Occasional Paper No.21

ポストクライシスの国際通貨体制を考える

～基軸通貨の将来像とアジアの使命～

Exploring Optimal International Monetary Regimes beyond the Crisis

~Perspectives on Global Currencies and Challenges for Asia~

財団法人 国際通貨研究所
Institute for International Monetary Affairs

Institute for International Monetary Affairs

はじめに

2008年のリーマンショックを端緒としたグローバル金融危機の荒波の中で、世界の基軸通貨としてのドルの地位が揺らいでいます。今回の危機の広がりの一端は、グローバル化した時代に米国経済さらに米国の通貨であるドルに過度に依存した金融経済構造にありました。この危機の教訓を踏まえて、今後世界が目指すべき国際通貨体制とはどのようなものなのでしょうか。その中でアジアにおける円や人民元の果たす役割はどうあるべきなのでしょうか。あるいはいよいよアジア共通通貨の実現に向けて、その胎動が始まるのでしょうか。

このような問題意識にもとづき、財団法人国際通貨研究所は、米国、欧州、アジアおよび日本から世界的に著名な方々をお招きし、2010年3月18日に経団連会館において「ポストクライシスの国際通貨体制を考える～基軸通貨の将来像とアジアの使命～」と題する国際金融シンポジウムを開催致しました。本シンポジウムでは、G7からG20へと大きな変化を遂げた新しい世界経済の体制の中で、世界経済がさらなる発展を遂げるために必要な国際通貨体制のあるべき方向、アジア諸国が取るべき通貨戦略を探るべく、パネリストそれぞれの視点から新しい国際通貨体制構築に向けてのご見解、ご意見を披露いただきました。

本稿は、同シンポジウムにおける各パネリストのスピーチおよびパネル・ディスカッションの議論を記録にまとめたものです。ご関心のある皆様方の今後のご考察への一助になれば幸いです。

2010年7月
財団法人　国際通貨研究所

Preface

The status of the dollar as the world's leading currency has been deteriorating since the global financial crisis struck. One reason why the crisis spread worldwide from the U.S. is that the global financial economic structure is excessively dependent on the U.S. economy and its currency. Learning from this crisis, what kind of international monetary system should we seek? What are the roles for the yen and the yuan in Asia? At long last, will we see the start of the new process toward introducing an Asian common currency?

With this background, the IIMA held a symposium titled **"Exploring Optimal International Monetary Regimes beyond the Crisis – Perspectives on global currencies and challenges for Asia –"** at Keidanren Kaikan in Tokyo on March 18, 2010. We were happy to welcome renowned discussants from the United States, Europe, Asia and Japan to explore new regimes which would contribute to world economic growth as well as the monetary strategies that the Asian region should pursue, under a new framework of the global economy shifting from the G7 to an expanded G20.

We sincerely hope this record of the symposium will help give you much inspiration in your business and academic considerations.

July 2010
Institute for International Monetary Affairs

パネリストの略歴/Profiles

高　海紅　中国社会科学院世界経済政治研究所
国際金融研究室主任

1989 年に現研究所に入所、現在に至る。この間カリフォルニア大学デービス校、シンガポール東南アジア研究所客員教授を務めるほか、各種学会の理事等を務める。北京大学および英デューラム大学より修士号取得。

Gao Haihong　Senior Fellow＆Director, IWEP, CASS

She joined IWEP, CASS in 1989. She was visiting scholar at University of California at Davis and Institute of Southeast Asia Studies in Singapore and now has many important posts at various academic councils. Received MA from Peking University and MSc from Durham University of UK.

中尾　武彦　財務省国際局長

1978 年大蔵省（現財務省）に入省、1994－97 年の IMF 出向、2005－07 年の駐米大使館公使勤務を含め、主税、証券、主計、国際金融局等で要職を歴任。2009 年 7 月より現職。カリフォルニア大学バークレー校より経営学修士号取得。

Takehiko Nakao　Director-General, International Bureau,
Ministry of Finance

He joined the Ministry of Finance in 1978 and served in a variety of bureaus such as Tax, Securities, Budget, International Finance, before taking present post in 2009. He also worked for the IMF from 1994 to 97, and served as Minister at the Embassy of Japan in Washington, D.C. from 2005 to 2007. Received MBA from University of California at Berkeley.

トマッソ・パドア・スキオッパ
プロモントリー・フィナンシャル・ヨーロッパ会長

1968 年イタリア中央銀行に入行、84-97 年の同行副理事, 93-97 年バーゼル金融監督委員会議長など要職を歴任し、98-2005 年 ECB 理事に就任。06-08 年には経済財政大臣を務める。MIT より修士号取得。

Tommaso Padoa-Schioppa　Chairman, Promontory Europe

He joined Banca d'Italia in 1968 and from 1984 to 97 he was Deputy Director General before he was assigned as Executive Director of the ECB in 1998. Also served as Chairman of Basel Committee on Banking Supervision from 1993 to 97. From 2006 to 08 he was Economy and Finance Minister. Received MA degree from MIT.

榊原　英資　早稲田大学教授

1965 年大蔵省（現財務省）に入省、1971-75 年の IMF 出向を含め、理財局、国際金融局等の要職を歴任、99 年財務官を最後に退職、慶応義塾大学教授を経て 2006 年より現職。ミシガン大学より経済学博士号取得。

Eisuke Sakakibara　Professor, Waseda University

He joined the Ministry of Finance in 1965 and served mainly in Fiscal Bureau and International Finance Bureau before retiring from the post of Vice Minister of Finance for International Affairs in 1999. He then became Professor at Keio University before taking the present position in 2006. He also served for the IMF from 1971 to 75. Received Ph.D. in Economics from University of Michigan.

ジョゼフ・E・スティグリッツ　コロンビア大学教授

1964年アマースト大学卒業後、イエール、プリンストン、スタンフォード大学等で教鞭をとる。現職の前には、1993－97年米国CEA委員および委員長、97－2000年には世銀上級副総裁を務めた。2001年ノーベル経済学賞を受賞。MITより経済博士号取得。

Joseph E. Stiglitz　Professor, Columbia University

After graduating from Amherst Univ. in 1964, he taught at many universities including Yale, Princeton, and Stanford. He served as member and then chairman of the CEA from 1993 to 97, and Chief Economist and Senior Vice-President of the World Bank from 1997 to 2000. In 2001, he was awarded the Nobel Prize in economics. Received PhD in Economics from MIT.

行天　豊雄　国際通貨研究所理事長

1955年大蔵省（現財務省）入省、アジア開銀、IMF出向、国際金融局、銀行局等を経て、1986年財務官。1990年プリンストン大学およびハーバード大学客員教授を務め、92年東京銀行会長に就任。1995年より国際通貨研究所理事長。

Toyoo Gyohten　President, IIMA

He joined the Ministry of Finance in 1955 and served in such bureaus as International, Banking etc, and also for the IMF and the ADB before he was Vice Minister of Finance for International Affairs in 1986. After retiring from the MOF he taught at Princeton and Harvard Universities in 1990 and was assigned as Chairman of the Bank of Tokyo Ltd. in 1992. Since 1995 he has been president of IIMA.

渡辺　喜宏　国際通貨研究所専務理事

1970年東京銀行(現三菱東京UFJ銀行)入行後、台北支店長、開発金融部長専務取締役グローバル企業部門長などを歴任。2005年三菱UFJフィナンシャルグループ専務取締役を経て、08年国際通貨研究所専務理事。ABAC日本委員、日印経済委員会常設委員会委員長も務める。

Yoshihiro Watanabe　Managing Director, IIMA

He joined the Bank of Tokyo （currently BTMU）in 1970, and served as General Manager of Taipei Office, of Structured Finance Division, Senior Managing Director/ Chief Executive of Global Corporate Banking Business Unit, etc. before he became Senior Managing Director of Mitsubishi UFJ Financial Group in 2005. He took the present position in 2008 and now also serves as member of ABAC and chairman of the Standing Committee of Japan-India Business Cooperation Committee.

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The English version is based on the transcript of the speeches and discussions which were conducted in English.

英語版

English Version

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The 19th International Financial Symposium

Exploring Optimal International Monetary Regimes beyond the Crisis

~Perspectives on Global Currencies and Challenges for Asia~

March 18, 2010 Keidanren Kaikan

Institute for International Monetary Affairs

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Part I

1. Opening remarks

Yoshihiro Watanabe, Managing Director, IIMA

Distinguished guests, ladies and gentlemen, good afternoon! It is my great honor and pleasure to welcome you all to our symposium today. I would like to express my sincere gratitude for your continued support to our institute. We are very pleased to welcome a number of outstanding panelists for this symposium today. I am deeply grateful to them to join us.

Today we are "Exploring Optimal International Monetary Regimes Beyond the Crisis." The discussion will be moderated by our president, Mr. Gyohten, which I am sure will be an animated one through exchanges of views among the distinguished panelists.

Before the session, may I quickly review the recent developments in the world economy and raise some potential points for discussion. The world economy is now recovering at a faster pace from the recession than expected. This recovery owes much to coordinated efforts of fiscal and monetary authorities of countries. However, I don't think the time has come to open the champagne bottles. The situation remains very fragile, with risks of adverse effects from very aggressive policy measures. As Mr. Strauss-Kahn of the IMF put it, 2009 was a year of unity or international cooperation. 2010 must be a year of transformation —we now face the global project of regulatory reform, review of economic policy, and reform of governance reflecting root cause of the crisis.

At the arena of international currencies, we have watched three developments since the outbreak of the crisis. First, events have reconfirmed the importance of the dollar as the key international currency in trade, investment and finance. While global financial markets almost dried up shortly after the Lehman Shock, the US dollar appreciated significantly in spite of the fact that the US was the epicenter. Until the Lehman Shock in September 2008, the Japanese yen remained rather weak. The euro was cruising at a historically high level. But as the crisis deepened, the dollar and the yen appreciated against the euro.

Asian currencies weakened significantly because of the fear of capital flight from Asia back to the US. China went back to the US dollar peg to avoid external shock, suspending the RMB's incremental appreciation. Currency fluctuations in Asian markets at the time intensified. Most Asian trades are denominated in US dollar in spite of the increase of trade within the Asian region. Also, the large part of the risk money in dollars invested in Asia has been provided through US and European financial institutions. The crisis revealed how strongly the Asian economy is dependent on the US dollar and US and European financial institutions.

During the liquidity crisis, the Fed acted promptly as a "lender of the last resort." Many emerging countries were rescued by the large-scale swaps. In this way the US dollar demonstrated its presence and importance as a key currency. During the crisis, efforts were made to strengthen the functions of the Bretton Woods institutions like the World Bank and the IMF, which also underlined the importance of the role of the dollar as a key currency.

Second, doubts on the dollar's role emerged as the financial market went into remission. In March last year, Dr. Zhou Xiao Chuan, the Governor of the People's Bank of China, attracted attention by casting serious concerns on the present currency system which is dependent heavily on the US dollar as a denomination, settlement and reserve currency. He argued that the function of a key currency is an international public good, and so it should not be subject to the national interest of a specific country. Dr. Zhou also expressed to make more use of the SDR, including the RMB among its components.

The current monetary system based on the US dollar is strongly supported by the fact that the US keeps on enjoying a superpower position in the world as a center of information and technology, as the biggest economy, and as a formidable military power. However, it was Asia, and especially China, that has led the world economy out of the crisis. There also is a popular forecast that China will grow into a superpower that can seriously compete with the US sometime in the future. At least we can say the center of gravity of the global economy is now shifting from West to East. Against this background, Dr. Zhou's views have gained much importance.

The third, the EU and the euro. The wave from the US had a severe impact on the peripheral European countries like Iceland. The rapid and speedy measures were taken by European authorities and the IMF. The euro as a stable anchor protected Euro-area countries. People expected that the euro would be another key currency complementing the dollar.

However, it was not long before cold water was poured on our rosy expectations for the euro. The currency started suffering from fiscal problems in some of the Euro member countries, even with its viability questioned. The Greek problem is one of the typical and most serious cases. Now, the idea of a European Monetary Fund, a European version of the IMF, is under consideration as an efficient remedy against possible economic and financial instability of the region. I look forward to listening to our panelists' view on how Europe will solve this problem in the end.

In the course of the crisis, we realized again the stable currency regime is a foundation of economic growth, especially for preventing outbreak of protectionism and sustaining growth in Asia. The arguments over the future currency system could be classified into three categories:

(1) the creation of a new international reserve currency,
(2) the tri-polar system consisting of the dollar, the euro, and a currency representing Asia, and
(3) the modification in the present dollar system.

May I touch on Asian currencies here? During the crisis, Asian currencies experienced wild fluctuations once again. After learning lessons from the Asian crisis and the latest crisis, the Chiang Mai Initiative was expanded and enhanced. It was a great step but just a starting point for seeking a stronger regime. On top of the Chiang Mai Initiative's reform, I hope more measures to come in order to prevent undesirable excessive moves in currency markets. The currency stability is crucially important to do business in Asia.

Asia's economic integration has developed rapidly after the Plaza Accord. We have many institutions such as ASEAN, ASEAN +3 and ASEAN +6. FTA between China and ASEAN has become effective and we now have a visionary prime minister in Japan advocating the East Asian Community. I believe Asia should pursue a regional monetary institution based on those backdrops. I am aware that political, security-wise integration might be just a dream, but economic integration is reality.

We should take steps forward. For example, steps like an Asian currency basket, an Asian Monetary Fund, and an Asian Currency Unit should be discussed. If we stay in the present regime, Asian economies remain vulnerable to any external financial shock. Asia's stable currency regime will contribute to the world through its sustained and balanced growth. Before the change of currency regime, optimal policy mix might be discussed.

The trilemma, or impossible trinity, is a term used in discussion. The current crisis seems to have triggered an important shift in priority among the three. Before the crisis, many believed in policy mix of currency flexibility, independent monetary policy and free capital mobility. But after the crisis, policy mix of a stable exchange rate supported by control on capital flows and prudent monetary policy seems to have achieved ground.

