Hiroshi Nakaso: Development finance in the economy facing double trilemmas

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Accompanying charts can be found at the end of the speech or on the Bank of Japan's website.

Introduction

It is a great honor for me to contribute to the Joint IMF-Bank Indonesia Conference. Under the title "Future of Asia's Finance: Financing for Development 2015", I will first look back at Japan's post-war experience of financing for the development of specific industries, and will then explain lending behavior of Japanese banks including their involvement in project finance for emerging Asian countries in the last two decades. Based on these two examples regarding Japan's financial intermediation function, I will finally share my views on policies for the stability of development finance in emerging economies facing double trilemmas, i.e., Mundell's and Schoenmaker's trilemmas.

Evaluation of the priority production system in Japan after World War II: Importance of price stability

A period of strong economic expansion known as the "Asian Miracle" ensued in the aftermath of World War II, characterized by a "flying geese" pattern of development. This began in the 1960s with high growth in Japan, followed by economic take-off in other Asian countries. To begin with, I would like to look at the situation during the period of post-war reconstruction in Japan.

The situation immediately after the end of World War II in Japan was characterized by a combination of severe problems such as ruined infrastructure, a sluggish recovery in goods production, and high inflation. For example, as shown in Figure 1, the level of industrial production dropped significantly to about 30% of the peak level before the war (1934–36). The stagnation of production at that time was caused not so much by a lack of production facilities as by a shortage of raw materials such as coal and steel. The coal production level in domestic mines dropped below 40% of the peak level before the war (1934–36) due to the lack of digging materials made of steel. In turn, the steel production industry remained stagnant due to the coal shortage.

In order to overcome this situation, the Japanese government at that time applied the "priority production system", in which resources such as materials, funds and labor were mobilized intensively and with priority being given to key industries such as coal and steel in order to reconstruct Japan's post-war economy. This policy was applied from 1947 to 1949.

The priority production system is considered to have had a stimulating effect on Japan's economy. However, most funding for the priority production system was central bank money provided through the "price-support subsidy system" and the Reconstruction Finance Bank. In the price-support subsidy system, the government provided subsidies to suppliers of important materials such as steel for the differentials between sales prices and production costs in order to enhance production, and these subsidies were financed through borrowing from the Bank of Japan. The Reconstruction Finance Bank was a government-sponsored bank established in 1947 to lend to the aforementioned key industries such as coal, and most of its funding also depended on financing by the central bank.

Both the price-support subsidy system and the Reconstruction Finance Bank supported the priority production system and contributed to the reconstruction of Japan's economy, but their dependence on central bank money became a factor causing high inflation (Figure 1). Inflation heightened the opportunity cost of holding deposits, with deposit avoidance behavior being observed among a large proportion of households. The decrease in deposits then caused a decline in private financial institutions' lending to firms in comparison with GDE (Figure 2). In sum, the inflation tolerant aspect of the priority production system weakened the financial intermediation function and impeded fund flows from household savings to corporate investments, thereby having a negative impact on the economy. The net effect of the priority production system on economic reconstruction was lessened due to high inflation.

Japan's experience of post-war reconstruction suggests that price stability is a necessary condition for a stable financial intermediation function, and that policy-makers should pay attention to price stability in order to fully realize the effect of mobilizing resources for financing development.

Role shared by public finance and private finance in the context of infrastructure investment

After overcoming the period of post-war confusion, Japan entered a period of rapid growth (during the 1960s). In its initial stage, funding by the World Bank supported Japan's engagement in big infrastructure projects such as construction of the Shinkansen, the bullet train line, the Tomei (Tokyo and Nagoya) Motor Expressway, and several power plants. This kind of social capital then improved the productivity of the Japanese economy, leading to a virtuous economic cycle.

Development finance during the period of rapid growth was also served by the so-called "guidance policy finance" of the Fiscal Investment and Loan Program (FILP). Postal savings funds deposited with the Ministry of Finance's Trust Fund Bureau were on-lent to the FILP, and the Development Bank of Japan, which acquired the assets of the Reconstruction Finance Bank in 1952, allocated funds for industrial development to meet national and regional development goals, as one of the major recipients of FILP funding.

