New Challenges and a Search for Better Global Governance

By Kumiharu Shigehara

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

The IMF advice to emerging market economies given in its World Economic Outlook of October last year is two-fold:

First, where needed, countries must put their macro houses in order by clarifying their monetary policy framework and maintaining fiscal sustainability. Second, they must let the exchange rate depreciate in response to (capital) outflows.

Given the increased economic weight of emerging market economies, the management of foreign exchange rate policy by them as well as advanced countries can have significant international ramifications. For such action not to become "beggar- thy-neighbor" policy, well–established frameworks of international policy co-operation are essential.

We can examine the past records of exchange rate management in the postwar world when it was governed by the Bretton Woods system of fixed but adjustable exchange rates. A timely appreciation of currencies of current account surplus countries such as Germany in the 1960s and 1970s helped to contain inflation pressure and contributed to better domestic economic management. On the other hand, Japan's delayed upward parity adjustment of its currency in the late 1960s, combined with excessive domestic monetary expansion, led to spectacular inflation hikes even before the outbreak of the first oil crisis of 1973. In the late 1980, the Bank of Japan, then a less independent central bank than the German Bundesbank, was put under external as well as domestic pressure to delay domestic monetary tightening in the context of the Louvre Accord. It was concluded by the then G6 in Paris on 22 February 1987 in an attempt to stop the US dollar's further fall from its low levels reached after the Plaza Agreement of 22 September 1985. By that time, the dollar's decline was threatening to accelerate US inflation. A delay in monetary tightening by the Bank of Japan resulted in asset market booms whose subsequent burst was followed by two decades of low economic growth coupled with deflation in Japan. A more prudent monetary policy management than actually conducted in the late 1980s would in the end have been more beneficial not only to Japan but also to her trade partner countries over the longer term.

Under certain conditions, currency appreciation and resulting weaker export demand can be helpful. For example, in countries where inflation pressure exists, negative domestic output effects of a decline in net exports as well as lower import prices associated with currency appreciation may be welcome. Even when inflation

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pressure does not exist, currency appreciation may not pose a serious problem, if conventional macroeconomic demand management tools can be used effectively to offset the deflationary effects of weakened external demand.

In the current situation, however, the fiscal positions of most of industrialized countries do not allow them to use expansionary fiscal policy to deal with aggregate demand deficiency. Moreover, the use of expansionary monetary policy to avoid deflation and sustain sufficiently low inflation is constrained by the zero bound on nominal interest rates in a number of countries where policy rates are already close to zero.

In such a setting, market intervention by countries to strengthen their international competitive positions -- by pegging nominal exchange rates at, or managing them around, low levels while prevailing economic slacks are containing domestic wage and price inflation lower than abroad -- involves a serious risk of undermining the domestic economic management of trade partner countries.

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

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

In February 2011, a group of monetary experts prepared a report on the reform of the international monetary system with the focus on the role of the IMF. Nicolas Sarkozy, then President of France, the country at the helm of the G20 during the year 2011, agreed to circulate it to his colleagues for their discussions at the Cannes Summit on November 3. However, that year's summit meeting was overwhelmed with more urgent topics such as the euro-area crisis, and the reform of the international monetary system was not discussed at all. So far, due to a lack of political impulse, the G20 has only agreed on a relatively modest set of proposals, far from the meaningful reform of the system.

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

As an exclusive club having exercised peer review for international macroeconomic co-operation for many decades, WP3 meetings continue to be attended by top officials of finance ministries and central banks responsible for macroeconomic policy making in capitals. However, its membership remains essentially G10-based, with heavy representation of small European countries.

In recent years, the increased economic power of non-member economies has eroded the advantage OECD as a forum for multilateral surveillance. In 1975, OECD countries accounted for 65% of world GDP. In 2015, their share of world GDP is projected to decline to about 50%. The G20 represents 85% of world GDP, with the same number of members as the OECD when it was created in 1961. Its original members are the United States, Canada and 18 European countries, with Japan becoming its member in 1964. The G20 includes a greater number of countries outside Europe and North America and does not include many European countries that are members of the OECD.

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

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

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