Interdependence, International Policy Spillovers and Global Governance

--- An Insider's Views---

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The world's economies and societies are becoming ever closer as a result of developments in financial markets and international trade, information and communications technology as well as transportation. In this setting, international policy spillovers are becoming growingly important and many of the economic and social challenges facing policy makers are converging. There is a heightened need for strengthening multilateral frameworks of dialogue for international policy co-operation and improving global governance.

This note first provides a brief review of some selected episodes of unsatisfactory international economic and financial policy co-operation among major developed economies and its consequences under both fixed and floating exchange rate regimes with some emphasis on the mistakes Japan made over the past several decades. In the light of this, it then discusses how to improve frameworks for such co-operation in a new global economic and financial environment.

1. Policy mismanagement under the Bretton Woods system

The global economy in the post-Second World War world was, until the early 1970s, governed by the Bretton Woods system of fixed, but adjustable, exchange rates with the US dollar as a predominant reserve currency. During most of this period, international capital transactions were fairly extensively subjected to exchange controls while international trade were only gradually liberalized under the GATT regime.

This system had two asymmetries.

First, countries with current account deficits, in particular those with financing problems, were subjected to multilateral surveillance on their policies, but surplus countries were not. This tended to retard upward adjustment of currencies of surplus countries and ran a risk of undermining the international competitiveness of the US

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and weakening its external account unless US inflation is kept below those of its trade partners.

Second, given the role of the US dollar as the key reserve currency, the macroeconomic policy management of the United States was not constrained by the limitation of foreign exchange reserves as in the case of non reserve-currency countries running external deficits.

Nevertheless, the system functioned fairly well in promoting macroeconomic stability and economic growth in the particular environment prevailing in the 1950s and the early part of the 1960s, when US inflation was kept fairly low.

That said, inflation divergences among European countries led to significant balance of payments imbalances. They were followed by the succession of devaluations and revaluations of important European currencies in 1967 and 1969.[1]

Otmar Emminger noted:

"One of major lessons arising from these events is that countries tend to resist, for various reasons, such parity changes for too long. The consequences are severe speculative crises and, in the end, the need to alter exchange rates in a more massive and disruptive way than would have been required with timely adjustment. Moreover, in the interval, the structure of production may have become gravely distorted – e.g. too export-oriented (Germany) or too concentrated on the home market (Great Britain) – or domestic equilibrium may have become seriously disturbed, as Germany's was by inflation which imported from abroad through an undervalued currency; in these circumstances, even after parity adjustment, it will take considerable time before external and internal equilibrium can be regained. Such delays will often be criticised as a "failure" of the respective adjustment measures, though in reality they are simply the result of undue hesitation before adopting the appropriate measures."[2]

Flaws in the Bretton Woods system became more visible towards the end of the 1960s when the US inflation rate continued to rise above those in Germany and some smaller European countries such as the Netherlands and Switzerland as well as Japan. By that time, the international spillover of US inflation into these European countries became a matter of particular concern.

An alarm bell did not ring loudly in Japan, which was emerging gradually as a country running persistent current account surpluses. On October 1st 1969 when the OECD published an annual report on Japan in which it argued that Japan's current account balance had shifted into a persistent surplus position, the Bank of Japan raised its official rate to ward off inflation.

[1] The UK Pound, then the second most important reserve currency, was devalued by 14.3 per cent from 2.80 dollars to 2.40 dollars per pound in November 1967. See below on parity adjustments in 1969.

[2] Otmar Emminger, "Practical difficulties of balance of payments adjustment" in "*Essays in honour of Thorkil Kristensen*" (page 5), OECD, 1970.

As an economist at the Bank's research department, I argued that Japan should revalue the yen exchange rate first rather than tightening monetary policy[3]. When my superior in the department asked me to prepare a press remark for the Bank of Japan governor Makoto Usami's use to make a critical comment on the OECD suggestion about yen's upward adjustment, I refused to do so because of my conviction that the Bank of Japan's action was a mistake.

0n 29th September, Germany moved to a floating of the Mark and then returned to a fixed rate system with an upvaluation of the Mark by 9.29 per cent on 24th October.[4] Japan did not follow the German move to my disappointment.

Thus, the mistakes of hesitation in making timely exchange rate adjustment in several European countries, which Emminger indicated in his article of 1970, was committed also by Japan.

At the time of the Smithsonian agreement of parity changes in December 1971, Japan was forced to accept a yen upvaluation of 16.88 per cent against the US dollar (from 360 yen to 308 yen to the dollar). Japanese exporters considered it to be an unacceptable burden on them and concern about deflation associated with yen appreciation developed in Japan. In such a situation, the Bank of Japan, controllable by the Finance Minister under the archaic central bank law introduced during war time following the German Reichsbank law of 1937 under the Nazis regime and still in force in the post-War Japan, was forced to adopt excessively expansionary monetary policy.

The end result was huge increases in money supply and credit leading to real estate and stock price bubbles and accelerated general price inflation in 1972 and 1973.[5] In contrast, Germany with an independent central bank did not experience such a disaster in the aftermath of the Smithsonian agreement. International spillovers of US inflation into Germany were more effectively offset by more prudent domestic monetary policy and greater readiness to adjust the German Mark upward if not at a sufficiently early timing and by a sufficiently large amount.

