Challenges in International Finance and Japan's Responses

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Introduction

Thank you very much. I am so honored to be able to participate with the distinguished panelists in this esteemed symposium organized by the Institute for International Monetary Affairs (IIMA). I would like to express my sincere gratitude to President Toyoo Gyohten and Managing Director Yoshihiro Watanabe and all the staff and parties concerned.

Looking back, I also had the opportunity to join this symposium on March 18, 2010, where I discussed such issues as the role of U.S. dollar as the key currency and the possibility of renminbi internationalization.[1] Last year, the symposium was unfortunately cancelled due to the Great East Japan Earthquake. We will never be able to forget the catastrophic earthquake and tsunami of March 11 last year and the nuclear accident, and the damage they have inflicted on the Japanese economy. The global economy has also undergone significant changes in the last two years.

Today, I would like to talk about nine themes regarding the recent global economy and international finance, paying particular note of how Japan has responded to these challenges.[2]

1. The State of the World and the Asian Economy

First, let me begin with issues of the world economy. With various factors considered, I currently see the world economy, as a whole, as being on its way to recovery from the Lehman crisis in 2008. In the process of this recovery, it appears, policy coordination agreed through international fora, particularly G-20 Summits and Finance Ministers and Central Bank Governors' Meetings, has proved

[1] The author's speech text at the IIMA symposium on March 18, 2010, "*Reforming the International Monetary System – Japan's Perspective –*" has been uploaded on the website of the IIMA.
[2] Please note that the main body of this speech is basically reproduced from my lecture at Peking University on March 13.

to be effective. That is, policy responses such as [1] government support to the financial sector in a number of countries, [2] expansionary fiscal and monetary policies, and [3] financial assistance to troubled countries by the IMF and the multilateral development banks (MDBs), stove off the deepening of the crisis and underpinned economic recovery.

Looking at the Japanese economy, it suffered serious damage in the wake of the Great East Japan Earthquake which occurred on March 11 last year, just in the middle of the recovery process from the recession following the Lehman crisis. But we have seen favorable signs, such as recoveries from the damage to consumer confidence, from disruption in the supply chain, and from electricity shortages, which are now developing the basis for new growth. We expect positive growth of 2.2 percent for Fiscal Year 2012[3] supported by government spending on reconstruction, amounting to around 18 trillion yen, which is equivalent to around 4 percent of Japan's GDP and incorporated in a series of supplementary budgets as well as the FY 2012 budget to be approved by Parliament.

For all this, however, the global economy is still facing various risks including the European sovereign debt crisis, its spillovers, and the rise in oil prices, which still require prudent economic policy management. In fact, the IMF's most recent World Economic Outlook (WEO) Update published in January 2012 revised downward the forecast of output growth in member countries from the previous forecast made in September 2011. Namely, the forecast of output growth for 2012 was adjusted downward from 1.9 percent to 1.2 percent for advanced economies, sharply revised from 1.1 percent to -0.5 percent for the Euro area, and from 2.3 percent to 1.7 percent for Japan (for the U.S., the forecast was unchanged at 1.8 percent). Meanwhile, the overall outlook for output growth for 2012 in developing and emerging economies was revised downward from 6.1 percent to 5.4 percent, with that for China revised downward from 9.0 percent to 8.2 percent.

Regarding the impact of the European sovereign debt crisis on other regions, we can think of spillover effects arising through three channels; namely, [1] the credit channel, [2] the trade channel, and [3] the confidence channel (which stems from the psychological aspect). The impact through the credit channel, by way of deleveraging (i.e., cuts in bank lending) by European banks, has already been observed in some Asian economies. In terms of the trade channel, we have seen a slowdown in exports to Europe in some Asian economies including China.

In spite of such negative impacts, however, I would like to stress that Asian economies have been resilient, maintaining relatively strong growth so far even after the Lehman crisis in 2008. At the time of the Lehman crisis, there was discussion on whether or not Asian economies could after all be "decoupled" from the contracting European and U.S. economies. Of course, no region, whether Asia or elsewhere, can be totally decoupled from the rest of the global economy, which is so much more integrated today than ever, due to globalization. In the case of Asia, however, the region has maintained growth and soundness of the economy promoted by robust domestic demand and supported by sound macroeconomic policy and the strengthening of the financial system since the 1997 Asian financial crisis. Consequently, it is safe to say that the Asian region has been decoupled to a substantial degree. In fact, when the advanced economies recorded a negative growth of -3.7 percent in 2009, developing Asia's output growth rate remained high and decreased only by 0.5 percentage point from 7.7 percent in 2008 to 7.2 percent in 2009. In particular, countries with large population such as China, Indonesia, and Vietnam maintained a high rate of growth during this period.

Some U.S. and European economists argue that products actively traded inside the Asian region ultimately are targeted at U.S. and European consumers and that it is their demand which is supporting Asian growth, but I would say that this is a simplistic view. First, Japan's imports alone from Asian economies have made significant contribution to the region's growth (for reference, the share of ASEAN's exports by destination in 2010 is 11 percent for the EU, 10 percent for the U.S., and 9 percent for Japan, whereas that of Chinese exports in 2011 is 20 percent for the EU, 17 percent for

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[3] Japan's fiscal year starts in April and ends in March of the following year.

the U.S., and 8 percent for Japan). Second, more than anything, domestic demand itself is becoming increasingly important in Asian economies. For example, there were approximately 18.5 million car sales in the Chinese market last year as compared to approximately 13.6 million in the U.S. market. Given the fact, for instance, that China's current account surplus decreased from 10.1 percent to GDP in 2007 to 2.7 percent last year, it is evident that domestic demand has begun to make a greater contribution toward the growth of economy.

