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Bank of Japan

For Sustainable Development of Emerging Economies

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the Emerging Markets Forum

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I. Introduction

It is my great pleasure to have the opportunity to give a speech at the Emerging Markets Forum today.

The situation surrounding emerging economies has been changing rapidly. The global economy has recently been slowing down and there are various downside risks, ranging from trade tensions to geopolitical risks.

At this difficult point in time, it is critically important for the global economy that emerging economies achieve sustainable growth. As you well know, after the global financial crisis, the growth of emerging economies contributed significantly to the recovery of the world economy. Over 70 percent of the recovery in the global economy since 2009 is due to the contribution of emerging economies. It would not be too much to say that the performance of emerging economies is key to the global economy.

From the medium- to long-term perspective, there have been constant structural changes, including further globalization, advances in digital technologies, and climate change. For emerging economies to achieve sustainable growth, it is essential to have a long-term vision for the economy and society, and to navigate the transition process successfully. Making use of the fruits of the G20 meetings under Japan's presidency this year, I would like to take up three topics today that are particularly important to the medium- to long-term development of emerging economies. Namely, promoting financial inclusion, achieving sustainable growth, and addressing the prospective aging of the population.

II. Issues for the Medium- to Long-Term Development of Emerging Economies

A. Promoting Financial Inclusion

The first topic I would like to consider is the promotion of financial inclusion. Although the definition of financial inclusion varies, it is commonly taken to mean that "households and businesses have access to appropriate financial services and are able to use them effectively." In emerging countries, a significant portion of the population does not have enough access to financial services, especially people on low incomes and those who live in remote islands and mountainous regions. According to a report by the World Bank, about 40 percent of the adult population in emerging countries does not have a bank account.[1] For those people to obtain access to appropriate financial services would accelerate the reduction of poverty and inequality.

Enhancing financial inclusion would not only help alleviate poverty and inequality, it also has huge potential in promoting economic growth. Many researchers and policy makers argue that financial inclusion would boost economic growth.[2] For example, borrowing from financial institutions allows a firm to invest more in R&D and capacity expansion than would be possible using only its cash reserves. Housing loans and credit cards enable households to consume and invest more than the amount of cash at hand. Savings in a bank account generate interest income. Access to financial services such as these leads to more efficient business development and active consumption, thereby promoting overall economic growth of the country.

Financial inclusion would also enhance the effectiveness of monetary and fiscal policy. Regarding monetary policy, as most of the interest rates of borrowings and savings by firms and individuals are based on policy rates, central banks can affect their behavior by changing policy rates. This would improve the effectiveness of monetary policy and help smooth the economic cycle in the long run. Enhanced access to financial services would also increase the effectiveness of fiscal policy. For example, ensuring a means to transfer money to every individual would allow policy makers to design subsidization programs that are targeted at a specific segment of society. This would make possible a finer-tuned redistribution policy. In addition, tax collection would become more effective.

In advancing financial inclusion, it is necessary to develop both "hard" and "soft" infrastructures. Hard infrastructures typically include telecommunications, such as the internet and mobile phones. Soft infrastructure includes for example the active use of Fintech, which, in addition to improving financial literacy, would be effective in broadening the range of financial services available. In the short run, the introduction of state-of-the-art

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[1] Asli Demirgüç-Kunt et al., "The Global Findex Database 2017: Measuring Financial Inclusion and Fintech Revolution," World Bank Group (2018).

[2] For example, see: Thorsten Beck, Asli Demirgüç-Kunt, and Ross Levine, "Finance, Inequality and the Poor," *Journal of Economic Growth*, Vol. 12 (1), pp. 27-49 (2007).

Fintech might lead to so-called leapfrogging. This refers to the phenomenon where the convenience of services is drastically enhanced by taking advantage of new technologies even before services based on older technologies have become entrenched. For example, mobile payments spread rapidly in China in just a few years. Providing payment services via mobile phone does not require conventional physical infrastructure such as branch and ATM networks that were considered indispensable in providing broad access to financial services. China not only enjoys improved access to banking services but has also saved on the cost of building the physical infrastructure required for traditional banking.

That said, it should be noted that these benefits come with new risks. For example, large-scale system problems and cyber-attacks can negatively affect corporate management and the daily lives of individuals. Privacy protection is important, and we should be mindful that these new technologies might be used for money laundering and tax evasion. Moreover, policy makers should consider carefully the possible impact of the broader use of digital technologies on financial stability and the effectiveness of monetary policy.

Authorities should endeavor to maximize the benefits of new technologies while appropriately addressing the accompanying risks, through close cooperation, both domestically and internationally.

