Masaru Hayami: The role of Japan amid the changing international financial environment

Speech by Mr Masaru Hayami, Governor of the Bank of Japan, at the Executive Board of Directors' Meeting of the Japan Foreign Trade Council, held in Tokyo, on 7 June 2000.

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1. Introduction

Thank you for inviting me to the 263rd Executive Board of Directors' Meeting. It is a great pleasure to have this opportunity to address such a distinguished audience. It also brings back memories of my days as one of the Council's Executive Directors and Vice Chairman under Chairman Mimura. Your invitation today allows me to be here again, for the first time in almost ten years since I left the Council to become Chairman of the Japan Association of Corporate Executives. Knowing that many of you come from trading companies which are active globally, today I'd like to share my ideas from the viewpoint of the role of Japan amid the changing international financial environment.

2. Tensions generated by globalization

Having previously worked for the Bank of Japan for 34 years, I had a chance to work in the then Foreign Department, our London Office and other positions related to the Bank's international activities. It was a great experience for me to attend important international meetings such as the BIS and the then G5 meetings.

Then, two years ago, I returned to the Bank of Japan as Governor. Now, representing the Bank, I have a chance to again take part in various international meetings. Attending such meetings, I have noticed two things. First, the number of international meetings has multiplied over the years. In this context, of particular note is that the presence of emerging-market countries, particularly the Asian economies, has also increased. One reason for this is somewhat paradoxical in that since the Asian currency crises of 1997, there is a consensus that the economic and financial stability of emerging-market economies is crucial for global economic and financial stability. Indeed, the rise in the number of international meetings and participants evidences the extent to which economies are becoming globalized.

The second thing I have noticed is that various kinds of tensions have arisen as the market economy has become more globalized. I clearly recall NGO activists surrounding the WTO's Ministerial Conference in Seattle last December. The IMFC meeting, which I attended in late April on the day after the G7 Meeting, was also the target of similar protests.

How can it be that the IMF, a pivotal contributor to the development of the liberalized market economy after the Second World War, and the WTO, a legitimate successor to GATT, have become the targets of such protests? Perhaps the phenomenon can be seen as a typical example of increased tension between those who have ridden the tide of the market-oriented economy and those who have grave concerns about global environmental issues and widening gaps among regions which are possibly caused by rapid global developments.

I think many agree that the world economy is currently in the midst of one of its most important turning points since the industrial revolution of the 19th century. Ongoing globalization and computerization are mega trends which will continue well into the future. In this context, competition at the global level is expected to intensify. It is global competition which is the principal driving force behind economic dynamism. No one can stop this trend and we should react positively. However, we cannot deny the fact that newly formed tensions and uncertainties have emerged. Therefore, we should continue to look for ways to promote the sound and stable development of the world economy through steady efforts to establish appropriate rules and regulations that are compatible with the new trends.

One thing is certain, such efforts will be accompanied by difficulties, involving some disagreements on the international front, and it is incumbent upon us to try to find solutions.

3. Meaning of IMF reform

Against the background of such trends, the international monetary and financial system is burdened with further responsibilities. In particular, the Asian currency crises brought to the fore various issues of concern to international financial circles including the prevention and resolution of future currency crises. And, the outcome of discussions constitutes part of the concept of the so-called “new financial architecture”. The Financial Stability Forum, which was inaugurated last April at the request of the G7, has published recommendations on such issues as highly leveraged financial institutions (for example, hedge funds) and international capital flows. This is one example of the fruit of work undertaken by international financial fora.

The reform of the IMF has been a most important issue. And it was also the Asian currency crises that triggered intense debate about the necessity of such reform. The Asian currency crises that broke out as the result of the rapid outflow of short-term capital are called “21st century-type crises”. Here, the IMF has come to be the target of criticism which holds that IMF should improve its surveillance ability and increase transparency of its policy-making processes because it has not sufficiently carried out its mission of crisis prevention and resolution. I personally think the problems surrounding the IMF are deep-rooted and partly reflect its history.