Now exit policy is in question but there may be another round of currency market turbulence without policy coordination among economies implementing exit policies. To avoid turbulence, I would like to recommend the authorities not only for policy coordination among leading economies, but also for starting serious efforts to take the necessary steps toward a more robust and stable global currency system.

Today I am very pleased to have with us very prominent panelists to discuss a future optimal currency system. I look forward to hearing their valuable insights with you. Thank you very much for your kind attention.

Toyoo Gyohten (Moderator), President, IIMA

Thank you very much. Now the time for panel discussion. But before declaring the opening of the session, I'd like to thank first of all those panelists who took the trouble of joining us for the symposium today. I truly appreciate your kindness. And also I'd like to thank all of you, our audience, for coming out in such a big force to participate in our discussion today.

I think we benefit very much from Mr. Watanabe's very comprehensive and well-balanced overview of the current situation. As everybody knows, the world economy is slowly recovering from the worst crisis in the entire post-war period. It is very important to note that this crisis exploded in the form of a global credit crunch, which induced a global collapse of demand. Well, it was a financial crisis, which quickly contaminated the real economy. In other words, it was not a currency crisis. In fact there was no major turmoil in the currency market.

Interestingly, however, as the economy started the slow process of normalization, there was a somewhat abrupt surge of interest about the issue of currencies, such as the role of the dollar, the reform of the international monetary system, stable exchange rate mechanism, etc. The reason why such a development has occurred is not too difficult to surmise, I think, because the experience of this crisis told us callously that the so-called "Goldilocks economy" we fancied at the beginning of the century was a total fallacy, a total illusion. Rather, the world economy is full of intractable problems, which have been with us for several decades, and which we have tried to avoid to face squarely.

These problems are; first, global imbalance; second, the world bloated role of finance; and last but not least, the future of the dollar, the topic of our discussion today. The renewed interest in the future of the dollar is obviously directly linked to the seeming decline of the hegemonic power of the US economy. The vulnerability of US financial industry, the dire prospect of their fiscal deterioration, and the soaring external debt, all of which were exposed through the process of this crisis, have enhanced the global concern about the credibility of the dollar and the stability of the international monetary system. This is why we are here today, and I strongly hope that we can shed some light on that cloud.

As was introduced, we have an almost perfect line-up of panelists to address this issue. What I'll do is ask the first three panelists, Stiglitz, Nakao, and Padoa-Schioppa, to make their opening remarks, from a global perspective. Then after discussions and a brief intermission, I will call upon Ms. Gao and Sakakibara to make their presentation from a regional and/or national perspective. And we will adjourn at 5:30. So, let's start. Joe, the floor is yours.

2. Reforming the International Monetary and Financial System
Joseph E. Stiglitz, Professor, Columbia University

Thank you very much for this opportunity to address you on a topic which I believe is of central importance to the well-functioning of our global economy. Let me try in a few minutes to give you an overview of what I see as some of the central problems and some of the most promising solutions.

There is a broad consensus today that the global financial system has not been working well. There has been a high level of volatility, with developing countries in particular bearing the burden of the risk of exchange rate and interest rate volatility. Of course, the most important symptom, right now, of a flawed global financial system is the global financial crisis. This is the crisis that has a "Made in USA" label on it, and the United States exported it around the world— not its proudest export. The financial system was part and parcel of the rapid spread of the crisis to the rest of the world. The important point I want to emphasize is that this is not the way efficient markets are supposed to work. They are supposed to be stable; they are supposed to be self-correcting. Good financial markets are supposed to make sure that risks are borne by those who are better able to bear them, the richer countries. There are lots of examples of other important ways in which markets did not behave in a way that standard theory would have predicted, and I'll come back to some of these later.

The crisis has generated extensive discussion of its causes. There is a broad agreement that deregulation allowed banks and financial sectors to engage in excessive risk taking and, in many cases, predatory lending. Moreover capital and financial market liberalization contributed to the rapid spread of the crisis around the world. Ironically, these policies were at the center of "financial reforms" of earlier decades—actually both contributed to creating the crisis and its rapid spread around the world.

In many ways what has happened in this crisis is not new. Crises, bubbles, panics have characterized capitalism from the beginning. There has only been one period in the history of market economy in which there has not been a crisis. That was the four-decade period after the Great Depression, in which there were only one or two minor crises anywhere in the world. The reason for that, I believe, has to do with learning the lessons of the Great Depression. That is, strong financial sector regulations were put into place. And those regulations not only led to greater stability, but also to rapid growth. Critics of regulation say that we have to be careful about regulation because it will stifle innovation and stifle growth. That's nonsense. The right regulation will actually encourage growth, stability and the *right* kind of innovation. I'll come back to that in a moment.

Part of the reason for the poor performance of the financial system is a misalignment of incentives. Having private incentives aligned with social returns is at the core of making a market economy work. In the financial sector, however, there are large disparities between private rewards and social returns. And these not only contributed to excessive risk taking and shortsighted behavior, but also to distorted innovation. The financial sector, for the most part, did not innovate in ways that enhanced the ability to manage risk. In fact, the financial sector created products which worsened risk management, which is why millions of Americans have lost their home, their most important asset. Indeed, the number of foreclosures expected in 2010 is actually larger than that in 2008 and 2009, with two and a half to three and a half million Americans expected to lose their home. The innovation was more aimed at regulatory accounting and tax arbitrage, in other words, undermining rules intended to make economy work well. Paul Volcker has very forcefully made the same point that I am making, a point which I also made in my recently published book, which has just come out in Japan, called Freefall. It's hard to find any evidence of a positive effect of most of the innovations on economic growth. When I was Chairman of Council of Economic Advisors, I saw a number of instances in which the financial sector actually resisted innovations that would have made our financial sector manage risk better.

What I want to talk about here, however, are some of the international implications of the high volatility associated with the market economy and the financial sector's failure to manage risk well. The high volatility induces large increases in reserves. This is especially true after the IMF/Treasury mismanagement of the '97 East Asia crisis. To me, it was no surprise that reserves shot up in the period after that crisis: countries had learned that if

they did not have sufficient reserves, they were at risk of losing their economic sovereignty, with the IMF imposing policies that had very serious adverse effects on their economies and societies. I'll return shortly to the explanations of these rapid increases in reserves. For now, I want to focus on the consequences: large reserves weaken global aggregate demand. Rather than spending their income, countries are saving their income. For those who remember their elementary economics course, it's called the Paradox of Thrift. This has led to what's sometimes been called the savings glut, but I rather view it as an investment dearth.

The real problem was that the financial and economic system failed to recycle the savings to meet global needs, needs like addressing poverty, or retrofitting the world to address the problems posed by global warming. Instead, money went into the housing bubble in the U.S., with a massive amount of money being wasted.

And this, of course, leads me to one of the central questions we are talking about, which is global imbalances. Simply put, this refers to the fact that part of the world is producing much more than it is consuming, and a part is consuming much more than it is producing. In some sense, that happens all the time. Some people save, some people borrow. The problem has been that it is the wrong countries that were doing the saving and dissaving and as I have noted, the savings/investment were not allocated well. It should have been the United States that was saving, getting ready for a large aging population of baby-boomers. But instead, the United States was living beyond its means. By contrast, the developing countries should have been borrowing to increase their capital stock. It was clear that this situation was not sustainable, and as one of my predecessors as Chairman of the Council of Economic Advisors put it, that which is not sustainable won't be sustained. Eventually a problem will arise.

Once it is recognized that the imbalances simply couldn't continue, there is a worry that they would be "unwound" in a disorderly way. It's important to realize that global imbalances did not cause this crisis, but they still represent a threat to the future stability of the global economy: a disorderly unwinding of these imbalances could cause the next crisis. Today, however, the critical problem facing the global economy is weak global aggregate demand, and the surpluses—the precautionary savings, the buildup of reserves—is a major contributor to this problem. Keynes emphasized that the problem of the surplus countries was that because they are not spending, they are contributing to weak global aggregate demand, which is one of the key problems facing the world today. And unfortunately, the problem of insufficient global aggregate demand is one that is likely to face the world for an extended period of time. What had sustained the

American economy, and to a large extent the global economy, *before the crisis,* was America living beyond its means. We had a consumption bubble, and that's gone. It's not going to come back again. Some people are hoping it will, but that would be a disaster for the United States. So this problem, which has been festering for some time, finally must be dealt with.

Let me spend just a minute going into a little bit of detail about the sources of these global imbalances. They need to be viewed from a global perspective. Part of the explanation of the global imbalances, of course, has to do with excessive spending in the United States, facilitated by the U.S. dollar's role as a reserve currency. Another part is excess saving in the rest of the world. There are several reasons for the buildup of reserves. I have already referred to one of the reasons, to protect against global volatility. The point was made very forcefully to me by the prime minister of one of the countries that went through the East Asia crisis. He said, "We were in the class of '97. We learned what would happen if you don't have enough reserves." And he went on to say that they would never let it go: "Never again." But the class of 2008 had to learn those same lessons again. The countries that had bigger reserves have managed this crisis better. They were able to weather the storm a lot better than those that didn't. The obvious lesson from that is the necessity of building up reserves. However, this carries its own complications: building up reserves protects the country that does it, but also leads to a weak global demand.

There is a second reason for the global demand for savings, and that has to do with export-led growth, China's buildup of reserves is greater than can be accounted for by just a concern over global volatility. Its buildup in part is a result of its desire to keep its exchange rate competitive. I want to make two observations concerning export-led growth and the global increase in reserves. First, it's important to realize that one can have export-led growth without large surpluses. That was actually the characteristic of many of the countries in East Asia in their rapid growth period. But, unfortunately, the WTO removed some of the key instruments other than the exchange rate for promoting growth. And TRIPS, which are the intellectual property provisions of the WTO Uruguay Round agreement, made things even more difficult. The result is that the exchange rate has become the preferred instrument for achieving export-led growth, and that means that it's likely to continue to be a basis of reserve accumulation.

The final reason for reserve accumulations has to do with the very large number of oil exporting countries who, in a period of high oil prices and natural commodity prices, quite reasonably save against a rainy day.

What are the prospects for global imbalances in the aftermath of the crisis? It is likely that the United States will at least increase its household savings. Right now the household saving rates have increased very quickly from about 0 to 5%, but that has been offset by increased deficits on the part of the government. The problem is, to the extent that the household savings remains high and government deficit reduction occurs, it will lead to weaknesses in global aggregate demand. Moreover, as we have note, the crisis has led to an even greater demand for "precautionary reserves." There is, at last, a recognition of this, and the IMF has now come forward with a number of proposals for it to take a greater role in providing insurance, arguing rightly that setting aside reserves is an inefficient way to protect oneself. Unfortunately there is a lack of confidence in the IMF; there is no confidence that the money will be there when they need it. It is very well appreciated that there has been a dramatic change in the IMF in the last couple of years under Strauss-Kahn. But what many in the developing world worry about is, if the IMF could change so dramatically in one direction, it could change dramatically back to the way it was. The result is that countries are not going to get rid of their reserves in the hope that they can turn to the IMF should they need funds in the future.

The G-20 proposed a particular approach to resolving the problem of global imbalances. This has involved the United States saving more and China consuming more. In my mind, there are two key problems with this. The first is that even if China adjusts its exchange rate and China consumes more, it won't do much to alleviate global imbalances. The United States will still have a very large trade deficit; it will not be exporting a lot more; and it will still be buying apparel and textiles –perhaps not from China, but from Sri Lanka, Bangladesh, or other developing countries. So the multilateral trade deficit of the United States will remain. But there is another more global issue: the planet cannot survive if everyone consumes in America's profligate style.

There is an alternative resolution, which involves deeper reforms based on the recommendations of the UN commission in which Prof. Sakakibara served with me. There are four issues. Let me just list those issues, since we are running out of time, and maybe we can come back to them later. One is a global regulatory system, the second is the reform of the global reserve system, the third is improvements in global risk mitigation, and the fourth is improved mechanisms of recycling savings to meet global needs. Let me say very briefly just a couple of points on each of these.

In terms of a new global financial regulatory system, it is clear that we need a much stronger regulatory system. The G-20 made a bold step of changing the name of the Financial Stability Forum to the Financial Stability Board. I am not sure that that, however, is going to be a deep enough reform to make a fundamental change in the way the global financial system works. The same people and same mind sets are not likely to make for deep reform. The FSF obviously didn't prevent the crisis from occurring. I do think global coordination is required to avoid regulatory arbitrage, but it's going to be difficult to achieve. And in fact, sometimes I suspect that those in the financial sector who don't want regulation keep emphasizing global coordination, knowing that it can't be achieved, as a way to prevent it from occurring.

So there is an alternative strategy that I think is beginning to emerge: let's regulate first, and harmonize later. Each country has the responsibility to its citizens to protect its economy, to protect its citizens, and in the absence of coordination, let's first get a good regulatory system in each country, and then figure out the details of how to coordinate.

The most important reform that the UN Commission emphasized for the medium term is a new global reserve system. The weaknesses in the current system have long been recognized, problems that contributed to instability and to weaknesses in global aggregate demand as these countries set money aside. The current system is also inequitable. The poor countries are effectively lending the reserve countries trillions of dollars, amounts greater than the foreign aid the United States gives. The dollar reserve system is already fraying, which is one of the reasons we are here talking about it. I don't think we are going back to a reserve system that is so extensively based on the dollar. It makes little sense in the 21st century multilateral world for so much of the world's global financial system to depend on the currency of one country. But unless we create a new global reserve system, the system to which we are headed--a two- or three-currency system: dollar/euro, dollar/euro/yen, dollar/euro/yen/RMB—, could be even more unstable than the current one. That's why I think it is absolutely essential that we create a global reserve system.

It could be done in a variety of ways, to enhance stability and to achieve a variety of other goals, including reducing global imbalances by providing incentives for countries to reduce their surpluses. There are some important predecessors, in particular, the IMF's SDRs, and the Chiang Mai Initiative. The UN Commission described various ways of moving from the current system to a new global reserve currency system. One is a "bottom up approach"—an expansion of existing regional initiatives; the other is a new international institution or an expansion of the IMF's

SDRs. The two approaches can be complementary. Parenthetically, I should say that I think the recent expansion of the Chiang Mai Initiative was important, but there is still a need for further expansion and to be de-linked from the IMF.

