and Financial Globalization, and Challenges Facing the Central Bank

Excerpts of a Speech Given by Atsushi Mizuno, Member of the Policy Board, at a Meeting with Business Leaders in Miyagi on February 28, 2007

April 16, 2007
Bank of Japan

I. Globalization and Macroeconomic Policy Management

Demographic changes and economic globalization are two major trends in the world today. Both are occurring at unprecedented speed and on a phenomenal scale. They are also having an impact on economic policy.

Japan is no exception: it is an important task for policymakers to formulate and implement appropriate policies in a timely manner to cope with demographic changes and economic globalization, which are inevitable. Fixation on past experiences and failure to take these developments into account in projecting the economic outlook will increase the risk of misjudging policy effects.

With the exception of the United States, the major economies are expected to experience either a decline in the population or a slowdown in its rate of increase. Among them, Japan has been the first to record a population decline. Similarly, Italy and South Korea are both facing a serious deceleration in population growth. To deal with this situation, Italy has raised the retirement age and issued inflation-linked bonds, and South Korea, where the total fertility rate has fallen to 1.08, is undertaking reform of its pension system. In the United States, issues related to the ongoing demographic changes are gaining more attention, and such issues include a downward revision of the potential growth rate of the economy resulting from the projected slowdown in the growth of the labor force, and political debate on the rapid increase in immigrants, mainly Hispanic. In the United Kingdom, increased immigration has continued to sustain population growth. Since around the end of the 1990s, there has been a noticeable net outflow of U.K. nationals and a net inflow of non-U.K. nationals.

On the issue of population ageing, points have been raised as to the effects it will have on household spending and saving, the degree of risks acceptable for household financial assets, or the availability of skilled workers. It should be noted that the issue is already affecting economic activity and asset prices.

The potential growth rate of Japan is estimated to be at around 1.5 percent. Real GDP has grown steadily at an annual rate of around 2 percent over the four years since fiscal 2003, despite fiscal tightening during the same period, which contributed to an annual loss of 0.5 percentage point. There is no doubt that this performance has been assisted by the ongoing global economic expansion at an annual rate of 5 percent. At the corporate level, firms that have successfully adapted to economic globalization through advanced technology are enjoying record profits due to increased gains in overseas business operations. Japanese firms are likely to maintain their competitive edge amid a globally growing awareness of the need to conserve resources and the natural environment.

In the manufacturing sector, firms are increasingly reorganizing their supply systems with an emphasis on international markets, as the projected decline in Japan's total population has dimmed the outlook for domestic sales. Furthermore, due to the accelerating pace of price reductions for new products, investment cycles have shortened, demanding continuous investment in plants and facilities, while, at the same time, forcing firms to resort to speed-oriented strategies such as mergers, acquisitions, and business tie-ups. Although firms have resolved the problem of the "three excesses" in debt, production capacity, and employment following the bursting of the economic bubble, they have still been restraining wage increases to cover the rise in costs, notably in energy, as they have been facing intensifying global competition. Firms are eager to restrain labor costs as they are generally concerned about their survival in the competitive climate of a globalized economy. This is one of the factors explaining why the strength in the corporate sector is not spreading to the household sector. The labor market is tightening, but even if the unemployment rate declines further, regular payments may continue to be under downward pressure.

The government has made clear its stance to place emphasis on economic growth. More specifically, the government has set a target for economic growth, and regarding the corporate sector, has announced plans to reduce taxes and reform the labor market. To raise the potential growth rate of the economy, Japan needs to increase the competitiveness of firms. The economic outlook will not brighten unless firms are constantly on the alert to maintain their competitiveness, dealing with the ageing of the population and overcoming differences in conventions and legal systems between Japan and other countries. In this regard, it should be pointed out that, since the bulk of large firms' profits are now derived from overseas business operations, the effect of a corporate tax cut, while enhancing international competitiveness, may not be as large as it used to be in terms of increasing business fixed investment and creating jobs in Japan. Given the possibility that the measures designed to enhance firms' international competitiveness may not have the same effects as they used to have, it is crucial that new policy measures take into account the behavior of firms adapting to globalization.

