Developments in International Economic Policy Co-operation and Japan's Tasks: An Insider's Views

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1. Introduction

Key words for a number of Japanese arts are simplicity, brevity and compactness. A typical example is "Haiku", composed in seventeen Japanese alphabets. Another is "Bonsai", with trees kept short and small through years of meticulous care for trimming branches and leaves. However, when it comes to the art of speech making in Japan, simplicity, brevity and compactness are not always key words. At seminars and conferences in this country, organizers fairly often ask me to speak for an hour and three-quarters in my initial presentation, leaving only a quarter of an hour for a questions and answers session. In today's seminar, Professor Aoki has asked me to keep my initial remarks to three quarters of an hour, leaving an equivalent length of time for an ensuing general session of questions and answers. There shall also be a separate short session for those of you who might wish to raise particular questions with me individually. Thus, in this seminar conducted in English, we can perhaps say that a "global" rule or standard will be followed rather than a "Japanese" rule or standard.

Given this format for today's seminar, in my initial remarks, I shall quickly review the evolution of international economic policy co-operation /co-ordination involving Japan over the past three decades. In so doing, I shall touch on the following issues:

- What sorts of influences have they had on the management of the Japanese economy?;
- What lessons can be drawn from Japan's past experience with multilateral surveillance?; and,
- What are Japan's tasks ahead?

On those issues I may talk about only very briefly or may not dwell on, you might wish to raise questions in either one of the ensuing two questions and answers sessions. I should then try my best to answer them.

At the outset, perhaps I should also add that economic policy co-operation between industrialised countries and newly industrialising and emerging market economies have gained particular importance over the last decade. And of course, for decades in the post-war period, economic development assistance and other forms of co-operation in the direct interest of developing countries have been an important aspect of international economic policies for industrialised countries – an area of my responsibilities when I was Deputy Secretary-General of the Organisation for Economic Co-operation and Development (OECD) in Paris. But, in my initial remarks today, I shall focus on international co-operation among industrialised countries over the past three decades or so, with some reference to multilateral surveillance at the International Monetary Fund (IMF) and the OECD(1) and to some less institutionalised fora such as the group of major five industrial countries which later turned into the Group of Six, then Seven, and from this year, Eight. I shall neither talk about multilateral development co-operation nor about the implications for Japan's economic policy management of arrangements for regional economic co-operation such as those in force in the European Union and the Euro area as well as the North American Free Trade Agreement (NAFTA) and arrangements related to the Association of Southeast Asian Nations (ASEAN).

2. International macroeconomic policy co-operation in the 1970s and 1980s

In its last stage, the Bretton Woods system of fixed exchange rates had contributed to a divergent pattern of real exchange rates, that is to say nominal exchange rates adjusted for inflation differentials between countries. This had in turn contributed to international payments disequilibria, giving rise to an increased protectionist sentiment in deficit

countries, in particular the United States and a concern about volatile dollar holdings as

well as growing inflation pressures in surplus countries. The floating exchange rate system introduced for major currencies in the spring of 1973 has provided a higher degree of external shock absorption capacity. For example, had the floating rate system been not in place, the economic management of countries highly dependent on imported oil such as Japan would have been disrupted far more than it actually was by the two oil crises of the 1970s. However, floating has not provided a panacea for payments imbalances despite high expectations entertained by strong believers in it. Indeed, it has not liberated domestic economic policy from all external constraints. Flexible rates have sometimes moved in abrupt and erratic manners, difficult to explain in terms of variations in underlying economic conditions, and their misalignments for sustained periods have led to a dislocation of productive resources across countries.

A matter of particular concern in the late 1970s was the re-emergence of persistent current account deficits in the United States and surpluses in Japan and Germany. Their external imbalances were subjected to multilateral surveillance by the IMF Executive Board and the Interim Committee meetings, at the OECD Economic Policy Committee, Working Party No. 3 and the Ministerial meetings and at regular meetings of central bankers at the Bank for International Settlements (BIS). The nature of these meetings differs, particularly as regards the representatives of national authorities who attend. IMF Executive Board meetings on the economic reviews of (now 133) member countries, for example, are attended by Executive Directors, who are resident in Washington. By contrast, OECD Economic Policy Committee's biannual meetings are attended by very senior government and central bank officials directly involved in policy making in national capitals of all member countries. The Working Party No.3, which met four to five times a year during my services at the OECD and now meets three times a year, is attended typically by very high-level Treasury and Central Bank officials in a smaller group of countries. BIS meetings are attended by central bank governors to review economic and monetary policy developments. Payments imbalances are also a recurrent subject of discussion at the OECD Economic Development and Review Committee which examines the economic situation and policy issues of (now 30) member countries individually and those of the Euro area

separately and publishes its reports on them piece by piece. The meetings are attended by high-level officials from the country under discussion and by resident representatives of other Member countries.