Since the release of the UN Commission Report, the idea of a new global reserve currency system has had considerable support from around the world including, from China, France, Russia, and recently, even from the IMF, as some have proposed using and linking the reserve emissions to help fund developing countries' expenditures for climate change adaptation or mitigation. A well designed global reserve system can thus help the international community simultaneously address two problems—providing finance for global climate change or funds for other global public goods, and global stability.

Let me conclude by making a remark about recycling savings to meet global needs. As I said, there is something very peculiar about the current situation: we have a world with excess capacity and a world with huge unmet needs, addressing the challenges posed by global warming and global poverty being the two most obvious ones. It should be obvious that what is required is more investment. Thus, to tell some countries they should save less doesn't seem to be the right answer. The answer is, we need to "recycle" the savings to more productive uses than the way they have been used in the past. The global financial markets before the crisis failed. Money was recycled to what in the end proved a highly unproductive use. So the challenge for making an optimal—or at least a better— global financial system is really to address this key issue.

Let me conclude by saying that while I think the G-20 is a big improvement over the G-8, the prospects of a globally coordinated resolution of the world's current economic problems under the G-20 framework are not good. To me, one of the most important reforms is the creation of a new global reserve system along the lines that I have discussed. It can be used to help, as I said, address the issue of global warming and global poverty, and to help stabilize global economy. It's an old idea. Keynes talked about it some 75 years ago. Perhaps it's an idea whose time has finally come. Thank you.

3. Reforming the International Monetary System—Japan's Perspective—

Takehiko Nakao, Director-General, Ministry of Finance of Japan

Thank you very much, Mr. Chairman. Usually when I speak before this kind of audience, I am not scared, but this time I am a little bit scared, because I am with such prominent speakers, including Mr. Gyohten, who was the Director of the division when I joined the Ministry of Finance in 1978. And also Dr. Sakakibara, when he made the proposal of the Asian Monetary Fund, I was touring with him to promote this idea, which was aborted later. So that is one scare and another scare is, as I am the only policy maker, government official, I can be criticized for any wrong doing of the government. But this provides frankly a very good opportunity for me and for the Ministry of Finance International Bureau to summarize what is going on, what should be the observation of the Japanese government standpoint regarding the reform agenda of the international monetary system.

There are many lessons from this crisis including macro-economic management and the regulations which Dr. Stiglitz just mentioned. But I would like to focus on the international monetary system today. I distributed the full text in Japanese[1] today. The English[2] one will be circulated later.

First, the background to the argument of the rise of interest in the international community over the international monetary system, and of course the reason is the recent international financial crisis started from the United States, which is the base for the key currency.

The second is the role of the IMF. Before the crisis, during what we call the "Great Moderation Period," the IMF functions were almost neglected, because the countries could finance their needs in the international private market instead of going to the IMF, which often advises as well as finances. During this crisis the IMF played the very important role of providing liquidity to the countries in need, including many East European countries and also made a lot of contributions in advising countries and

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[1] Please refer to IIMA web site:
(Japanese) http://www.iima.or.jp/pdf/sympo_speach/Mr_Nakao_Speech_text_j.pdf
[2] (English) http://www.iima.or.jp/pdf/sympo_speach/Mr_Nakao_Speech_text_e.pdf

also in supporting the discussions of the G-20 and so on.

The third element is the emergence of China. As Mr. Watanabe mentioned, resurgence of China as a super-economy is one of the reasons for this interest in the international monetary system, and the People's Bank of China's Governor Zhou's report of last spring raised a lot of discussions, including the status of the dollar as an international key currency.

The fourth element is the challenges to the euro. When the crisis started, the euro went up to some point, maybe Dr. Padoa-Schioppa would talk about it, but until some time, the euro was regarded as a base for resilience in the European countries because compared to the situation in which individual country's currency was attacked individually during the crisis, the euro is a single currency and a common currency, and it could show the resilience to the attack from the currency market. But after the Greek case, it is becoming once again an issue in the international community whether the euro can be the optimal currency area since it doesn't have labor mobility and the fiscal transfer as usually mentioned in the textbook of the international economy. So there are many issues regarding the international monetary system.

I would like to talk about how we look at the dollar as a key currency. It is obvious that the dollar is the single most important key currency in the international monetary system today, including the usage in the reserve. The dollar's share in the reserves is 62% and the euro is 28%, so it is a very predominant currency there. In other areas, like trade transactions and denominations of oil prices, liquidity needs and so on, it's obviously the single most important key currency. For this phenomenon, there are many elements; they could be political power, military power and cultural power, and also very deep and reliable financial market and the responsibilities of financial authorities. At the same time, we can mention what we call the "network externality." Once people start using something, it's better to use it. There can obviously be a "network externality." So my conclusion at this moment is, although the dollar status is challenged in terms of whether it will continue to be a single key currency or not, it is very difficult to find an alternative for that. It is too early to say that the U.S. is declining and its power is weaker. Of course, compared with 1950's and 60's, the U.S. power is weaker, but I doubt myself whether the U.S. started declining, because it has a tremendous dynamic flexibility and diversity which is needed for a sustainable growth.

About the plural multiple-currency system including the tri-polar system which we argued often in 1990's or 1980's. Of course there is a merit, advantage to have this, because the United States as a country of key currency can be provided certain discipline for the policy, and this is good to avoid moral hazard of a key currency. But at the same time, as Dr. Stiglitz mentioned, it can be even more unstable than the single currency system because from time to time there emerges volatility depending on the situation of the economies in different key currency areas.

About the RMB, Chinese currency, they started a promotion of the international usage of the RMB, especially for trade with the neighboring countries. But what the authorities are saying to us is that, what they do is to try to facilitate the trade finance for the traders when the dollar liquidity is in shortage. So it's not the internationalization of the RMB per se, but it's rather for facilitating the trade. And for them the international usage of the RMB is not the policy objective, but rather the consequence of transactions of the private sector. In addition, even if they want to promote the usage of the RMB just for trade, the exporters, when they earn money in RMB, they should have a chance to manage it and importers need the money to finance their imports in RMB. So, even if it is only used for trade, we need a certain level of free capital account transaction. We started the policy of letting the yen be used in trade as early as in 1960's, so from the Japanese experience, I would say the RMB's internationalization is at a very early stage, and it would take some time. However, Chinese development model can be said to be more open system than that of Japan in 1960's, so the RMB's usage in international trade or asset management can be expanded more rapidly than the case of the yen, but it will take some time.

And for Japan, it is a very welcome phenomenon or policy that China starts the promotion of the RMB for international use. It is convenient for the Japanese enterprises. But at the same time, I hope the Chinese authorities would pursue responsible fiscal, monetary, and exchange rate policies, as well as deregulations of financial markets on a fair basis.

About the SDR, this is a composite of the dollar, the euro, the yen, and the pound, and this is a very artificial currency, but it's not really a hard currency. There is no paper bill or coin, and we cannot use the SDR as it is for the lender of the last resort function. It's in essence the credit line between the authorities which have reserves. So, of course we can promote the usage of the SDR, but we cannot expect the possibility that the SDR can take the status of a key currency.

It seems to me that the dollar will, for a foreseeable future at least, remain as a single key currency, and we should ask the U.S. authorities to pursue responsible fiscal and monetary policies. I think they are doing that, although their fiscal balance has deteriorated so much in the wake of the crisis because of the stimulus package and also lower tax revenue, but still the U.S. has the power to sustain the dollar. Other key players like Japan, Euro Area, and China, those countries should also cooperate to keep the international monetary system stable.

I would like to touch upon a little bit about the internationalization of the yen. There are maybe three meanings in the internationalization of the yen. One is to have a full convertibility of the yen in terms of current account transactions and capital transactions, and it was already done over a long ago. The second is to make the yen more usable and to promote the usage of the yen, especially in the Asian region. And we have made a lot of efforts by exempting the withholding tax of the government bond and local government bond, and then corporate bond is exempted this year. And also we tried to deepen the Japanese financial market for the sake of investors in the yen and for borrowers of the yen.

But at this point, if we look back at the objective of yen's internationalization, as Mr. Smaghi of the ECB mentioned, and also Mr. Zhou of People's Bank of China, or Prime Minister Wen mentioned, the international usage of the currency can be the consequence of the choices of the players in the market. So what is very important for Japan is to seek the strengthening of the financial sector in Japan, and this is really needed to provide the basis for the higher growth in Japan, and also to take the opportunities of earning money by servicing the dynamically growing Asia. So this financial market strengthening is really important, and yen's international usage should follow. So these two policies should come together.

Regarding the IMF, I don't have time to speak in detail, but the IMF's role is once more critically important. Instead of just looking at the balance of payment difficulties and macro-economic policies behind them, they should also look at the financial stability in countries' markets, because it would have a contagious impact on the international financial market. So, although the Financial Stability Board and regulators are dealing with this issue, the IMF should also have a mandate to look at the financial stability more closely.

Regarding Asia, we have made a lot of efforts after we tried to have the Asia Monetary Fund in 1998, and after that we still continued our efforts by having Manila Framework, which is a gathering of surveillance and financing co-operations during a crisis, and also technical assistance for the needed countries. And this led to the Chiang Mai Initiative which is the arrangement of a network of bilateral swaps. And then it is now being multilateral framework, and the surveillance unit which is a kind of secretariat to the Chiang Mai Initiative will be established soon. We don't think this will replace the function of global role of the IMF. It should complement the IMF's role. But still this is really important to provide the confidence during a crisis of this time. And also there is the Asian Bond Market Initiative, which is trying to intermediate the saving and investment within Asia, instead of going to New York and then returning to Asia. So if you look at the prepared text, those discussions are made in detail.

In conclusion, I would like to touch upon a little bit about the exchange rate system. During the Bretton Wood system it was a fixed exchange rate, anchored by the dollar and gold, and at that moment we tried to regulate, not prohibit, but restrain the capital flow across the border. But after we gave up the idea of pursuing the currency stability for the sake of the free flow of capital and the independence of monetary policy, which is the trilemma of international financial system, we started promoting free flow of capital without any restraints. And we started regarding the free flow of money as a very good thing as it is and we tried to promote it, and then came together the financial deregulations which also sought the free flow of money within the domestic market, innovations of financial products whether it is very exotic or not. We thought this was in itself a virtue, or good thing. But those two elements, domestic financial deregulations and the change of international monetary system to the free flow of money were one of the causes of this crisis. But my conclusion is that we cannot reverse this trend. And we cannot give up the idea of free flow of capital across the border, because it provides a lot of opportunities to the world economy including to the emerging economies, and I think one of the reasons for high growth of China and other emerging economies is because they could get money more easily than before because there was a free flow of capital. Of course they caused a lot of problems but we should accept that we must live in this kind of world, and we can make efforts on how to regulate it, how to restrain the bad part of the system, including through better macro-economic policies. But still I don't think we can return to the world of the Bretton Wood system with fixed exchange rates and very strict regulations on capital flow. So that concludes my remarks. Thank you very much.

4. Monetary Aspects of the Crisis and Desirable Reforms
Tommaso Padoa-Schioppa, President and CEO, Promontory Europe

Thank you very much, Toyoo, and many thanks to the Institute for International Monetary Affairs for calling this conference and for giving me the opportunity to comment on this topic. I particularly welcome the subject of the conference, "Exploring Optimal International Monetary Regimes," because in my view it points to an aspect of the crisis and of the reforms that hopefully should follow it, which has not yet been a centrum as it should have been. I will develop my remarks in six points, revolving around the monetary aspects of the crisis and the desirable reforms.

The first point is about the monetary factors of the crisis. There are a lot of analyses about the weaknesses of financial regulations, about the external imbalances, about the growth model based on consumption and debt that have led to the crisis, but the factors which are specifically monetary are still underestimated. An important monetary factor is *domestic*, although linked to globalization: this is the fact that the highly expansionary monetary policy conducted by the United States did not result – as textbooks predict– in inflation (a consequence that would in turn have triggered an adjustment) largely because a price ceiling was at work in the form of very inexpensive manufactured goods imported mainly from Asia. The usual effect of an excess of money, to inflate consumer prices, did not materialize. Inflation in asset prices was created instead. Unfortunately, while inflation in consumer prices makes everyone feel poorer, inflation in asset prices makes everyone feel richer and may –and in fact did – further encourages an unsustainable course.

The other monetary aspect at the origin of crisis is fully *international*. This is the fact that due to the international reserve role of the dollar, a national currency it was possible for the issuer to prolong an external deficit without any disciplinary mechanism to be set in motion by the need to correct the payment imbalance. We can say that this monetary factor has been at work for much longer than the 10 or 15 years preceding the crisis; it brings us back to 1971, when the dollar was de-linked from gold. What happened in 1971 is that, for the first time, money was completely disconnected from a commodity to become a purely man-managed entity. The world lost any form of international standard, such as gold had been until that time.

As it was de-linked from any 'real' commodity, money became more strongly linked to political power as the real anchor of policy decisions. And, as a consequence it was made more national than it had ever been before. This is what Robert Triffin had seen earlier on and formulated in what is known as the Triffin dilemma. In the early 60's he stated that there is a fundamental dilemma between the need for domestic stability (according to which a *national* currency has to be managed) and the need for international liquidity (according to which an *international* currency should be managed). He predicted that this contradiction would eventually cause the end of the system then prevailing. His diagnosis was right, in spite of the fact that what happened was different from his prediction: not an excessive scarcity of dollars but over-abundance. What really matters is that the fundamental contradiction between the motives that drive the policy of a national currency and the needs of an international currency was rightly identified by Triffin.

