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Managing the international economic crisis

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"After the Storm?" was the main title of the editorial of Economic Outlook 83 published by the Organization for Economic Cooperation and Development (OECD) in Paris last May. Developments since then have been such that it would have been a disaster for OECD forecasters if the question mark had not been placed at the end of the title.

True, the editorial warned that several quarters of weak growth lay ahead for most OECD countries. But instead of weak growth, a number of major economic powers such as the United States, Japan and Germany have since been experiencing negative growth. The main title for Economic Outlook 84 published in late November is "Managing the Global Financial Crisis and Economic Downturn."

The recent Group of 20 meeting of political leaders in Washington stressed the importance of reforming financial market supervision and regulation, and called for an action plan to this end. Such action is necessary for crisis prevention in the future. But in the meantime, major countries need to strengthen their crisis management through internationally well-coordinated actions to improve the function of their domestic financial markets and systems, and through active macroeconomic policies to restore economic growth and create jobs.

Indeed, political leaders of G20 countries declared that they would use fiscal measures to stimulate domestic demand in the short run without undermining fiscal sustainability over the longer term. On monetary policy, another key instrument of macroeconomic demand management, the leaders simply recognized the importance of monetary support. This somewhat detached stance is appropriate, with the independence of central banks from governments not only established in the OECD area but also increasingly recognized to be important in many non-OECD countries.

It is also notable that the G20 communique did not mention foreign exchange rate policy issues. For an open economy with free international flows of not only goods and services but also capital, and with flexible exchange rates, domestic monetary policy action and induced changes in domestic money and financial market conditions can bring about large shifts in foreign exchange rates. Thus monetary policy changes can have important international ramifications and, depending on how they are conducted, can become an instrument of "beggar thy neighbor" policy.

The recent sharp appreciation of the yen against the dollar, euro and other currencies, including those of emerging Asian economies, has considerably weakened Japan's international price competitiveness. With a 29 percent appreciation of the yen's real effective exchange rate from mid-2007 to the end of last month, it was more than 17 percent above the March 1973 benchmark level. The yen rose further during the first week of December.

Recent large declines in the dollar prices of oil and other commodity prices coupled with a sharp yen rise have started to exert strong downward pressure on Japan's average import prices in yen. Moreover, incoming data indicate that the Japanese economy has already entered its first recession in seven years, and that slack in the economy will most likely widen next year. Unless further expansionary domestic policy action is taken and/or a significant yen exchange rate correction occurs, Japan will likely start to experience deflation much earlier than recently forecast by the OECD.

What is striking in the OECD's new forecasts is the contrast in the contribution of net exports to GDP growth between Japan on one hand, and the U.S. and the euro area on the other. While the OECD predicts a net positive growth contribution from net export volumes for the latter, Japan's net export volumes are projected to make negative contributions amounting to 0.7 percentage point of real GDP in 2009 and a further 0.4 percentage point in 2010.

In other words, the projected increase in the OECD area's net export volumes in the coming two years will benefit essentially the U.S. and Europe. Thus, Japan will stand alone as a country not benefiting from non-OECD market growth. Declines in its net exports will more than offset the positive GDP growth effect of domestic demand expansion, resulting in a 0.1 percent contraction of output next year. Given this, I contend that:

・As for Japanese demand management, on top of the fiscal boost the Bank of Japan must act more aggressively, rather than keep its policy rate at 0.3 percent.

・Authorities must not hesitate to intervene in the foreign exchange market as appropriate — particularly to smooth out volatile movements — with a clear commitment to conduct reverse operations to net out balances over a reasonable but unspecified time span as foreign exchange market conditions settle down.

Yen depreciation from current levels consistent with no change in Japan's net export volumes in the coming two years (rather than declines as projected by the OECD) will definitely be compatible with the shared goal of avoiding beggar-thy-neighbor policy.

・To minimize undesirable international spillover effects of national macroeconomic policies amid the current fragile global financial and economic situation, conduct in all major countries, including emerging Asian countries like China, must be closely examined not just in the fiscal policy field but also in the area of monetary policy and its interaction with exchange rate developments.

Multilateral surveillance should be strengthened at the meetings of the OECD Working Party No. 3 of the

Economic Policy Committee (gathering of vice finance ministers and central bank deputy governors of selected OECD member countries as well as the International Monetary Fund, Bank for International Settlements and EU representatives) and the G20 meetings (at the level of vice finance ministers and central bank deputy governors).

But informal forums — including nongovernmental organizations such as where former senior officials of international organizations with long experience in the fields of international macroeconomic policy cooperation and international banking issues are assembled to evaluate the relevance, consistency and effectiveness of economic policy recommendations and results of policy analysis by the IMF and the OECD — could also play a useful role, acting as a "watchdog."

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