Asia has vigorous direct investment targeted on domestic demand, like many Japanese plants for consumer goods such as motorcycles, cosmetics, and beverages, being newly constructed in Indonesia, Vietnam, and so on, as I saw in my first business trip to Asian economies right after assuming my current post of Vice Minister last August. Japan's experience of high economic growth after the 1950s also shows that we cannot stop such a momentum of consumption once consumers get accustomed to the convenience provided by refrigerators, air conditioners and other sophisticated daily consumer goods and begin to demand more high-end products.

As this shows, Asia already has strong consumer demand as well as investment demand, including that in machinery and equipment and in infrastructure, on the one hand. Asia also has a strong production capacity based on high-quality and young labor force, on the other. The production network plays a key role, which connects industrial clusters in different parts of the region, as demonstrated by vigorous intra-Asian trade. I therefore have no doubt that these factors will continue to drive Asia's endogenous growth going forward.

2. Perspectives on the European Debt Crisis

Now, as the second theme of my discussion, let me turn to Europe, the region drawing the most attention today in terms of risks to the global economy. Of course, whether or not Europe is able to weather the current crisis will have important implications for Asia's economic prospects.

To begin with, I would like to set out in order the causes of the euro-zone sovereign debt crisis. The most obvious cause is the mere fact that some peripheral countries have accumulated huge public debts. Amid the euphoria following the introduction of the euro in 1999, several governments repeatedly expanded their public spending in a careless manner. We can say that this was precisely the case of moral hazard arising on the part of governments.

But at the same time, we must reflect on why these countries could keep financing their fiscal deficits at such very low interest rates. Until the autumn of 2009 when the European debt problem came to the fore, the Greek government bond spread vis-à-vis German's had been no more than 1 percentage point (100 basis points), maintained thanks to the strong appetite of private investors. Investors did not pay sufficient attention to the disparities in the competitiveness and soundness of public finance among euro-zone countries, because to the euro-zone investors there was no exchange rate risk in the intra-regional transactions due to the euro being ubiquitously used in the euro zone, and governance in the public sector was also considered to be equally stable among the member countries under the Stability and Growth Pact. With these facts considered, we must say that moral hazard existed on the part of the private sector too.

Causes of the current euro crisis also include the disparity in competitiveness, on top of the fiscal deficits owing to extravagant government policies. For instance, in the case of Greece, which requested IMF financial assistance, its unit labor cost rose by as much as nearly 40 percent from 2000 to mid-2009. The competitiveness of Greece and Portugal worsened due to wages increasing beyond their means, resulting in large current account deficits. The current account deficits had been financed by capital inflows from other euro-zone countries, but once a sense of crisis mounted, the capital flow reversed and importers had difficulties in financing their settlements.

The crisis in Ireland, on the other hand, did not stem from the problems of public finance or

competitiveness, but rather from the collapse of the banking system, which grew to be over-sized relative to the economy. Irish bank assets substantially increased from 400 percent of GDP in 2002 to 640 percent in 2009. In Japan and the U.S., for comparison, the size of bank assets relative to GDP was 220 percent and 100 percent, respectively, in 2009. For reference, the smaller-than-expected size of bank assets in the U.S. is considered to be due to the American financial system relying more on the securities market than on the banking sector in financial intermediation. As Ireland aimed to become a thriving financial nation, so to speak, Irish banks expanded their lending in an unsustainable manner by raising funds with deposits and borrowings from overseas.

What, then, are the challenges facing Europe now? First is the challenge of fiscal consolidation and structural reforms to enhance competitiveness. The primary focus is on whether European countries, including peripheral ones, can steadily implement the needed fiscal consolidation and structural reforms, such as labor market reforms. Also, with the new fiscal treaty to be concluded by 25 EU countries other than the UK and Czech Republic, the region will introduce new rules of fiscal governance, which will be more strongly binding members' fiscal discipline. The question is to what extent they will be able to abide by these rules.

The second challenge is regarding the extent to which the euro zone can build up a strong "firewall" against future possible sovereign problems in the region. At present, Europe has the European Financial Stability Facility (EFSF), which has a lending capacity of 440 billion euro, financed through issuing bonds guaranteed by euro-zone countries. Out of this 440 billion euro, approximately 200 billion euro has already been used for Ireland and Portugal and is also set aside for the second Greek bail-out program, with the remaining capacity being about 250 billion euro. In addition, as a more permanent mechanism replacing the EFSF, the European Stability Mechanism (ESM), is to be established, with a lending capacity of 500 billion euro, financed by the paid-in capital and callable capital contributed by the member countries, as well as by bond issuance.

In the wake of the ongoing crisis in Europe, the December 2011 Euro Summit decided to frontload the establishment of the ESM to July 2012, one year ahead of the originally scheduled mid-2013. The EFSF and the ESM would make available 940 billion euro in total, or about 750 billion euro for future use net of the about 200 billion euro already committed. But because the ESM is understood as being a successor to the EFSF, and the total usable amount of these two is constrained by the cap of 500 billion euro, both of them cannot be mobilized together as firewalls. This 500 billion euro cap is supposed to be reviewed by the end of this month.

The third challenge relates to the banking sector. European banks are subject to strong pressures in the financial market in terms of financing and stock prices of European banks once market concerns about peripheral countries emerge, because of banks' exposure to these countries through lending to these countries and holding their government bonds. In the bank recapitalization exercise, which was agreed by the EU Summit last October, European banks are required to evaluate the price of hold-to-maturity government bonds based on the market value as of September 30, 2011, taking into account the impact of drops in government bond prices in the case of peripheral countries (instead of the book value, in accordance with the International Accounting Standards (IAS)). Because banks are required to raise the Core Tier 1 capital adequacy ratio to more than 9 percent on this basis by the end of June this year, it is expected that these banks will suffer a substantial amount of capital shortage.

Naturally, banks will need to reinforce their capital base, and they are required to achieve this themselves, first through increasing retained profits by cutting dividends and bonuses and through raising funds from the capital market as their own efforts, and if still deemed necessary, capital injection by the government will also be considered. Given current low stock prices, however, recapitalization through issuance of new shares would be difficult. Also, capital injection by the government would not be easy as it would further increase fiscal deficits while governments themselves are concerned about the downgrading of their bonds. In this context, if banks find it tough

to increase capital as the numerator of the capital adequacy ratio, finally the only option left would be to deleverage, namely, to shrink their assets in the denominator to raise the ratio. Thus, the macroeconomic repercussions of this deleveraging in the global context are a matter of concern.