My second point concerns floating exchange rates. Many argue that if all currencies were allowed to float, the lack of international adjustment and discipline would disappear. They contend that the universal floating regime has the double advantage of being politically feasible, because it preserves national sovereignty, and economically optimal, because it produces adjustment. I think this is a complete illusion. Politically, it makes little sense to think that acceptance of universal floating would be a smaller surrender of national sovereignty than acceptance of an exchange rate rule; experience confirms that every day. Economically, it is false to think that it would be optimal, first because markets do not produce the desirable levels of exchange rate timely enough to be a guide and, second, because when they do, they do not produce adjustment in full. They *signal* the need for an adjustment, but they do not *produce* the adjustment they call for. The fact is that much of the imbalances are due to policies, and there is absolutely no evidence that the exchange market can enforce changes in policies as they would be desirable. Finally, a world of 150 to 200 floating currencies (this is the number of sovereign countries issuing and managing their own currency) would probably be a nightmare. We talk generally about a few key currencies, but for the very large number of small and open economies, even theory tells us that the floating regime is not the best.

The third point goes back to Triffin. His dilemma can be restated today in a way that generalizes it to a regime of floating, and to a multi-currency world. The stability requirements of the system as a whole – so says a Triffin dilemma reformulated today -

are inconsistent with economic and monetary policies pursued solely on the basis of domestic considerations in all monetary regimes devoid of some form of supranationality. In other words, even if all currencies were floating, and even if there were no single dominant currency, as long as monetary policies, and therefore the global monetary stance, are determined by national needs, the resulting overall monetary stance (which, in this case, would be an average of national needs) would be the one that satisfies the needs of global economy as a whole. Also with floating, also with many currencies, the fundamental dilemma of Triffin holds, simply because it is a dilemma between national needs and international requirements.

The fourth point can be stated in brief. While the *analysis* until this point can be probably subscribed by many, its *conclusions* are often rejected as unrealistic. After I had exposed the above analysis, a journalist once asked me "What do you have in your mind? Do you advocate a return to gold, or the SDR, or fixed exchange rates, or a single global currency?" I escaped by giving the following answer: 'I do not know yet. One thing is to demonstrate that there is no solution unless we have an object that flies, another is to invent the aeroplane. So far, I have demonstrated that we need an object that flies, I admit that I have not invented the aeroplane.' But it is not because the aeroplane has not yet been invented that it becomes false that without a flying object we will have no solution.

What did people know about the aeroplane before inventing the one that could fly? I think we know a few things about the flying object we need for the international monetary order to be sustainable. We know that there are two key issues on which the inventor must concentrate: one is the exchange rate regime, and the other is the global anchor. About each of the two we know something. This leads to my fifth point, which is on exchange rates.

I have discarded universal floating as a solution. For the globe, one should, in my view, also discard a fixed exchange rate regime. 'Irrevocably fixed' exchange rates were, in the end, the solution for Europe, but they cannot be the solution for the world. At a global level, exchange rates must be adjustable. The difficulty is that money is, by definition, one. A regime of monetary federalism is much more complicated to invent than one of fiscal federalism, where 'federalism' stands for a distribution of policy power across different levels of the government. If pure floating and irrevocable fixing are both to be discarded, what we have to deal with are intermediate regimes, namely regimes in which exchange rates have a degree of stability, but can also change. And here, of course, the fundamental difficulty consists in reconciling the need for stability with the fact that capital mobility tends to make a guided stability extremely hard to obtain. Ultimately, the challenge is how to rebalance the roles of markets and policies in the determination of exchange rates. Twice, these roles were successfully balanced, each time for periods of about 20 years: in the world, first, and in Europe, subsequently through the EMS. In both cases the intermediate regimes eventually collapsed under the pressure of capital movements; at the same time, however, both provided a period of much better conditions than either a completely fixed, or completely floating exchange rates. It is not the aeroplane, it is a thought about one aspect of it.

A relevant role, as Joseph Stiglitz referred to, can be played by regional arrangements. Globalization is a conglomerate of regionalizations. Much of the phenomenal growth in international trade is growth in regional trade. Regional arrangements - like those adopted by Europe, not only with the euro, but previously with the EMS - may be a useful component of a better global order. They would simplify the shape of the world and make the relationship between large monetary areas and a kind of residual, less difficult to manage than going directly from the national to the global level.

The sixth and last point concerns the second aspect of the aeroplane, namely, the need for an anchor. Here is the debate on the SDR, which involves two issues: first, how to enlarge its role and, second, whether it is a possible anchor. Europe has a most significant experience to offer in this regard, one that the audience may not be very familiar with. In Europe there was a basket unit of account, called ECU, which grew into the denomination of assets that circulated, as such it was used as a denomination by many issuers and was held by many investors. Clearly, it acquired several characteristics of a currency. To say that the SDR is an artificial currency does not mean much; indeed, issuing SDR is not more artificial than printing paper. The role and status of currencies is driven by *use*, just as much as by *institutions*. To see a currency develop from the 'use' end of the spectrum, rather than from the 'institution' end, is perfectly possible. In many respects the SDR is more advanced than the ECU was in its time, because - unlike the ECU – it has an official issuer, the IMF as well international status and recognition. Its handicap is that it does not circulate. But its circulation could be promoted. A clearing system could be created. And the SDR would be an obviously attractive denomination for financial assets, because it would be more stable than the components of the basket. It would be attractive as a denomination for pricing primary commodities as much as it may be to price financial instruments.

The question is: "Could the SDR be also an anchor?" At the time of the ECU, German officials were hostile to it because they considered that, being an average, it was less good than the best component of the basket, which was their currency. Indeed, in the case of the ECU the dominant currency was better than the average. In the case of the SDR, instead, the dominant currency is not better than the average, which completely destroys the arguments that were used against parallel or basket currencies at the time of the ECU. In many respects, and for quite a while, the SDR could be a better standard than the dollar, and also a better anchor, because it would be a composition of currencies which are on average more stable than the dominant currency.

Yet, and here I will end, this would not yet be a complete solution, precisely because of the 'generalized' Triffin dilemma formulated before, namely because the SDR remains an average, a basket of policies. A larger role of the SDR would not solve what economists call the problem of the n-th currency. To solve this problem, what is needed is one currency more than the number of countries. In other words, as long as the standard is *internal* to the system of currencies, and has no policy management of its own, the fundamental dilemma remains unresolved. Thus, a wider use of the SDR would represent a good progress, which could last for a few decades before we invent the aeroplane, but it is not yet the aeroplane. Thank you

5. Panel Discussion for Part I

Gyohten : Thank you very much, Tommaso. Apparently our three panelists have provided us with truly provoking food for thought, each exposing their desirable, hopeful, plausible idea about the future system. And interestingly, as you did see, there are more than subtle nuances among them. I truly welcome that. I have some 30, 40 minutes before we take a short break. So what I will do is to pose one question to each of the three panelists, very simple one, and also invite all panelists including Sakakibara and Ms. Gao to join exchanging views among yourselves.

Now, first question to Mr. Stiglitz…Your proposal, which was embodied in your recommendations to the UN, is truly innovative and I can assure you that that has created a great amount of interest in Japan as well. Now people still ask what is the sequence of necessary steps to make it happen and also if you believe that it is feasible, then what time frame are you thinking about?

Stiglitz : There are a couple of ways that we could evolve toward a new global reserve system. This is one of the questions we did address in our UN Report. One way is a bottom-up approach. That is, begin with initiatives in each of the regions, the Chiang Mai Initiative, or some of the other regional initiatives, such as the one that has been discussed in Latin America. We could then move from these regional reserve systems to an integrated global reserve system.

A second approach is in a way a gradual evolution of current global programs. We already have the SDRs. The G-20 expanded the supply of SDRs by 250 billion dollars in response to the global crisis. There is a provision within the IMF that allows for the SDRs to be expanded. The only problem has been that the U.S. has repeatedly vetoed the expansion. But the institutional structure is already there. The current arrangements, however, call for only episodic expansions; we are arguing that it should happen on a regular basis, rather than episodically. There are a number of problems with the SDR approach because the SDRs are allocated on the basis of IMF quotas, implying that the largest allocation goes to the United States, which obviously doesn't need the additional reserves. But those problems are understood and have been widely discussed. The institutional reforms that are required to make the system work better can be worked out over time.

The third approach, which is the one I favor, but is more difficult, is to try to create a new international institution, a global reserve institution. One of the problems with the IMF that I mentioned before is that the reason countries want to have reserves is that they worry that if they have to go to the IMF in times of a crisis, it would impose conditions that they will find unacceptable. So rather than doing that, they say it's worthwhile to build up hundreds of billions of dollars of reserves, despite the huge opportunity cost. However, in doing this they are articulating a view that the value of that independence is high. These countries recognize their common interest in trying to set up a global system that would provide automatic access to funds; they realize the value of creating this new global currency. Keynes talked about it as "Bancor," a reserve currency that would be exchangeable with other currencies.

Let me mention an issue that has been raised by a couple of the panelists. One doesn't need to have an international market for "bancors" for bancors to be useful as a global reserve currency. What is required is that governments be willing to convert this SDR into dollars, into euros, or whatever -- an agreement, in other words, among governments that this is going to be a reserve currency. Once they agree to be able to convert according to certain rules of the game, then they convert to a currency in which there is considerable depth. What I have been talking about is a *reserve* currency. It doesn't have to be a currency used in ordinary circulation. One can view the reserve system as a mutual insurance society. This perspective is especially clear in the Chang Mai initiative.

Indeed, there are advantages in having the proposed reserve currency limited to being used only as a reserve currency. It's a problem that was already hinted at: the more extensively that it's used, the more volatile it can be because of international speculation, as we have seen over and over again. One of the advantages in not being tradable in the usual way is that the scope for speculation is reduced. As a reserve currency, based on the kind of agreement among countries that I described earlier, it will provide mutual insurance, so that countries won't have to put aside as much in dollars or other currencies.

Finally, let me say this new system can exist side by side with other systems so that you don't have to switch instantaneously from one system to another. In fact we even argued that you could have a group of countries form this mutual insurance society among themselves, and make a commitment that, over time, they would more and more rely on their "collective reserves." As they did so, the demand for dollars as reserves would decrease. Americans might like the dollar to have remained as *the* reserve currency, but it's not up to the United States to decide how other countries hold reserves. It's the other countries who choose whether they want to hold dollars. And if there is a viable alternative, they would choose that instead.

In terms of the time horizon, the way I think about this is the following: The movement to *some* alternative system has already begun. The dollar reserves system is already fraying; the Chiang Mai Initiative is already here. This is an evolutionary process -- the change will happen. What I worry is that if we don't move this along fast enough, we will move to a two- or three-currency reserve system, which could be very unstable.

Gyohten : Thank you very much. Are there any questions or comments from other panelists? Tommaso?

Padoa-Schioppa : Well, if this reserve did not circulate - and I see the advantages you point to, or the lack of need, being sufficient an agreement among countries - what would be the position of the United States in this kind of game?

Stiglitz : As I said, it wouldn't have to be a "club" that includes everybody. If the United States joined this "club," the understanding would be that if the United States had a financial problem like it has right now, it too could get access to funds; the Fed would not have to expand its balance sheet in the way that it has been doing, which has caused a great deal of anxiety. It would have a right to draw from the SDR pool.

Padoa-Schioppa : But there would still be surplus countries which instead of accumulating dollar, would accumulate this reserve, and deficit countries which would not feel any scarcity pushing them to adjust?

Stiglitz : That's a good point, which I had to skip over. One of the points I had wanted to mention was that one could design the global reserve system to provide incentives for countries *not* to have a surplus, for instance, by reducing surplus countries' allocations of the global reserve currency. That was one of Keynes' ideas; he recognized that the surplus countries are contributing to an insufficiency of global aggregate demand, and so he recognized that one had to put pressure on them. There are other ways of putting pressure on the countries with either persistent deficits or surpluses. So the global reserve system could be a rule-based way of avoiding long term systemic imbalances.

Gyohten : Thank you. Let's shift our target…

Sakakibara : Could I ask one question about the SDR? The SDR could and has been a good instrument for IMF to distribute drawing rights, and the countries receiving the SDR could draw it, and could acquire the US dollars. However it could never be a transaction currency. It could neither be a reserve currency. Surplus countries like Japan would not accumulate the SDR. We would rather accumulate the US dollars, right? So I think the SDR as an alternative to either the US dollar or the euro may not be practical. How would you respond to that kind of criticism?

Stiglitz : First of all, the attractiveness of people holding dollars as a reserve currency is decreasing greatly because it is viewed as very volatile. People looking at the soaring U.S. debt and expansion of the Fed's balance sheet worry about inflation. It is not surprising that central banks have been moving out of the dollars. At the same time, if you look at the recent problems in Europe, one can recognize the euro has its problems, and this goes back to the point that Tommaso made: that a bundle of the SDR is in fact stronger than any single currency of which it is composed; it can be stronger than any of its components. So as a reserve, an effective "store of value", it can have some advantages.

Sakakibara : I understand your point, but any central bank would like to have a combination of their own. They may opt to hold the euro, they may opt to hold the yen or Thai Bahts, but on their own option, rather than fixed amount of various currencies as stipulated in SDR. How would you respond to that?

Stiglitz : I guess in the end what I would say is that all countries have an interest in trying to create a stable global financial system. Our current system is not very stable.

If people are persuaded that this is a system which is both more stable and is likely to lead to stronger global aggregate demand and stronger growth, then I think there is some hope that this would happen. In other words, you might say that the global financial system is a global public good. The current system is not performing that role very well, and part of this discussion is about whether we can think of a system that would be, from a global point of view, better and in which various countries, major countries at least, would be persuaded that it would be in all of their interests to change the way that they hold their reserves.

Gyohten : Thank you. Let's shift our target to Nakao-san, because he seems to be of the view that the dollar is still the most important currency. Nakao-san, I think you said that in the near future, at least, there will be no replacement for the dollar as the international key currency. And certainly you are, as I took it, hoping that the U.S. will make the best effort to restore this position of the dollar. Now, the question is, in rather concrete terms, what the U.S. will have to do to get that goal? And for that matter, what are the responsibilities of the rest of the world, particularly Japan, and what does Japan need to do in order to support this U.S. effort to revive the viability of the dollar?

