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Bank of Japan

Lessons from the Global Financial Crisis: Asian and Global Perspectives

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It is an honor to be a part of this esteemed panel. With the hope of stimulating further debate, I would like to discuss three lessons from the global financial crisis and the resulting challenges they present.

First, in this globally interconnected world, nothing is purely regional anymore. A global perspective is crucial.

When the euro area crisis was initially brewing a couple of years back, there was reluctance from our European colleagues to discuss it as an issue with global implications. The euro area economy was recovering and it was argued that the current account of the euro area as a whole was balanced and that intra-area imbalances were manageable. It was presented as a regional problem with regional solutions. We all know now that this was not the case. The euro area crisis has impacted global growth through both trade and financial channels, probably in a much larger way than initially expected. Resolving the euro area crisis has become a key agenda item for the G20, and the IMF is playing a key role together with the euro area core countries towards its resolution.

To give another example, when economic growth decelerated in the advanced economies last year, there was hope that the emerging economies, especially those in the Asia would pick up the slack. Asian economies provided approximately 40% of global growth in 2011 and their share in global exports was more than 30% in 2011. This, however, did not mean they were immune from the slowdown of the European economy. Weakness in Europe has impacted Chinese exports, and through the regional supply chain, exports and growth have been impacted broadly throughout Asia. The IMF, in its Regional Economic Outlook published yesterday, points out that two-thirds of emerging Asia's exports are linked to demand from Europe and the United States, and Fund has reduced its growth outlook for Asia in 2012 from 6.0% to 5.4%, and that of 2013 from 6.5% to 5.9% respectively. They have also noted that this estimate is based on the premise that conditions in Europe improve gradually and that the fiscal cliff in the United States will be avoided. Considerable downside risks remain.

The second lesson is that putting one's house in order is an essential prerequisite condition for each country to achieve sustainable growth, but not a sufficient condition.

In formulating macroeconomic policy, the traditional emphasis was to ensure domestic stability or to put one's house in order. However, the simple sum of each country's policy actions may not necessarily achieve an optimal outcome at the global level. Although policy-makers in each country may be acting rationally from its own individual perspective, collectively there is the risk of a fallacy of composition.

Currently, many central banks in advanced economies have entered the realm of unconventional monetary policy such as the purchase of various types of assets to spur growth and to buy time as the sectors of the economy go through balance-sheet repairs. However, as the domestic monetary transmission mechanism is constrained, there may also be unintentional cross-border spillover effects, such as increases in capital inflows to other countries. The effects could also feedback to the originating country.

Meanwhile, central banks in emerging economies have also shifted toward monetary accommodation or relaxed recent tightening moves. These steps are necessary to support growth. But what this global monetary accommodation ultimately means for global commodity prices and inflationary pressures, and as a result to global macro-economic stability, is something that will likely require close monitoring.

Another dimension would be the tendency to focus on external demand to spur domestic growth. This is a natural reaction when domestic demand is fragile. When the global economy as a whole is growing rapidly this would not be an issue, but when global growth is weak, this could mean taking away possible opportunities from other economies. If rapidly growing emerging economies were to succumb to the temptation to resist the appreciation of one's currency, this could be counterproductive from a global perspective.

The third lesson is that although measures taken by central banks, both individually and collectively, have been successful in stabilizing the economy and the financial system during the crisis, policy-makers, including central banks, cannot be complacent.

For example, the ECB's OMT has significantly taken away tail risks in the euro zone. This respite is probably, nonetheless, only temporary and this opportunity must be used to fundamentally resolve the root causes of the crisis within the euro area.

Another example would be the central bank swap lines which were introduced during the height of the crisis after the collapse of Lehman Brothers and still function as a backstop to maintain stability in global interbank markets. The swap lines substantially reduced stress in the interbank funding market for foreign currencies. The flexibility that central banks have to act when necessary, and to introduce measures as necessary, is a powerful framework in times of crisis. However, they are not permanent in nature and do not resolve the possible risks arising from global imbalances and volatile capital flows.

The liquidity that central banks provide can be quite effective in alleviating the pain of the adjustment process, or temporarily stabilizing the situation in times of stress. The key is to use this temporary respite to initiate a positive cycle of fundamental reforms which will provide the foundation for strong, sustainable and balanced growth.

I have presented what I believe to be three lessons from the global financial crisis. How could they be seen from both an Asian and global perspective?

First, putting one’s house in order does remain a key objective for all countries. Sound macro-economic policies will continue to be of utmost importance.

Second, in putting one's house in order, policy-makers need to be conscious of the cross-border spillover effects and the ensuing feedback effects on their own economies. Such elements in their totality will need to be internalized within the decision-making process. Such considerations will be important not only for macro-economic policy, but also macro- and micro-prudential policies. Prudential rules to stabilize a financial system in one jurisdiction could push business across borders or influence global capital flows. Furthermore, extra-territorial application of domestic rules, in spite of its good intentions, could have unintended negative consequences for the stability of financial systems of other countries.

Third, regional frameworks such as the Chiang Mai Initiative can play a vital role in maintaining financial stability in the region. It reflects the unique characteristics of the region and provides strong incentives to countries in the region to work together. At the same time, it does not replace existing international financial arrangements, but rather supplements them. Furthermore, the stability of the Asian region naturally has global implications. Thus, the regional surveillance provided by the ASEAN+3 Macroeconomic Research Office, AMRO, together with the global surveillance provided by the IMF will both play a pivotal role in the effective operation of the Chiang Mai Initiative.

Thank you.