Statement by the Hon. Shoichi Nakagawa
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I. The World Economy and Global Financial Markets

The financial crisis that erupted in August 2007 appears to have become even more profound today. Credit quality concerns are broadening, as further declines in house prices and tighter lending conditions spread across countries, notably in the United States and Europe. Financial firms face greater difficulties in raising capital to cover losses, while efforts to squeeze assets add to downward pressures on asset prices.

Recent developments in the U.S. financial industry have led to a considerable deterioration in market participants' sentiments. Although the decisive measures adopted by the U.S. authorities have prevented further disruptions to the global financial system, significant uncertainty remains regarding the way forward. We, as policymakers who have the responsibility of dealing with global financial issues, should use the term "crisis" with utmost care, but it would be difficult to blame anyone for describing the current situation of the world economy as a "financial crisis."

Presumably not independent from the financial turmoil, commodity prices have demonstrated very volatile movements over the past year. The price of oil more than doubled between December 2006 and mid-July 2008, before easing in recent weeks, while food prices rose by over 50 percent during the same period.

While commodity prices have recently leveled off, underlying inflation has risen, particularly in emerging and developing economies. The tightening of policy rates in some emerging economies is considered to have been behind the curve. Implementing policy responses to inflationary pressures from exogenous shocks will be quite challenging, given weaker growth prospects throughout the world.

Against this backdrop, the world economy is likely to display a marked slow down. Not only are advanced economies expected to go through a period of very sluggish growth for the remainder of 2008, but emerging and developing economies are also projected to continue to slow. Hence it would be advisable for us to prepare against a "global recession." We should also bear in mind that the global credit contraction arising from the present financial turmoil may increase the risk of squeezed private capital inflows to emerging economies.

Considering the situation I have just outlined, I believe that now is a time when the resilience of the international financial system as a whole, as well as the policy responses of individual countries, must be put under thorough scrutiny.

We believe that Japan can contribute to the stability of the world economy by pursuing to secure Japan's own growth. On August 29, the government announced a package of measures to address the global surge in commodity prices, and a supplementary budget to implement these measures has just been passed by the Lower House of the Diet. Monetary policy continues its accommodative stance. In response to elevated strains in the global financial markets, the Bank of Japan has taken coordinated actions with other central banks to provide U.S. dollar liquidity, and supported interest rate cuts taken by other major central banks. The Bank of Japan intends to carefully assess the outlook for economic activity and prices, while closely examining the likelihood of its projections as well as upside and downside risks, and implement its policies in a flexible manner.

Since the situation in the international financial markets has an enormous influence on the Japanese economy, we will very attentively watch the global financial developments and make our utmost efforts to maintain the stability of the international financial system.

II. Expected Role of the Fund

Let me now refer to the role of the Fund in addressing current turmoil. In the midst of concerns about the financial crisis and a global recession, recently, it has often been questioned whether the Fund properly fulfils expectations. We have some concern that, in response to this criticism, the analytical and advisory capacity as well as the policy tools of the Fund might be scaled back, despite a genuine demand for them, from the international community.

I would like to offer some proposals regarding possible ways in which the Fund can fulfill its expected role.

First, the Fund can make an intellectual contribution to advanced economies affected by the financial crises. The Fund is well situated to accumulate the expertise of member countries on how to respond to financial crises. It is therefore important for the Fund to build up and organize member countries' existing experiences and provide effective input to those countries currently fighting against a financial crisis. The Fund should also improve its ability and capacity to analyze financial market issues, and to accelerate its ongoing efforts toward enhanced coordination between analyses of financial markets and macro-economy. In that sense, it is important that the Fund closely cooperate with the FSF. I would also urge the Fund to improve its early warning capabilities so as to be able to issue an appropriate warning on potential risks involved in member countries.

Second, there is room for intensifying the Fund's engagement with international financial crises. Addressing global financial crises, and helping member countries cope with those crises, both lie at the heart of the Fund's *raison d'etre* as an international institution. When emerging economies and smaller countries that host large financial institutions implement such measures as providing capital to financial institutions and deposit guarantees, to ensure the stability of financial systems in the midst of a crisis, these countries are likely to encounter difficulties in financing their budgetary needs. The Fund should be responsible for providing financial assistance in such cases, and should seriously consider how to fulfill this responsibility. It does need to convey to the market the Fund's determined commitment to tackle against spreading financial stresses, and thus, have a positive impact on restoring confidence. If the Fund requires additional resources, Japan stands ready to supplement needed funds.

Third, the Fund needs to prepare for reduced access to private capital by emerging and developing economies. As international intermediation falters as a result of the global credit crunch, such a situation may arise as thinner private capital inflows to emerging and developing economies would bring some countries to face balance of payment difficulties. The Fund should vigorously examine how effectively it can fulfill its role and consider possible regimes of international cooperation for those countries.

Fourth, technical assistance is the Fund's area of unique competence. From a mid- to longer-term perspective, capacity building of developing countries in the macroeconomic policy field is critical in order to achieve economic growth and stability. Japan, for its part, has been expanding its financial contribution to the Fund's technical assistance programs through the Administered Account for Selected Fund Activities—Japan, and will continue to extend support for the Fund's operations in this area. We believe it is indispensable that technical assistance programs be mutually beneficial providing a tangible outcome for both recipients and donors. To this end, particular importance is attached to an objective ex-post evaluation, with particular attention to serving accountability to taxpayers in donor countries.

Fifth, external relations are vital in order to send messages all over the world. It is essential that the Fund issue timely and relevant messages as a tool toward strengthening its effectiveness in promoting international economic and financial stability. Candid advice would be also appreciated by countries facing economic difficulties. While we commend the recent improvements in the Fund's communication strategy, sending out clear and objective messages with due consideration toward market sensitivity should continue to be a priority issue for the Fund.

III. Sovereign Wealth Fund

We strongly welcome the efforts made by the member of the International Working Group to formulate the Santiago Principles. We also commend the Fund for contributing to this process as an objective facilitator. These principles will be a major milestone in order to integrate sovereign wealth funds into international financial markets, as well as protect open investment environments in recipient countries. As a major recipient country, Japan looks forward to maintaining a continuous engagement with ongoing dialogue. The next step is to ensure steady implementation and transparency would be a priority. To this end, I propose to establish a monitoring system to assess their implementation status.

IV. Conclusion

The world economy is experiencing a period of rapid change. Developments in the financial markets of one country are almost instantaneously transmitted to financial markets of other countries. Moreover, the factors influencing financial markets are increasing their tendency to affect the real economy through a so-called “negative feedback loop.” In such a world, no country can maintain its prosperity without thoughtfulness toward the health of the global economic system. Today, we hear many observations indicating that the Fund needs to be fundamentally reformed or that it should do much more to cope with the current new environment. These observations, however, can be interpreted as proof of continued high expectations for the Fund. Japan hopes that the Fund will live up to those high expectations by fully utilizing their splendid human resources.