2. Ad hoc multilateral agreements after the demise of the Bretton Woods system

After the generalized floating of currencies of major industrialized countries in the spring of 1973 following the breakdown of the Bretton Woods system, international

[3] My view was that, combined with differences in productivity performance between manufacturing and services sectors in Japan, the Bank of Japan's policy of stabilizing consumer prices rather than wholesale prices which was advocated by Dr. Toshihiko Yoshino, then Director of the Research Department of the Bank of Japan, would be associated with persistent declines in wholesale and export prices, and that they would strengthen Japan's international competitiveness and result in growing current account surpluses unless Japan moved to a floating exchange rate system and accepted yen appreciation. This view was expressed at a panel discussion on Japan's price problems among Bank of Japan staff economists and reported in the Bank of Japan monthly staff magazine "Nichigin" (an abbreviation of "Bank of Japan" in Japanese) of May 1969 (page 14). To my knowledge, no other Japanese economists expressed such a view at that time.

[4] Earlier, in August 1969, the French franc was devalued by 11.1 per cent from 4.937 francs to 5.554 francs per dollar.

[5] Consumer price inflation in Japan rose from 4.5 per cent in 1972 to 11.7 per cent in 1973 and 24.5 per cent in 1974 whereas that in Germany rose from 5.5 per cent to 6.9 per cent and 7.0 per cent respectively.

macroeconomic policy concern gradually shifted away from the sustainability of current account imbalances, in part because transitory imbalances became easier to finance with the liberalization of international capital transactions and the development of international capital markets. Current account positions were increasingly seen as the outcome of national saving and investment decisions and, to that extent, neither intrinsically good nor bad.

That said, both persistent current account imbalances and exchange rate volatility and misalignment under the floating rate system were focal points in international policy dialogue among policy makers and advisors of major industrialized countries. Thus, several ad hoc agreements were made among a limited number of major countries to deal with specific issues.

A typical example was the 1978 agreement at the Bonn Summit of Group of Seven (G-7)[6], which exchanged fiscal expansion by Japan and Germany for a commitment by the United States to reduce its inflation and raise its domestic oil prices to world levels.

Another example was the agreement among the Finance Ministers and Central Bank Governors of Group of Five (G-5)[7] at the Plaza Hotel in New York City in September1985 which was designed to depreciate the US dollar, then considered to be overvalued against the Japanese yen and the German Mark, by intervening in foreign exchange markets.

A third example was the Louvre Accord signed by the then Group of Six (G-6)[8] in February 1987 in Paris, with Italy, an invited member, declining to finalize the agreement. It called for the stabilisation of the US dollar, which by then was threatening to become too weak, and, second, for US fiscal consolidation.

These agreements or accords reached by the G-5/G-6/G-7 in the late 1970s and the 1980s can be viewed as discretionary international policy co-ordination under the floating exchange rate system. Discretion has the obvious appeal of enabling policy makers to respond to circumstances flexibly, without constraints imposed on them by pre-determined rules under the Bretton Woods system. But, it can lead to so-called time-inconsistent policy actions, which can be unsatisfactory in the long run.

A typical example of time-inconsistent discretionary international economic policy co-operation with an unsatisfactory outcome in the long run is found in Japan.

Arguing against discretion, Allan Meltzer noted:

“ Japanese policy-makers in the second half of the 1980s changed from a credible policy of maintaining low inflation to an exchange rate target at a time of deregulation. The new policy financed the so-called bubble economy. The monetary base increased at a compound rate of 11.5 per cent for the three years 1986-89. This was nearly double the growth rate of the previous three years. The stock of base

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[6] France, West Germany, Italy, Japan, the United Kingdom, the United States and Canada.
[7] France, West Germany, Italy, Japan, the United Kingdom, the United States.
[8] France, West Germany, Japan, the United Kingdom, the United States and Canada.

money increased more than 38 per cent in these three years. By 1991, the monetary base growth went into asset markets in anticipation of higher inflation. When money growth fell, anticipations changed to disinflation or deflation, and asset prices collapsed".[9]

As an international economic policy adviser at the OECD, I periodically expressed doubt about the orientation of monetary policy in Japan during that time[10]. But, I must point out that the conduct of Japanese monetary policy during this period was particularly difficult, both technically and politically.

Pressure from both domestic and foreign sources were put on the Bank of Japan to contribute to exchange-rate stability and to promote domestic demand-led economic growth with the view to achieving a substantial reduction in Japan's current account surplus[11], which had grown against the background of a combination of expansionary fiscal policy in the United States and fiscal consolidation in Japan in most of the 1980s.

Throughout this period, a very low inflation prevailed in Japan, rising only very gradually from 0.1 per cent (in terms of GDP deflator) in 1987 to 0.7 per cent in 1988, which made it extremely difficult for the Bank of Japan to justify an early tightening of monetary policy that could work against the Louvre Accord aimed at the stabilization of the US dollar. Moreover, uncertainty after the worldwide stock market crash of 19 October 1987 (Black Monday) added to the difficulty in finding a right timing for changing the stance of monetary policy in Japan.

In the summer of 1988, the German Bundesbank raised its discount rate by a full percentage point, but monetary policy tightening was delayed in Japan even though economic recovery was more solid than in Germany. It was in May 1989 that the Bank of Japan raised its discount rate as the first step of tightening in 9 years and 2 months. It followed the US Federal Reserve move towards monetary restraint which started in March 1989.

3. Unsatisfactory international policy co-operation in the 1990s

Multilateral action to intervene in foreign exchange markets was rarely conducted in the 1990s onwards. A main exception was a concerted intervention of G-7 countries on 18 March 2011 to counter excessive volatility and disorderly movements in the

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[9] Allan Meltzer, "Commentary on the Role of Judgment and Discretion in the Conduct of Monetary Policy", in "*Changing Capital Markets: Implications for Monetary Policy*" (pp. 213-259), Federal Reserve Bank of Kansas City, 1993.