Fourth, there is the issue of how the European Central Bank (ECB) will stand in terms of its active response to the problems of sovereign debts and the banking sector. On the sovereign problem, to begin with, the ECB had not conducted liquidity supply in the form of purchasing member countries' government bonds, out of concern that this could be perceived as indirect assistance to individual member countries' public finance, while it had accepted these bonds as collateral for lending to banks. Amid the evolving crisis, however, the ECB launched its Securities Markets Program (SMP) in May 2010, under which it purchases the government bonds of peripheral countries.

In addition, the three-year long-term refinancing operation (LTRO), which the ECB launched last autumn after President Draghi succeeded Mr. Trichet, aimed to cope with financing difficulties that the banking sector was facing. Under this operation, the ECB provided liquidity amounting to nearly 490 billion euro in its first operation last December, and again around 530 billion euro was provided to approximately 800 banks in its second operation at the end of February. There was an argument that while the LTRO would help European banks address the liquidity shortage, it was still uncertain that tapped liquidity would be invested in government bonds of European peripheral countries and so narrow the spread. But, as the merits of the LTRO, banks can earn large margins by purchasing government bonds with funds borrowed at a low interest rate from the ECB and collateralize these bonds for various transactions including new borrowings from the ECB. Consequently, these ECB large-scale operations have made a significant contribution to narrowing the spread, including those of Italian and Spanish government bonds, and also to stability in the financial markets.

Fifth is implementation of the Greek second bail-out program whose framework was agreed at the Eurogroup Finance Ministers Meeting on February 20. In this package, the so-called "Private Sector Involvement (PSI)" was incorporated, which seeks voluntary debt reduction by private investors at above 70 percent in net present value (NPV), with a view to decreasing the rescue amount by euro-zone countries and the IMF and reducing future Greek burden of debt redemption. Related issues include how Greek government bonds held by the ECB should be treated; what we should think of the "Collective Action Clauses (CACs)" that will be retrospectively applied to avoid free-riding by bondholders unwilling to join the PSI; and what kind of impacts the activation of the Credit Default Swaps (CDS) on Greek bonds would have on other countries' government bond markets; and so on, although I will not delve into these issues today.

3. Strengthening of IMF Resources and Japan's Position

How can the international community cooperate for the stability of Europe? Concretely, there is a view that strengthening IMF resources would provide a backup against European problems and thus lead to the stability of the region. In this respect, it would be most likely that, as in the communiqué of G20 Finance Ministers and Central Bank Governors Meeting on February 25-26 in Mexico, IMF member countries implement the necessary lending to the IMF. As clearly stated in the communiqué, however, increasing IMF resources should be conditional on the further and utmost efforts by European countries themselves. We will wait for this condition to be met, and then anticipate that progress will be made on the issue of IMF resources in the forthcoming late April G20 meeting and International Monetary and Financial Committee (IMFC) in Washington D.C.

We certainly recognize that the euro-zone countries have made great efforts so far in stabilizing the region. In fact, many of them are implementing decisive measures for fiscal consolidation and structural reforms, which would be too tough for most other advanced economies outside the euro zone to follow suit. However, further efforts are necessary in Europe to work out sustainable solutions.

Countries outside the euro zone, including Japan, have long supported the IMF, and we are prepared to play a role in continuing international efforts. That said, it is critically important that IMF resources would never be able to replace credible measures by the euro zone themselves for maintaining the euro.

The euro zone is a wealthy, large economic area with its own currency, and so the ECB should in principle have the capacity to support its member countries including peripheral ones. To the extent that the region enjoys high level of income and vigorous intra-regional capital movements, the size of funds needed for financial rescue in a crisis would also be massive. Since the demise of the Bretton Woods system in the 1970s, the target of IMF financial assistance has been emerging and developing countries, so the IMF did not envisage a rescue program being implemented for such advanced economies as those in Europe. In this sense, the IMF is now confronted with a situation which is beyond the conventional design of its resources and lending facilities. This is exactly why the euro zone by themselves must first increase the scale of the firewall, such as the EFSF and the ESM.

Again, I would like to reiterate that Japan is prepared to cooperate to support Europe through the lending to the IMF. In fact, in the autumn of 2008, Japan announced its financial support to the IMF in the form of lending up to 100 billion USD to strengthen IMF resources just after the Lehman shock occurred. This paved the way for the same type of bilateral support by other countries, and subsequently for the significant expansion of New Arrangements to Borrow (NAB: a set of voluntary bilateral lending to the IMF by advanced and emerging countries), which would supplement bilateral support.

Also, I would like to mention that Japan has been continuously supporting Europe by the purchase of EFSF bonds. There have been nine issuances of EFSF bonds so far and Japan has invested in from 5 to 22 percent of each issuance, totaling approximately 4 billion euro, which is 14 percent of the total EFSF bond issuance. Japan is not reluctant to cooperate. The IMF and international society should support Europe, because this is a global issue. But first and foremost, European countries should make further efforts to solve the issue.

4. The Optimum Currency Area and the Interaction among Governments (Fiscal Authorities), Central Banks and the Banking Sector

The Euro issue has various implications in terms of economic theory as well. Now I would like to touch upon two points.

The first point is about how a crisis could evolve in an "optimum currency area". There was an argument when the euro was introduced in 1999 regarding whether the euro zone was deemed an "optimum currency area" or not, given that labor mobility and fiscal transfers were limited while a substantial degree of economic integration was already achieved. Here, "fiscal transfers" originally mean permanent transfers through the tax system and unemployment benefits etc., not through lending which requires future repayment. Such a transfer mechanism functions in a sovereign state, but in the case of the euro zone, not only was fiscal transfer unstipulated but rather explicitly prohibited in the treaty.