In the latter half of the 1970s, a framework for demand management polices for correction of payments imbalances was provided by both IMF and OECD staff economists in the form of medium-term scenario exercises. The analytical underpinnings were offered basically through the measurement of existing output gaps and potential output growth rates in surplus and deficit countries. Japan and Germany as current account surplus countries were asked to reduce output gaps gradually by achieving higher growth above potential output growth rates over the medium term and to contribute to the growth of the world economy as "locomotives". The United States and other deficit countries were asked to adopt restrictive demand management policies with a view to moderating economic expansion, taking into account estimated lower potential growth rates, and thereby control inflation. The international deal at the highest political level along these lines was made at the 1978 Group of Seven (G-7) Bonn Summit where fiscal expansion by Japan and Germany was exchanged for a commitment by the United States to reduce its inflation and move its domestic oil prices to world levels. This deal turned out to be a failure, adding further stimuli to world demand at a time when sufficient growth momentum was already in the pipeline, giving rise to inflation pressure and providing background to the outbreak of the second oil crisis in 1979.

I might add that, in contrast to the importance attached to demand management policies, structural reform was not high on the international policy agenda during the 1970s. It is true that, for example, at the IMF annual meeting in Belgrade in October 1979 which I attended as adviser to Teiichiro Morinaga, then governor of the Bank of Japan, Jacques de Larosière, then managing director of the IMF argued that structural reform had been neglected and industrial economies had become less flexible behind the illusory defence of protective devices and complex regulations. But the special areas for constructive action he laid emphasis on were limited to energy policy and the freedom of international trade only(2). I shall later come back to the issue of international co-operation/co-ordination in a wider range of structural policies.

Turning back to the issue of international macro-economic policy co-operation, a particularly difficult problem in this area emerged in the first half of the 1980s. In the United States, a major reorientation of fiscal policy by the Reagan administration resulted in large budget deficits. This, coupled with restrictive monetary policy followed by the Federal Reserve to control inflation, brought about high interest rates and an appreciation of the dollar in early 1980s. These developments in the United States, together with fiscal prudence in Japan and Germany, changed international savings and investment balances. A growing current account deficit of the United States was matched by persistent significant surpluses of Japan and Germany, and the correction of external imbalances came to the forefront of international economic policy agenda. It was pretty obvious what the United States should do at that time. The international consensus was that the United States should reduce fiscal deficits, which would moderate pressure on domestic interest rates; an induced weakening of the dollar exchange rate, together with a shift in domestic savings and investment balances resulting from fiscal consolidation, would reduce its external deficits.

On the other hand, it was less clear what Japan and Germany should do. Views were divided within the OECD. One view was that the two countries should expand fiscal policy and tighten monetary policy -- the so-called "reverse fiscal/monetary policy mix". The other view, put forward by myself, was that they should not do so, given prospective global savings shortages. I argued that their external surpluses, the counterpart of their excess domestic savings, should be considered in the global context where the OECD area as a whole should run current account surpluses matched by sustainable capital outflows coupled with technological transfer to the non-OECD area. Rather, I maintained that Japan and Germany should concentrate their efforts on structural reforms to strengthen domestic growth potential and, in the case of Japan, also to accelerate domestic market opening. As it happened, the OECD could not speak about this issue with one voice at that time.

In this context, it might be interesting to note that Baron Howe of Aberavon, then Sir Geoffrey, expressed a particularly strong view about the orientation of Japanese fiscal/monetary policy mix at the OECD Ministerial meeting in the spring of 1982 and

at the following Helsinki meeting of the Group of Ten finance ministers and central bank governors where I represented the OECD on behalf of the Secretary General. It appeared to me that his unusually forceful argument for fiscal expansion in Japan was at odds with what he was then doing in the United Kingdom as Chancellor of the Exchequer in the Thatcher government. Donald Regan, then US Treasury Secretary under the presidency of Ronald Reagan, held the same view about Japanese fiscal policy. Indeed, a number of participants in multilateral surveillance from external deficit countries continued to consider fiscal expansion in surplus countries as a highly useful policy prescription for global demand management, despite the growing recognition of the importance of monetarism and reduced emphasis on fiscal policy as an instrument for domestic economic management.