[10] Kumiharu Shigehara, "Testimony" (pp. 597~639) in "*Decision-making process about Japanese economic policy during the periods of bubbles and deflation*", The Economic and Social Research Institute of the Cabinet Office of the Japanese Government, March 2011, http://www.esri.go.jp/jp/archive/sbubble/history/history_03/analysis_03_02_13.pdf
In the 1986 report on Japan prepared in early autumn and published in November, the OECD argued that "(F)urther relaxation (of monetary policy) may risk excessive monetary growth and rekindling inflationary pressure in the future" (p. 93), *Economic Surveys: Japan 1986*. However, the Bank of Japan reduced its discount rate by a half percentage point to 2.5 per cent on 1st November 1986.

[11] Japan's current account surplus as a percentage of GDP rose from 0.4 per cent in 1981 to a peak of 4.2 per cent in 1986 and gradually declined to 1.5 per cent in 1990. Germany's current account surplus as a percentage of GDP reached a peak of 4.6 per cent in 1986 and narrowed to 3.3 per cent in 1990.

Japanese yen in the aftermath of Japan's earthquake and tsunami. Prior to this, the US, the euro-area, UK and Canada did not jointly intervene in foreign exchange markets since the coordinated action to support euro in 2000.[12]

In the 1990s when regional economic and financial integration in Europe accelerated with the move towards the adoption of a single currency, intra-Asian trade integration developed with the US dollar remaining as the most important currency for international trade and financial transactions within Asia. In the mid-1990s, I as OECD chief economist advised senior government officials of emerging Asian economies that their exchange rate policy should better be conducted with the aim of maintaining stability in exchange rates against a basket of currencies of their trade partner countries rather than in terms of bilateral currency relationships vis-à-vis the US dollar. However, the proposed change in their policy did not materialize.

In such an external environment, Japan conducted unilateral, un-coordinated foreign exchange market intervention in the US dollar-Japanese yen market essentially as a supplementary instrument to support aggregate demand management faced with a contraction of domestic demand following the collapse of the equity and real estate bubble in the early 1990s.

In fact, Japan's export performance after the burst of the bubble was in sharp contrast with those of the UK, Australia and Nordic countries which had earlier managed to get out of recessions and to solve balance-sheet problems associated with asset price collapse through export-led recovery induced by sharp currency depreciation[13].

Over a ten-year period from 1993 (about a year after the burst of the bubble) to 2002, Japan's share in world merchandise trade exports declined sharply from 10.0 per cent to 6.6 per cent. During the same period, both the US and German shares were remarkably stable at around 11 per cent and close to 10 per cent respectively. Japan's poor export performance in the face of weak domestic demand was largely a result of weaker international price competitiveness associated with the yen's excessive appreciation.

It was in this situation that unilateral foreign exchange market intervention was conducted by the Bank of Japan as the agent of the Ministry of Finance to contain upward movements of the yen. However, the effectiveness of un-coordinated foreign exchange market intervention appears to have been limited, and the yen's effective exchange rate remained well above the level justified by relative prices as well as nominal wages and other production costs. This deterred foreign direct investment into Japan and encouraged Japanese direct investment abroad, giving rise to concern about the "hollowing" of Japan's manufacturing industry.

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[12] L. Goldberg, C. Hull and S. Stein, "Do Industrialized Countries Hold the Right Foreign Exchange Reserves?" *Current Issues in Economics and Finance,* Volume 19 Number 1, 2013, Federal Reserve Bank of New York, http://www.newyorkfed.org/research/current_iss
http://www.esri.go.jp/jp/archive/sbubble/history/history_03/analysis_03_02_13.pdfues/ci19-1.pdf

[13] Similarly, increases in net exports as a result of the depreciation of the US dollar and the UK pound in the aftermath of housing market collapse in 2007 helped to offset the deflationary forces working on domestic output.

In this context, it may be worth recalling that in a speech given at Harvard University in 2001[14], Allan Meltzer noted:

"Japan's problems are mainly homemade. Mainly, but not entirely. The US Treasury had a role. It recommended publicly, and I am told privately, that Japan should rely on fiscal stimulus and avoid sufficient monetary stimulus to depreciate the yen/dollar exchange rate. --- In 1998, monetary stimulus showed signs of depreciating the exchange rate. The yen/dollar exchange rate depreciated to 145 in June from 100 a few months earlier. Then Deputy Secretary Summers came to Tokyo and ended that policy. The yen soon appreciated to 105, a massive and foolish change in an economy with falling prices and rising unemployment. The policy was mistaken, wrong, and it failed. The major mistake was a failure to recognize that the yen was overvalued. If Japan could not depreciate its nominal exchange rate, prices had to fall until Japan had a real exchange rate that was consistent with steady growth and stable prices. This took time and is still continuing. Where was the stronger dollar policy? This failure was extremely costly to Japan, to Asia and to us. A stronger, more rapidly growing Japanese economy would certainly have mitigated, and possibly prevented, the Asian financial crisis. Japan would serve as a source of demand for Asian exports now, when US demand has slowed."

