

Masahiro Kawai, Dean of Asian Development Bank Institute

# Outlook of Global Governance & Currency Management

Interviewer: *Japan SPOTLIGHT* Editorial Section

Masahiro Kawai, Dean of the Asian Development Bank Institute, is one of the few Japanese economists with a distinguished worldwide reputation. His area of expertise, international macroeconomic policy coordination, has recently drawn much attention globally, in particular with regard to intra-Asian currency stability. Drawing on his many years of working experience in academia, the World Bank, and Japan's Finance Ministry, Dr. Kawai talks about how to achieve optimal global and regional governance on trade and investment liberalization and macroeconomic policy management, including exchange rate policy issues.

**The recent yen appreciation (at the beginning of August 2011) has drawn the world's attention to the fact that the other G7 countries are facing a more serious economic crisis than Japan, which is suffering from the serious damage to the economy from the earthquake on March 11. The rating of the US sovereign bond has been downgraded due to growing fiscal deficits and mounting public debt, and the euro is in danger of collapse due to mismanagement of the sovereign debt crisis in Greece and other Southern European countries. What is your own overview of the current state of these G7 economies?**



*Masahiro Kawai*

**Kawai:** Many investors believe today that the Japanese economy, although suffering from serious damage from the triple disasters in the wake of the Great East Japan Earthquake, is still in better shape than the EU and US economies. Thus, we now see a strong yen, with some positive outlook for reconstruction and recovery of the Japanese economy.

Before the US budget deficit and debt crisis attracted the world's attention and provoked a weak dollar and strong yen, the US Federal Reserve Board had been forced to implement a low-interest-rate policy and quantitative easing policy to address the economic and financial crisis after the Lehman shock in the fall of 2008. In principle, this encouraged capital outflows from the US and set an environment for a weak dollar. Then, the question of how to address the large fiscal deficit and mounting public debt of the US government was highlighted in the context of conflict between the Obama administration and Congress. While the administration believes that the US economy needs continued fiscal support due to the sluggish recovery and high unemployment, Congress dominated by the opposition party is focusing on the importance of

fiscal consolidation. But there is no question that the US economy is fragile.

In Europe, doubt about fiscal sustainability in Greece eventually developed into a sovereign debt crisis, and this fear is spreading to other countries such as Portugal, Spain, and Italy. This has resulted in a weak euro. I see this situation as better than that of the US or Japan, as Germany and France, core countries in the eurozone, are relatively healthy and do have the financial capacity to bail out Greece, thereby preventing further contagion of the crises to other Southern European countries. Only weaker nations such as those in Southern Europe are dragging down the eurozone's overall economic performance. The problem for Europe is political as Germany is reluctant to bail out Greece because of the associated moral hazard problem, and keeps

insisting on the need for serious efforts on the part of Greece to substantially reduce budget deficits through sweeping structural and fiscal reforms.

Whether Japan, the EU, and the US can return to a stable growth path or not will depend on each government's ability to manage a critical situation. The US needs to continue to provide fiscal support in the short run to help reduce unemployment and households' debt overhang, while laying out plans to consolidate the budget in the medium run. Europe needs a cooperative policy that could lead to a fiscal union to support the euro. In Japan, the first priority is to end the crisis at the Fukushima Dai-ichi nuclear power plant and to accelerate the reconstruction of the disaster-affected areas; then the government must focus on implementing a growth strategy, clarifying its short-run and long-run energy policy, and reforming the social security and tax systems to achieve fiscal sustainability. Clearly a significant increase in the consumption tax is needed.