As you well know, the period preceding the Second World War was characterized by such negative factors as competitive devaluations, restrictions on current account transactions, and the widespread use of protectionist measures. Without doubt, these had a significant impact on the international economy and created tensions between countries, only fueling pro-war sentiment. The IMF was established with the aim of avoiding the repetition of such disruption. The primary concern of the time was to create a well-structured and crisis-proof international monetary system. For example, fixed parity between the US dollar and gold (with $1 equivalent to 35 ounces), the adoption of the adjustable peg system, and abolition of restrictions on current account transactions were key elements underpinning the Bretton-Woods architecture. Regarding capital account transactions, member countries of the IMF were allowed to impose some degree of restrictive measures. Therefore, it is fair to say that more attention was paid to the stable expansion of current account transactions rather than capital account transactions.

However, things have dramatically changed since then. With respect to the foreign exchange regime, the so-called “Nixon shock” in 1971 marked an abrupt end to convertibility between the US dollar and gold, which eventually led to the arrival of floating exchange regimes on a global scale in 1973. And, capital account liberalization was pursued much more vigorously than most architects of the Bretton-Woods system envisioned. As a result, the volume of today’s cross-border capital flows far exceeds current account transactions. As I noted earlier, the huge increase in cross-border capital flows seems to exert a bigger impact than current account transactions on the economic and financial conditions of individual countries, and, at times, could trigger serious currency crises.

In brief, present conditions surrounding the international financial system are entirely different from what they used to be when the IMF was created. Amid accelerating globalization and accompanying rising tensions, what kind of contributions can the IMF make to the stability of the international monetary system? What should be the core functions of the IMF in this context? These questions are prime movers behind recent discussions on IMF reform.

The IMFC meeting I attended this April in Washington was previously called the Interim Committee. But, unlike the Interim Committee, the IMFC is structured as a permanent forum. Thus, the transformation of the Interim Committee into the IMFC comprises part of efforts to strengthen the IMF, and it can be seen as a symbol of the current challenges facing the international financial system. At the first IMFC meeting this April, we had lively discussions on how to reform the IMF. Although further consideration is needed to reach any realistic conclusions, I believe that some kind of consensus was formed regarding the future direction we should take in reforming the IMF.

First, we agreed to develop rules under the basic concept of utilizing market functions. In this regard, the latest G7 and IMFC communiques underscore the importance of involving the private sector in forestalling and resolving currency and financial crises. At the same time, it was agreed to strengthen the IMF's role in making various rules that can be applied to new developments in global markets, and in monitoring the observance of such rules by member countries. Such a role can be considered as ensuring conditions for proper market functioning are in place, or to correct market failures.

Second, we agreed to review or redefine IMF operations under the basic concept of utilizing market functions. In this regard, it was suggested that, for instance, IMF lending operations be limited to short-term liquidity provision to members facing capital account crises. It was also argued that medium and long-term financial support for promoting development be reduced.

Third, since the IMF has been strongly criticized for lack of transparency in its decision-making procedures, its accountability should be enhanced in the interest of better governance.

IMF reform has just started. However, it is an important challenge that may determine the future course of the international monetary and financial system. Japan is the second largest subscriber to the IMF, following the US. At the same time, Japan is one of the countries most involved in international financial markets, as witnessed by the fact that Japan is the world's largest capital exporter as well as largest net creditor. Japan has made various contributions to the formation of a consensus among international financial circles regarding the direction of IMF reform and it should continue to do so.

4. Role of Japan in a changing international financial environment

(1) What is expected of Japan?

Now, let me clarify Japan's role in this period of changing international finance. First, Japan should actively participate in developing international rules. The introduction of international standards and codes involves important elements that determine not only the future path of global economic development, but which may also have a substantial impact on domestic finance and the economy. For example, this can be seen in Japan by observing how corporate management is being affected by the introduction of international accounting rules. In practice, however, to take part in international rule making is not as easy as it may sound. It requires an enormous amount of knowledge as well as powers of persuasion. And here we should note Japan's position in the global economy as well as the role it plays in Asian economies. It is thus desirable that Japan be actively involved in and contribute to international rule-making efforts with a full understanding of the situation in the region. In this context, the Bank of Japan seeks to strengthen relations with colleagues in EMEAP (Executives' Meeting of East Asia-Pacific Central Banks) through more intensive dialogue regarding the regional economy and finance. Furthermore, Japan is expected to contribute to the process of implementing rules in Asia through technical assistance in the field of financial system reform and the establishment of economic and financial infrastructure such as data collection and dissemination systems.