The dollar started to weaken somewhat from early 1985, but remained well above a level justifiable by fundamentals. Correction of this abnormal currency situation was the purpose of the meeting of G-5 finance ministers and central bank governors at Hotel Plaza in New York in September 1985. It was agreed that in addition to concerted action in the foreign exchange markets to weaken the dollar, the United States would strengthen its efforts to reduce fiscal deficits and Japan and Germany would make efforts to expand domestic demand which would help to reduce their external surpluses.

By early 1987, a sharp reversal of the trilateral currency relationship had gone beyond what seemed justified by fundamentals, and the Louvre accord was reached among G-6 finance ministers and central bank governors to terminate the dollar's fall. At that time, Japan pledged to continue to follow expansionary domestic demand management policies. To meet this international requirement, monetary policy was used extensively.

Japan's subsequent growth performance was spectacular. Expansion of total domestic demand accelerated to 5.3 per cent in 1987 and 7.3 per cent in 1988 and maintained a high pace of above 5 per cent in both 1989 and 1990. As a result, its current account surplus as a percentage of GDP declined from a peak of 4.2 per cent in 1986 to 1.5 per cent in 1990. Another striking feature of this high growth period was the combination of enormous increases in land and equity prices with general price stability.

The sustainability of this situation was a subject of discussion at a series of meetings of the OECD Working Party No. 3 in the late 1980s. Having returned to the OECD as Director of Policy Studies Branch in the Economics Department in September 1987, I argued that a reversal of a very easy stance of Japanese monetary policy with a view to moderating asset price inflation would minimize the risk of a sharp downturn of asset prices and business investment in the future and help to maintain the economy on a sustainable path. Another member of the Working Party who took the same view was William White, then deputy governor of the Bank of Canada, now Economic Adviser of the Bank for International Settlements.

Having said this, I must hasten to add that during the late 1980s, the causes of the very high domestic asset prices and, associated with them, the relatively low cost of capital in Japan, were a subject of a number of studies by both academic and non-academic experts in Japan and abroad. Unfortunately, the results of such studies remained inconclusive. However, it appeared to me that despite the inherent ambiguity in various market signals, information then available on the whole suggested that Japanese monetary policy should have been tightened earlier in the second half of the 1980s.

I should also add that, in their 1997 paper(3), Yoshikawa and Ohara argue that, given the overall price situation, the Bank of Japan could not have tightened monetary policy for the sake of pursuing the ultimate objective of price stability; it could have embarked on earlier monetary tightening only for the sake of using monetary policy as an instrument of smoothing fluctuations in economic activity. I agree with them on this observation. Overall, a lesson from Japan's episode in the second half of the 1980s is that there is a limit to the effectiveness of multilateral surveillance particularly when the writing was not on the wall.

3. International macroeconomic policy co-operation since early 1990s

A natural question concerning the 1990s experience of multilateral surveillance is: What role did multilateral surveillance have in encouraging monetary policy easing and fiscal expansion earlier and more aggressively than they actually took place in Japan? A related question is: When was the writing about the seriousness of subsequent deflation

actually hanged on the wall so that peer pressure for more active demand management policies in Japan could have been exerted more effectively?

Indeed, it is not fair to criticize the Japanese authorities' actual conduct of monetary and fiscal policies solely with the benefits of hindsight. The usefulness of multilateral surveillance for exerting effective peer pressure on the authorities of a potential problem country to take appropriate precautionary actions to prevent undesirable scenarios from happening actually or getting worse, depends importantly on the capacity of participants in this process to precisely assess the actual economic and financial situation in the country in question and to make reasonably accurate economic forecasting and evaluation of the pros and cons of various policy options for the authorities of that country. Without such capacity and credibility, peer pressure cannot influence policy making in surplus countries, while countries in a payments crisis and in need of external financial assistance can be subjected more effectively to such pressure from creditor countries as well as from international financial institutions. .

As already mentioned in my paper(4) presented to a central bankers' panel on the occasion of the 1997 annual conference of the International Economic Association, I started to argue for monetary easing in Japan right after the end of the Gulf war in early 1991. The Bank of Japan took the first measure of monetary ease in the summer of that year. From autumn 1991, I began to argue that the Japanese government should prepare selective programmes for increasing public works with careful evaluation of economic and social returns to such investment. My prediction was that the Japanese economy would undergo not only a phase of inventory adjustment but also a protracted period of downturn in private business fixed investment and residential construction. With output gaps expected to widen for an extended period, it would be time for improving social infrastructure needed for the rapidly ageing Japanese population.