Japan also faces the constraint of an overlarge government debt. The government has set the target to achieve a surplus in the primary balance by fiscal 2011. This has led to public debate on other related fiscal targets and the publication of various tentative calculations. In this connection, it should be kept in mind that the recent increase in the tax revenue is largely due to the buoyant world economy and the depreciation of the yen, in addition to successful efforts by the corporate sector to adapt to the ongoing trend of economic globalization. In response to debates over new fiscal targets, the Cabinet Office and the Ministry of Finance have made public various calculations based on different premises. More importantly, however, to maintain a surplus in the primary balance, the potential growth rate needs to be raised, and therefore, it is essential to discuss specific ways and means of raising the potential growth rate, in addition to making projections based on various scenarios for nominal GDP growth, real GDP growth, and long-term interest rates.

In this regard, it is encouraging that the Minister of State for Economic and Fiscal Policy, Hiroko Ota, has pointed out the need to establish economic structures appropriate for the era of economic globalization and the decreasing population. However, it must be noted that economic globalization is taking place at great speed.

I believe one of the policy aims of the government is to increase productivity through innovation, with the private sector playing the leading role and the government supporting its efforts. To raise the potential growth rate, total factor productivity needs to be raised. The former Koizumi administration, under the slogan "from the public to the private sector," increased expectations for structural reform, leading to an inflow of capital from abroad. Foreign investors are paying attention to the progress in the reform of government financial institutions and the privatization of postal services, both of which are important measures intended to reduce the presence of public-sector financing. Foreign investors are, at the same time, irritated at the slow progress of reforms in the services sector, which continues to retain unprofitable lines of business and has refrained from restructuring through mergers and acquisitions, even though it suffers from much lower productivity than the manufacturing sector.

As seen above, policymakers in Japan must conduct macroeconomic policy in a changing environment as evident in (1) the globalization of the economy and financial markets, (2) the increasing public burden arising from massive government debt outstanding, and (3) demographic changes brought about by the rapidly ageing population. I will next discuss the remedies for the various problems the economy faces.

First, the global integration of financial markets means that, should markets perceive economic policy to be inconsistent with economic fundamentals, this may have unforeseen consequences for asset price formation both at home and abroad. Under such circumstances, it is important to raise the profit expectations foreign investors have when investing in Japan. To this end, a reduction of the role played by the public sector in the area of finance can provide an effective remedy.

Second, in order to reinvigorate regional economies, local governments have deliberated on measures to promote job creation. These include inviting firms and factories to their respective areas to halt the outflow of the young, and encouraging retired city workers to return to their home town. There is a tendency that metropolitan areas, where returns on capital are higher, attract more capital, thus creating greater job opportunities than non-metropolitan areas. This type of widening income inequality between urban and rural areas is widely observed in industrialized countries and is a major problem. While such efforts by local governments are essential, it is also necessary to expand the economy as a whole by raising the potential growth rate through innovation. Furthermore, it is indispensable to see whether the business management of regional banks is not impaired by regional economic difficulties such as increases in bankruptcies of small firms in the area.

Third, it is necessary to make full and effective use of market and interest rate mechanisms to encourage the active entry and exit of businesses, and to ensure greater efficiency of the labor market and mobility and diversity of personnel. In the current economic environment where speed is essential with managerial resources such as personnel, goods, capital, and information crossing borders at short notice, it is inevitable that economic policy should be based on capitalist values, which reward hard-working personnel and firms. Otherwise, Japan's economic strength may be undermined by an exodus of competitive companies and personnel.

Fourth, it is important to keep in mind the effective utilization of market and interest rate mechanisms when discussing issues relating to the management of pensions, income inequality, and structural reform. The January 20, 2007 issue of the *Economist* with its cover title "Rich man, poor man" has a leading article that points to the risk that economic globalization may promote income inequality. In the United States, income inequality seems to be a topic that is attracting more interest since the Democratic Party gained a majority in Congress.

