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Statement by Fukushiro Nukaga
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On behalf of Japan

Statement by the Hon. Fukushiro Nukaga
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I. Changing Environment Surrounding the IMF and its Implications

In the past few years, the world economy has enjoyed a so-called era of "Great Moderation," where business cycles appear to have all but disappeared. This phenomenon has been accompanied by a looser market discipline, such as excessive risk-taking lured by abundant liquidity. Governments did not, or could not, take effective counter-measures to address this problem. Indeed, only now have we begun to discuss what can be done to minimize the damage already inflicted, and how to improve the future situation.

If we are to enhance an ex ante response to the budding problem, it should be the IMF that stands in the forefront, sounding the alarm, and leading global discussions. In this sense, the IMF could have played a more active role in the run-up to this summer's market turbulence. It is true that the main function of the IMF lies in its expertise in macroeconomic policies, but the IMF has also strengthened its capacity to deal with issues related to financial markets and financial oversight. Thus, I look forward to a more pro-active response from the IMF in future occasions.

To be fair, prior to the recent market turbulence, the IMF did make some efforts: the Fund pointed out potential risks and rung the alarm in various reports issued before the summer. However, these reports did not attract much attention in the capitals or in the markets. In reality, nowadays the IMF does not command the same authoritative position that it used to enjoy. Things were different in the past. Close attention was always paid to the analyses or recommendations of the IMF, when balance of payments crises were frequent and the IMF was tasked with ensuring the stability of each economy and of the international financial markets, through its programs with policy conditionality attached. However, now that private capital can easily finance global imbalances, it appears that incentives to revere the IMF's opinion have declined. Considering that the fundamental goals of the IMF are to ensure the sustainable development of the global economy and to stabilize the international monetary system, one can even argue that the absence of a balance of payments crisis indicates that the IMF has accomplished its mission.

II. Where should the IMF go?

Does this, then, mean that the IMF no longer has a *raison d'etre*? I do not subscribe to this point of view.

First and foremost, the IMF should still deal with financial crises. It is too optimistic to think that, from now on, there will be no financial crisis anywhere in the world. The role of the IMF as a central player in an international effort to supply liquidity at times of financial crisis will remain indispensable. It is expected that future crises will be triggered by the movement of private capital as it flows freely across borders. In response, the IMF should establish a new financial crisis-resolution strategy built upon the responses to these capital movements

Second, the IMF should continue its efforts to prevent financial crises. It is regrettable that, despite the long time spent on deliberations, the Executive Board still has not agreed to a detailed design of the new financial crisis-prevention instrument for emerging market economies. The IMF should make further efforts to establish a user-friendly preventive instrument as soon as possible, taking into consideration the views of major emerging market economies.

Effective surveillance is the first step toward preventing a financial crisis. Surveillance practices have been enhanced through recent reforms. However, IMF staff and member countries do not necessarily share a unified view about how to implement the new principles. Such confusion will damage the credibility of the IMF. I strongly call for the prompt adoption of clear and detailed guidelines that all members can agree to.

As for the method of surveillance, the IMF should shift its emphasis from a static analysis of the current situation toward a dynamic analysis of the risk of financial crises over a medium-term horizon. At the same time, the IMF should pay attention, not only to the specific country in question, but also to conditions surrounding the country, and the region, including the confluence of international capital flows and developments in international financial markets.

Third, I would like to stress the importance of thoroughly investigating, from a new angle, issues that the world economy will likely face over the medium- or long-term, and advocating these findings in a most straightforward manner. I would like to list a few examples regarding such issues.

- What makes excess liquidity start to shrink? A trigger may be, for instance, a change in the monetary policy stance in advanced countries, a decrease in the large current account surplus in some countries including oil-exporting countries, or a decline in leverage in the credit markets. And, should international liquidity rapidly shrink, how would this affect emerging market economies?
- As economic growth in emerging market economies raises their per capita income, how would this affect the prices of commodity goods and manufactured exports? Would central banks in the advanced countries have to adjust their monetary policy framework to this new situation?
- How will the rapid ageing of the population, observed in several of the advanced countries, affect their public finance over the long-term? How should these countries

prepare for it?

In my view, the IMF should offer candid policy recommendations on these and other challenges. In doing so, there may be some room for better communications with the press and the markets. Euphoric markets may not listen to a message that they do not want to hear. Still, the IMF must play the role of 'ruthless truth teller' more effectively, building upon improved dialogue with the authorities of its member countries.

It is fortunate that the current turmoil occurred while the fundamentals of the world economy remained stable. According to the World Economic Outlook published recently, the global economy is forecast to expand vigorously in 2007 and 2008, albeit a little lower than the July update thanks to the expected effects of the financial market turbulence. This is partly due to solid economic fundamentals in advanced countries such as the United States, the EU, and Japan; but, more so, to strong domestic demand in emerging market economies. Emerging market economies are expected to continue to support the world economy in the future. Needless to say, there is much uncertainty regarding developments in the financial markets; thus, we need to remain vigilant.

