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Bank of Japan

European Debt Problem and Its Impact on Asia

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Introduction

Thank you for giving me an opportunity to speak at the 8th Tokyo-Beijing Forum. Today, I will talk about the European debt problem's spillover to Asia and measures taken to address it.

I. Essence of the European Debt Problem

The European debt problem is a rapid correction process of three things which emerged under the unified currency euro, namely, excessive financial expansion, profligate fiscal spending, and ineffective economy.

In the process, in the European Union (EU), mainly in Southern European countries, financial contraction, fiscal austerity, and economic stagnation occurred simultaneously, and an adverse feedback loop has been formed among the three. That adverse feedback loop is the essence of the European debt problem and when and how the loop can be cut off are the key to solving the problem.

II. Future of the European Debt Problem

While fiscal integration and financial integration have been under discussion within the EU toward a fundamental solution of the European debt problem, the discussions are likely to have a long and bumpy way to go.

There seems to be two risks to the way. One is the so-called tail risk of international financial and capital markets tumbling into turmoil and the global economy deteriorating substantially. The other is strains in financial and capital markets might continue, albeit intermittently, and the global economy might not recover solidly. Of course, given the efforts by the countries concerned, the first risk can hardly manifest itself. However, there is not a remote possibility that the second risk will become a reality.

In the wake of the agreement reached at the EU summit, international financial and capital markets are regaining stability for now. However, the fundamental solution of the problem is yet to be achieved. There still seems to be a jittery sentiment at the root of the markets.

III. European Debt Problem's Spillover to Asia

In Europe, the adverse feedback loop among private finance, public finance, and economic activity has been at work and financial and capital markets have still basically been jittery. Needless to say, such a situation has been affecting the Asian region including Japan and China.

First, economic stagnation in Europe has led to put downward pressure, directly or indirectly, on economic activity in the form of a decline in exports from Asian to European countries. In particular, there seems to be not a small impact on China, which relies heavily on exports to European countries.

Second, the effects of financial contraction in Europe, especially deleveraging of European financial institutions, are a matter of concern. While the presence of European financial institutions is not so large in Japan and China, there are some other Asian countries that rely heavily on those institutions. At this stage, as the pace of deleveraging by European financial institutions has been moderate and Japanese financial institutions have partly been substituting such deleveraging, funding conditions of Asian firms have not been deteriorating substantially. However, changes in Europe might change the situation drastically.

Third, moves in international financial and capital markets. A decline in stock prices contains private consumption and other forms of economic activity through the negative wealth effect. Changes in foreign exchange rates, for example, a substantial yen appreciation might, especially for Japan's economy, worsen corporate profits and put downward pressure on economic activity. In addition, it is very likely that a jittery market sentiment itself will make Asian economic entities' sentiment cautious, thereby containing their spending.

IV. Japan's and China's Efforts

Like that, the European debt problem has been affecting substantially both the Chinese and Japanese economies. Therefore, for both China and Japan, it is extremely important that

the European debt problem will be fundamentally solved as soon as possible. Toward achieving fiscal soundness and financial system stability, I believe it necessary to urge the EU to further accelerate their efforts.

Meanwhile, from a viewpoint of minimizing the spillover of the European debt problem to Asia, first of all, each Asian country has to make policy responses properly on both fiscal and financial fronts to cope with downward pressure on economic activity. In addition, in order to maintain the financial facilitation in Asia, I believe there is not a small role Japanese financial institutions should play. In fact, based on such judgment, Japanese major banks have been actively providing loans. If those responses are smoothly carried out, a risk that economic entities' sentiment becomes substantially cautious could be reduced.

Of course, from a long-term perspective, it will be necessary to consider a case that, if by any chance, an extremely large negative shock emerges from Europe. In Asia, trading ties have been further deepened, along with the development of supply chains. It also means that, as revealed during the earthquake disaster in Japan and the flooding in Thailand, once the supply chains are disrupted for some reasons, there will be a large negative impact on economic activity in Asia as a whole. As already seen in some firms, it will be critical to take action including diversifying supply chains.

In addition, preparations should be made for possible massive capital outflows. While a safety net has been improving in recent years through various initiatives including Chiang Mai Initiative, it is necessary to continue to think very hard about how to promote regional cooperation in order to enhance the robustness of financial markets and financial systems. In that regard, I realize that a viewpoint of ensuring stability of the settlement system has become more important than ever before. Japan and China are required to take the role of leading various efforts.

Concluding Remarks

I have talked about the European debt problem's spillover to Asia and measures taken to address it. In conclusion, let me add that fiscal sustainability will be a solid basis for

ensuring economic stability in a country or a region, and, from a central bank's standpoint, the stability of the financial system will be extremely important.