Fifth, in order to develop leading industries in Japan other than manufacturers, it is necessary to establish a truly effective system of cooperation between industry, government, and academia. At present, firms that are likely to survive increasing economic globalization are found mostly among manufacturers. However, it appears to be only a matter of time before Chinese and East European firms catch up. The government stresses that productivity in the services sector needs to be increased to raise the potential growth rate of the economy. It is generally believed that medical and nursing care services are promising areas of growth, but I personally hope that the financial services industry will develop further. While Japan languished in the doldrums of 15 "lost years," the United

States, the United Kingdom, Singapore, and Hong Kong have all seen a great leap in profitability in their services industries thanks to the advance of the financial services industry and the IT industry. In the United States, for example, automobile manufacturers have made a successful entry into the credit card business and other financial services, making use of their existing customer base and forming alliances with financial institutions or setting up financial services subsidiaries. In Japan, trading companies are in the process of adding financial services to their main line of business.

And sixth, it is necessary to enhance transparency and dispel uncertainty over future reforms in the tax and pension systems as much as possible in order to alleviate public concerns about the future.

It takes much time and energy for the effects of productivity growth achieved through innovation to materialize. Further refinement of policies through deeper discussions is required to achieve the challenging target of raising the potential growth rate in the current environment where demographic changes are taking place due to the ageing of the population and the declining birthrate and where economic globalization is advancing. The Bank of Japan formulates monetary policy on the basis of its economic outlooks spanning one and a half to two years, given the time lag for policy effects to appear. Meanwhile, I believe the government's time span is much longer than the Bank's: the government considers that it takes five years or longer for the effects of policies designed to raise the potential growth rate to emerge. Considering the different time spans, the argument that a slight tightening of accommodative monetary conditions will have a negative effect on efforts to raise the potential growth rate does not sound very convincing. Furthermore, given the possibility that increases in productivity and demographic changes can cause the potential growth rate to change substantially, it is necessary to allow some leeway for a neutral interest rate level.

The public at large will have to overcome many difficulties in the future to live a life free of anxieties. It is the responsibility of policymakers to see to it that various policies -- fiscal, monetary, or deregulatory, as well as those concerned with structural reform -- are consistent with each other. Likewise, short- and long-term policies should be in harmony and not in conflict. It is also important to enhance the transparency of policy conduct by disseminating more information through greater disclosure. The objective of these proposals is to raise the potential growth rate on a sustainable basis. To achieve this objective, it is necessary to make active use of market mechanisms and not rely on makeshift short-term policies, on policies that temporarily grant virtual subsidies, or on extremely low interest rate policies that are not consistent with economic fundamentals.

The globalization of financial markets adds further impetus to the cross-border transfer of capital. Continuation of a low interest rate policy that is not consistent with economic fundamentals gives rise to negative side effects such as (1) a weaker yen against all other major currencies, leading to increased protectionism by trading partners; (2) distortions in asset prices worldwide through the acceleration of capital outflows; and (3) growing income inequality due to the wealth effect. In response to economic globalization, central banks are required to take into account not only domestic but also global economic and financial developments.

II. Financial System Policy Issues and the Conduct of Monetary Policy

A. The Interaction between Monetary Policy and Financial System Policy

While economic activity has continued to recover for five years or so and prices have started to increase, the financial environment has remained extremely accommodative compared with other countries. In this environment, it is becoming increasingly important to foresee the risks that may arise from excessive financial activity from the viewpoint not only of the conduct of monetary policy but also of ensuring financial system stability.

Looking back on the experiences of industrialized countries, until the 1970s, it was often the case that any risks that threatened the sound development of the economy were first reflected in price developments. From the 1980s to the 1990s, however, these risks did not become immediately apparent in prices but were reflected in asset prices and were absorbed in the financial system; economic instability emerged only after a time lag. Japan is no exception.