Since the 1970s, social infrastructure investments have been financed through the issuance of Japanese government bonds. Many empirical analyses suggest that the productivity effect of social capital is significant and contributes to a rise in potential growth of the Japanese economy. While the government-led system worked well in Japan in the latter half of the 20th century, an important issue to be tackled emerged as outstanding government debt continued to rise significantly and fiscal conditions became severe: how to introduce private funds and the necessary know-how to social infrastructure development. In order to tackle this problem, the PFI (private finance initiatives) Law was promulgated in 1999, and an action plan for the drastic reform initiatives of PFI/PPP (public private partnerships) was launched in 2013. By making use of PFI/PPP, safer, convenient, and resilient social infrastructure will be developed efficiently.

Loans to emerging countries by Japanese banks

Asian countries face issues similar to Japan's, i.e., how to increase PPP from the economic efficiency perspective in addition to effective utilization of financing from foreign countries. As there is huge demand for infrastructure funding in Asian countries, Japanese banks have recently been actively increasing their project financing and syndicated loans, which have contributed to promoting infrastructure projects in these countries.

However, we should also be mindful of the historical record of fluctuation in the amount of lending to Asian countries by Japanese banks. When the Asian financial crisis broke out in the late 1990s, Japanese banks drastically reduced their lending to Asian countries (Figure 3). The background factors include a decline in both their lending capacity and demand for funding in the Asian region.

Limits on the funding capacity of Japanese banks and the deterioration of their equity capital was the most significant factor at that time, considering that the scale of the reduction in loans by Japanese banks was much bigger than that among U.S. and European banks. For Japanese banks, the burden of disposing of domestic non-performing loans that had mounted up after the bursting of the asset bubbles resulted in erosion of their equity capital. The Japanese financial crisis in the late 1990s led to a decline in their creditworthiness and hence the loss of their funding capacity in foreign currencies.

Since the mid-2000s, Japanese banks have returned their balance sheets to soundness and started to increase their loans to Asian countries (Figure 3). In contrast to U.S. and European banks, among which lending to Asian countries was disrupted after the Lehman crisis due to their deteriorating balance sheets, Japanese banks have been constantly engaged in project finance and have increased their share of syndicated loans.

Financing for development and stability of the global financial system

As I have discussed so far, the financial system of emerging countries has been affected by the lending behavior of advanced countries' banks, and this trend will continue. Therefore, as a prerequisite to the stability of development finance in emerging countries, stability must be maintained in the financial intermediation function of advanced countries' banks and domestic banks.

As the financial globalization process evolves, it is important for us to pay attention to two kinds of trilemmas in order to stabilize the financial system and facilitate development finance in emerging countries (Figure 4). As Japan's post-war experience, which I explained in the first part of this article, suggests, price stability is important for fully realizing the effects of financing for development. However, in emerging countries, monetary tightening against the backdrop of inflationary pressure due to overheating of the economy often induces carry trades and accompanies a rapid increase in capital inflows from advanced countries. This boosts the economy further and/or leads to a surge in asset prices and financial imbalances. In such conditions, it is difficult for policy-makers facing Mundell's Trilemma to achieve price stability by choosing the combination of national monetary policy and capital mobility. Therefore, it is important to use macroprudential policy tools in order to mitigate the effect of capital flows on the real economy and the financial system, and this then contributes to the stability of development finance.

When conducting macroprudential policy, global (or regional) financial coordination is important beyond the national-level financial policy framework. In a country faced with Schoenmaker's Trilemma, it is impossible to simultaneously achieve national financial policy, capital mobility and financial stability including the stability of development finance[1] Therefore, a global (or regional) macroprudential perspective is indispensable for maintaining financial stability while allowing for capital mobility. The Chiang Mai Initiative – a multilateral currency swap arrangement among Asian countries – and cross-border usage of collateral assets, which are eligible instruments for central banks, are notable examples of regional financial coordination to complement macroprudential policy of each country.