Indeed, the yen rate reached a record high of less than 80 yen per US dollar in 1995, triggering massive direct investment flows to emerging Asian economies. As these economies followed a policy of maintaining stability of their bilateral exchange rates of their currencies contrary to my proposal noted-above, the subsequent correction, though partial, of the overvalued yen rate against the US dollar tended to weaken their international price competitiveness. This was one of the causes of the East Asian crisis in 1997. An external deflationary impulse arising from the East Asian crisis added further difficulty to domestic economic management in Japan which had been struggling with homemade deflation associated with the balance-sheet problems of the banking sector and heavily indebted non-financial enterprises.

4. Continued unsatisfactory multilateral co-operation since the early 2000s

In early 2003, around the time when Lars Svensson, professor of Princeton University, now deputy governor of Swedish central bank, published a paper[15] in which he proposed the pegging of the yen at 150 or 160 per dollar as a means for Japan to escape from deflation, I contributed an article to the Financial Times (April 2, 2003), calling for a global solution to deal with the so-called "Japan problem" of protracted deflation and slow growth.

My article was based on the note, which I had earlier sent to the Cabinet office of Junichioro Koizumu, then prime minister who was secretly considering me as the prime candidate for the post of Bank of Japan governor to be appointed in April

[14] Allan Meltzer, "International Economic Policy in the Clinton Administration", prepared for "*American Economic Policy in the 1990s*", Harvard University, 27 June 2001.
[15] Lars E. O. Svensson, "Escaping from a Liquidity Trap and Deflation: The Foolproof Way and Others", Princeton University, CEPR and NBER, February 2003, for the Journal of Economic Perspectives. See also Allan Meltzer, "appreciate the Yen", Comments, The Financial Times, 15 April 2002, and Kumiharu Shigehara, "Developments in International Policy Co-operation and Japan's Tasks: An Insider's Views", Research Institute of Economy, Trade and Industry, Tokyo, 3 July 2002.

2003[16]. The note was also intended to be circulated to foreign central bank governors if I had been appointed BOJ governor.

In this note, I argued that:

"*The Japanese economy has been in a protracted phase of deflation with a large unused production capacity despite monetary policy geared to virtually zero nominal short-term interest rates and huge increases in the monetary base over a sustained period. As pointed out by myself as OECD chief economist in the period of yen's sharp appreciation in 1994-95 and argued also by some prominent US and European economists including Profs. Jeff Sachs, Joseph Stiglitz and Lars Svensen, an effective way to jump start the economy after the burst of a bubble is aggressive easing of domestic monetary conditions to ward off a deflationary spiral; and once the zero bound to nominal interest rates is reached, it is essential for an open economy to resort to another stimulative mechanism, namely currency depreciation with the understanding and support of its trade partners*".

In this context, I added that:

"(T)he Japanese government should take a leading role in the post-Uruguay round of trade liberalization including agricultural products and services. Further opening of Japanese markets should increase the import content relative to the expansion of the size of the domestic market which should grow more rapidly a while after a jump-start of the Japanese economy triggered by yen exchange rate adjustment. Only in this way, Japan can secure support from her trade partners in her efforts to achieve economic recovery through active use of exchange rate and monetary policies".

Furthermore, my proposal for a global solution included the following component:

"*(I)n the context of preparing the forthcoming economic summit at Evian, France, the Japanese government should argue that like in the Unites States, some fiscal flexibility be allowed in the European Community countries. In particular, fiscal discipline imbedded in the Growth and Stability Pact must be adjusted so that targets for cuts should be based on structural balances allowing for the working of automatic stabilizers. This would help prevent the euro-zone countries from getting into recession arising from weaker exports associated with the recent firming of the euro against the US dollar and the yen*".

The original title of my Financial Times article was "*A global solution needed to deal with the Japan problem*".[17] This version was privately sent to the then chief

[16] A Japanese monthly magazine "Sentaku" of June 2003 (P.87) revealed an inside story that, under heavy pressure from the establishment, the prime minister Koizumi was forced at the last moment to abandon his idea of appointing me as the next Bank of Japan governor. Earlier, the Financial Times published an editorial "*Koizumi's timidity*" (February 25 2003) in which it argued that: "*Mr Koizumi should therefore insist that his nominee takes the Bank of Japan's existing remit of stable prices seriously and does not countenance further deflation, even if that means using unorthodox measures to raise prices. Simultaneously, he must return to the reform process. That would be no mean feat after yesterday's disappointing news about the next Bank of Japan governor*."

[17] The electronic version of my Financial Times article (published: April 1 2003 20:54 pm) had the title: "*A weaker currency will make Japan stronger*"; the printed version (published: April 2 2003) was

economist of the IMF and the then undersecretary of the US Treasury responsible for international finance as well.

However, this global deal I advocated was never realized during the 2000s. In such a situation, Japan conducted unilateral foreign exchange market intervention. In a recent report prepared by staff of the Federal Reserve Bank of New York, it is noted that: "*from 2000 through 2004, Japan's Ministry of Finance regularly conducted foreign exchange interventions. These interventions eventually tapered off, but were revived in September 2010. Japan attempted to further weaken the yen with unilateral interventions in August 2011 and between October and November 2011*".[18]

The tapering off of the Japanese authorities' foreign exchange market intervention occurred as Japan's output expansion resumed. Its real GDP growth from 2002 to 2007 was the longest in the postwar history. During this period, export increases accounted for about two-thirds of output growth. Export advances, in turn, led to buoyant business investment growth, accounting for a third of the rise in Japan's output. Total output increased at an annual rate of 2.1per cent during the expansion, while private consumption remained weak and underling inflation negative.

Japan's economic expansion stumbled by late 2007 in the context of global economic downturn in the aftermath of the US housing market debacle. It was then trapped in the deepest recession of the postwar era.