**Globalization is entering a new era when BRICs rather than G7 are leading the world economy. The G7 countries' economic policy management is not working**

## **well, whereas BRICs do not know yet how to govern the world economy as leading countries. Is this a big issue in thinking about the global economy today?**

**Kawai:** Yes. The global economy today is in transition in the sense that the change of power from G7 to BRICs reflects a structural shift in the global economy but BRICs have not yet taken a leadership role commensurate with their economic importance. The conflicts of interest between G7 and BRICs may make it difficult to achieve progress in such areas as global rebalancing, global trade liberalization, and climate change and global warming. BRICs do not yet seem ready to take the initiative in tackling these global challenges. They do not seem to have their own global strategy that would enable them to make their own contribution to global prosperity, stability and peace.

For example, IMF policies have so far been organized in accordance with the way of thinking and values of developed countries, particularly the US and Europe. However, these policies may not necessarily be the best ones from the perspectives of BRICs. Thus in any international decision-making forum there exist not only conflicts of interest but also a variety of views and values. This transition period, I believe, will continue for some time.

## **G20, of which BRICs are members, has emerged as a new global governance forum instead of G7. It is engaged in international coordination of macroeconomic policy, including the adjustment of currency values. But there are conflicting views on the performance of G20. How do you assess the function of G20?**

**Kawai:** It is certainly true that G20 has been working well in resolving critical macroeconomic policy issues. However, it is also true that G20 cannot resolve all the issues. The G20 leaders' process was created at the end of 2008 and its first meeting was held in Washington, DC to discuss macroeconomic policy coordination by the key players in the global economy in order to prevent the financial crisis from evolving into a full-blown depression, as in the 1930s. Member countries recommended that each economy adopt a set of coordinated policies to lift the global economy out of crisis rather than pursuing self-centered, beggar-thy-neighbor policies such as raising import tariffs and depreciating currencies. On the basis of this discussion, they recommended an expansionary fiscal policy in each country, avoidance of trade protectionism and more effective global surveillance of the financial system, the weakness of which was one of the causes of the crisis. The policies adopted then have been working well so far.

However, G20 has not been working well in resolving other issues involving the emerging economies' interests, such as the rebalancing of the global economy, WTO Doha Round negotiations, and climate change actions. Although the emerging economies alone cannot be responsible for leading global economic growth, China and other emerging economies need to support global growth by reducing their enormous current account surpluses. The Chinese authorities have been trying to promote household consumption and services sectors, but have been slow on currency adjustment.

In the Doha Round, negotiations have been stuck due to the conflicts of interest and views between the developed nations and the emerging economies. Another challenge is global warming. As achieving rapid economic growth is the highest priority for the emerging economies while making their own efforts to reduce CO<sub>2</sub> emissions, these efforts are

not considered sufficient by the developed nations.

To sum up, G20 was successful in achieving an immediate remedy to deal with the financial crisis but not necessarily successful in achieving sustainable global economic development because of conflicts of interest between the developed nations and the newly emerging countries.

## **A regional community framework could work well as a learning-place for the emerging economies to adjust to a new international environment where they have to play the role of leading countries, rather than G20 doing so.**

**For example, a new Asia-Pacific regional framework such as APEC plus India would be useful for the emerging economies, including India, China and Russia, to learn about sharing responsibility with the US and other developed country members, for managing the global economy. Regional initiatives, though often criticized for being inward-looking and inconsistent with the multilateralism that international organizations like the IMF, the WTO and the OECD advocate, could make a remarkable contribution to improving global governance, if it works as mentioned. What are your thoughts on this?**

**Kawai:** I basically agree with you. BRICs and other emerging economies have certainly benefited so far from the global economic system—for trade liberalization, economic development, and macroeconomic and financial stability—which has helped them to achieve high economic growth. However, if they believe that the current system is not perfect, they need to propose how it can be improved or reformed, as responsible players in the system, rather than criticizing it from outside and, at the same time, free-riding on it.