In addition to global financial coordination, when considering macroprudential policy, global financial regulation is also a key factor. If the financial intermediation function of internationally active banks subject to macroprudential regulation is stable, then financing for development is also expected to be stable in emerging countries.

During the Asian financial crisis, U.S. and European banks filled lending gaps that Japanese banks had left as a result of their withdrawal from the cross-border lending arena, whereas during the recent global financial crisis, these roles were reversed. This kind of substitution

[1] Dirk Schoenmaker (2011), "The Financial Trilemma," *Economic Letters*, 111, 57–59.

by internationally active banks may have somewhat mitigated the shortfall in financing for development in emerging countries. However, it's not beyond the realms of possibility that all internationally active banks might cut lending simultaneously in the next crisis. It is desirable that as many internationally active banks as possible constantly maintain their lending without severe disruptions. To this end, global regulations are expected to play a crucial role from a longer-term perspective.

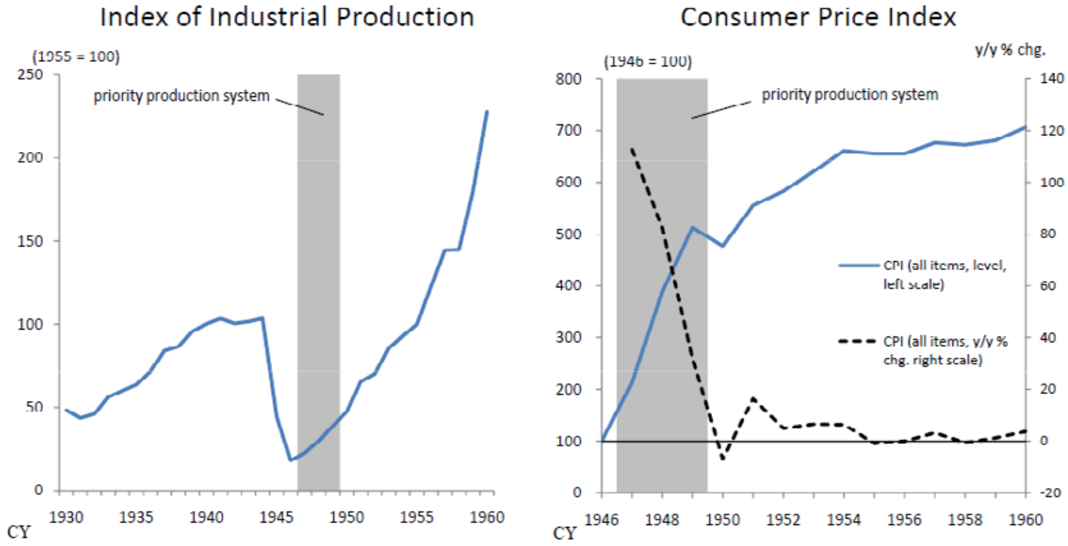
Finally, in relation to global regulation, let me share my views on an ongoing issue. Last December, the BCBS (the Basel Committee on Banking Supervision) published a consultation document entitled "Revisions to the standardised approach for credit risk". In this document, it is proposed that the risk weight for corporate exposures, project finance, and equities be heightened. Not a few market participants have sent comment letters to the BCBS, pointing out that a significant increase in risk weight leads to a decrease in banks' capital ratios, and the potential impact on financing for development can be huge. While I understand that the revisions proposed by the BCBS were made to reflect the experience of the last global financial crisis, a thorough cost-benefit analysis including an examination of the impact on financing for development is necessary.

Conclusion

As the Japanese case shows, the productivity effect of social capital is significant, and stable development finance supported by price stability contributes to an improvement in potential economic growth. In order for emerging countries to stabilize development finance, not only price stability but also effective utilization of financing from advanced countries' banks is indispensable. Facing the double trilemmas, an adequate combination of monetary policy and macroprudential policy is needed to achieve price stability and stabilize capital flows including those banks' loans, which will contribute to higher potential growth among emerging economies.