A major challenge for Japan at that time was to find ways to counter the deflationary pressure arising from rises of the yen's exchange rate, not only against the US dollar but also against the currencies of China and other emerging Asian and Latin American economies that manage their exchange rates against the U.S. dollar.

The decline in Japan's export volume, at an annual rate of some 55 percent between the third quarter of 2008 and the first quarter of 2009, occurred against the background of global export market contraction. But the contraction of Japan's export volume was far shaper that the decline in the size of Japan's export market which was estimated to be 16.6 per cent for 2009, not much different from the OECD area average of 15.4 percent.[19]

The most important factor was the Japanese yen's sharp rise since 2007. The rise of the yen between 2007 and 2009 amounted to some 19 percent against the U.S. dollar and to 25 percent in effective terms. The yen's advance being sharper in effective terms than against the US dollar reflects the decline of the currencies of the United Kingdom, Korea and emerging economies in Asia and Latin America over this period as a whole. It may be noted that the Japanese authorities did not intervene in the foreign exchange market to counter upward pressure on the yen exchange rate in the aftermath of the debacle of the US housing market, thus contributing to a softening of

tilted: "*A weaker currency is the best medicine for Japan*". The original title was changed into theses by the editors without consultation with the writer. An article written to the same effect in Japanese was published by the Nihon Keizai Shimbun of 28 April 2003.

[18] See footnote 11.

[19] Japan's share in world exports declined from 4.4 percent in 2008 to 4.1 per cent in 2009 whereas the US share rose from 9.4 per cent to 10.1 per cent. Over the same period, both Germany's and the UK's shares remained unchanged at 8.9 per cent and 4.0 per cent.

the contraction of US output arising from a sharp decline in domestic demand.[20]

These currency movements exerted unwelcome deflationary pressure on the Japanese economy, basically through four channels: (1) weaker export demand widened the output gap; (2) a further decline in import prices accelerated consumer price deflation; (3) international cost comparisons against Japan encouraged a further shift of production bases abroad by Japanese producers, aggravating business fixed investment and reducing employment at home; and (4) those firms maintaining production bases at home were forced to cut wages and other costs even more to cope with a further loss of international price competitiveness associated with the yen's sharper rise.[21]

Lower consumer prices tended to moderate the decline in real wages relative to nominal wages. Nevertheless, real wage cuts together with reduced employment tended to lower household income and consumption in real terms in a situation where Japan's personal savings rate had already fallen to about 3 percent, somewhat lower than U.S. and U.K. levels and far below Germany's.

With a zero bound on nominal interest rates, intensified deflation increased real interest rates and weakened credit demand even more, thus entailing a deflation spiral.

In the context of dealing with the global financial crisis, the central banks of the two countries where the housing market debacles occurred, the Federal Reserve and the Bank of England, adopted a policy of aggressive easing of monetary policy.

Almost a year after the outbreak of the US housing market crisis, Donald Kohn, then vice-chairman of the US Federal Reserve, said that the Fed had learned that the aftermath of a bubble could be far more painful than it had imagined.[22]

Several days after his speech was delivered, I contributed an article "Japan's monetary authorities must act more aggressively" to the Financial Times of 25 November 2008.[23]

In the following year, outside the two countries directly hit by the housing market

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[20] US real total domestic demand contracted by 1.5 per cent in 2008 and 4.0 per cent in 2009, whereas declines in real GDP were limited to 0.3 per cent and 3.1 per cent due to increases in net export volumes. In contrast, declines in Japan's real GDP, of 1.0 per cent in 2008 and 5.5 per cent in 2009, were larger than those in the US, while the contractions of Japan's total domestic demand (1.3 per cent in 2008 and 4.0 per cent in 2009) were broadly of the same magnitude as for the US.

[21] Japan's export performance measured as actual growth in exports relative to the growth of the country's export markets worsened in 2008 (by - 1.9 per cent) and substantially in 2009 (by – 17.0 per cent), whereas that of Korea, whose currency depreciated not just against the yen but also against the US dollar, strengthened in 2008 (by 2.3 per cent) and substantially in 2009 (7.2 per cent). In fact, the decline in Korea's export volume in 2009 was limited to 1.2 per cent, while Japan's contracted by 24.2 per cent. See Annex Tables 38 and 44 of OECD Economic Outlook November 2012 (pp.244 and 250).

[22] Donald Kohn, "Monetary Policy and Asset Prices Revisited", a speech at the Cato Institute's 26th Annual Monetary Policy Conference, Washington, D.C. on November 19, 2008, http://www.federalreserve.gov/newsevents/speech/kohn20081119a.htm

[23] Kumiharu Shigehara, "Japan's monetary authorities must act more aggressively", The Financial Times, 25 November 2008, http://blogs.ft.com/economistsforum/2008/11/japans-monetary-authorities-must-act-more-aggressively/

collapses, an interesting experiment to counter international spillovers of deflationary impulses originating from the US and the UK was tried by Canada. In its monetary policy report published in July 2009, the Bank of Canada stated "a stronger and more volatile Canadian dollar could act as a significant drag on growth and put additional downward pressure on inflation for Canada," thus indicating the level beyond which the bank did not like to see the Canadian dollar rise.

Note that this statement was made at a time when the Canadian dollar was fairly stable — C$1 equaled about $0.80, some 20 percent lower than the level prevailing a year earlier. The statement was preceded by the Bank of Canada's decision, announced in April 2009, to make a conditional commitment to hold the central bank policy rate at 0.25 percent until the second quarter of 2010.