At the time when the euro was introduced, I myself had concerns regarding the euro zone. In the euro zone, where member authorities cannot adjust exchange rates, their fiscal policy is constrained by the Stability and Growth Pact, an option of fiscal transfer across national borders is excluded, and single monetary policy makes impossible the country-specific responses, even in a situation where member countries experience different economic climates, I worried that there would be a problem that a single monetary policy decision could be too tightening for some countries in recession while being too loosening for others in boom.

What actually took place in the euro zone, however, was rather rapid widening in bond spread

among the different governments' bonds. One can take the view that the government bonds of countries burdened with problems of public finance or current accounts were attacked in the bond markets, resulting in falling bond prices and soaring interest rates, instead of their currency being attacked in the foreign exchange markets. I suppose that few could have anticipated that the crisis would materialize through such a channel. Some are arguing once again that fiscal transfers have proven to be necessary to a substantial degree, as they had expected, in cases where there is a difference in productivity or in its rate of change in the region.

Second, it became clear from the current euro crisis that interaction and cooperative relationships among governments (fiscal authorities), central banks, and the banking sector are crucial.

Regarding the relationship between the government (fiscal authorities) and the central bank, the independence of the central bank and a credible monetary policy underpinned by this notion are considered essential for any country today, in terms of maintaining price stability without being influenced by political factors. But at the same time, we should note that the government and the central bank complement each other. The central bank generally provides "seigniorage" (i.e. profits from printing money) to the government, whereas it may receive support from the government when it incurs financial losses arising from its crisis operations. In the case of Japan, the stipulation in the Bank of Japan Act that the finance minister can request actions from the BOJ in case of crisis is to clarify the responsibility of the government.

In the meantime, the central bank may pursue market stability by purchasing government bonds when the liquidity condition of government bonds markets deteriorates. In many countries, although the "monetization" of fiscal deficits by the central bank is legally prohibited, the central bank is authorized to purchase government bonds in secondary markets. In fact, many central banks including the BOJ, FRB and ECB now hold a certain portion of long-term government bonds on their balance sheets.

The relationship between the government and the banking sector is crucial as well. The banking sector regards government bonds as important investment products, and uses them as collateral for their financial transactions. Government bonds of advanced economies are the foundation of confidence in financial markets, so the current situation where the market recognizes the credit risk of governments is extremely unusual. The government, on the other hand, is in charge of regulating and supervising the banking sector and, as necessary, can liquidate financial institutions using the deposit insurance framework or recapitalize them through capital injections.

Regarding the relationship between the central bank and the banking sector, it goes without saying that the central bank adjusts money supply by transactions with banks through open market operations and direct lending to banks and that at a time of crisis the central bank should serve as the "lender of last resort".

Thus, fiscal authorities or, more generally, the government, the central bank, and the banking sector in a sovereign state are closely tied and complement each other while maintaining an arm's length relationship. A stable relationship is imperative particularly at a time of crisis. Among the three, the government has special functions in that they can mobilize funds collected from taxpayers in cases of emergency, and in that they can enforce regulations ultimately by imposing punishments. And the justification of the government being able to exert such functions is that it has the legitimacy that it reflects people's will through the democratic process. In fact, budgeting and the power to levy taxes are the origin of a parliamentary system and democracy from a historical viewpoint, and so constitute an integral part of a sovereign state.

Looking at it this way, in the case of the euro zone, although the national central banks are integrated under the ECB, fiscal authorities remain separate in 17 sovereign states and behind them are the respective parliaments and peoples. Government bonds are distinct financial products among the members though they are commonly denominated in euro. While financial regulations are harmonized at the EU level, regulatory authorities remain at the national level. It is because of this

specific nature of the euro zone, which is a single economy but not a sovereign state, that policy responses to the crisis take a long time and the ECB's actions in this respect are constrained.

To summarize, I have described that the euro zone is prone to crises triggered in the government bonds markets, and that the region tends to face bigger challenges during a time of crisis than an ordinary sovereign state would. Nevertheless, even if the euro zone is not an optimum currency area in a theoretical sense, and even if we find it improbable at this stage to see the region heading for full-fledged fiscal integration in the foreseeable future, within such constraints the euro zone is strengthening its governance on fiscal discipline, enhancing its firewall as a backup for times of crisis, and is putting in place the European Banking Authority (EBA), which oversees EU banking regulations as a whole. What I can say here, as a non euro-zone official rather than a commentator, is that the euro zone is continuing in their efforts to stabilize the region, and so international society must support the euro-zone countries in accordance with their efforts.

5. Strengthening the Financial Safety Net in the Asian Region

As I said, the Asian economy has been robust and is expected to enjoy high economic growth in the coming years. However, the effects of deleveraging by European financial institutions, damaged during the euro-zone crisis, have been emerging even in the Asian region. In order to address such a situation, strengthening regional financial cooperation and enhancing the regional safety net through mutual financial assistance using foreign reserves of countries are important. Japan is working on such initiatives to strengthen safety nets both in bilateral and regional frameworks.

Let me give some numbers to see what the size of deleveraging has been in Asia. Statistics by the Bank for International Settlements (BIS) show that, from end-June to end-September last year, European banks' lending to major ASEAN countries[4] and Korea dropped by 8 percent. Excluding UK banks, the decline in lending jumped to 12 percent, and it was 25 percent if you focus on French banks. On the other hand, Japanese banks, whose share of lending in the region accounts for approximately 15 percent, increased exposure by 5 percent during the same period. So in a sense, Japanese banks are offsetting the reduction in lending from European banks. Exposure by U.S. banks also decreased by 2 percent, so, all in all, the whole exposure by the BIS reporting banks to ASEAN and Korea was down by 3 percent in this period.