As seen above, interaction between monetary policy and financial system policy, both of which fall under the prerogative of central banks, appears to have increased because of the worldwide trend in which various distortions in the economy do not show up immediately in prices.

B. Taking a Preemptive and Forward-Looking Stance

In the current changing environment, the stance and actions required of a central bank in monetary policy and financial system policy have much in common. Here, two points can be made.

First, I believe the experiences of various countries have taught us that, if an extremely accommodative monetary policy is maintained even when it is no longer consistent with economic fundamentals, there is likely to be a negative side effect -- the other side of the coin of the effects of low interest rate policy. Taking note of such historical lessons, central banks must examine various potential risks even when they do not appear in prices.

And second, I would like to point out that -- just as in the case of monetary policy -- it is very important to take a forward-looking approach in the conduct of financial system policy that prevents the accumulation of risks which could cause uncertainty over the financial system.

I will illustrate these two points using the case of real estate investment.

Having experienced the emergence and bursting of the economic bubble, there is no doubt that Japan’s risk management concerning real estate loans and real estate investment has improved. For example, the practice of valuing real estate based on accruing cash flows is gaining wider acceptance. It must be remembered, however, that such risk management will not function properly if forecasts for the cash flow and the discount rate, that is, the long-term interest rate, are biased on the optimistic side.

Long-term interest rates, such as Japanese government bond yields, are basically determined by the long-term outlook for economic activity and prices. If economic entities base their investments on inconsistent wishful thinking, such as "office rents will rise, but the long-term interest rate will not," then risks associated with such premises will accumulate in the economy.

In the same vein, there are risks involved in the way interest rate spreads on loans are set.

At present, corporate profits continue to rise in line with the sustained recovery of the economy. Firms' interest payments have been small due to low interest rates. Thus, it follows that in this economic situation the likelihood of corporate defaults is low. If, however, financial institutions' interest rate spreads on loans are determined on the basis of unrealistic forecasts assuming, for example, that "the default probability will not change," risks are bound to increase.

Given this situation, it is important for the central bank to make public its assessment of risks in the financial system, ensure that financial institutions and other entities in the financial system understand these issues, and support their efforts to manage risk effectively. This is in line with worldwide trends in financial system policy.

The Bank makes public its assessment of the financial system through, for example, the publication of the *Financial System Report*, and supports the risk management efforts of financial institutions through on-site examination, off-site monitoring, and activities of the Center for Advanced Financial Technology. I believe this is one of the major areas in which the central bank can contribute to the national economy as a whole.

C. The Current Situation of the Japanese Financial System

Keeping the foregoing in mind, I will now talk about my personal view of the current situation of the Japanese financial system.

It is already apparent that the financial system has regained stability, having overcome the nonperforming-loan (NPL) problem. Various risk factors, such as credit and interest rate risks, are unlikely to immediately and unduly disturb the system.

However, Japanese financial institutions, having been encumbered by the NPL problem, were relatively slow in expanding new types of financial business, such as investment banking, and due partly to this factor, the recovery in their risk-taking capacity has tended to lead to intense competition in the areas of traditional financial business such as corporate and housing loans.

At present, heated competition among financial institutions is unlikely to immediately become a cause of large risk. Having experienced the bursting of the economic bubble, firms and other economic entities have, despite the low interest rate environment, maintained a cautious stance toward increasing leverage and expanding expenditure. This cautious stance has also contributed to the long-lasting economic recovery.

It must, however, be noted that this cautious stance is changing, albeit marginally, as evidenced by the increase in real estate investment and intensifying competition in extending low interest rate loans. Such developments need to be watched closely.

D. Globalization and the Financial System

The financial system has integrated globally and rapidly, undergoing structural changes. This poses new policy challenges to central banks.