In the monetary policy report published in that month, the Bank outlined a framework describing unconventional measures it could employ, if needed, and principles that would govern the use of those tools. This policy framework of the Bank of Canada was far more transparent and more helpful in providing information about the future course of its monetary policy than that in use by the Bank of Japan.

Another interesting experiment was found in Sweden. In July 2009, its central bank lowered the interest rate on its one-week deposit facility to negative 0.25 percent at the same time that it squeezed its benchmark-lending rate down to 0.25 percent.

Citing these experiments, I contributed another article "Japan needs more aggression in warding off deflation" to the Financial Times of 26 October 2009[24] and an article "Central banks 'experimenting' to counter deflationary pressure" to the Japan Times[25], suggesting that the BOJ should use a greater variety of unconventional policy instruments than were actually in use in Japan in a situation where its policy rate was as low as 0.1 percent. However, the Bank did not adopt an as aggressive policy stance as I suggested in warding off deflation.

The outbreak of the euro-area crisis gave rise to another wave of international deflationary forces affecting the Japanese economy. Between early August 2009 and mid-July 2012, the yen rose from around 137 yen to 95 yen per euro, some 45 per cent appreciation. Thus, according to the OECD calculation using 2005 as the base year, the yen's effective exchange rate continued to rise from a low point of 87.7 to 124.7, by some 42 per cent.

Some ten years after the publication of my Financial Times article "*A weaker currency will make Japan stronger*" (the printed version of 2 April 2003), a new

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[24] Kumiharu Shigehara, "Japan needs more aggression in warding off deflation", The Financial Times, 26 October 2009, http://blogs.ft.com/economistsforum/2009/10/japan-needs-more-aggression-in-warding-off-deflation/. My article written to the same effect in Japanese was published by the Nihon Keizai Simbun of 12 October 2009.

[25] Kumiharu Shigehara, "Central banks 'experimenting' to counter deflationary pressure", The Japan Times, 3 November 2009, http://www.japantimes.co.jp/opinion/2009/11/03/commentary/central-banks-experimenting-to-counter-deflationary-pressure/#.UlnhgxZdK68. My article written to the same effect in Japanese was published by a weekly magazine "Economist" of 3 November 2009.

policy framework, the so-called "Abenomics", was announce by Shinzō Abe, then president of the opposition Liberal Democratic Party and now prime minister of Japan, in December 2012. This has three main elements or "arrows": aggressive monetary policy easing, flexible fiscal policy, and structural reforms. Commenting on it, the IMF in the October 2013 World Economic Outlook reports that its simulations suggest that negative spill-over effects of Abenomics are likely to be mild. The depreciation in the yen exchange rate[26] attributable to monetary easing has a very small negative impact on short-term growth in the rest of the world, with the negative impacts limited to a few countries (for example, China, Germany, Korea) and is on the order of 0.1 and 0.2 percentage point of GDP in the near term. Moreover, it notes that should the broader Abenomics package be successful, it would have clear positive net growth spillovers over the longer term. However, it also warns that under an incomplete scenario these positive long-term benefits do not materialize.[27]

Turning to Europe where the euro-area crisis erupted only a few years after the outbreak of the global financial and economic crisis, one may note that Switzerland, considered to be a safe haven country in the European turmoil, began systematic foreign exchange market intervention in the spring 2009 to resist further appreciation of its currency. In September 2011, the Bank announced a new policy of keeping the euro-franc exchange rate above a minimum level of 1.20 Swiss francs per euro with a consequent build-up in foreign currency reserves.

5. New and old challenges and a search for better global governance

The IMF World Economic Outlook published in October this year argues:

"*The world economy has entered yet another transition. Advanced economies are gradually strengthening. At the same time, growth in emerging market economies has slowed. This confluence is leading to tensions, with emerging market economies facing the dual challenges of slowing growth and tighter global financial conditions*".[28]

In this new global economic situation, emerging market economies are faced with two challenges: how to adjust to lower potential growth and how to deal with the potential impact on these economies of the normalization of US interest rates.

The IMF advice to emerging market economies is twofold:

"*First, where needed, countries must put their macro houses in order by clarifying their monetary policy framework and maintaining fiscal sustainability. Second, they must let the exchange rate depreciate in response to (capital) outflows. Foreign currency exposure and balance-sheet effects, which have created adverse effects in the past, are more limited today, and emerging market economies should be able to*

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[26] The yen's effective exchange rate the OECD assumed for the average of 2013 in its economic projections published in the June 2013 Economic Outlook was 102.63 to be compared with 124.65 for 2012.

[27] See Box 1.4, "*Abenomics: Risks after Early Success?*" IMF World Economic Outlook, October 2013 (p.57), http://elibrary.imf.org/view/IMF081/20382-9781484340639/20382-9781484340639/Other_formats/Source_PDF/20382-9781484385890.pdf

[28] IMF World Economic Outlook, October 2013 (p. xiii).

adjust to the changed environment without a major crisis".[29]

Given the increased economic weight of emerging market economies, the management of foreign exchange rate policy by them as well as advanced countries can have significant international ramifications.

Unilateral, uncoordinated exchange market intervention not just to reduce exchange rate volatility but also to influence exchange levels and thereby international competitiveness and export performance can lead to a significant shift of demand across trade partners. For such action not to become "beggar-thy-neighbor" policy, well–established frameworks of multilateral surveillance are essential.