Nakao : That is a very difficult question, but one of the lessons from this crisis is that the sovereign institution's fiscal policy is a very important backstop of financial stability. Also for currency stability fiscal backstop is a key. So in that regard, for instance, deposit insurance for financial institutions, and also lender of the last resort facility which is provided by central banks, also backed by sovereign states, are really important sources for the stability. And the final resort is the tax payers' money. The sovereign state only has the power to resort to the tax payers' money and that is the final backstop of a currency and financial stability. So in that regard the most important policy which the U.S. should pursue is the fiscal responsibility, or sound fiscal policy, because in the end, reserve currency means that people want to hold the government bond for the reserves. So one of the problems of the euro is that although the euro is a single currency, the government bonds are separated, and their markets are not deep and liquid enough in Europe. So in that sense the dollar is in a very superior position because of its depth and liquidity of the U.S. Treasury bond market, and it is backed by the responsible fiscal policy of the United States. So if they give up the idea of pursuing responsible fiscal policy, that would cause problems.

And for other countries, what is important is to pursue also appropriate and sound economic policies and regional framework like the euro and one in Asia should be promoted to share some burden of the key currencies. Although I mentioned the question of whether the euro is an optimal currency area or not, they are making serious effort of how to tackle the current problem of the euro, and I hope they would overcome the problem. So once again, I support the idea of regional cooperation and developed countries' efforts to pursue the good economic policies, but I am too realistic, and I would say that for the foreseeable future, for the reasons I just mentioned, I don't think the dollar status will be compromised. I believe the U.S. is still a responsible country.

Gyohten : Thank you very much. Any questions or comments from other panelists?

Stiglitz : Let me just make a couple of comments. First, I want to pick up a point that Tommaso made before about the Triffin dilemma, the inherent contradiction between national interests and global interests. For a reserve system you want a sound, stable currency. On the other hand, right now it is not in the interest of the United States to have a strong dollar. We want a weak dollar. We want to export. Of course, it's not America's "official" policy— if you are the Secretary of Treasury, you have to make a speech about believing in a strong dollar— but you know that nobody believes you. That's one example of a conflict of the two perspectives.

The second one is that America right now suffers from a huge debt overhang that is weighing down on our households. On one quarter of all mortgages, people owe more money than the value of their mortgage. Unless we solve this problem, it's going to be very hard for the United States to return to robust growth.

Now, there are only two easy ways of dealing with this problem of debt overhang. One is to restructure debts, through bankruptcy for example. The banks don't want that, and they have been strong enough to make sure it doesn't happen. There have been bills submitted to try to facilitate debt restructuring, but they all get defeated because of the influence of the banks. The other way is to inflate the debt away. That's not going to happen as a part of an official policy, but in terms of what is in the national interest versus what is in the international interest, moderate inflation -- at least if we could get away with it without other people noticing it and interest rates soaring -- might be the best policy. The central bank probably won't do it, but what I wanted to illustrate is the difference between what is in U.S. economic interest in terms of our own economy and what would be good for the United States as a reserve currency. That conflict of interest just illustrates why it is so difficult for the dollar to remain as the dominant reserve currency.

Gyohten : Thank you. Tommaso, you have something to say?

Padoa-Schioppa : Notwithstanding what Mr. Sakakibara was saying, in my view all this would create an ideal condition for the SDR to develop, because the only thing that is missing for its further use is that there is no critical mass yet. As there is nothing intrinsic that would be an impediment, the problem is how to bear the initial cost of creating the critical mass. And this is typically something that the market may be incapable of doing, but an enlightened policy can.

Sakakibara : Let me put myself in the position of Tim Geithner. If I were the Treasurer of the United States, I would have nothing to lose by weak dollar policy. Weak dollar policy would promote exports, improve balance of payments, and even their balance sheets. Most of the U.S. assets and liabilities are denominated in U.S. dollars and some of the assets are denominated in foreign currencies. So in terms of balance sheets, the U.S. would gain as well. And you could print money and the dollar may depreciate. The countries which lose are Japan and China. So if you think in terms of the national interest of the United States, why not a weak dollar policy? How would you respond to that?

Stiglitz : I think the Secretary of Treasury must know this. But there has been a tradition of Secretaries of the Treasury like Robert Rubin, giving a speech, saying "I believe in a strong dollar." There is confusion between a strong dollar and a strong country, so when you become a Secretary of Treasury you are expected to give that speech. Giving that speech can be viewed as part of the job description, but it has nothing to do with economics. Everybody understands this, and I assume he understands the economics that you just explained. If he doesn't, he should listen to you.

Gyohten : I think I have to shift to Tommaso, the last question to you. Although the euro is now unquestionably the second most important currency in the global scene, yet, it is my understanding that most leaders of this eurozone do not advocate that Europe should promote the euro to become the international currency, replacing the dollar. Am I right? And if I am right, why? Then the next question is, although the euro may not become the key currency, how would the euro develop in the coming years?

Padoa-Schioppa : I think you are right. The euro and the ECB have inherited a many conceptions and attitudes from Germany and the Bundesbank. Indeed, at the moment of the creation, the fundamental deal was, on the German side, that 'we give up our currency, but the European currency will have to be managed and conceived in the same way in which we have conceived ours'. It is part of this legacy to be very reluctant, hesitant, about the international role of the currency. I would say that this reluctance is 70% sincere and 30% rhetoric. Germany and the Bundesbank were wary to an expansion of the international role of the Deutsche Mark partly for fear of harming the priority task of ensuring the stability of domestic prices. So, what you say about European attitudes towards the euro is true. I would add that I don't believe that the euro can 'replace' the dollar as it is sometimes said. And if it did, this could be detrimental to the EU economy, particularly in a world in which Asian currencies are not floating. A sharp decline of the dollar today would result almost entirely in a dramatic appreciation of the euro and this would be a source of serious difficulties for the European economies. I do not view, nor do I advocate, the euro as the likely successor of the dollar.

But I also think, like Joseph, that a multi-currency system would not be stable. The euro is, in my hope, the first example of a possible constellation of regional monetary arrangements or even regional currencies. If reality moved towards regional arrangements, then the issue would be how to organize or manage the relationship between large monetary areas: a complex configuration, but still less complex than what we have today.

In the mid 70's Europe took a twofold decision. It decided to float outside and to peg inside. The Asian region is still facing this choice. It has not yet split into two regimes: one vis-à-vis the outside world and the other internal to the region. Most of the trade of East Asian countries, including Japan, is regional, and an arrangement that stabilizes the intra-regional relationships may be as important as it was for the European trade. East Asia is a kind of single production chain that moves from one country to another. In Europe, it was largely a trade of the same goods produced by the same countries. In conclusion, I think we should continue to look at the euro as a regional currency and not as the international currency replacing the dollar.

Gyohten : Thank you. Any comments or questions from other panelists?

Stiglitz : Let me provide an argument for why Europe should not want to become a reserve currency. One of the things I talk about again in my book, Freefall, is that there are some advantages of being a reserve currency, but that there are also big disadvantages, and in the end I think the disadvantages outweigh the advantages. The advantage is what is sometimes called seigniorage: the fact that the U.S. can borrow right now at almost zero interest rate from other countries. That's worth a great deal. And that has really been the focus of U.S. concern about the creation of other reserve systems. But the flipside of countries taking your reserves, holding dollars, is a trade deficit. That's the way they get dollars; in equilibrium that the reserve currency country's trade deficit is equal to the outflow of T-bills that people hold in their reserves. A trade deficit contributes to a weak domestic aggregate demand: you import more than you export. And the way I put it is, you're exporting T bills rather than automobiles; exporting T-bills does not create any jobs. And when you have unemployment – right now one out of six Americans who want a full-time job cannot get one – there is a lot of concern about lack of domestic national aggregate demand. Europe should worry about the same problem. At least in the United States we don't have our hands tied with a central bank that focuses only on inflation and by a Growth and Stability Pact -- it should be called the non-growth with instability pact -- that limits the size of the deficit. The result of that is that Europe doesn't have the instruments to countervail the weak aggregate demand the way the United States has done it, where there has been to run a large fiscal deficit and lose monetary policy. The problem for the United States is that that particular strategy has led to some problems, and it is likely to be difficult to continue. And that's why I think it's important for the United States to move out of the current system. The creation of the global reserve system is really an imperative for the United States. Our political leaders have not yet fully comprehended this. They understand both sides, the advantage in being able to borrow cheaply and the disadvantages arising from the accompanying trade deficit, but right now they focus on the ability to borrow at close to zero interest rate. Even that will begin to fray at the seams, though, as countries around the world look at the risk associated with lending to the United States because of the potential of inflation and instability.

Gyohten : Thank you, Nakao-san?

Nakao : Yes, I have two short comments. One is about Triffin's dilemma. Mr. Padoa-Schioppa and Dr. Stiglitz both mentioned the Triffin's dilemma. In my view, in this world of free flow of capital, the U.S. can have a surplus in trade and still provide short term capital liquidity by providing longer term loans to other countries. That was the case in the United Kingdom in 19th century, if I am correct. So that is one point.

Another point is; you mentioned that a global reserve currency should reflect the international interest instead of the interest of a single country. That is true, but it's like regarding that a collective security arrangement of United Nations is much better than security provided by the United States. Of course this can be different by individual observations, but I myself feel that the composite arrangements like the United Nations is very important but not necessarily as effective and as efficient as the single country arrangement like that of the United States. It depends foremost on the responsible attitude of the United States, and I still believe that the U.S. has that kind of responsible idea.

Gyohten : Thank you. Haihong, you have the floor.

Gao : Just one comment. The disadvantage of holding the U.S. dollar as a reserve currency is the huge public debt of the United States. But holding the euro as a reserve currency has disadvantage too, because we don't have euro denominated bond backed up by collective governments and there does not exist a unified Treasury in Euro land. So this is a problem. And I totally agree that it is very difficult for the euro to replace the dollar. I sense that it is even more difficult for the euro to get closer to the U.S. dollar as a reserve currency anytime soon. So this is really a bad news for many emerging countries with an accumulation of their foreign reserves, especially for China.

Gyohten : Thank you. I am running a bit late, so I have to wind up the first session here. We'll take a 15-minute break until a quarter past four. Please be punctual coming back to your seats because in the second session, Ms. Gao is going to talk about the RMB, and Mr. Yen is talking about the yen.

Part II

6. Prospects of the RMB to Become an International Currency

Haihong Gao, Professor,Institute of World Economics and Politics, CASS

I should thank the Institute for International Monetary Affairs for letting me speak here and discuss such an important issue. I am going to focus on China with the specific topic: prospects of the RMB to become an international currency.

So let me start with the background. There is a strong argument that in order to correct the long lasting global imbalance where the U.S. dollar dominates, we need to reform the current international monetary regime. However, regarding how to reform the regime there are different perspectives and the path and timeframe are still unclear. So what is China's desirable international monetary regime? This could be your interest to know. I think China has two options at current stage. One is the idea put forward by the Chinese central bank governor Zhou Xiaochuan earlier, which is well known as to establish a "super-sovereign reserve currency" in the world. I think this is an ideal format, given the fact that a sovereign currency has fundamental flaws to play a role globally. But it seems to me that this idea could remain as a blueprint in the long-term. Meanwhile China is seeking for another option, which is more practical and feasible: a multi-currency regime where the dollar, the euro, the yen, and maybe the yuan and the SDR together to play international currencies' role. I understand that Dr. Stiglitz argued this type of multi-currency regime is more unstable. But it is likely to happen if we don't come up with any commonly agreed initiative in regard to a new international reserve system.

Recently we witnessed some new developments. One is the sovereign debt crisis in Greece. This seems to be a small event in the beginning, but if we look at it from the perspective of euro's future, it turns to be not small at all. Soros even predicted the possible breakdown of the euro. Another development is the huge budget deficit in the U.S. Bernanke admitted before the Congress in recent hearing that the debt level is unsustainable. And it seems that how to find a way out is a very sensitive and big issue. The worst situation is to end up with more dollar printing.

What are the implications of these changes? These changes actually added uncertainties to the reform agenda of the international monetary regime. One concern is “a single currency without a single Treasury sustainable?” If we look at the euro, the euro is supposed to be the biggest competitor to the U.S. dollar in the future. But unfortunately the euro tends to be troublesome in the wave of public debt problem in Europe. The second concern is, no matter the Greek debt problem is solved or not, the fallout will indicate that a collective form of currency may have inevitable drawbacks, which cast doubts on the possible formation of an Asian regional currency. The third concern is that, we always witnessed that the dollar remains the role of a safe haven in times of crisis. So this brings back the question: if the dollar’s role is declining will that bring an end to the so-called “dollar hegemony” in the long-term, how long is long enough for us to see it happen? I think we have already discussed this issue earlier. So, the real question is where and how soon we see the alternatives come? And this leads to my topic today: Will the Chinese currency be a candidate?

I am going to address the issue from the following aspects. One is current degree of the RMB being used internationally or regionally. The second is the pros and cons to have the RMB internationalized, and the third is about the conditions. I will conclude with a brief road map.

This table summarizes the international or regional use of the RMB at current stage. Actually in terms of size and range, the use of the RMB is very limited, and mostly they are tied with certain official arrangements. For instance, for the public purpose, the RMB is used as payment currency in bilateral swap arrangements under the Chiang Mai Initiative with three countries. And the RMB is used as payment currency in bilateral swap arrangements between central banks during the global financial crisis this time. For the private purpose, you can see that the RMB is mainly used in the cross-border clearing and settlement. The most important step taken by the Chinese government was to implement Administrative Rules on Pilot Program of Renminbi Settlement of Cross-border Trade Transactions in July 2009. This is a big step because the RMBs being used in trade settlements are

Degree

Summary of international / regional use of the RMB

In terms of size and range, the use of the RMB has many limitations, and mostly, they are tied with certain official arrangements.