B. Achieving Sustainable Growth

The second topic is the achievement of sustainable growth. Since the industrial revolution, the global economy has undergone remarkable development. At the same time, however, a number of issues have emerged that require international cooperation to solve, such as those related to poverty, inequality and the environment. In 2015, the United Nations adopted the Sustainable Development Goals (SDGs), a set of goals to be achieved by 2030 targeting poverty, the environment, and other issues.

Here, I would like to provide two observations on social and environmental issues in relation to achieving sustainable growth.

First, the enormous effort and cost involved in dealing with social and environmental issues is justified by the expected returns. In other words, there is no trade-off between solving social and environmental issues and achieving economic growth. Rather, they are complementary to each other.

For example, significant progress has recently been made in reducing poverty. According to the World Bank, in 1981, more than 40 percent of the world's population was living in extreme poverty, but the figure has fallen to around 10 percent in 2019.[3] While economic growth leads to a decline in the poverty rate, the reduction of poverty and the resulting inclusive growth will in turn enhance economic growth, leading to a further reduction in poverty. The relationship between economic development and poverty reduction can be regarded as mutually-reinforcing.

Consensus has not yet been reached on the causal relationship between income disparity and growth rate in economies with a low poverty rate, as much theoretical and empirical research shows differing results.[4] That said, I believe an increase in the number of people who are given the opportunity for higher education and to learn advanced skills would lead to an accumulation of human capital, positively affecting economic growth from the supply side. With the digitalization of the economy, human capital becomes more important as the industrial structure changes over time, shifting from labor-intensive to capital-intensive, and eventually to knowledge-intensive. Moreover, the promotion of financial inclusion, which I mentioned earlier, and a more stable political and social situation through the reduction of inequality would surely have a positive impact on economic growth by attracting business investment, and through stabilizing macroeconomic conditions more generally.

Environmental problems are, needless to say, a common threat to both advanced and emerging countries. Climate change has already affected emerging economies through the increase in extreme weather events and natural disasters such as storms, floods, and drought. According to an estimate by the United Nations, the world population is expected to

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[3] World Bank Group, "September 2019 PovcalNet Update."

[4] Some researchers argue that it is not inequality of income, but inequality of opportunity that matters for economic growth. For details, see: Shekhar Aiyar and Christian Ebeke, "Inequality of Opportunity, Inequality of Income and Economic Growth." *IMF Working Paper* No. 19/34, International Monetary Fund (2019).

increase by 2 billion in 30 years, reaching 9.7 billion by 2050. Based on this estimate, poor harvests and water shortages caused by climate change would become even more serious.[5]

The effects of climate change have been studied from a variety of perspectives. For example, there is a wealth of research on the relationship between temperature and labor productivity. One study shows that an increase in temperature of 1 degree Celsius from 25 degrees reduces work performance by 2 percent.[6] Does this tally with your own experience? There is also a large body of research concerning the effects of climate change on energy demand, public health, and social stability, among other things.[7]

My point is that there is a strong link between resolving social and environmental issues and macroeconomic growth, and we should tackle these challenges in a proactive manner, not only to meet the demands of society but also to enhance medium- to long-term economic growth.

The second observation is that we should use the markets and incentive mechanisms to pursue sustainable growth. For example, when making investment decisions, investors have increasingly been taking into account environmental, social, and governance (ESG) criteria, alongside purely financial factors. This trend has been triggered in part by the Principles for Responsible Investment initiative supported by the United Nations. This initiative calls for investors to consider ESG factors in investment decisions while fulfilling their fiduciary responsibilities. Although the main target of ESG investing was initially equities, it has been expanding to include also bonds and loans. In Europe and China especially, there has been a dramatic increase in the issuance of so-called green bonds, to finance projects aimed at addressing environmental problems. These moves are expected to lead to environment-related innovation in such areas as the use of renewable energy.

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5 United Nations, "World Population Prospects: 2019 Revision."

6 Olli Seppänen, William J. Fisk, and David Faulkner, "Cost Benefit Analysis of the Night-Time Ventilative Cooling in Office Building." (2003), https://escholarship.org/content/qt3j82f642/qt3j82f642.pdf?t=li4xtt

7 Melissa Dell, Benjamin F. Jones, and Benjamin A. Olken, "What Do We Learn from the Weather? The New Climate-Economy Literature." *Journal of Economic Literature* 52 (3), 740-798 (2014).

Of course, appropriate institutional arrangements and guidance by the authorities are essential to maximize the potential of the markets and incentive mechanisms to address these issues. For example, governments and public institutions should continue to engage actively in long-term and large-scale infrastructure investment, as well as in establishing the regulatory systems necessary to deal with environmental issues. Initiatives to ensure the smooth functioning of market mechanisms are also important, including establishing frameworks for the standardization of ESG investments. Of course there are many issues which cannot be dealt with solely by market mechanisms, including international assistance for very low-income countries and direct support for those who are left behind in developing countries.