As reviewed earlier, timely appreciation of currencies of current account surplus countries such as Germany in the 1960s and 1970s helped to contain inflation pressure and contributed to better domestic economic management. On the other hand, Japan's delayed upward adjustment of its currency in the late 1960s, combined with excessive domestic monetary expansion, led to spectacular inflation hikes even before the outbreak of the first oil crisis of 1973. Furthermore, external as well as domestic pressure put on the Bank of Japan after the Louvre Accord in the late 1980s, then less independent than the German Bundesbank, to delay domestic monetary tightening to prevent a further fall of the US dollar ignited asset market booms whose subsequent burst resulted in two decades of low economic growth coupled with deflation in Japan. Japan's attempt to reduce its current account surplus by domestic-demand led growth in the late 1980s failed to provide positive spillover effects on the economy of the rest of the world in the 1990s onwards. More prudent domestic demand management in Japan than actually conducted in the late 1980s even in the face of pressure from the United States may in the end have been beneficial to the United States and Japan's other trade partner countries as well as to Japan over the longer term.

While currency appreciation and resulting weaker export demand may not be welcome in countries where inflation pressure does not exist, negative domestic output effects of a decline in net exports may not be considered to be a serious problem in those countries that are equipped with effective conventional macroeconomic demand management tools which they can use to offset the deflationary effects of weakened external demand as a result of currency appreciation. In the current situation, however, the fiscal positions of most of industrialized countries do not allow them to use expansionary fiscal policy to deal with aggregate demand deficiency. Moreover, the use of expansionary monetary policy to avoid deflation and sustain sufficiently low inflation is constrained by the zero bound on nominal interest rates in a number of countries where policy rates are already close to zero.

In such a setting, unilateral uncoordinated foreign exchange rate policies and market intervention by countries to strengthen their international competitive

[29] IMF World Economic Outlook, October 2013 (p. xiv).

positions (for example by pegging *nominal* exchange rates at, or managing them around, unduly low levels while prevailing economic slacks are containing wage and price inflation at home at levels lower than abroad, and thereby resulting in a depreciation of *real* exchange rates) involves a serious risk of undermining domestic economic management of trade partner countries.

Since the demise of the Bretton Woods system, multilateral surveillance activities have been strengthened by the IMF as a universal institution for both developed and developing countries and by the OECD as an international institution for a group of advanced economies.

When G20 leaders called at their Seoul Summit in November 2010 for enhanced economic surveillance, they specifically urged the IMF "to focus on systemic risks and vulnerabilities wherever they may lie."

In February 2011, a group of experts[30] established at the initiative Michel Camdessus, Tommaso Padoa-Schioppa and Alexandre Lamfalussy approved a report on the reform of the international monetary system with focus on the role of the IMF.[31] President Nicolas Sarkozy of France, which was at the helm of the G 20 during the year 2011, agreed upon reception of the report to circulate it to his colleagues for their discussions during the Cannes Summit of November 3rd. However, the Cannes Summit meeting was overwhelmed with more urgent topics such as the euro-area crisis, and the reform of the international monetary system was not discussed at all. So far, due to a lack of political impulse, the G20 has only agreed on a relatively modest set of proposals, far from the meaningful reform of the system.[32]

Compared with the IMF, the OECD has had the advantage of smaller size and the relative homogeneity of its membership. Surveillance at the OECD is essentially a peer review process based on analytical reports and policy recommendations prepared by the Secretariat. Unlike the executive directors of the IMF Board who reside in the Washington area to exercise surveillance activities, top officials working in capitals of member countries gather in its Paris headquarters to attend the OECD Economic Policy Committee and its Working Party No. 3 (WP3) dealing with multilateral macroeconomic policy surveillance.

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[30] Members of the Group, from fifteen different countries were: Sergey Aleksashenko, Hamad Al Sayari, Jack Boorman, Michel Camdessus, Andrew Crockett, Guillermo de la Dehesa, Arminio Fraga, Toyoo Gyohten, Xiolan Hu, André Icard, Horts Koehler, Alexandre Lamfalussy, Guillermo Ortiz, Tommaso Padoa-Schioppa, Maria Ramos, Venugopal Reddy, Edwin Truman and Paul Volcker.

[31] Jack T. Boorman and Andre Icard (edit), "Reform of the International Monetary System - The Palais Royal Initiative", SAGE Publications, September 2011.

[32] See André Icard, "A Commentary Note: Global and Regional Surveillance", presented to an international conference "The Limits of Surveillance and Financial Market Failure: Lessons from the Euro-Area Crisis", 23 September 2013, http://office.shigehara.online.fr/en/Icard.pdf. Also see Michel Camdessus, "The Palais Royal Initiative and its aftermath" in "In search of a new World Monetary order", Proceedings of a conference to celebrate the 100th anniversary of Robert Triffin, International Triffin Foundation.

As an exclusive club which did function as the most important peer review group for international macroeconomic cooperation for many decades[33], WP3 meetings continue to be attended by deputy finance ministers and deputy central governors involved in macroeconomic policy making in capitals. However, its membership remains essentially Group of Ten (G10)-based, with heavy representation of small European countries.

Over recent decades, the increased economic power of non-member economies has eroded the advantage OECD as a forum for multilateral surveillance. In 1975, OECD countries accounted for 65% of world GDP. In 2015, their share of world GDP is projected to decline to about 50%. The G20 represents 85% of world GDP, with the same number of members as the OECD when it was first created. The OECD originally included the United States, Canada, and 18 European countries, but no members from the Asia-Pacific region or Latin America. The G20 includes a number of countries in these regions. It does not include many European countries that are members of the OECD.