Globally active mega-financial institutions have shifted their business models from the traditional "buy and hold" to "originate and distribute." Their business has changed from undertaking credit and interest rate risks to making use of their worldwide networks to mediate between borrowers of funds (firms) and lenders of funds (institutional investors such as investment funds), thereby efficiently distributing risks and returns among them. The financing of mergers and acquisitions and the extension of leveraged loans are examples of such new business.

The following are some of the developments occurring in the process of financial system globalization.

First, the number and types of participants are increasing. That is, various investment funds, such as private equity funds and hedge funds, are increasing their presence as financial intermediaries. This trend has given rise to the term "fund capitalism." In Japan, banks have suffered from the NPL problem. This, coupled with the dissolution of the traditional cross-shareholdings with their client firms, has made it difficult for banks alone to function as financial intermediaries and to assume risks associated with firms' business projects. Inflows of risk money from abroad via investment funds have been rising at a time when activity in corporate revitalization business as well as mergers and acquisitions have been increasing. These developments should be welcomed, because they help to invigorate the economy through a greater distribution of risks that previously were borne by banks alone.

Second, the private placement market has expanded, reflecting the increased presence of investment funds. Investment funds are raising funds through the private placement market instead of the traditional public offering market, which requires detailed disclosure. The private placement market is also functioning as a meeting place between investment funds and borrower firms. In response to such structural changes in the financial system, globally active mega-financial institutions have developed a business model that relies on their own networks to efficiently link lenders and borrowers for a fee instead of relying on the public offering market.

Traditionally, regulation of financial intermediaries has focused on banks and especially their capital adequacy. Such regulations require banks to be able to pay back deposits, or in other words, to perform financial intermediation without defaulting. However, the increased diversity in financial assets held by households and firms and in the methods for raising corporate funds has expanded the scope of risks stemming from the financial system -- that is, risks that the impairment of financial assets held by economic entities or a decline in the financial intermediation function may trigger economic destabilization. To deal with these risks, ways and means of examining activities of nonbank financial intermediaries and developments in the private placement market must be explored.

Third, "search for yield" activities by real money investors in an environment of ample liquidity have led to the narrowing of credit spreads worldwide, the increase in investment in developing countries, and the buoyancy in yen carry trades.

I am personally of the opinion that there is no need to be concerned about the increased presence of investment funds or the expansion of the private placement market.

In principle, the increased diversity in investment funds should encourage the proper formation of market prices in line with economic fundamentals. No doubt, if an investment fund with a dominant market position behaved erratically, this could throw the market into confusion. The global expansion of financial markets, however, is making it increasingly difficult for any one investment fund to grasp a large market share, and in this situation, investment that is not consistent with economic fundamentals will in the long run suffer from losses. In fact, there are various types of investment funds in the market, and although their degree of risk preference may vary, they are all invariably looking for investments with a high risk-reward relationship and investments that help diversify risks.

Similarly, the expansion of the private placement market does not in any way threaten the advantages of the traditional public offering market, whose role is to raise funds from the public in general. Additionally, it is unlikely that price formation in the private placement market will diverge greatly from the efficient price formation in the public offering market.

It is my opinion that the expansion of the nonbank financial sector and the private placement market is an inevitable outcome of global integration of financial markets. Therefore, I do not think we should find fault with such phenomena. Rather, we should aim to promote the well-balanced development of financial intermediary functions by, for example, examining whether the public offering market is sufficiently efficient or whether regulations are fair and unbiased and are not excessively controlling some particular areas of business.

E. Advancing Financial Services and Ensuring the Consistency of Macroeconomic Policy with Economic Fundamentals

I would like to explain my views on the following two points.

Firstly, taking into account the characteristics of the Japanese financial system, the development of advanced and high-value-added financial services contributes not only to the sound development of Japan's economy but also to the long-term stability of the financial system.

If Japanese financial institutions do not change their financial services business models in line with the recovery in their capital adequacy, they are likely to again experience difficulties: competition is likely to intensify in lending business, causing them to reduce interest rate spreads on loans, and in the event of a recession, they are likely to incur losses due to an increase in credit costs. The recent narrowing of interest margins on loans and the flattening of the yield curve of Japanese government bonds have been making life more difficult for regional financial institutions.