Figure 1

Industrial Production and CPI in Japan’s Post-war Period

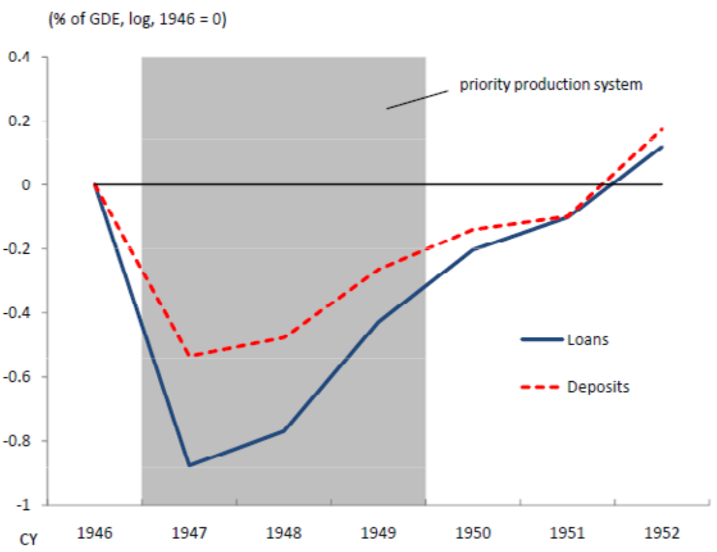


Note: Figures are calculated on an added-value weighted basis
Source: Ministry of Economy, Trade and Industry

Note: Figures are consumer price index (all items) values.
Source: Ministry of Internal Affairs and Communications

Figure 2

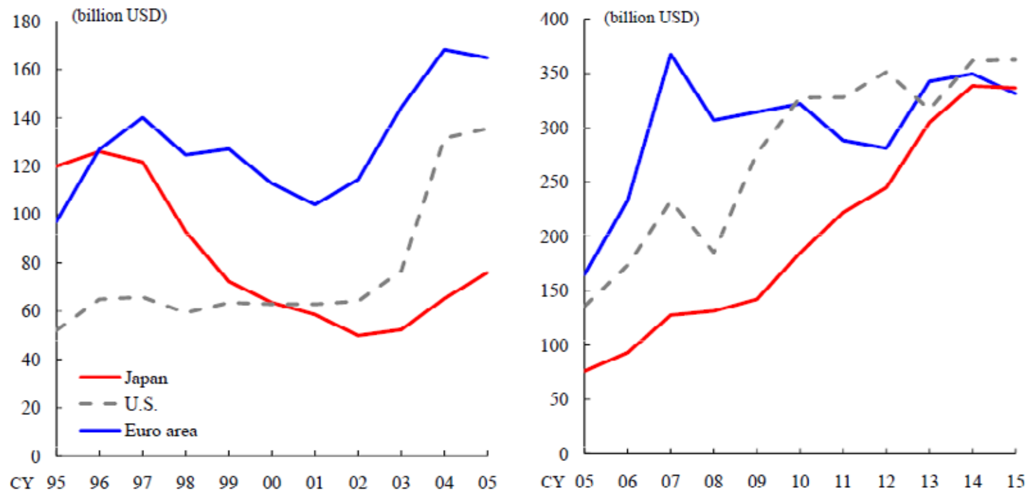
Bank Loans and Deposits in Japan’s Post-war Period



Notes: Figures are the logarithm of a ratio to GDE.
Sources: Bank of Japan, Ministry of Finance and Ministry of Economy, Trade and Industry

Figure 3

Lending to Asian countries from banks in advanced countries



Notes: 1. Figures are calculated on an immediate borrower basis.
2. Asian countries include 47 countries and regions. The "Asia & Pacific" category of BIS "Consolidated International Banking Statistics" is used.
3. Figure for 2015 is that for 2015/1Q.
Source: BIS, "Consolidated International Banking Statistics."

Figure 4

Sustainable Growth in the Economy Facing Double Trilemmas