WP3 needs an overhaul of its membership. Following my meeting with China's finance minister and central bank governor in Beijing in 1997 as the head of the OECD high-level mission team in my capacity as deputy secretary-general responsible for OECD relationships with non-member economies, I wrote to both of them inviting them to send their deputies from time to time to WP3 meetings in the following year. My invitation was sent to them with the full support of Larry Summers, then deputy secretary of the US Treasury and Chairman of WP3. Some time earlier, following my official visit to Moscow, I had written similarly to the Russian finance minister and central bank governor to send their deputies occasionally to WP3 meetings.

Now the time has come to open these meetings to other key non-OECD countries. At the same time, to allow the WP3 to retain its effectiveness, fewer European countries should attend, so as to keep the total number of countries represented there within single figures.[34]

6. Some concluding remarks

Some broad policy lessons can be drawn from the above review of selected episodes under the fixed and floating exchange rate regimes.

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[33] In his book "Working for the World Economy", Emile van Lennep, WP3 chairman (1961-1969) and later OECD secretary-general (1969-1984), wrote: "(T)he American Treasury also felt that Working Party 3 exerted a much more powerful influence on British policies than the IMF ever could." He also wrote that at a dinner hosted by Pierre-Paul Schweitzer as the IMF managing director (his term was 1963 to 1973) in honor of van Lennep on his first working visit to the IMF as OECD Secretary-General, Schweitzer gave a speech in which he said the OECD "had done for years the work that the IMF should have done, particularly in Working Party 3." Van Lennep added that: "… to the majority of his (Schweitzer's) staff this was the bitter truth." See also Andrew Crockett, "WP3 – High-level policy making in a stimulating forum" in "*The OECD at 50*" (p.86), 2011.

[34] Kumiharu Shigehara, "The way forward: Streamlining policy discussions for more effective multilateral surveillance", "*The OECD at 50*" (p.52), 2011.

(1) Delayed dollar parity changes, both upwards and downwards, under the fixed exchange system run the risk of entailing large long-run economic costs both at home and abroad.

(2) Foreign exchange rate management policy geared to the stability of bilateral currency relationships vis-à-vis the US dollar under the floating rate system can distort international resource allocation significantly, particularly in Asia where trade patterns are increasingly diversified with lessening of the relative importance of trade relationships with countries in the US dollar zone. Trade-weighted effective exchange rates should be given greater importance in exchange rate management.

(3) Misalignment of effective exchange rates cannot be effectively checked by unilateral foreign exchange rate intervention; multilateral action involving all major trade partners with short-run adjustment costs shared among them could bring about longer-run benefits to all of them.

(4) Ad hoc multilateral efforts to stabilize effective exchange rates under the floating rate regime at the sacrifice of domestic price stability can entail significant long-run costs for all partners.

(5) Compared with international spillovers of inflationary impulses, those of deflationary impulses would be more difficult to neutralize in countries where the initial levels of inflation are very low and policy interest rates are already close to the zero bound. In such a situation, international policy co-ordination of not just macroeconomic but also structural policies among countries concerned would be urgently required.

(6) Multilateral surveillance by the IMF and the OECD should be strengthened to find out suitable ways of such policy co-ordination so as to realize better economic performance in all trade partner countries in the longer run, preventing them from adopting myopic "beggar-thy-neighbour" policies to bring about short-run benefits at home at the sacrifice of partner countries with longer-run economic damages to all concerned.

Let me finish by quoting eloquent words with which my old friend and former governor of the Bank of England, Mervyn King concluded his speech on "Through the Looking Glass: Reform of the International Institutions":

"*The meetings of the IMF in Washington and Singapore this year marked the beginning of an attempt to define more clearly the role of the Fund in the world economy. Whether that will prove successful is too early to tell.*

But the challenge is clear. Globalisation increases our dependence on each other. It is no longer sufficient to rely on the commitments made sixty years ago – the world has changed too much since then.

It is up to the member countries to make a multilateral trading system work. As Joseph Conrad wrote a century ago in his great novel ***Nostromo****, "Action is consolatory. It is the enemy of thought and the friend of flattering illusions". The frenetic activity of international meetings and the flattering illusions of a stream of*

communiqués do not add up to a coherent set of commitments.

Failure to reform the international institutions will condemn them to irrelevance and obscurity. We are at that point. If this generation fails, then the work of those who were "present at the creation" will have been undone.

It is our duty to re-create the institutional framework that we inherited. It will not be easy. But in case like Alice you are tempted to think that, "There's no use trying; one can't believe impossible things", remember the Queen's reply: "Why, sometimes I've believed as many as six impossible things before breakfast." [35]

Nearly 7 years have passed since this speech was delivered on 21 December 2006.

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[35] Mervyn King, "Through the Looking Glass: Reform of the International Institutions", Inaugural International Distinguished Lecture to the Melbourne Centre for Financial Studies, Australia on 21 December 2006,
http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2006/speech296.pdf

See also Kumiharu Shigehara,"Comments on Mervyn King's Speech: Division of labour between the IMF and the OECD?" (Selected Articles), http://office.shigehara.online.fr/en/index.html and "Multilateral Surveillance: the IMF, the OECD and G-20", presentation at a conference on "Outlook for the European Union in 2030" in Paris on 1 February 2011,
http://office.shigehara.online.fr/en/index.html and
http://www.dailymotion.com/video/xh5xan_kumiharu-shigehara_news#from=embed