BRICs should begin to provide a variety of international public goods. For example, if they want to play a key role in the IMF, they may offer innovative ideas of how to resolve the eurozone crisis, or provide funds to strengthen the technical capacity of low-income nations. Laying out a blueprint for capital account liberalization would also be a good contribution to other member countries and the international financial community. They need to express their visions of how global macroeconomic and financial stability can be realized, rather than only requesting a high-ranking post in the IMF. They should also contribute funds to other international organizations as well, such as the World Bank, the United Nations and many others, asking them to use the funds in the best interests of all the members for the purpose of financing international public goods. If they were to do this, they would be considered to be among the leading countries. In addition, they should have a sense of greater responsibility for achieving a more integrated world economy in WTO negotiations and for realizing sustainable global economic development in negotiations on global climate change actions.

The Asia-Pacific region includes the US and China, which are very different from, and yet complementary with, each other. In this region, there are parallel processes to strengthen economic dialogue and cooperation, such as ASEAN+3, ASEAN+6, the East Asia Summit (EAS), and APEC.

APEC is an important trans-Pacific economic forum that includes both the US and China. It is a very useful forum for discussing a wide range of potentially conflicting issues as well as issues that could result in cooperation, and for reaching a consensus to promote sustainable, balanced Asia-Pacific economic growth. If India joins APEC in the future,

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most of the main players in the global economy such as the US, Japan, China, ASEAN, India and Russia will be members.

The ASEAN+3 group—which includes the 10 ASEAN members plus China, Japan and Korea—has been focusing on various types of policy dialogue and cooperation, including trade and investment integration and financial and monetary cooperation. The bigger group, called ASEAN+6—which also includes India, Australia and New Zealand—has been working on trade and investment integration and has formed the body officially called the EAS. The EAS is now in the process of expanding from 16 to 18 members, by adding the US and Russia. As the membership of the new EAS will be similar to that of APEC, which is an economic policy forum, it is expected to be a forum more on political and security issues, thereby complementing the role of APEC.

In the region, there are several efforts to forge trading groups such as ASEAN+3, ASEAN+6 and the Trans-Pacific Partnership (TPP). To form an ASEAN+3 or +6 free trade agreement (FTA), a trilateral FTA among China, Japan and Korea needs to be created and to be connected with the existing ASEAN+1 FTAs, i.e., FTAs between ASEAN and its individual “dialogue partners” such as Australia, China, India, Japan and Korea. Clearly the US is not a member of ASEAN+3 or +6. The TPP, which includes the US, Australia, Chile and Singapore among others, is attempting to create a high-quality FTA, and is likely to exclude China, at least for some time to come. It is important for Japan to join this as part of its growth strategy. Eventually, it would be worthwhile pursuing larger-scale trade liberalization in the Asia-Pacific region by integrating these parallel efforts, through cooperation among the US, Japan, China, India and ASEAN, which can affect the worldwide trade regime in a substantial way.

On the question of a possible inconsistency between multilateralism and regionalism, there may be concerns, as there were when the EU and NAFTA were formed, that Asia’s regional initiative could lead to a closed system. However, Asia has always pursued an open approach to outsiders, without backtracking, and furthermore, through a region-wide FTA, countries are trying to not only lower tariffs and non-tariff barriers but also to rationalize behind-the-border regulations and restrictions and harmonize institutions inside the region. This approach should affect the world economy positively. So, I do not believe there is any reason to worry about the possibility that Asia’s regional economic integration would result in a closed-fortress Asia.

People who value the WTO as central to trade liberalization may be concerned about too much political energy being concentrated on FTA negotiations and too little on WTO Doha Round negotiations. However, the reality is that each WTO member today is involved in both FTA and WTO negotiations simultaneously. A bottom-up style of first consolidating Asia’s various overlapping FTAs into a single regional FTA (among the ASEAN+3 or +6 countries) and then connecting the existing and new regional FTAs (such as the EU, NAFTA and an Asia-wide FTA) to realize multilateral liberalization should be considered a realistic approach. Combining an ASEAN+3 or +6 FTA with TPP would serve this purpose, and a similar connection with the EU could be next on the agenda. As FTAs can be building-blocks towards multilateralism, FTAs and the WTO are not mutually contradictory, but in fact are mutually consistent.