The impact of deleveraging differed from country to country. For instance, in Korea, the impact was very acute, with cross-border lending to the country decreasing by 9 percent between June and September last year. As a result, concerns over U.S. dollar liquidity among Korean banks were rising toward the end of September, with the Korean won depreciating, stock prices falling and foreign reserves decreasing. Under such circumstances, upon request from Korea, Japan and Korea started deliberation and agreed last October to increase the maximum amount of the bilateral swap arrangements from 13 billion USD to 70 billion USD in total.

Even prior to the October agreement, we had already put in place a so-called "crisis resolution" type of bilateral U.S. dollar-Korean won (and U.S. dollar-Japanese yen) swap arrangement with a maximum amount of 10 billion USD between the Japanese Ministry of Finance (JMOF) and the Bank of Korea (BOK), in addition to the swap arrangement for crisis resolution under the Chiang Mai Initiative Multilateralization (CMIM). Also, the two central banks, namely, the BOJ and BOK, had had the so-called "non-crisis time" yen-won swap arrangement with a maximum amount of 3 billion USD. In the October agreement, the two central banks agreed to increase the maximum amount of this yen-won swap arrangement substantially to 30 billion USD.

Furthermore, in order to supplement this "non-crisis time" swap, the agreement added another

[4] Here, Indonesia, Malaysia, the Philippines, Thailand and Vietnam.

U.S. dollar-Korean won (and U.S. dollar-Japanese yen) swap arrangement with the maximum amount of 30 billion USD between the JMOF and BOK, which is of a so-called "currency stability" type. This new swap arrangement can be activated together with the "non-crisis time" yen-won swap arrangement for the purpose of stabilizing financial markets before a situation reaches crisis level. Also, this new swap arrangement can provide foreign currency liquidity in a more flexible manner needed without linking to an IMF program (borrowing from the IMF), while the conventional 10 billion USD swap arrangement of "crisis resolution" type and the CMIM are premised on being linked to one.

From Japan's viewpoint, the enlargement of the swap arrangements between Japan and Korea this time could have the effects of avoiding such circumstances where the competitiveness of Japanese industries is further damaged via Korean won depreciation together with Japanese yen appreciation, in addition to the general idea that they contribute to Korean economic and financial stability, which is important to growth in Japan and the Asian region as a whole. In hindsight, the Japan-Korea swap agreement contributed to the stability of the exchange rate of the won without actual withdrawal taking place. Japan also agreed on increasing the maximum amount of the bilateral swap arrangement with India last December.

Another issue on the financial safety net in Asia is the strengthening of the CMIM by ASEAN+3 members. We are now considering increasing the size of the CMIM from the current 120 billion USD, including the possibility of doubling it, and also increasing the IMF "de-linked" portion, which allows withdrawal without the IMF program and is currently 20 percent. Furthermore, ASEAN+3 members are now considering introducing a regional crisis prevention function in addition to the current crisis resolution function. In this regard, there are models at the IMF. The IMF introduced precautionary facilities after the Lehman shock such as the Flexible Credit Line (FCL) and the Precautionary and Liquidity Line (PLL), which aim at preventing countries implementing appropriate economic policies from being adversely affected by other countries in crisis. Mexico, Colombia and Poland have already received assistance through the FCL.

Like the IMF precautionary facilities, the crisis prevention function under the CMIM would enable member countries to withdraw currencies before facing an actual crisis. In the case of facing a real crisis, it is natural to assume that the member country in trouble will seek financial assistance from the IMF, and therefore, the issue of withdrawing the IMF de-linked portion is just that of timing: namely, whether the de-linked portion comes first or not. However, in the case of a crisis prevention function by which the member country can withdraw the currency without facing a crisis, it is probable in theory that there may be incentives for a country to request such liquidity support without thinking about requesting an IMF program. We need to make sure that, in order to avoid moral hazard, the crisis prevention function carefully sets out the eligibility which restricts its use to the eligible members with sound policies, and also the conditionality to be observed after concluding an arrangement contract.

In terms of economic policy surveillance, daily and close collaboration between the IMF and the ASEAN+3 Macroeconomic Research Office (AMRO), which was established last April as a macroeconomic surveillance unit under the CMIM, will be more crucial, not less, when the de-linked portion is increased.

6. Increased Use of Asian Currencies in the Region and the Japan-China Agreement on Financial Cooperation

Another issue we should consider in relation to the financial safety net in Asia is how to expand the use of our own currencies for trade and investment in the region. Japan began its efforts on the internationalization of the yen back in the 1980s. Since then, regulations and tax barriers to restrict

international use of the yen have been removed. The Japanese yen has become used more widely, and it currently accounts for about 40 percent of settlements for Japan's exports and about 25 percent for its imports. The U.S. dollar, on the other hand, has remained the dominant currency in trade and investment activities in Asia. It is a currency supported by deep and liquid financial markets in the U.S. and its strong and competitive financial sector, and confidence in the U.S. economy. Inertia and so-called "network externality" have also contributed to the wider use of the U.S. dollar, since a currency becomes more convenient for its users as it becomes used more widely.

Our experience at the time of Lehman crisis and the latest euro crisis shows, however, that in such crises interbank funding markets can become clogged up and U.S. dollar liquidity can drain very rapidly. We must avoid such situations where smooth financing for trade and investment in Asia is hindered and the real economy is negatively impacted, just because of difficulties in U.S. dollar liquidity. From now on, we need to once again work on promoting the use of our own currencies in the region, whether this is the Japanese yen, the Chinese renminbi, the use of which is being gradually expanded in the current account items, or the Korean won.

On Christmas Day last year, Japan's Prime Minster Noda and China's Premier Wen agreed in their meeting in Beijing upon mutual cooperation for the development of financial markets of both countries. The agreement included [1] promoting the use of the Japanese yen and the Chinese renminbi in cross-border transactions between the two countries; [2] supporting the development of direct exchange markets between the yen and the renminbi; [3] supporting the sound development of yen- and renminbi- bond markets; [4] encouraging the private sector to develop yen-denominated and renminbi-denominated financial products and services in overseas markets; and [5] establishing a "Joint Working Group for Development of Japan-China Financial Markets" to promote mutual cooperation in the above-mentioned areas.

