Haruhiko Kuroda: Opening remarks

Opening remarks by Mr Haruhiko Kuroda, Governor of the Bank of Japan, at the 2013 Bank of Japan-Institute for Monetary and Economic Studies (IMES) Conference, hosted by the IMES of the Bank of Japan, Tokyo, 29 May 2013.

* * *

I. Introduction

Good morning, ladies and gentlemen. It is my great honor to say a few words at the beginning of the 2013 BOJ-IMES Conference. On behalf of my colleagues at the Bank of Japan and myself, I would like to welcome all the participants from the academia, central banks, and international organizations.

This year, we are going to tackle the issue of “Financial Crises and the Global Financial System.” It is no doubt a very familiar theme for all of you. In fact, we have discussed this topic time and again. Every time we faced an international financial crisis – we had far too many of them – the international financial system had to evolve in response, and that called for new ideas, or at least, new twists on old ideas. This was no easy task, as many of you, who were my colleagues in arms, would attest without any hesitation. Working on the front lines of international finance in the recurring process of turbulence and evolution of the global financial system, under many different hats, I have always struggled with seemingly intractable problems, such as large fluctuations in the exchange rate and huge swings in the flows of capital. In retrospect, past discussions and responses regarding the global financial system did not follow a straight line. We saw a series of trials and errors. Karl Popper, who was a philosopher of scientific methodology, mentioned that for the quest of the truth, “there is no more rational procedure than the method of trial and error.”[1] Through repeated trials and errors in every past financial crisis, economics has actually accumulated new wisdom. As we face the formidable task of rebuilding the international financial system severely hit by the most recent financial crisis, our trials and errors from the past will certainly provide us with valuable insights.

II. The role of the trilemma of international finance in the evolution of the global financial system

In light of wisdom that has been accumulated so far, the starting point of discussion on the organization of a global financial system is the trilemma of international finance. As you know, the trilemma shows that no economy can simultaneously achieve the three goals of capital mobility, a fixed exchange rate, and independent monetary policy. Global financial systems were adopted under the constraints of this trilemma. When an adopted system became unsustainable, the result was a financial crisis, leading to the adoption of a new global financial system. This cycle was repeated many times over. Let me briefly turn to a few historical examples.

At the end of World War II, the Bretton Woods system was introduced to solve several problems that had occurred during the interwar period, including competitive devaluations. With controls over capital mobility, this system allowed the simultaneous pursuit of independent monetary policy and the peg to the U.S. dollar, which was exchangeable with gold at a fixed rate. In the 1960s, against a background of deteriorating U.S. balance of payments, there were changes in the international financial environment: the amount of U.S. dollars held by non-residents increased and the Eurodollar market came into being and

---

[1] Popper, Karl, “Science: Conjectures and Refutations,” *Conjectures and Refutations*, Routledge and Kegan Paul, 1963.

expanded. Under such circumstances, the U.S. gold reserves continued to flow out and as the world became more uneasy with the convertibility of the U.S. dollar, the Bretton Woods system was abandoned. Consequently, advanced economies maintained independent monetary policy, while adopting the floating exchange rate system and further liberalizing capital mobility.

A few decades on, in the 1990s, currency crises hit a number of emerging economies, such as Mexico, Thailand, Indonesia, South Korea, Russia, and Brazil. Against a background of increasingly liberal capital mobility and the accompanying growth of capital account transactions, the principal driver of the crises was the unsustainable current account deficits in many of those economies with de facto U.S. dollar-pegged exchange rates. After the crises, the economies have pursued independent monetary policy and have increased the flexibility of their exchange rates, while upholding capital mobility. Moreover, taking into account the lessons of the currency crises, Asian emerging countries have significantly increased their foreign exchange reserves and have promoted regional financial cooperation, such as the Cheng Mai Initiative.

In sum, the evolution of the global financial system to date is heavily influenced by the episodes of past financial crises, at the same time constrained by the trilemma of international finance.

III. Issues for the rebuilding of a global financial system after the recent global financial crisis

The recent financial crisis has had a great impact on the global financial system as much as or even more than past crises. In a world of deepening financial globalization, financial crises were usually associated with emerging economies and triggered by a sharp decline in the exchange rate. But this crisis was different in two respects. First, the epicenter of the recent crisis was in the advanced economies and the crisis spread out from there to many emerging economies. Second, the crisis was triggered and then amplified by the dysfunction of financial systems.

Reflecting on these observations, I believe that the global financial community must, in its efforts to rebuild the global financial system, come to terms with two issues: capital controls and financial regulation and supervision.

On capital controls, in the past currency crises involving emerging economies, there was some contagion between those economies. In contrast, in the recent financial crisis, stress that arose in the United States and the euro area was transmitted at once to many emerging countries, including those in Central and Eastern Europe and Latin America. One of the causes of such international transmission of the crisis is deemed to be financial globalization and the accompanying global upsurge of gross capital flows, which has led to increasing attention over prudential capital controls. Moreover, in recent years, the International Monetary Fund, which has long emphasized the benefits of capital mobility, has, at least partially, accepted the necessity of capital controls as a macro-prudential policy tool.

Turning to the regulation and supervision of financial institutions for the purpose of maintaining the stability of the financial system, in the wake of the recent financial crisis, there is a globally renewed recognition of the importance of financial stability. Against that background, international meetings, like those of the G20, have discussed how financial regulation and supervision could be enhanced and harmonized internationally. Meanwhile, in the euro area, the discussion on a banking union is underway. In this context, the concept of "financial trilemma," which has recently been proposed in the academia, seems to offer a useful viewpoint[2]. In the argument of financial trilemma, it is held that any economy cannot

[2] Schoenmaker, Dirk, "Financial Trilemma," *Economics Letters*, 111 (1), 2011, 57–59.

simultaneously achieve three goals of financial integration (capital mobility), financial stability, and national financial policy.

IV. Conclusion

Finding solutions to these two issues and building a new global financial system under the trilemma of international finance are no easy tasks. Even if we could establish a global financial system that is robust at this time, such a system is unlikely to last forever, given that a financial crisis beyond our imaginations may occur in the future. Having said this, it is by no means futile for us to examine the relevant issues and pursue a more robust global financial system. As history has shown, there were more than a few financial crises, and on each occasion, there were discussions on building a new financial system. The accumulation of wisdom in the process has been helpful for shaping the policy responses to subsequent crises and rebuilding of the financial system.

Today, the global economy has not yet completely shook off the effects of the global financial crisis, even after five years since the onset of the crisis. Nevertheless, I am convinced that the great challenges posed by the crisis will give us new insights and help us create a new and better world. I hope that with all the distinguished participants from around the world exchanging their experiences and views, this conference will contribute to the accumulation of wisdom that is urgently needed for the current efforts to rebuild the global financial system and sure to be useful in the future when black swan events strike again.

Thank you.