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Bank of Japan

Eurozone Crisis: Implications for Asian Economies

*Initial Remarks for the Panel Discussion
at the Asian Development Bank Institute*

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I. Introduction

I am honored to be invited to this panel discussion at the Asian Development Bank Institute. In discussing today's topic, "the Eurozone Crisis and Its Implications for Asian Economies," I would like to speak briefly about three key aspects. I will begin with reviewing the current Eurozone crisis, then consider its implications for Asian economies, and lastly I will outline the Bank of Japan's contribution to regional monetary cooperation in Asia.

II. Nature of the Eurozone crisis

I am sure that most of today's audience is already familiar with developments in the current Eurozone crisis, but I would like to emphasize two points about the nature of the crisis. The first is that the Eurozone crisis highlights the difficulties of so-called monetary union without fiscal union. Eurozone countries introduced the single currency, the euro, under the European Central Bank, while each member country maintains its own fiscal sovereignty. However, there have been ongoing intensive discussions, since even before monetary union began, especially in academic circles, about the necessity for an adjustment mechanism in the form of fiscal transfers, labor mobility etc., if a common currency is to work. Thus, the issue of how to manage fiscal policies under a single currency regime is one of the most fundamental and most enduring challenges for the Eurozone.

Second, as long-term interest rates in member countries converged at low levels following the introduction of the single currency, the Eurozone enjoyed the benefits of the expansion of trade and investment. At the same time, however, it also gradually accumulated economic and financial imbalances, such as loose fiscal spending and a bubble in the real estate market. Because these imbalances were built up over a period of more than a decade following the introduction of euro in 1999, it would not be surprising if it takes a long time for the Eurozone to achieve a full recovery. If this is indeed the case, we must be aware that there is a risk of the crisis becoming a severe headwind against the global economy in the longer-term perspective. I will come back to this point later.

III. Implications for Asian economies

It took about 50 years, from the signing of the European Coal and Steel Community Treaty in 1951, for Europe to achieve the introduction of the euro. Meanwhile, the possibility of deeper economic and financial integration in Asia, and in particular the introduction of an Asian single currency, has been discussed at various levels. There may seem to be little possibility, at the present time, of a common currency being established in Asia, but the day might come some time in the future when the introduction of an Asian single currency might be discussed as a concrete option. In preparation for such a future possibility, I think it is important for Asian countries to deepen their understanding of the implications and lessons to be learned from the current Eurozone crisis. I would like to touch briefly upon three issues.

First, as we all recognize, the Eurozone crisis has had a notable impact on Asian economies through several channels: through trade, through the financial system and through asset prices. Although Asia has been enjoying relatively high economic growth, it would be overly optimistic to expect a complete decoupling of Eurozone economies and Asian economies. Considering in particular the degree and persistence of the Eurozone crisis, we must be aware that the downside risk continues to weigh on the Asian economies.

Second, the question of how to develop and manage fiscal policy under a single currency regime is a huge topic for Asia, if in fact it considers monetary union as a concrete option. As I mentioned, in the case of European monetary union, monetary policy was centralized under the European Central Bank, while fiscal policy remained the responsibility of each member country. Furthermore, Article 125 of the Lisbon Treaty, the so-called no bailout clause, makes it illegal, in principle, for one member state to assume liability for another member state. This means that, even if one member country falls into a fiscal crisis, other member countries are not allowed to support the troubled member with fiscal transfers. Thus, the crisis management of fiscal problems has become a major challenge for Eurozone countries. If the Asian region makes a step towards monetary union in the future, a consensus must be achieved in advance among the members as to how fiscal integration should proceed

and how social security systems, such as pension and health care systems, should be harmonized.

