Kiyohiko G Nishimura: A central banker's perspective on the international monetary system

Remarks by Mr Kiyohiko G Nishimura, Deputy Governor of the Bank of Japan, at the International Symposium of the Banque de France: Regulation in the Face of Global Imbalances, Paris, 4 March 2011.

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Introduction

The theme of this panel, "Towards which international monetary system?" is a grand theme which cannot be easily captured in a ten minute intervention. So, I will focus on two issues. One is the over-arching issue of how to understand the role and limitations of the current international monetary system, or IMS. The other is the challenges for central bankers in fulfilling our responsibilities within the current IMS.

The role and limitations of the current IMS

First, the current IMS. The IMS provides a critical underpinning for the global economy. It enables the efficient and smooth allocation of goods and services as well as capital, both domestically and in a cross-border context. The central issue confronting the current IMS is how to introduce symmetrical adjustment between external surplus and deficit countries. The current IMS does not have a built-in mechanism which automatically fosters a balanced adjustment process. The United States as the main reserve currency country has little incentive to reduce its current account deficit, especially because once a currency is established as the main reserve currency, there is a strong inertia to continue its use. On the other hand, surplus emerging economies are expanding their foreign currency reserve holdings both from a precautionary motivation and from the perspective of maintaining their export competitiveness. To the extent domestic price developments are manageable, there are few constraints to this strategy. Past attempts to reduce imbalances have been conducted mostly on a bilateral basis and have, in some cases, turned into quite contentious discussions and negotiations.

Another issue regarding the IMS is the extent of the adjustment that would be required among surplus and deficit countries. The distinction between longer-term trends in investment-savings balance, which are strongly influenced by the stage of economic development and demographics, and short-term cyclical trends, is not necessarily straightforward. For example, in the 1980s there was substantial pressure on Japan to reduce its trade and current account surplus. However, such pressure could easily turn into misdirected attempts. In the Japanese case, using macro-economic policies, especially accommodative fiscal and monetary policy, failed to achieve its goal and rather contributed to foster an environment where it became more difficult for authorities to act promptly when there were signs that the economy was overheating. We all know where this ended up.

That is why the G20 mutual assessment process which aims to bring about strong, sustainable and balanced growth and reduce persistent large imbalances, and the G20 discussions on the IMS, such as dealing with global capital flows and global liquidity, are interlinked. Combined, they are expected to work to enhance the long-term stability of the global economy and financial system. What is important here is that the mutual assessment process will likely be, at least in its initial phase, a process through which countries better understand each others' policies and the implications of their domestic policies on other countries. This will become the basis for constructive dialogue aimed at reaching an optimal combination of economic policies across multiple countries. The reform of the IMS will also be a long-term project. A caveat here in this global debate is that there will not be any single model or concept applicable to all countries and situations. A thorough analysis, taking into consideration each country's unique situation, both cyclical and structural aspects, will be required. Even the IMF with its immense amount of expertise and resources has struggled to identify unsustainable imbalances over the years. In 1989, in the Article IV discussion for Japan, staff noted that inflation in Japan was not "a matter of concern" and therefore "no compelling reason" could be found to tighten monetary policy. In the 2007 Article IV Staff Report for Ireland, it explained that "economic performance remains impressive" and that "banks have large exposures to the property market, but stress tests suggest that cushions are adequate to cover a range of shocks." The IMF Staff Report for the US in 2007 also presented "a soft landing" as the most likely scenario. It also noted that "financial innovation and stability have underpinned US economic success." The limitations of IMF surveillance in the run-up to the current global crisis are detailed in the recently published IEO[1] report. I am not trying to single out the IMF for criticism. Nobody was completely successful in recognizing beforehand the emergence of bubbles and the huge negative impact after its collapse. I simply wanted to highlight that when a single approach toward assessing an issue dominates the intellectual climate, it can cloud our judgment in finding emerging risks which could be seen when approached from a different angle.

The challenges for central bankers in the current IMS

Let me move on to the challenges for central bankers in the current IMS. I would like to raise three aspects.

First, the implementation of macro-prudential policy. The recent global financial crisis has brought to the forefront the importance of macro-prudential policy. We have not been able to nail down its definition nor come up with a comprehensive toolkit. It may take some time before we can make it truly operational. But, we do need to recognize that it took a couple of decades before the importance of price stability for macro-economic stability was fully appreciated and became embedded in central banks' monetary policy framework worldwide.

Second, dealing with tail risks. Taking preemptive action to avoid the emergence of bubbles which can seriously harm the economy means implementing measures to prevent the build-up of tail risks or occurrence of low-frequency, high-severity events. The independence and the need for a clear mandate are often emphasized as an important basis for a macro-prudential authority. However, I believe that is not enough. A fundamental change in the way economic policy is perceived is called for. A collective understanding within society that it would be acceptable and appropriate for the macro-prudential authority to take away the punch bowl when conditions still seem to be benign, is necessary. This is a large change from the current policy paradigm, where measures are typically introduced after specific negative shocks occur.

Third, the cross-border spillover effects of policy actions. Due to continuing globalization and financial innovation, the interlinkages among economies and financial markets continue to strengthen. In this environment, regardless of whether it is monetary policy or macro-prudential policy, policy-makers will have to inevitably be cognizant of the cross-border implications of their policy actions. It also needs to be recognized that there will be feedback effects from overseas economies and markets which will influence domestic economic and financial conditions. Forums such as the BIS have played critical roles in enhancing central bank communication and cooperation over the years. Their importance will increase further in such an environment.

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[1] Independent Evaluation Office of the International Monetary Fund. The IEO released a report titled the "IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004–07" in January 2011.

I will not go into details here, but issues such as strengthening the plumbing of the financial system though, for example, further improvements in foreign exchange settlement, and enhancing the framework for resolving cross-border failures of financial institutions must not be forgotten as well.

Concluding remarks

Already forty years ago, the Nobel Prize-winning economist Sir John R. Hicks predicted that in a globalized financial market "a national central bank will no longer be a true central bank," but will become "single banks in a world-wide system." Whether we like it or not, this is clearly the direction we are heading.