Japan's second role is to directly contribute to the stable growth of the global economy by securing its own sustainable growth. For this purpose, bringing the economy back to the recovery phase of the business cycle is an important challenge. Furthermore, it is more important that Japan goes beyond this by regaining economic dynamism by steadily pursuing structural reform. In addition, as I will discuss later, it will be a big challenge for Japan to win global confidence in its economy as a whole.

(2) Japan's economy and the role of the Yen

I do not have enough time today to discuss Japan's expected role in a comprehensive manner. Therefore, I would like to focus my thoughts on one of the important issues regarding the role of Japan's economy in the global economy and finance; that is "the role of the yen as an international currency". This issue is also closely related to the point I have just made: how to win global confidence in Japan's overall economy.

International currency can be defined as “a currency actively used by non-residents as a tool to measure, to store, and to exchange value”. Although non-residents are using the yen, it is perhaps hard to say that it is “actively used”. Rather, it is often argued that the yen is not sufficiently used as an international currency relative to Japan’s status in the global economy. What does this mean?

For currencies to be widely used in a global manner, there are several conditions to be met. First, it is indispensable to win confidence in the currency internationally. In order to realize this goal, we need a strong economy supported by a stable currency value.

In this connection, let me briefly describe the current state of Japan’s economy. It is becoming increasingly clear that the economy is improving with support from decisive macroeconomic policy. In particular, we are observing welcoming signs in private sector demand as evidenced by a continuing gradual increase in capital expenditures against the background of improving corporate profits. In the coming period, we will carefully examine momentum of the recovery, focusing on how such recovery in the corporate sector will spread to the household sector.

Here, I come back to the issue of an international currency. As the second condition for the international use of a currency, I can point out its “user friendliness”. For a currency to be user friendly, the existence of a liberalized and open economic environment, which includes deep financial and capital markets, is necessary. Third, the existence of a mechanism by which the creation of an international network for a currency is catalyzed and accelerated is significant. For example, the global activities of the shipping, finance, and insurance industries under the British Empire, and then American multinational firms in the finance and IT industries, respectively accelerated global use of the pound and US dollar. It may be possible that Japan’s contribution to other countries through more intensive technical assistance will lead to an expanded network for the yen.

In sum, to what extent a nation’s currency is globally used depends on confidence in the nation’s economy as a whole. To enhance such confidence, every measure should be taken with the three aspects I mentioned in mind.

I would like to take up the issue of the Japanese government bond (JGB) market as an example. The ratio of JGBs owned by non-residents is currently only a few percent, which is extremely low compared to the US and other G10 countries. This is especially understandable when Japan’s cumulative current account surplus and high savings rate are taken into consideration. However, in terms of the global bond index, which world bond investors refer to when making investment judgments, the share of JGBs is the second largest next to that of US government bonds. If the current budget situation of the two countries remains unchanged for some time, it is possible that the share of JGBs will become comparable to that of US Treasuries. If so, it is imperative that the JGB market becomes attractive for international investors.

What is necessary for the JGB market to achieve the global standard? Needless to say, policy decisions that might impair confidence in JGBs must be avoided. In this regard, budget policy of the government should be constrained in the long run. It would also be significant to improve the safety and user friendliness of the JGB market from the viewpoint of such aspects as the usability of futures and repo markets, the tax treatment of JGBs, and the standardization of trading and settlement customs.

In my speech today, I have touched upon three conditions for a currency to be internationally used, namely, confidence in the currency, high degree of user friendliness, and an international network. I believe that these conditions coincide with the direction that Japan should move in the coming century. Let me add that every time I refer to the “internationalization of the yen”, it carries my strong hope that Japan will adjust to the new global economic order and contribute to international rule making and the foundation for sustainable economic and financial development in the Asian region.