C. Addressing the Prospective Population Aging

The third topic is the prospective aging of the population. "Aging and its policy implications" has been adopted as one of the G20 priorities under Japan's presidency. You may perhaps think that aging is not an imminent policy issue in your country. In many emerging countries, the working age population is expected to grow for a while. However, once the birthrate declines and the size of the working age population begins to decrease, the shape of the demographic pyramid could change drastically within a timeframe of perhaps 20 to 30 years. Let us take Japan's case as an example. In 1970, about 10 workers supported one elderly person. The figure had decreased to 4 workers in 2000, and 2.3 workers in 2015. The decrease in birthrate and the aging of the population occurs over a shorter period and at a faster pace than you might expect.[8]

The good news about demographic change is that we can forecast prospective changes well in advance and with a certain degree of accuracy. In addition, emerging countries can learn from the precedents set in those advanced countries that are already experiencing problems related to an aging population. It is not too early to start preparing for prospective aging.

Although population aging has a wide range of economic implications, I would like to focus today on one of the main issues associated with aging, the pension system, by reviewing

[8] National Institute of Population and Social Security Research, "Population Projections for Japan." (2017)

Japan's experience. The pension system is at the core of the social security system. As the pension system has a significant impact on people's lives, careful and detailed consideration is necessary before implementing reforms. For over 20 years in Japan, we have been discussing various issues, including how to secure the financial resources necessary to support the pension system, and have made steady progress with reforms.

The Japanese pension system is largely based on the so-called pay-as-you-go scheme, where benefits for the elderly are paid out of premiums collected from the contemporary working age population. Therefore, the aging of the population demands a regular review of the balance between premiums, benefits and government subsidies. After long and intensive discussion, a number of reforms have been adopted, including a raise in the pension age and an increase in the subsidy from the government. A mechanism called the "macroeconomic slide" has also been introduced, which automatically adjusts the amount of pension benefit by taking into account changes in the number of people insured and average life expectancy. At least once every five years, the government must carry out a comprehensive review of the financial conditions of the pension system, including its long-term prospects.

The aging of the population has huge implications not only for the pension system but also for public finances in general. Expenditure on health and elderly care has increased significantly in Japan. The proportion of social security expenses to total annual expenditure has soared from around 14 percent in 1970 to around 35 percent at present. Maintaining the credibility of public finance by ensuring medium- to long-term fiscal sustainability is essential. To this end, planning and reviewing the social security and tax system so that they can adapt to demographic changes is critically important.

Maintaining economic vitality amid an aging and shrinking population is also a critical issue. From a macroeconomic perspective, labor participation and labor productivity need to be increased. Labor participation of the elderly and women has risen significantly in Japan over the past several years, helping to support economic growth. Japanese society has come to accept a greater diversity of work styles, better suited to individual circumstances, particularly for families with small children. Faced with serious labor shortages, firms have been making labor-saving investments, using information and communication technologies and artificial intelligence to offset the shortfall in labor. In terms of industrial structure, the aging of society can induce the growth of new industries, creating jobs and spurring innovation. Medical, health, and nursing care are prime examples. As aging is a global trend, industries providing elderly care services and support have a good opportunity for rapid growth. Policy makers also have an important role to play in facilitating adaptation to the changing business environment.

Lastly, I would like to emphasize that the aging of the population itself is by no means a negative thing. The proportion of the elderly to the total population is around 30 percent in Japan at present.[9] With improvements in living conditions and the progress of medical technology, the number of healthy and active elderly has been steadily increasing. Let me give you an example of an elderly person who made a significant contribution to the world. The Italian Renaissance sculptor, Michelangelo, worked as chief architect in the refurbishment of Saint Peter's Basilica when he was 74 years old, coincidentally, the same age as I am at present. Aging can enrich our lives, and social systems should be designed so that the richness of aging can be enjoyed to its fullest.

III. Concluding Remarks

I have talked today about the issues to be addressed for sustainable growth in emerging economies. As the issues are wide-ranging, it is no easy task to deal appropriately with all of them. However, emerging countries do have a so-called latecomers' advantage in being able to benefit from the leapfrogging I mentioned earlier. By making use of advanced digital technologies, emerging countries can skip investment in the infrastructures that have already become obsolete in advanced economies. And when it comes to population aging, they can learn from the experience and mistakes of advanced economies. I believe that emerging economies will make steady progress in overcoming difficulties and will be able to achieve sustainable and balanced development.

Thank you for your kind attention.

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[9] Ministry of Internal Affairs and Communications, "Demographics of Japan."