**A political process such as the East Asia Summit (EAS) and an economic process such as ASEAN+3 or +6 and APEC may as well be integrated, as you say, since politics and economics are today inseparable and, in addition, while the issue of the safety of**

**nuclear power stations is extremely important, non-traditional security issues would increase their weight in the subjects to be covered by a regional initiative.**

**In that sense, can integration of political and economic processes represented by the EU be created in the Asia-Pacific area?**

**Kawai:** In the long run, I certainly hope that the US and China’s interests in political and security issues will converge, as well as their economic interests. However, in the short run, this may be difficult. Integration of political and economic processes in the EU style would not be possible without significant convergence of political and economic systems and standards of living across countries. In the absence of such convergence, perhaps a multilayered, variable-geometry approach is appropriate. In other words, ASEAN+3 or +6 and APEC will focus on economic issues and EAS will cover political and security issues. As long as the Asia-Pacific region can create and maintain a loose form of security community in the sense of avoiding serious military conflict and making efforts to maintain peace and stability through dialogue, I hope that economic interests would further strengthen economic interdependence, which can also support a peaceful political and security environment in the region.

**In an Asia-Pacific community or in Asia, should we have a common currency?**

**Kawai:** In the very long run, the Asian economies will be much more closely interconnected and this economic reality may be reflected in the convergence of political institutions. Then, it would be rational to have a common currency.

However, in the next 10–20 years, it would be difficult and even unrealistic to have a common currency, as we have learned from the crisis of the eurozone today, among countries with different political and economic systems and different stages of economic development.

Even in the eurozone, where regional economic integration is already tight and a common currency exists, the Germans are very reluctant to help the Greeks through German taxes. In Asia, this would be even more difficult. The reality is that the general public of any country would be reluctant for its tax revenues to be used to finance another country’s budget deficit. Nonetheless, when the degree of economic interdependence becomes high, it is natural for businesses to demand that policymakers make efforts to avoid excessive fluctuations in the intra-regional values of currencies. To achieve this, some exchange-rate policy coordination is needed, and I think a good starting point for Asia would be to adopt a similar managed floating system against the US dollar and the euro and to try to reduce excessive volatility among Asian currencies. For this purpose, I would suggest the creation of a basket of Asian currencies and using it to monitor Asia’s currency market developments and induce policymakers to take actions to reduce large fluctuations in intra-regional exchange rates. Promoting a currency basket such as an Asian currency unit (ACU) similar to the European Currency Unit (ECU) that existed before the euro would eventually gain the support of Asian policymakers.

Both the Japanese yen and the Chinese renminbi should play important roles in the ACU. Japan is still a large economy with large financial assets and highly sophisticated financial markets and the yen is a fully convertible international currency. Although China is now the world’s number-two country

and will overtake the US in GDP size in a few decades, its financial markets are still rudimentary and highly controlled, its exchange rate is highly managed, and the renminbi is not fully convertible. So further internationalization of the renminbi and further liberalization of capital accounts are very important for the healthy development of the Chinese economy as well as the rest of the world. By joining a regional cooperative framework to stabilize intra-regional exchange rates in Asia, both Japan and China can be beneficiaries, and similar benefits will be shared by all participating economies. Japan and China can take joint leadership in developing mechanisms to promote various uses of ACU in the market, including the issuance of ACU-denominated bonds to make them internationally accepted reserve assets.

It would of course be necessary for Japan to make the yen a more globally accepted currency by creating a more liquid capital market for assets denominated in yen, where non-Japanese investors and businesspeople can buy and sell yen-denominated assets and liabilities in Tokyo without significant costs.