The importance of this agreement was reaffirmed at the meeting between Japan's Finance Minister Azumi and China's Vice Premier Wang on February 19, and the inaugural meeting of the Joint Working Group took place on the next day. This cooperation initiative covers broad areas, and both governments will cooperate in promoting market-driven developments in these areas, including making the Tokyo market the key offshore renminbi market in the future. The expansion in international use of the renminbi is not an easy task, as it relates to such issues as greater exchange rate flexibility and liberalization of interest rates and financial products in domestic financial markets, although the Chinese authorities are gradually implementing the liberalization of the capital account following on from the liberalization of the current account.

Having said that, it is in China's own interest, in my view, that both our countries cooperate together to facilitate this process. Increased use of the Chinese renminbi is not inconsistent at all with increased use of Japanese yen. On the contrary, further use of the renminbi between the two countries and in Asia is expected to induce more use of the yen and also to increase business opportunities for the private financial sectors of both countries. As such, wider use of the two currencies should be considered as mutually complementary.

Lastly, I would like to mention that as part of the above-mentioned agreement between the Japanese and Chinese leaders, the two countries also agreed to initiate procedures for the Japanese authority to invest in renminbi-denominated Chinese government bonds, and that a quota of approximately 10 billion USD (65 billion renminbi) has already been approved for Japan by the Chinese authority, thanks to its prompt action. Such approval is needed because of the capital control by China.

This agreement aims at enhancing bilateral cooperation including by ensuring mutuality of investment in government bonds and facilitating information exchange between the authorities of both sides in charge of foreign reserves management, given that China has already invested a substantial amount in Japanese government bonds (JGBs). Japan's investment in Chinese government bonds using its foreign reserves will start with a limited amount within the approved

quota for the time being, and so it is not the case that the credibility of the US dollar, which constitutes a large share of foreign reserves for both Japan and China, is in question. Neither do we intend to accelerate diversification in Japan's foreign reserves portfolio. In fact, according to the IMF authorities, the renminbi lacks convertibility and thus is not considered as a "freely usable currency", so that Japan's investment in Chinese government bonds is not currently counted as foreign reserves, but as "other foreign currency assets" held in the balance sheet of the foreign exchange fund special account.

7. Financial Regulatory Reform and the Macroeconomic Perspective

Financial regulations have become an important issue since the Lehman crisis and have been dealt with at the G20 Summit and the G20 Finance Ministers and Central Bank Governors meetings. The Lehman crisis and the current European debt crisis can be attributed to accommodative macroeconomic policies, which had long been entrenched, but excessive financial activities and insufficient financial regulations are also considered to be one of the root causes of the crises. Reckless lending by banks, excessive leveraging and risk-taking were not only overlooked by self-risk screening by banks but also unchecked properly by regulations.

Managers and shareholders of banks can enjoy extremely high compensation and dividends during the boom when their business is going very well. And once they face trouble, they would get support from taxpayer's money. This is not only unfair from taxpayer's standpoint but also causes a serious moral hazard problem in terms of resources allocation. That is, such actions, which aim at gaining high profits through excessive leveraging and risk-taking, can be repeated unless regulated, leading to yet another crisis and also to rising costs of public bail-outs. Hence, there is a clear case for strengthening financial regulations.

But at the same time, we need to pay attention to the implication of stronger financial regulations on the macro-economy. One of the lessons learned from the recent crises is the importance of the macro-prudential viewpoint that prudential rules, which are effective for individual financial institutions, can nevertheless be insufficient to avoid the creation of bubbles and ensuing crises to the economy as a whole. If this idea is applied on the current situation, however, the point is that we should be mindful that individual regulations, combined together, could shrink the macro-economy. Of course, we need to steadily implement the international agreements decided at the Basel Committee on Banking Supervision (BCBS), the Financial Stability Board (FSB) and other standard setting bodies. But when they are applied, we should sufficiently utilize the advantage of assumed time for preparation and of phased implementation. For instance, Basel III regulations on capital, including capital buffers, are supposed to be implemented between 2013 and 2019. Markets tend to demand perfect, frontloaded achievement, but hasty implementation could accelerate de-leveraging of bank assets and negatively impact the economy.

In addition, we need to be alert to the unintended negative consequences of the regulatory reforms. For instance, a number of authorities including Japan, the UK and Canada have expressed concerns about the "Volcker rule" in the U.S. Dodd-Franc Act, which was legislated in October 2010; namely, the regulations that restrict the U.S. banks' ability for "proprietary trading". The rule in itself takes into account the fact that excess pursuit of profits by banks conducting proprietary trading constituted a cause of the financial crisis. However, it is indispensable, in maintaining the liquidity for financial transactions including government bonds and foreign exchange swaps, to have the "market-making" function, which banks provide using their own balance sheets for the sake of their customers, although distinguishing this trade from a pure proprietary trading for their own sake is very difficult in practice.

The U.S. authorities released the draft regulations for public comment before actually implementing them. The draft, however, stipulates an exemption for trading with U.S. government

securities but not with other sovereigns. We are concerned about the possible rise in issuance costs of government bonds due to decrease in liquidity in the government bond markets other than the U.S. securities market, with the introduction of this regulation. In addition, the "Volcker rule" makes difficult the important financial transactions between the U.S. and foreign banks such as exchange rate swaps. While excessive financial activities are harmful, functions fulfilled by smooth financial markets are essential for favorable recovery and growth of the global economy, which is why each country is now discussing this issue with the U.S authorities.