In the past, the Japanese banking system has undeniably played a key role in absorbing shocks in the economy, for instance, through cross-shareholdings for the purpose of long-term investment. However, risks accompanying economic activity are becoming increasingly diverse and complex due to economic globalization. Under these circumstances, financial institutions need to accurately identify their risk-taking capacity and pass on risks that they cannot shoulder themselves, thus promoting appropriate risk-sharing. This will eventually contribute to the efficient allocation of economic resources and the sound development of the economy.

In this regard, I think that the Bank, as the nation's central bank, should do its utmost not only through the appropriate conduct of monetary policy but also through communicating its thinking on the financial system from a forward-looking perspective and supporting financial institutions' risk management as well as their efforts to provide advanced financial services.

The second point I would like to mention is that, to prevent excessive financial activity and the excessive accumulation of risks in the financial system, policymakers need to conduct policies that are consistent with economic fundamentals.

Going back to my earlier example, it is difficult to imagine that investments by a large number of investment funds will rest on irrational projections of economic fundamentals. Even when investments appear irrational, past episodes such as currency crises suggest that they were often the result of a divergence between policies and economic fundamentals or distortionary regulations.

Examining my second point in terms of monetary policy, I think the Bank should implement monetary policy measures that are consistent with the economic situation in a timely manner. This will prevent excessive financial activity and the risk that asset prices are formed based on the expectation that the low interest rate environment will continue for a long period of time despite the expansion of the economy. Although the appropriate level of interest rates depends on the projection for economy activity and prices, the current level of market interest rates, especially short-term interest rates, is extremely accommodative, considering that the potential growth rate is currently estimated to be at around 1.5 percent and the expected inflation rate is assumed to be positive. The Bank carried out a series of drastic monetary easing measures to overcome deflation and influenced interest rates on term instruments through its commitment in terms of policy duration. However, when the economy enters a phase in which we become convinced that -- based on a forward-looking assessment -- the inflation rate is likely to become positive on a sustainable basis, it is desirable that the yield curve gradually converges toward a level consistent with the potential growth rate and the medium- to long-term projection for prices. I believe this will, in the long term, contribute to reducing risks stemming from financial markets and the financial system as a whole.

I will next elaborate on this point in terms of market participants' behavior.

The overnight call rate, a short-term interest rate, is guided by the central bank's money market operations, while medium-term rates are determined by market expectations of the Bank's future conduct of market operations; long-term rates, finally, are determined by economic fundamentals. Therefore, whether these interest rates form a smooth yield curve depends on whether the central bank adjusts interest rates in line with economic fundamentals.

If the expectation becomes widespread that the Bank will continue to implement extremely accommodative monetary policy despite the improvement in economic fundamentals, this will lead to an excessive flattening at the short end of the yield curve. As a result, this will hamper arbitrage transactions at the short end of the yield curve and market participants will avoid investing funds in instruments with interest rates that are greatly affected by a policy change, or they may shift to raising funds through instruments with extremely short maturities or investing funds in long-term instruments. Since the extremely low interest rate environment will not be everlasting, the impact of necessary rate adjustments by the central bank will intensify if such behavior becomes deep-rooted among market participants.

As these examples show, it is desirable that the policy interest rate should gradually converge toward a level consistent with economic fundamentals, and this will, in the long term, contribute to minimizing the risk of economic instability. In the United States, the Fed has successively raised the federal funds rate target from 1 percent to 5.25 percent from June 2004 through June 2006. As a result, while the differential between ten-year government bond yields in Japan and the United States is currently 3 percentage points, that between the two policy interest rates is as large as 4.75 percentage points. Against the background of the raising of the key interest rate, the U.S. economy is likely to realize a soft landing and bond and stock markets have been steady. As this shows, adjustments in the key interest rate consistent with economic fundamentals do not cause economic instability but in the long term lower the risk of instability.