**In order to make the ACU operational, member countries should promote coordination of their monetary policies at least. Since the Lehman shock, the international system of monitoring macroeconomic policies has been adopted. In Asia, do we need to create such a system to avoid a bubble developing?**

**Kawai:** Yes. In ASEAN+3, there is a policy coordination mechanism among the finance ministries and central banks, called the Economic Review and Policy Dialogue (ERPD) process and the Chiang Mai Initiative Multilateralization. Its secretariat office, called the ASEAN+3 Macroeconomic Research Office (AMRO), was founded in Singapore in April this year. This new office is in charge of conducting economic and financial surveillance of each member country and the region as a whole, in particular monitoring the potential risks of the national and regional economies and providing policy recommendations. I think this process, together with the IMF country surveillance and the G20 process, will work well to contain the risk of a financial crisis and to minimize the impact of one if it does happen.

**The IMF has been playing an important role in managing the global macroeconomy. The reform of IMF governance to better reflect the reality of the global economy is very important. What is your assessment of what has been achieved in the reform efforts so far and also your future outlook of the role of IMF?**

**Kawai:** Some good reform has started but much more needs to be done. The IMF has certainly been an extremely Western-oriented organization. Its headquarters is in Washington DC, where it is constantly watched by the US government, while its head has always been a European and the first deputy has always been an American. In addition, the US is the only country that has the right to veto a decision, as its funding contribution and hence voting rights exceed 15% of the total. Europeans are over-represented in both voting rights and the number of chairs for executive directors. For example, while some small European countries have representatives among the executive directors, some large emerging economies have never had any such representation.

Clearly the bias towards the US and Europe in terms of voice and representation should be corrected as the current situation lacks fairness and legitimacy. The emerging economies' voices and voting rights should be increased, while those of the US and the European nations should be reduced. The problem is that it would be very difficult for the Western nations to accept a decline of their voices and voting rights, since they have their own vested interests to protect.

To make progress towards realizing such reform, the emerging economies should not only demand an increase in their voices and voting rights but also provide their vision as to what sort of institution they want the IMF to become and fulfill their responsibilities to contribute to the stability and prosperity of the global economy. For example, if China wants to influence the IMF decision-making process, it must fundamentally improve its currency policy, try to reduce its trade imbalance, and thus contribute to global financial stability and eventually to the stable growth of the world economy.

**International organizations such as the UN and the IMF seem to take a long time to reach a decision, due to the large number of members. Would it be useful to take advantage of a regional governance scheme or possible cooperation between a regional cooperation mechanism and a multilateral process?**

**Kawai:** Certainly, it would be very useful. As I mentioned before, AMRO would be in charge of surveillance and monitoring of the Asian regional economy, whereas the IMF has recently started regional economic surveillance to identify the possible spillover impact of a change in one regional economy on another, through the interdependency of the regional economies.

It will be very useful to achieve cooperation between AMRO and the IMF in order to maintain Asian financial stability. Even though a mini-crisis could be managed by AMRO alone, in the case of a major crisis AMRO needs to work with the IMF. This is exactly what is happening in the current European crisis where the IMF and the EU closely cooperate with each other to resolve the crisis. However, for this to happen in Asia, the IMF needs to be accepted as a useful institution by Asian policymakers, dispelling its negative perception created during the 1997-98 Asian financial crisis. For this reason also, IMF governance and operational reform is essential.

**What would be the role of Japan in improving such global economic management?**

**Kawai:** Japan is in a unique position; it is an Asian country, being a member of ASEAN+3, and at the same time a developed country, being a member of G7. Having started with a war-torn economy in 1945, it has liberalized its trade and investment regimes, developed a well-functioning, open financial market, and achieved fully flexible exchange rates. It has accumulated significant experience and knowledge of global crisis management, macroeconomic policy coordination, and development aid. In this sense Japan can build on the great contributions it has made over the last 50 years or so to international economic and financial management. Japan can be a bridge between developing and emerging Asia and the developed economy community, and a bridge between Asian regionalism and global multilateralism. This would enable Japan to take a leading role in regional and global economic management. **JS**