Third, the risk of economic and financial imbalances must be monitored closely. The Eurozone, especially the peripheral countries, enjoyed good economic performance after the introduction of the euro. That is because foreign exchange risks were eliminated within the Eurozone, expanding trade and investment in the area, and also because the long-term interest rates of these countries went down toward the level of German government bonds and converged at low levels, which also stimulated the economy in the peripheral countries. At that time, market participants called this convergence of interest rates the “interest rate bonus,” and praised it as being “the fruit of monetary union.” In hindsight, however, this convergence of long-term interest rates encouraged loose fiscal policies, or combined with overly optimistic economic projections, led to real estate bubbles in some countries. Meanwhile, necessary structural reforms were stalled, including labor market reforms, and the competitiveness gaps within the region remained unsolved. Given that growth potential in Asia is high and its middle-class is expected to grow further, Asia must avoid over-heating of the economy such as excess investment or the creation of bubbles. This lesson should be relevant even when Asia faces the downside risk associated with the Eurozone crisis, because excessive short-term policy stimulus may increase the potential risk of these imbalances. In addition, even though economic growth is relatively high in the region, it is still important that Asia makes progress on the structural reforms that are necessary for it to maintain this growth over the medium- and long-term.

VI. Bank of Japan’s contribution to regional monetary cooperation in Asia

In the light of this discussion, I would like to outline the Bank of Japan’s contribution to regional monetary cooperation in Asia. The European Council and the European Commission have played a major role in market integration in Europe, through what we might call “top-down integration.” However, it seems to me that market integration in Asia is moving forward autonomously through trade and foreign direct investment by the private sector, that is to say, through “bottom-up integration.” In light of this, central banks in Asia are working together in promoting regional monetary cooperation

to develop deep financial markets. The Bank of Japan also contributes to these undertakings.

For example, the Bank of Japan is a leading member of the Executives' Meeting of East Asia and Pacific Central Banks, or EMEAP, an international forum for 11 central banks from the Asian and Pacific regions. Under the umbrella of the Governors' Meeting, EMEAP has a number of meetings at different levels: the Deputies' Meeting, the Working Group on Financial Markets, the Working Group on Banking Supervision, the Working Group on Payment and Settlement Systems, the IT Directors Meeting, and the Monetary and Financial Stability Committee. To address a wide variety of practical on-site issues, member central banks cooperate closely with each other, which could also be described as a bottom-up approach.

One specific example of an EMEAP initiative is the effort to develop liquid local bond markets that are able to link directly the region's abundant savings and its investment opportunities. This grew out of the experience of the Asian currency crisis of 1997, where there was a fundamental recognition that Asia remained highly dependent on banks, indicating that the local bond and other capital markets were not sufficiently developed. To address this problem, the EMEAP central banks established an investment trust called the Asian Bond Fund (ABF) in 2003, and became the initial buyers by investing in sovereign and quasi-sovereign bonds in eight EMEAP member economies. When it was launched, the Fund was limited to investment only in U.S. dollar-denominated bonds, but in 2005 began to purchase local currency-denominated bonds as well. In the same framework, EMEAP also launched an exchange-traded fund (ETF) called the Pan Asia Bond Index Fund (PAIF), which was first listed on the Stock Exchange of Hong Kong in 2005, and later cross-listed on the Tokyo Stock Exchange in 2009.

In addition, the Bank of Japan, together with the Japanese Ministry of Finance, participates actively in the ASEAN +3 meetings. Under the Chiang Mai Initiative, it has contributed to the creation of a framework to prevent currency crises, and to

respond once they occur. Through these kinds of practical activities, members cooperate to develop robust financial markets and establish stable financial systems.

V. Conclusion

I have discussed the current Eurozone crisis and its implications for Asian economies, as well as the Bank of Japan's contribution to regional monetary cooperation in Asia. Given its growth potential, Asia is expected to maintain an increasingly large presence in the global economy even when it faces the downside risk associated with the crisis. In that process, a variety of financial supports will obviously play important roles, where the bottom-up nature of the Asian integration process must be recognized and respected. But we should also be fully aware of the potential risk of economic and financial imbalances such as excess investment and credit bubbles in the case of Asia. In deepening regional financial integration, we should always remember the basic viewpoint of achieving sustainable long-term growth in the region.

Thank you very much for your kind attention.