Public purpose	Private purpose
▪ **Payment currency in BSAs under CMI with (in USD billion)** – *Korea: 8* – *Japan: 6* – *Philippines: 2* ▪ **Payment currency in bilateral swap arrangement between central banks, with (in RMB billion)** – *Korea: 180* – *HKMA: 200* – *Malaysia: 80* – *Belarus: 20* – *Indonesia:100* – *Argentina: 70*	▪ **The cross-border clearing and settlement:** *Implement of <Administrative Rules on Pilot Program of Renminbi Settlement of Cross-border Trade Transactions>(Jul. 2009)* ▪ **RMB deposits in HK:** – *Initial amount with RMB 895 million (Feb. 2004)* – *Peak with RMB 78 billion (May 2008)* ▪ **RMB bond issuance in HK by state and commercial banks (in RMB billion):** – *China Development Bank: 5 (Jun. 2007).* – *Export-Import Bank of China: 2 (Jun-Jul. 2007)* – *Bank of China: 3 (Sep. 2007)* – *Bank of Communications: no more than 5 (Mar. 2008)* ▪ **RMB government bond issuance under ABF2 (Jun. 2005)** ▪ **ADB: 1 billion yuan Panda bonds (Dec. 2009)**

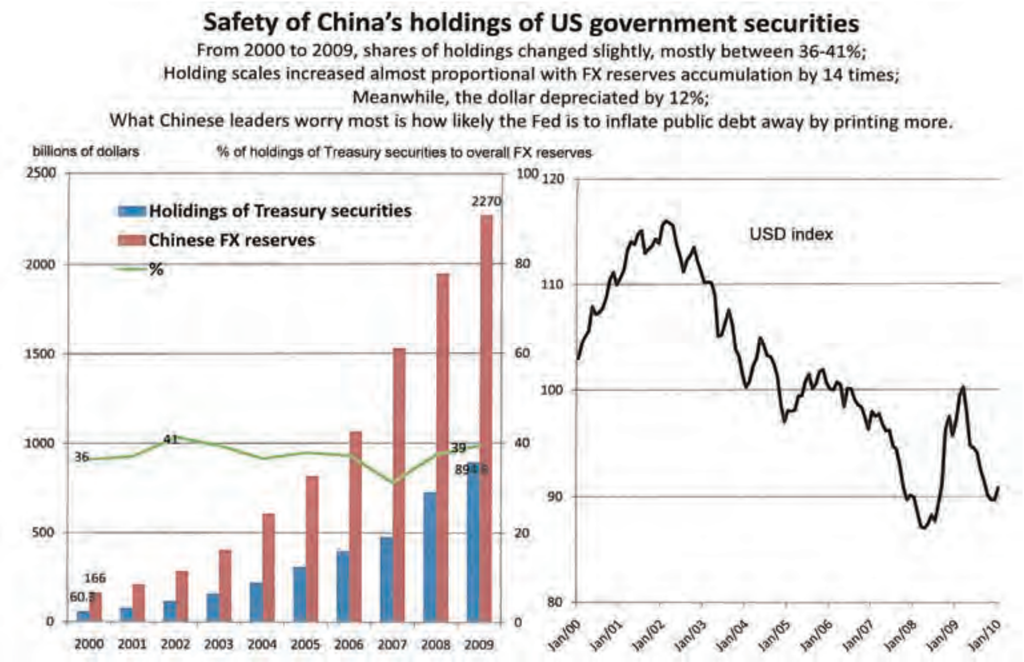
somewhat formalized by rules. It also shows the ambition of the Chinese government to move forward to have the RMB to be of international use. Other important rules include: the RMB deposits in Hong Kong, which was the first time to allow the RMB to be retained outside of Mainland China; the RMB bond issuance in Hong Kong by four state and commercial banks; the RMB government bond issuance under Asian Bond Fund 2 and yuan Panda bonds issued through ADB in 2009. So I agree with Mr. Nakao who argued that the RMB's international use is actually at an earlier stage and not an international currency. Of course the RMB is neither a currency playing the role of store of value, nor an anchor for public purpose.

Now let me turn to the pros and cons. I think it is commonly agreed that there are a number of benefits that China can have from the RMB internationalization. First is to reduce the risk of exchange rate for Chinese firms. Secondly, it helps extend Chinese financial sector. Thirdly, it is a great push for China to establish financial centers because Shanghai is planned to be shaped as the second international financial center after Hong Kong by the year of 2020. Last but not least, it is always a means for the government to gain seigniorage by printing money that is used internationally.

The cost, I think, for China mainly comes from the risk of opening up this capital account. China is not ready to deal with the high volatility of short-term capital flows in a very efficient way. And of course the impact on domestic monetary policy is mixed. Generally, the international use of a currency can bring a quick adjustment of market interest rates to official rates, which actually enhances the effectiveness of monetary policy. But there are some other disturbing elements which we learned from the experience of Germany, back in 1970's and the experience of Japan in the 1990's. One is to result in currency substitutions in the third countries which could have an impact on the central bank's control over monetary aggregates. It can also stimulate arbitrage activities when monetary policy changes, which can offset effects for the monetary policy.

Anyway, if you ask, does China want to have its currency internationalized? I think the answer is yes. And more important, there is new impetus for the RMB's internationalization: that is, as the biggest holder of the U.S. Treasury securities, the safety of Chinese holdings of those securities became a big concern.

The first chart shows the Chinese foreign reserve accumulation and the holdings of Treasury securities from 2000 to 2009. You can see that the shares of holdings changed slightly, mostly between 36 to 41%. And the holding scales increased almost



proportionally with foreign reserve accumulation. The figure in 2009 is 14 times the figure in 2000. So the scale of holding increases mainly because of the increase of absolute overall value rather than the adjustment of the portfolio. Meanwhile as the right chart shows, the USD index depreciated by 12% in the same period. So the capital loss is obvious. And more important, this is not the end of the story. What the Chinese leaders worry about is how likely the Fed is to inflate public debt away by printing more. Meanwhile China is finding way out itself. In doing so, China is trying to stop reserve accumulation with a long-term project of growth pattern shift. To have the RMB used internationally so as to reduce the reliance on the U.S. dollars assets is clearly another option.

Now let me turn to the conditions. There are some general conditions, such as economic size, degree of convertibility, financial strength and degree of financial market development, stability of intrinsic value, and, of course, the flexibility of the exchange rate. There are also some other non-economic factors, such as political and military power. Inertia is very important in regard to status shift of international currencies. I am going to focus on the following specific factors: capital account convertibility, financial market developments and exchange rate flexibility.

Let me discuss the first condition. The table is a summary of the framework of capital controls in China by the end of 2007. I won't go through item by item. Briefly to say, all the items under direct investment are free. The stock market, bonds and other debt securities are mainly subject to institutional investors. And of course,

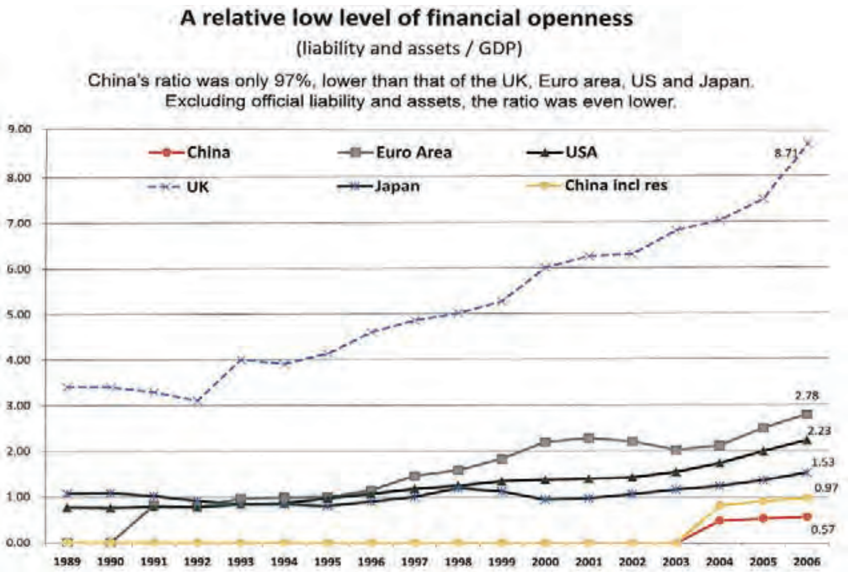
1. Degree of convertibility

Framework of capital controls

Major items		Inflows	Outflows
Direct investment		Free Inward remittance converted into Renminbi	Free Subject to SAFE reviewing sources of foreign exchange assets investments abroad.
Stock market	nonresidents	Purchase B shares and QFIIs subject to a set of limitations	Sale B shares, repatriate of QFIIs
	residents	Sale B, H, N and S shares abroad	QDIIs
Bonds and other debt securities	nonresidents	QFIIs	International development agencies are permitted to issue RMB denominated bonds locally, with the approval of the MOF, the PBoC, and the National Development and Reform Commission.
	residents	Prior approval by State Council for Examination and SAFE. Earnings should be repatriated.	Authorized entities (insurance companies, securities firms and qualified domestic banks) may purchase foreign bonds that meet rating requirement, subject to approval of the CIRC and the SAFE.
Money market	nonresidents	QFIIs	No permission
	residents	Bonds with less than one year duration and commercial instruments, approval by the SAFE.	Authorized entities (insurance companies, securities firms and qualified domestic banks)
Collective investment securities	nonresidents	QFIIs invest in domestic closed-end and open-end funds.	No permission
	residents	Prior approval by State Council for Examination and SAFE. Earnings should be repatriated.	No permission for residents, except authorized entities
Derivatives and other instruments	nonresidents	No permission	No permission
	residents	Operations in such instruments by financial institutions are subject to prior review of qualifications and to limit on open foreign exchange position.	Banking institutions with approval by CBRC for the purpose of risk hedging, not for speculation. Non-financial institutions through approved business of local financial institutions with no prior permission, but through foreign financial institutions with prior approval by the SAFE.

inflows are much more open than outflows. The money market, collective market, derivatives and other instruments are subject to tight control, and are principally closed to non-residents.

As a result, China has a very low level of financial openness, which is measured by international liability and assets to GDP ratio. The chart shows a comparison of China and other countries including the U.K., Euro Area, U.S., and Japan. China was at the bottom of the chart. The ratio was only 97%, while the same figure for Japan was 153%. This includes the official assets. If we exclude the official assets, the number could be much lower. So what I am saying is that the world gave too much focus on official asset holdings by China. In term of private financial flows, China actually is far from a big

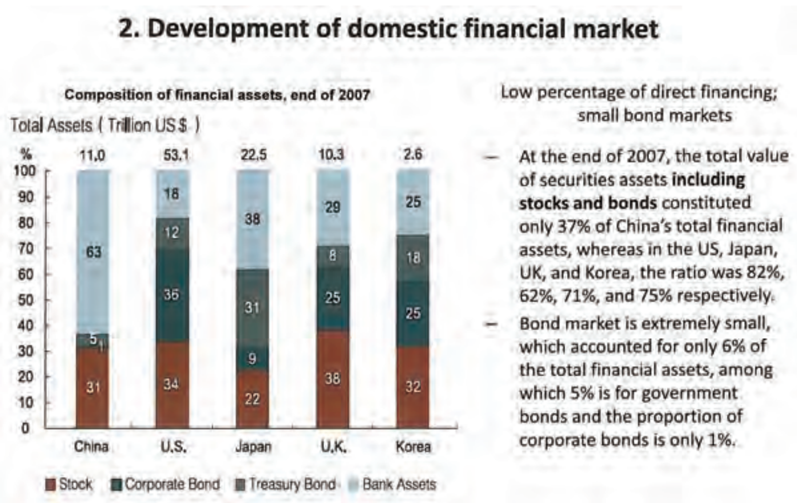


player in the world market.

So back to the issue of currency internationalization, is inconvertibility a barrier? I think this issue is debatable. When it comes to the theoretical discussion, inconvertibility is certainly a barrier because the structure of capital controls to a large degree limits the channels and the size of the RMB to be used. But at the same time, back in history, we saw many exceptions. For instance, both the German and Japanese experience showed that capital controls stimulated offshore market development, which in return broadened the use of the currencies in international market. There are also some other cases indicating that convertibility does not necessarily equal to internationalization. In Asia we have some other fully convertible currencies which are not regarded as international currencies.

What are the implications for China? I think the first is that convertibility can certainly bring convenience, but convertibility does not naturally lead to internationalization. International demand for a currency occurs only when the size and influence of the economy becomes large enough. Second, market force can drive the process of currency internationalization despite certain capital controls being in place. Third, currency internationalization should not be a policy objective for China. At this point I fully agree with Nakao's argument. It's not a policy objective for the Chinese government at all, nor an excuse to accelerate the pace of full convertibility. So personally I think the Chinese government actually likes to see that the currency internationalization and convertibility of its capital account can go hand in hand, and it's a process of interaction. In this regard, China needs to learn from the Japanese experience because in the 1990's the Japanese government pushed very hard on Japanese yen's internationalization and ended up with domestic financial market development from this ambition.

Now, the second condition is the development of domestic financial market. China's financial market is featured by low percentage of direct financing and small bond markets. The chart shows the composition of



financial assets in China and other countries. It clearly shows that China has a very small direct financing market. At the end of 2007, the total value of securities assets including bonds and equity constitutes only 37% of China's total financial assets, whereas in the U.S., Japan, U.K., and Korea, the ratio was 82%, 62%, 71%, and 75% respectively. So China remains at a low level in direct financing market. More important, bond market is always regarded as a very important indicator for the potential of a country's currency to become an international currency. Unfortunately China has an extremely small bond market. You can see this from the chart that only 6% of the total financial assets comes from the bond market, of which 5% is the government bonds. The proportion of corporate bonds is only 1%. This is too small to do anything to have the RMB accepted by the external demanders. The lack of domestic financial market development also limits the use of the RMB in trade settlements.

When we talk about the U.S. dollar as the international currency, we see a strong inertia. One reason for that is, the U.S. has the most liquid, deep and broad financial market of the world. Most specifically, because China has a very small bond market, there is no benchmark interest rate in China equivalent to the Fed funds rate in the U.S., the overnight call rate in Japan, or the refinancing rate in the Euro area. And of course interest rate control is another issue. Because of this the Chinese government cannot fully take the advantage of quick response of exchange rate resulted from the international use of the RMB. So I think before having the RMB used internationally, a more comprehensive financial market, and a more liberalized interest rate mechanism should be in place.