As for the Japanese economy, the new Fukuda cabinet continues to promote both structural reforms and stable economic growth. With both stable economic growth and stringent spending cuts, the integrated fiscal reform, addressing both expenditures and revenue, will be vigorously pursued, aimed at achieving, without fail, a surplus in the primary balance of the central and local governments combined in FY 2011.

Against such a background, I strongly hope that the IMF will adopt a new way of thinking, in order to further solidify the foundation of the world economy, building upon lessons learned from the recent turmoil.

III. Governance Reform and Sustainable Financing of the IMF

It is the exchange of diverse values that will foster a new way of thinking. However, since the Bretton Woods Conference held 60 years ago, the IMF has failed to properly reflect the changes observed in the global economy. To enhance the legitimacy of the IMF, it is necessary that the composition of the Executive Board and the staff, including senior staff, reflect the reality of the global economy of 2007, not that of 1944. The operations of the IMF should be based on a flexible philosophy that represents the broader views of its membership.

The first step is the reform of the voting shares. Japan has insisted, since its affiliation more than 50 years ago, that all members who are under-represented be allowed to eliminate their under-representation so that the voting shares of the IMF properly reflect members' relative positions in the world economy. This is because Japan believes these reforms are indispensable in order to produce international benefits by means of contrasting and amalgamating various values of the time. It is regrettable that, before this Annual Meetings, we could not agree on a concrete package for the second-round quota reform, but it is important to overcome our existing differences to advance the discussions in a constructive manner. Based on last year's Resolution of the Board of Governors, Japan continues to participate pro-actively in the ongoing discussions to complete the quota and voice reform by the Spring Meetings of 2008, and no later than the next Annual Meetings.

I would like to emphasize the following four issues regarding the quota and voice reform.

(1) With respect to a new quota formula, we should agree on a formula, which is transparent, simple, and durable. Such a formula should be linear and include market exchange rate GDP in order to properly capture members' capacity to contribute to the IMF. However, acknowledging that some members argue the PPP-GDP play a role in assessing the positions and responsibilities of member countries in the global economy, we are ready to consider using the PPP-GDP as an additional yardstick, the so-called filter approach.

(2) With regard to the allocation of an ad hoc increase, all under-represented countries should be eligible. Such allocation should aim toward achieving a uniform proportionate reduction in under-represented countries. Although Japan has been one of the most, and longest, under-represented countries, I am prepared to consider accepting a smaller reduction in its degree of under-representation, with a view toward contributing to further progress in the quota reform. More specifically, we can accept an approach that would enable under-represented G7 countries to receive the same proportionate reduction in the gap between their calculated and actual quota shares, as the United States.

(3) Regarding the increase in basic votes, the size needs to be reviewed in order to properly reflect the voice of low income countries in the decision making process of the IMF. Therefore, I can support more than doubling of the basic votes.

(4) It should be noted that the objective of this quota reform is to realign members' quota shares with their relative positions in the world economy. I understand that the whole reform package, including the second round ad hoc quota increase and the increases in basic votes, would result in a shift of voting shares from advanced countries to emerging market economies and developing countries as a whole. Nonetheless, we cannot accept an approach that would measure the appropriateness of this reform package according to the size of the shift in voting shares from one group to another group.

New ways of thinking give rise to the redefinition of core competencies and priorities. The income of the IMF, which relies on interest generated by lending, is decreasing against the background of the stabilization of the global financial markets and the reduction in the number of countries borrowing from the IMF. As a consequence, the IMF has been in the red since FY 2007, and its deficits are forecast to expand rapidly.

In this critical situation, the Fund's measures to increase income are currently being examined, based on the recommendations by the Crockett committee. However, it is obvious that increasing income alone is not at all sufficient to put the IMF's finances in order. Japan strongly requests that the IMF initiate significant spending cuts by shedding non-core operations, organization and staff, based on a re-appraisal of its core competencies and priorities. The IMF must realize that its credibility is at stake if it simply aims at an uncritical, supply-driven maintenance of operations and personnel through increased income without any progress on spending cuts. It is indispensable that reforms on both the income side and the expenditure side be pursued simultaneously.

I am confident that the new Managing Director, Mr. Strauss-Kahn, is as passionate about the IMF reforms as Mr. de Rato. As the world economy undergoes dramatic transformation at a speed much faster than we expected, I strongly hope that, at the earliest opportunity, Mr. Strauss-Kahn will present his views about what the IMF should look like in the new era, after conducting thorough discussions with the Executive Board and staff.