8. Japan's Public Finance and Common Challenges for Advanced Economies

A glance at the euro-zone difficulties has made clear how important it is to sustain sound public finance even in advanced economies. Certainly, economic conditions following the financial crisis are a matter of concern and thus there has also been an argument that short-term economic stimulus should be prioritized over fiscal consolidation. But unless we start tackling fiscal consolidation now, each advanced economy may possibly be confronted with such dire problems as a sudden rise in government bond interest rates and sharp depreciation of the currency. The 10-year JGB interest rate currently remains low, at just below 1 percent, but once it starts to hike due to concerns about the fiscal health, the rise in itself will be a factor expanding fiscal deficits. This could further undermine credibility in Japan's public finance, which could force the interest rate into an upward spiral.

The earthquake, tsunami and the nuclear accident brought about huge difficulties for the Japanese economy. Nevertheless, the Japanese government has compiled a reconstruction budget of about 4 percent of GDP within a short period of time, relying for its funding not on issuing special deficit-financing bonds but on temporary measures for individual and corporate income taxes, expenditure cuts and so on. At the same time, to address the long-term fiscal challenges amid the rapidly ageing society, the government is determined to promote the comprehensive reform of social security and tax, including raising the consumption tax (value-added tax) rate in two stages from the current 5 percent to 10 percent by 2015.

Japan's general government deficit (deficit of the central and local governments combined) in 2011 was 10 percent of GDP, and the gross debt outstanding is almost 230 percent of GDP, much worse than Greece, according to IMF statistics. Japan's current account is still in surplus (2.1 percent of GDP in 2011), and some argue that as long as the current account remains in surplus, even a substantial amount of government debt will not be a major problem as the situation is different from the Greek case. True, the current account surplus means excess savings for the country as a whole. In Japan's case, the government sector has large deficits (excess investment), while the private sector (both household and corporate sectors) has large excess savings, which are more than sufficient to finance the government's deficits. In fact, foreign investors only account for 7 percent of the whole of JGB holdings. It is not realistic, however, to permanently allow the debt-to-GDP ratio to expand and diverge, and it is therefore reasonable to think that we need to make progress in fiscal consolidation in a concrete manner while the government bond market is stable, as it has been so far.

With respect to the current account balances *per se*, as the trade balance turned to a deficit last year for the first time in the past 31 years, current account surpluses are being maintained by income account surpluses exceeding trade deficits. Trade deficits last year reflected temporary factors such as a decrease in exports which resulted from the interruption in the supply chain due to the Great East Japan Earthquake and the flooding in Thailand, and a sharp increase both in the import volume and price of natural gas, which was in demand for electricity generation in place of nuclear power generation. That said, we need to pay attention to the trend of the external balance going forward.

What is the reason behind Japan's fiscal deficits having grown so large, in the first place? The major cause lies in the substantial decrease in tax revenues which resulted from the continued

economic slump and deflation after the bubble burst in 1990 and also from tax cuts to stimulate the economy in the late 1990s. In fact, tax revenue of the general account of national budget decreased by 31 percent from 60.1 trillion yen in FY1990, when the bubble reached its peak, to 41.5 trillion yen in FY2010. This decrease was substantial, even as compared with GDP, which, albeit slowly, increased by 12.6 percent in real terms and by 6.0 percent in nominal terms during these two decades.

Equally important is the fact that social security expenditures have increased substantially along with the progression of ageing. Social security expenditures (on a general government basis) doubled in these two decades, from 12 percent relative to GDP in 1990 to 23 percent in 2009. On the other hand, the ratio of tax and social security payments to GDP decreased from 30 percent to 28 percent during the same period. As the public sector needs to pay for other expenditures including public works and education as well, the government has naturally become mired in large fiscal deficits.

In many countries, the social security system including pensions and medical care was designed when economic growth was high, the demographic structure was favorable with more young people, and average life span was not as long as it is today. In Japan's case, people over 65 years old accounted for only 6.3 percent of the total population of 98.26 million in 1965, with 9.1 working-age people (20 to 64 years old) taking care of one elderly person. In 2012, however, it is projected that 24.2 percent of the total population of 127.5 million will be over 65 years old, meaning that 2.4 working-age people will need to care for one elderly person. The share of the aged population will rise further going forward.

Looking to longevity, in 1961 when Japan introduced the universal coverage of pensions and healthcare, the average life expectancy for men and women was 66 and 71, respectively, whereas in 2010 it was 80 and 86, respectively. The average life of expectation remaining at the point of being 65 years old was extended from 12 to 19 years for men and from 14 to 24 years for women during the same period. Of course, I believe that a longevity society where women at 65 can expect to live 24 more years, up to 89 years old on average, is great. This means, however, there is a growing share of very old population. No one can be free from health problems when they get very old. This, together with progress in medical technology and the prevalence of advanced medical treatment, has led to a marked increase in healthcare costs.

We can describe the Japanese government as financing fiscal burden to cover expanding social security costs by issuing a huge amount of JGBs, without being able to impose the burden on taxpayers. In fact, many advanced economies are faced with a similar situation today. Of course, strategies for economic growth, including innovation and improvements in the business environment, are imperative, but we can never go without fiscal consolidation.

People tend to regard these kinds of issues, including the policy to raise the consumption tax (VAT) rate, as issues of the government versus the citizens, but I think this is not the case. It is rather a distributional issue between today's elderly and those in the future, an issue which relates to generational fairness. In addition, we should consider this as an issue not only of achieving the soundness of public finance but also of recovering the soundness of the national economy as a whole. Once a system is instituted, revamping it is extremely difficult politically, whether it is a social security system or a tax system. This is particularly the case under a democratic regime. I expect that emerging economies currently striving to develop their social security systems will learn many lessons from experiences in advanced economies.

9. Stability in the Foreign Exchange Market and Flexibility of Exchange Rates

Finally, I would like to briefly touch upon exchange rate issues. The recent yen/U.S. dollar conversion rate is around 83 yen as of the March 13 closing price, up from just above 76 yen at the beginning of February, as yen-selling became predominant in the market, against the backdrop of the BOJ's decision released on February 14 on the enhancement of monetary easing (including the release

of "*The Price Stability Goal in the Medium to Long Term*"), and progress made towards the Greek second bail-out program. The Japanese government has constantly expressed strong concerns about the one-sided appreciation of yen since last summer, so we do not feel anything odd about the latest movement in the foreign exchange markets.