The third condition is flexibility of the RMB exchange rate. Practically speaking, the function of an international currency does not depend on the types of exchange rate regimes. Just look at the U.S. dollar. The dollar experienced different types of exchange rate regimes. Of course a floating rate has a problem of instability. I would argue that flexibility is a condition for a currency's internationalization, because no country wants to anchor its currency to a currency that is pegged to the dollar, like the case in the Chinese currency. I think the main reason for China to have a more flexible exchange rate lies in the impossible triangle problem. That is, the internationalization of a currency needs a free capital flow. A free capital flow needs a flexible exchange rate in order to have an independent monetary policy, which can ensure the credibility of the central bank's policy, hence the credibility of the currency.

So let me conclude with the road map. So far there is no clear agenda for the RMB internationalization. It actually started with the market force. The increasing cross-border use of the RMB in trade and financial transactions plays a critical role in the early stage of the RMB internationalization. Meanwhile, the policy means are also important to give a push, such as, issuing RMB government and corporate bonds, encouraging the use of the RMB as an invoicing currency in China's Free Trade Areas, and encouraging the RMB to be used as a means of payment in bilateral or multilateral swaps between China and other economies.

In the medium and long term, the region-wide use of the RMB shall be the natural outcomes of its covering more areas of China's neighboring countries, which shall naturally lead to the internationalization of the RMB.

One last point. Being accepted by other countries is another key element for China to have its currency internationalized. In doing so, economic importance is of course a key factor. But there are other factors beyond the economic sphere, which are subjects that need a broader view. I shall stop there. Thank you.

7. Need for More Cooperation in Asia.

Eisuke Sakakibara, Professor, Waseda University

Thank you very much, Mr. Chairman. Since I am the last speaker, I have the obligation not to put the audience to sleep. So I will try to be a little bit more provocative, and a little bit more down to earth than the previous speakers.

There have been somewhat heated debates on Chinese foreign exchange policy when Wen Jiabao in his news conference on March 14th openly criticized the United States, saying that their weak dollar policy that was pressuring China to appreciate the RMB amounts to protectionism in disguise. In return, 130 Congressmen in the United States sent a letter to President Obama to label China as a currency manipulator. These severe exchanges between the United States and China these days reflect to a substantial degree, I think, major structural changes that are taking place in the world economy. In my view, there are two major structural changes taking place in the world economy at this moment. One is about the developed countries of the world, namely the United States, Europe, and Japan that have moved from the phase of economic growth to economic maturity. Second, the emerging countries of the world, namely China, India, and Brazil, etc., have come to the central stage of the world economy.

One symptom of this maturity of the developed economy is that the automobile sales in these areas have dramatically declined. In the United States, between 16 to 17 million cars used to be sold annually. It has now come down to close to 10 million. In Japan, new car sales were above 6 million, and it has come to a little bit above 3 million. They have almost halved. Of course this is obviously the result of the recession. But even after the recession is over, I don't think car sales would come back to the previous peak. On the other hand, the sales of automobiles in China are now more than 3 million, and exceeded those of the United States. And this move will probably accelerate in the coming years. So any manufacturing companies, including Toyota and other automobile companies, have to move to the emerging economies to sustain their growth.

This shift of economic gravity to emerging economy could be called the "reorient" phenomenon. About ten years ago, an American historian named Andre Gunder Frank wrote a book entitled Reorient. This has a double meaning: reorientation of the world economy to the Orient. If you look back 4000 years, 5000 years of history, China and India, through most of the period, had been the center of the world economy. It was only during the last 150 to 200 years that the western countries have come to the forefront of the world economy. According to Angus Maddison, even in 1820, that is early 19th century, GDP of China and India combined was 45% of the world. And the population of China and India combined was 55% of the world. So it was only after mid 19th century that Asian countries, particularly China and India had declined. This was because of the colonization by the western imperial powers. India was colonized in the middle of the 19th century. And China was partially colonized during the same period.

This structural change in the emerging countries implies that the U.S. dollar's position as the key currency slowly deteriorates. However, we have to recognize that the U.S. is still the superpower; the U.S. dollar is still the key currency. No currency will replace the U.S. dollar in the foreseeable future. The euro, which is a candidate, is currently very weak, because of the Greek crisis or what can be called the PIIGS problem. Although the immediate crisis seems to be over, the problem will probably persist for some time. Of course I would like to hear Tommaso's view on this later. When the economy was on the rise and Europe was expanding, the euro was in a virtuous cycle. But it seems to me that the euro seems to have entered the phase of vicious cycle. Since monetary policy and foreign exchange policy are not available for individual countries, the only policy instrument that Greece has is fiscal policy. And the only option they have is to tighten fiscal policy. If a country is put in a position of having to tighten fiscal policy in the midst of a recession, this is a disaster. In the midst of the East Asian crisis, when Thailand was in recession, the IMF urged Thailand to tighten their fiscal policy. I think the European Union doesn't have any other choice but to request Greece to tighten their fiscal policy.

As has been mentioned by Prof. Stiglitz and others, the U.S. seems to have shifted from strong dollar policy to weak dollar policy. This, combined with a weak euro, has resulted in the appreciation of the Asian currencies such as Indian Rupees, Thai Bahts, Malaysian Ringgits, and it has resulted in the pressure to appreciate Chinese RMB. Even the yen has appreciated somewhat, because of Japan's closeness to Asia. Against the euro, it has come down from 135 to 42 yen, down to around 110. Against the dollar, the yen used to be above 100, it is now hovering from 85 to 90. In countries like China and other Asian countries, they have intervened in the forex market and accumulated foreign reserves in a very rapid way.

Given the situation like this, what should Asian countries do? What is taking place is the appreciation of the currencies and accumulation of huge amounts of foreign reserves. One sort of strategy that could be thought about is the effective use of foreign reserves. Creation of sovereign wealth fund, like Singapore GIC, Temasek of Singapore, or use of foreign reserves, at least parts of foreign reserves, to invest in various assets. And China has created a sovereign wealth fund as well.

The other would be the pooling of foreign reserves to jointly manage. In 1997 the Japanese government suggested the creation of Asian Monetary Fund. It was thought at that time as a crisis management mechanism. However at this moment pooling of foreign reserves could be considered not as the crisis management mechanism, but as a starting point to coordinate foreign exchange policies and monetary policies in the medium- to long-run. As has been pointed out, there is already an arrangement called Chiang Mai Agreement. It was a bilateral swap agreement, but it is now being extended to a multilateral arrangement. This Chiang Mai Agreement could be extended to ear-marking of foreign reserves and could eventually develop into what we call Asian Monetary Fund in the medium- to long-run.

Another thing is, of course, this is again medium to long term objective, the creation of an Asian currency like the euro. Of course we could not do it immediately, but we could start from the study of Asian currency unit, and eventually form some kind of snake floating within very wide ranges, then narrowing down the snake gradually. You might say that creating an Asian currency unit is a far-fetched idea, and it would never realize. But one thing we need to notice is that what could be called a market driven integration is proceeding very rapidly in East Asia. Intra-regional trade in East Asia in 1990 was only 40%. But intra-regional trade in East Asia right now is 57 to 58%. It has increased dramatically. Probably within a matter of the next 5 years, intra-regional trade within East Asia will reach 60%. And we got to know that intra-regional trade in the EU is 65%. So intra-regional trade of 60% in Ease Asia is really close to the level of the EU. This implies that this area is really quickly integrated, driven by market and driven by corporations.

So I think it is probably the time for the Japanese government, Chinese government, and the other governments of East Asia to start some kind of institutional building à la Europe. Of course Chiang Mai Agreement is one good start for the institution building. But we should really study what Europe has done in the last 50 years, and try to emulate Europe to build the necessary infrastructure in the coming years. East Asian economy is already closely integrated. And it is a horizontal integration. We have created a production network, or what could be called a “supply chain network" across the borders. So East Asia as a whole is a huge factory, particularly in manufacturing. So it may not be entirely a dream to have an Asian Central Bank in 40 years from now. Of course I will not be alive at that time, but it is a nice dream to have when I get older. Thank you very much.

8. Panel Discussion for Part II

Gyohten : Thank you very much. We have just over half an hour left for the session. And I have been wondering what would be the best way to make use of this remaining 30 minutes. My conclusion is that I will again try to pose questions to each panelist so that we can stimulate a discussion, and this round, I'm afraid, needs to be a bit more mundane, because after all the audience in this room are people who are doing business, doing research works. They are probably interested in concrete and practical information. So I'll give each panelist a bit embarrassing questions. I certainly don't want to force them to respond. If they don't want or they cannot respond, just say so. Nobody will be offended.

Now, I will reverse the order and start asking Haihong very embarrassing questions. I am sure you are anticipating this embarrassing question. You said there are lots of talks about the RMB's exchange rate, but it seems to me there is some confusion between appreciation and free floating. I believe what is most needed for the Chinese leadership to think seriously about is the appreciation of the RMB's exchange rate, particularly vis-à-vis the dollar.

To make a long story short, I'll tell you what I expect to happen. The RMB is already under the regime of managed float starting from July 2005. The only thing is that that regime is not working now. What I would anticipate is that China will start activating this managed float regime, and probably let the exchange rate appreciate to the upper limit of the range, and then starting from that level, you can apply the same kind of managed float range by 2% or 3%, or whatever. And repeating this practice as a sort of repetition of crawling peg system, China can achieve a considerable real appreciation of the currency in several-month time. I think this process will start at the latest at the end of this year. But if you think that I am totally wrong, you just say so.

And also, people are very much interested in the real situation of the Chinese economy because it is so important now. You can easily imagine two concerns: one is bubble, another is inflation. So I would appreciate very much if you can share with us your view on whether there is a real bubble appearing in Chinese asset market, housing market and other real estate market. And the recent trend in inflation is a bit worrisome, too. The Japanese scholar Takatoshi Itoh contributed an article on this morning's Financial Times arguing that the inflationary situation in China is something of a worry. These are my questions to you.

Now, my question to Prof. Sakakibara. I am very much encouraged to hear that you are very positive about future regional arrangement of currencies for Asia. Again I have to embarrass you by saying that we often hear that you are very influential adviser to the DPJ government on economic policies. One thing I am a bit worried about is that there seems to be no clear economic policy framework of the government now, particularly on external economic policies. So what is the present government's policy on international finance or exchange rate, or whatever? Knowing that it will embarrass you very much, I'd appreciate it if you can give some thought on it.

Now, Nakao-san again, I have to ask you as the only policy maker on the panel. What is the Japanese government policy, particularly on the dollar exchange rate? It is reported that some minister said a stronger yen is better, but others said that a weaker yen is better. We don't know. You are surrounded with a very tight limitation, but I would appreciate if you can tell us anything about the policy on the dollar and exchange rate, particularly on what you are going to do if the collapse of the dollar happens And also, do you have any thought you can share with us about the utilization of Japanese foreign exchange reserves, which is the second largest only after China? It's almost 1 trillion dollars, of which almost 800 billion dollars is in the U.S. Treasury bonds. That's my question to you.

Tommaso, about the euro. My question is, "this Greek episode, was it in the framework of your anticipation?" If so or not, what reforms do you think the euro system needs now to prevent the recurrence of this situation, or to improve the current situation? And do you think there is any danger of contagion? That's my question.

Joseph, you have responded to many questions, but again I am sure our audience is very much interested to know your view. What do you think of the recovery of the American economy in the coming months? And what is your prospect of the fiscal deficit, and again what do you think the U.S. authority will do if there is a chance of collapse of the dollar in the market?

These are the questions I would like to pose to the panelists. So may I ask you first, Ms. Gao, whatever response you may have to my question? Haihong.

Gao : Thank you for the question. It is not embarrassing but it is difficult. And actually I am very happy to hear that you are confused between appreciation and free float of exchange rate, because many people are confused with the two concepts without knowing that they are confused. Of course the appreciation is related to the level of exchange rate which is very difficult to say what the correct level is. So that's why we see the debate between economists and government officials in the U.S. and in China.

So actually I think, if you ask the Chinese government to make a move toward free floating, they would be very happy to accept the proposal because this is a long term benefit for both China and the rest of the world. And I think it is very likely to happen. Some people make bet on whether China can have one-off appreciation or just follow the gradual pattern to broaden the band or to give more room to the exchange rate to fluctuate. I'm not sure whether I am right, but my guess is that one-off appreciation is very unlikely to happen in the first half of the year, and even the second half it is hardly to happen. My guess is that China will follow the gradual way to have the currency appreciate. And this is actually the thought of the market force. Otherwise China will continue to suffer the so-called misalignment between the nominal rate and the equilibrium rate. And personally I believe that the Chinese currency is somewhat undervalued, and with regard to what degree, there are many calculations, and actually I don't know which one I can follow, but I can sense that it is in the interest of China to have its currency appreciate. But to which margin, it is completely up to the Chinese government because there are some other priorities for the policy makers to concern, like the employment in China which is getting worse, and also the social stability. There are more domestic concerns. The exchange rate issue is actually not a pure economic issue at all. And especially in the current days debate on that issue tends to be more political, and I sense that the Chinese government won't make any move under the pressure, and when the market calms down there could possibly be a move. And of course I am an advocate of floating, and it's a long term objective of the Chinese government because China is a big country, and as I said, if China wants its currency to be internationalized, China has to have capital flow move more freely, and if China wants to have an independent monetary policy, China has to let the exchange rate float. This is my answer to your first question.

And the second one regarding the bubble and inflation. Yes, it is true, especially in the second half of last year and the first month of this year we saw the price spike in the stock market, and the Central Bank just expanded credit, and all the credit actually added into equity market. As a result the stock market moved far ahead of the real economy, and this is a big problem because the economy is still weak. Inflation is of course another concern. The February CPI figure was 2.7% which is much higher than expected. I think those elements could be a reason for the Chinese government to think about to have the RMB appreciate a little bit because appreciation helps cool down the economy domestically.

Gyohten : Thank you very much. Sakakibara-san, can I hear anything from you?

Sakakibara : OK, sure. Before answering your question on DPJ, let me touch briefly on Chinese RMB problem. The crawling up type of mechanism that you have described is really a realistic one, I think. But whether the Chinese authority would adopt that kind of policy or not is quite uncertain. One thing which we recognize is that, as Ms. Gao has said that as well, China wouldn't do anything under pressure. And the American government should understand the difference between Japan and China. China is an independent country. And when they are pressured, they wouldn't do anything. So it is quite contrary to the Japanese reaction. This is extremely important. They've got to stop pressing China, but if they adopt the right policy, I think China's RMB will appreciate quite dramatically during the course of next 10 to 15 years. What happened to the yen in the 1980's and 1990's would probably happen to the Chinese RMB. Given the rate of expansion of the Chinese economy, it is natural. It is only the question of time and the question of the strategy.

With regard to the DPJ government, they invite me to fund-raising dinners quite often, but they never ask my advice on their policies. I think they are not in the mood to ask the advice of anybody. They haven't really established close relationship either with intellectuals or corporate managers and they are now groping within themselves what to do. They haven't even consulted with competent bureaucrats like Mr. Nakao, since they have been saying that bureaucrats should never lead the policies. So all those amateurs or novices, those young DPJ politicians are now groping to come up with the right policy.

But having said that, I have to say that this government is going to continue for another 5 years, and possibly for another 10 years. Because LDP is now collapsing, and there will be more people getting out of LDP, and creating a third party. But the third party would never get the power. So we got to understand that this DPJ government is going to continue. So some kind of major modification of the course that they are treading at this moment is necessary. I think it will eventually come. The Prime Minister may change or may not change. But this is the first genuine change of the government after the World War II. There was a brief change in 1993, but this is the first genuine change which cannot be reversed that easily so that since I am quite close to DPJ, I ask the audience to be patient. Thank you very much.

Gyohten : Thank you very much. OK, Nakao-san.

Nakao: Yes, I'm becoming even more scared after I heard Mr. Sakakibara's remarks. And my previous boss Mr. Gyohten raised two questions of which one is difficult to answer, and the other is impossible to answer (laughter). The difficult question is how to reform our foreign reserve management. I am in charge of 1 trillion-dollar management of the foreign reserve, and Minister Kan already expressed that this government would review the special accounts of the budget because there might be some saving by reforming the special accounts, including the foreign exchange special account. Maybe there are many ways to look at this. The size of the reserves is big and the exposure to the dollar is large. One idea aired from time to time is to use this money for sovereign wealth fund type of things, but my feeling is that I don't think the taxpayers want to leave this big money to the bureaucrats or any fund managers, because this money is not the real surplus. It is financed by the financial bond, which is short term government bond, and invested in very safe foreign assets. So I don't think ordinary people want us to manage such a big fund in a very innovative way. That is my sense.

The impossible question is about the dollar/yen exchange rate. I just repeat the G-7 statement of the last autumn which is "excessive and disorderly movement in exchange rate has adverse implication for economic and financial stability." I expected that kind of question. That's why I have brought this statement with me today. Thank you.

Gyohten : Thank you. Tommaso?

Padoa-Schioppa : You mentioned Greece and you started by asking whether this shock was in my anticipation. No, it was not in my anticipation that there would be precisely this type of drama. But the fact that the fiscal discipline of the Stability and Growth Pact could at some point be put to test, and a test that comes from the market, this is not completely surprising. There has been an accumulation of factors: one is that there were huge alterations or errors in the statistics, which delayed the understanding of the real situation, another was the propensity of markets to panic generated by the crisis. What is now put to test is the union of the European Union. Stretching the analogy somewhat, we could say that you Americans had a test of your union 70 years after the Constitution, we Europeans are having it now, 60 years after the first European Treaty. In one way or another, young unions are subject to such test. And the test is political, not technical, nor financial. It is a test of the extent to which the union prevails over centrifugal forces. I deliberately referred to the historical experience of the United States in a completely different field. There, too, an original compromise was ambiguous and that it took generations to clarify what it really meant.

Returning to Greece, what needs to be understood is that two types of contagion have to be avoided. One is contagion in case of *default*, and the other contagion in case of a *bailout*. The whole problem is to see what are the possibilities and conditions to avoid both and how to take a third way. It's not obvious which of the two contagion chains would be more costly for countries other than Greece. In spite of all the rhetoric pretending that Greece ought to be punished by letting it default, it should be clear that a default would be the case in which Greece would pay the least and the loss would be borne by those who hold its debt, which are largely outside Greece.

If you ask what my prediction is, I would say that there will be a package of adjustment measures which will go to the limit of what is both politically possible and economically useful, and that this package will be backed by the Union in a way still to be found: this is the third way I was referring to. What we see happening is that the cliché of saying 'It's their fault and nobody should help the Greeks' is quickly understood to be false. What is at stake is, for Germany, the stability of its own currency. It's not an external problem. It is an internal problem. If you read the language of the German Chancellor and of the other European heads of government, you see that this awareness is there. Of course, each has to deal with its own public opinion, which needs to be persuaded in Greece, in Germany, in France and elsewhere. Politically it is a difficult operation, but my sense is that the Union will emerge stronger from this test.

Gyohten : Thank you very much. Joe? By the way I forgot to ask you about your view on the end result of the regulatory reform exercise now being practiced in the States, particularly what will happen to the so-called Volcker rule. Thank you.

Stiglitz : OK, you gave me a large task to be accomplished in two minutes, but I think I'll run over my time. On the first, the recovery of the American economy is likely to be markedly slower, sometime towards the end of 2010, beginning of 2011. Just to give you a picture of where things are, the number of foreclosures is expected to be higher in 2010 than 2009, something like two and a half to three and a half million. The number of bank failures is supposed to be higher in 2010 than in 2009, a year in which 140 banks went belly up. The commercial real estate problems are just beginning to come to the fore. About half a trillion dollars of mortgages have to be rolled over each year for the next 3 to 5 years; a quarter of all the residential real estate mortgages are under water. In commercial real estate the market has more complexity because of the way it was securitized, so the ability to roll it over smoothly is very much in question. The state governments have a shortfall of more than $200 billion a year, and it's growing larger. They have a balanced budget framework, and they can't print money. So they are cutting back, and that's a negative stimulus of a very large magnitude. I think it's clear to most economists that there is a need for a second round of stimulus in the United States, but having the political ability to get that is very low.

That's not to mention the difficulties in the labor market. As I mentioned before, while there is about 10% unemployment, the really relevant statistics include the numbers of discouraged workers and workers who are working part time. More than one out of six American workers who want a full-time job can't get one. 40% of the unemployed are now long-term unemployed. There are very negative interactions between the labor market and the housing market. America used to have the most dynamic labor market, but that entailed people moving; now, it's going to be very difficult for them to move because they can't sell their home to move to buy another home, because those who own homes that are "underwater" can't get back any equity when they sell their home. There are also complex interactions in migration patterns; when people retire, they frequently move, quite often to the South— it's been part of the dynamics of the country. But now, they can't move because they can't sell their home for any value in excess of what they owe, and that means that the problems in the Sunbelt States are going to be protracted. There is a broad consensus that *even in* the optimistic view the labor market won't return to normal before the middle of the decade. To put it another way, right now the job deficit, the shortfall in the labor market between the jobs that should have been created and the jobs that were lost in the last 2 years or so is more than 10 million. All this gives a troubling picture, and that's not to speak of the problems in the financial sector

Some Americans thought that when Europe mismanaged its crisis in Greece, it was good for America because it made the U.S. look *relatively* good. But the predictable result was that the euro lost value, and that meant the dollar was stronger. So from our narrow point of view, saving Greece was a good thing.

Let me talk about the U.S. deficit, which is of growing concern. It's quite remarkable how the financial markets often are so short-sighted. It was perfectly clear we were going to have this blowing up of the deficit. It was clear in the way we were bailing out the banks, it was clear in the way that we were handing the recovery, but it took about a year before the financial markets grasped what was going on. The joke in the United States was that the deficit hawks in the financial sector in the United States went on vacation roughly beginning in September 2008 while they were asking for the bailouts. When they got all the money that they could get from the bailouts, they came back from their vacation, and started talking about the deficit again. That was about March, and now they are talking about the deficit all the time. I am very critical of this deficit fetishism. It was short-sighted policies that got us into the mess. We should be focusing on the long run. We should have learned the lesson from the IMF in Thailand and Indonesia. If you have deficit-reduction prematurely, the economy is going to shrink, and the deficit may actually get larger. But if you spend the money on investments, you can grow the economy in the short run and in the long run, and the deficit will get lower. All it takes is about 5 to 6% return on the public investments to get a lower long-term debt in response to deficit spending today. Concern about the deficit means that we have to be careful about our spending. Right now, we're spending hundreds of billions of dollars a year in weapons that don't work against enemies that don't exist. It's a good thing that the enemies don't exist, but it's still a waste of money. My own view is that the war in Afghanistan is a waste of money. There are lots of ways the bank bailout was not well done. There are lots of ways we could spend more efficiently and get higher long-term returns. Worries about the deficit should not lead us to cut back on spending, but to increase the quality of spending, to increase the return on spending.

The third question was what will happen if there is a collapse of the dollar. The answer is nothing. There will be lots of speeches. The Secretary of Treasury will say that we believe in a strong dollar, and we are doing everything to make sure that we have a strong future. But I recall very vividly when the dollar started plummeting against the yen, I think it was around April of '95, I was the Chairman of the Council of Economic Advisors. I had to get up early every morning to find out how much more the dollar had gone down. Then I would report it to the President's senior team. We had a very tense meeting every morning with the whole economics team, including the Secretary of Treasury and the Chief of Staff and everyone would say "this is terrible". And the next morning it would happen again. But nothing *real* happened—except that American exporters were delighted. So I think that's what will happen again if the dollar were to start to fall.

I think there is some chance of that kind of calamity. People forget that these things do happen. There was a collapse of the dollar in the early 70's when we went off the Bretton Woods system. One should be aware that it could happen again. But the way I like to think about exchange rates is like this: Keynes talked about the stock market being like a beauty contest. I think of the exchange rates as a negative beauty contest of "who is the ugliest in the world?" The U.S. and Europe have been competing very strongly. For a while we were the clear winner, and then it looked a couple of weeks ago that Europe was pulling ahead. Now, however, it looks like we will surpass Europe. Thus, I have a little bit of confidence that we will continue to get weaker—not steadily but in a process with many ups and downs. There is somewhat of an equilibrating mechanism, but the process of equilibration is far from perfect. When the dollar gets cheap enough, enough Europeans will come and buy Florida up, and start spending money to buy our assets. That helps to stabilize exchange rates.

The final thing I want to talk about is regulatory reform. It's been a very difficult and long process. It's been more than a year since the collapse of Lehman Brothers. It's been actually more than 2 years since the bubble broke. And it was really the breaking of the bubble that made it very clear that we were in for trouble. It was possible to see one thing coming after another. Among the first international "incidents" was the turmoil in the markets in August of 2007 and then a little bit later Bear Stearns collapsed, and a little bit later Lehman Brothers went bankrupt. These all can be viewed as the consequences of the breaking of the bubble. But so far, there's been almost no change in regulation, no changes significant enough to prevent another bubble and its aftermath. There has, in fact, been very strong resistance to some of the key reforms. It looks like now there is at least a 50-50 chance that there will be significant regulatory reform in the United States. But it may be missing some of the pieces that Europe thinks are important, missing some of the pieces that most economists in America think are important. Let me just mention a couple of things that probably will not be done adequately. Mervyn King, who is the governor of the Bank of England, has said something to the effect of "if you are too big to fail, you are too big to exist." We ought to break up some of the big banks, tax them, and restrict them. That is what Paul Volcker has advocated, but it is very likely that this will not happen. There will likely be more intense supervision, but it will be supervision by the Fed, which did not do a great job before the crisis. So there is not going to be a lot of confidence on that.

The second big issue where there will likely not be enough done is that of the over-the-counter, non-transparent credit default swaps and other derivatives. The official position is they want to encourage them to trade on exchanges, but there is no evidence that the exchanges will be adequately capitalized, and the encouragement is not enough. A couple of the banks have huge profits from over-the-counter credit default swaps. They issue them, but they are effectively underwritten by the U.S. government, since it insures the banks because they are too big to fail. The banks that are issuing them are almost all too big to fail, and it unlikely that anything adequate will be done about this. Remember, the total amount that the government eventually had to extend to AIG, one company, was an amazing $182 billion. That is a large amount of money. The equivalent of all the foreign aid that goes to all of the developing countries from all of the developed countries over a period of two years went to one company. Or, it's the amount of money that goes to Africa from the United States in a quarter of a century. And that went to *one* company. For a while, we didn't even know where all of that money eventually went. They tried to keep it a secret. Then we discovered that the largest recipient was Goldman Sachs, and now we know why they wanted to keep it a secret. That's the second very big issue where there won't probably be anything done, or where what will be done will be far from adequate.

The third big issue, one that Volcker has emphasized, is the propriety trading of depository institutions. This gives rise to conflicts of interest; worse still, basically the government is providing insurance for speculation. Moreover, there is a lot of concern is that financial institutions should be encouraged to go back to doing what they are supposed to be doing, which is *lending*. But that's not where their profits have been. All their profits have been from trading (speculation). The fact credit has been constrained is one of the factors that is leading to a weak economy. But this is a third area where I think it is very likely that nothing or very little is going to be done.

Right now it looks like *something* more will happen—and some form of regulation looks more likely than it did, say, a few months ago. At the same time, it looks very *unlikely* that Congress will do many of the things that Paul Volcker has been advocating. When Paul Volcker is viewed as a radical, then you know something has happened to American politics.

Gyohten: Thank you very much, Joe. I know some moderators try to summarize the discussions we had, but I will not do that, because I believe the responsibility to sum up what you have learned is not my responsibility, but it's yours. So, having said that, I thank you very much for your participation, particularly my great thanks to all panelists for their great contribution. So join me in applauding the panelists. Thank you very much. The meeting is adjourned.

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