One frequently encounters the argument that the current yen movement has been within the range of long-term trend in terms of the real effective exchange rate (REER), an indicator measured by yen's trade-weighted exchange rates against other major currencies that also adjusts for inflation rate differences. The yen's REER, however, appreciated by 30 percent between July 2007 and December last year. Given that Japan, during this period, suffered a larger-than-expected shock from the Lehman crisis of autumn 2008 and furthermore that the economy is still in the middle of a painful recovery process after the unprecedented catastrophe a year ago, I think it is difficult to conclude that the yen's appreciation reflects the underlying economic fundamentals in a true sense. Concerning the great volatility in the exchange rates, the WEO Update of the IMF released last January states that "*currency markets were volatile, as the Japanese yen appreciated and many emerging market currencies depreciated significantly.*"

In the first place, the exchange rate is the relative aggregate price between two countries. It is one of the most important among the various price indicators and its volatility has a large impact on economic activities. The communiqués of previous G-7 and G-20 meetings state that exchange rates should in principle be determined in the market, whereas they also confirm that "*excess volatility and disorderly movements in exchange rates have adverse implications for economic and financial stability*". This is an international consensus on exchange rate movement. It is also agreed among the G-7 authorities that coordinated intervention would be made when necessary, as was stated in the agreed terms of reference by the G-7 Ministers and Governors dated September 9, 2011: "*We will consult closely in regard to actions in exchange markets and will cooperate as appropriate.*"

The Japanese authorities had not intervened in the foreign exchange market since March 2004, but starting in September 2010, we implemented an intervention in the dollar-yen market several times, in September 2010, and in March, August, and the end-October through early-November of last year. Among these, the intervention in March last year just following the Great East Japan Earthquake was a coordinated intervention by the G-7 authorities, while the others were unilateral. However, we always keep close contact with the relevant currency authorities of G-7. Although yen-selling recently became somewhat predominant in the market, further yen appreciation would still constitute a downside risk to the Japanese economy. We need to be sufficiently mindful of another one-sided yen appreciation which could be triggered by market speculation. The stance of the Japanese government remains the same that we will closely monitor the markets with caution and will act as appropriate.

The goal of greater exchange rate flexibility in the currencies of emerging economies including China is also a matter of international consensus, as has been repeatedly mentioned in the G-20 communiqués. In the case of emerging economies with rapid productivity improvement and high economic growth, currency appreciation reflecting market demand and supply is beneficial for these countries themselves, in terms of rising purchasing power, price stability, facilitating domestic consumption and correcting current account imbalances.

Meanwhile, some argue that one of the lessons for China to be careful of in increasing its exchange rate flexibility is that the sharp yen appreciation following the Plaza Accord in 1985 led to Japan's low economic growth since 1990 and subsequent deflation. However, in my view, the situation surrounding Japan at that time was different from today's China in that Japan was already an advanced economy adopting a floating exchange rate regime and flexible exchange rates. More important is the fact that Japan experienced an asset bubble and boom instead of deflation during the period from the Plaza Accord to 1990.

In my view, the causes behind the bubble include: [1] expansionary fiscal and monetary policy to

respond to sharp yen appreciation; [2] an increase in purchasing power and further expansion in domestic demand during the boom; and [3] excess financial activities against the backdrop of financial liberalization. On the other hand, Japan's sluggish economic development since the bubble burst up to present is the result of: [1] the serious impact of the bubble burst and possible problems of policy responses after the burst; [2] a maturing consumption and technologies; [3] demographic change including ageing; and [4] intensifying competition with emerging economies, all combined together.

Hence, any lesson that could be drawn from Japan must instead be that the creation and bursting of a bubble should be avoided by any means.

Concluding Remarks

In 1992, immediately after the Soviet Union collapsed and the Cold War had come to an end, Francis Fukuyama, the U.S. political scholar, authored the book "*The End of History.*" But, looking at the conflicts frequently happening in different parts of the world due to a rising tide of nationalism and religious fundamentalism, we can see now that it is perhaps optimistic to assume that history has ended with the world converging on democracy and market-oriented regimes. Similarly, with regard to economic issues, the IMF's WEO published in October 2007, when the seriousness of the U.S. subprime loan problem was becoming clearer, shed light in its fifth chapter on the "great moderation" , the period of stable economic growth particularly in the U.S. up to 2007. It analyzed that there was a possibility that output volatility had shrunk structurally, reflecting such factors as progress in IT technology, improvements in the conduct of central banking policies, political stability in many countries and increased flexibility in labor markets.

In hindsight, we might even say now that the degree of output volatility and frequency of economic crises have been rather increasing, in the wake of the expansion in cross-border capital flows and deregulations of financial activities. Also, structural fiscal deficits and government debt accumulation associated with an ageing population have thrown down difficult challenges to many advanced economies. At the same time, while we are being confronted with many challenges, the world as a whole can offer more safety, more liberty, and more prosperity to more people, and we have also seen ongoing progress in measures to address climate change and to reduce poverty. There are many opportunities to develop, such as through technology innovation and rapid economic growth in emerging economies.

Some argue that whereas democracy works well when a society is capable of allocating more in the form of improved social security services, benefiting from a favorable demographic structure and high economic growth, but that democracy does not work well when a society is like the current advanced economies where the government has to request more in terms of public burden. We cannot, however, envisage an alternative, a superior political system that could replace democracy. The only option for us is to let the leaders and experts in various parts of society play the part that they are supposed to fulfill, bring together the citizens' power and wisdom, and thereby address the numerous challenges and capture new opportunities.

I would like to conclude my remarks here by stressing the importance of sharing the experiences of each country, and of close dialogue and collaboration among countries, in addressing international challenges, just as is shown by today's symposium.