In a paper published in June this year(5), US Federal Reserve staff economists noted that Japan's sustained deflationary slump had been unanticipated not only by Japanese policy makers but also by Japanese private-sector and foreign observers including the IMF and Federal Reserve staff economists. They did not mention the forecasting records of OECD economists, but I must admit that they also tended to underestimate the severity and persistence of deflationary pressure in Japan. My own forecasts as OECD

Chief Economist were almost always more pessimistic than those of my colleagues in the Economics Department. Even so, actual outcomes generally proved to be worse than I had personally predicted.

A particular subject of debate at the OECD Working Party No. 3 meetings for most of the 1990s was the roles of macroeconomic policies in reviving the Japanese economy, as Germany slipped into a current account deficit country with domestic demand booming in the wake of unification in July 1990. For the first several years of the 1990s, the Working Party was chaired by Hans Tietmeyer, then Vice-President of the German Bundesbank, and subsequently by Larry Summers, first as US Treasury Under-Secretary and later as Deputy Secretary. The so-called "Japan problem" got more complicated, as the zero lower bound on nominal interest rates and deflation started to put upward pressure on real interest rates with a consequence of further restraining economic activity.

In theory, countries that are experiencing balance-sheet problems and weak domestic economic activity and that have little scope for the use of conventional monetary and fiscal policy measures can rely on currency depreciation and associated export growth for economic recovery, which in turn alleviate balance sheet problems. Indeed, in a number of OECD countries which suffered from the burst of bubbles in the late 1980s or early 1990s, the recovery of output activity was generally triggered by a sharp upturn in exports as a result of large currency depreciations associated with a loss of market confidence in their economies. In contrast, the Japanese yen followed an uptrend even after the burst of the bubble in early 1990s and Japanese export volumes continued to decline relative to the growth of Japan's export markets. Thus, Japan's share in world exports, which had fallen from a peak of 10.5 per cent in 1986 to 9.3 per cent in 1991, declined further to 7.9 percent in 1996 and 6.8 per cent in 2001.

An important indicator of international price competitiveness is the real effective exchange rate. This is measured as a composite of bilateral nominal exchange rates weighted on the basis of a country's trade pattern and adjusted for international inflation differentials. Despite large variations in bilateral exchange rates between the US dollar on the one hand and the Japanese yen and the German mark on the other, the dollar' s

effective exchange rate remained fairly stable throughout the 1990s, as many Latin American and emerging East Asian economies either pegged their currencies to the dollar or managed their dollar exchange rates to keep them in a narrow band. The German mark's effective exchange rate variations have also been limited by the existence of the European Exchange Rate Mechanism (ERM) and more recently by the introduction of the euro. In contrast, developments in the yen's effective exchange rate have closely reflected the dollar-yen bilateral rate that has remained misaligned relative to fundamentals such as inflation differentials between Japan and the United States. For example the yen's sharp appreciation against the dollar in 1994 and 1995 appears to have reflected speculative yen purchases triggered by difficult bilateral trade negotiations between the two countries.

The misalignments of the yen effective exchange rate had not only domestic but also international ramifications. The yen rate reaching a record high of less than 80 yen per dollar in 1995 triggered massive direct investment flows to emerging Asian economies. I must add that Japanese manufacturing firms' shift of their production bases were not only encouraged by relatively low labour and non-1abour costs there but also facilitated by the improved quality of labour forces in those economies. As they followed a policy of maintaining stability in the bilateral exchange rates of their currencies against the US dollar, the subsequent correction, though partial, of the overvalued yen rate against the dollar tended to weaken their international price competitiveness. This was one of the causes of the East Asian crisis in 1997. In the mid-1990s, I as OECD Chief Economist advised senior government officials of those economies that their exchange rate policy should better be conducted with the aim of maintaining stability in exchange rates against a basket of currencies rather than solely against the US dollar. Had such a policy been adopted, the shift of production bases to emerging East Asian economies by Japanese manufacturers could have been less volatile and the process of their economic development smoother, thereby enhancing the mutual interest of these economies and Japan.

As it happened, the efforts to promote economic recovery in Japan basically took the forms of domestic monetary ease and fiscal expansion for an extended period. Throughout this period, at OECD meetings, I urged for more effective monetary easing

in Japan, partly as I held a more pessimistic view on the underlying strength of domestic private demand than the Japanese authorities and the IMF, and partly also because I was concerned about the negative demand effects of both Japanese banks' balance sheet problems and the high value of the yen(6). As I already said, in retrospect, aggregate demand proved to be even weaker than I had personally projected.

With respect to the problems of credit restraint associated with bank balance sheets, it proved very difficult to arrive at a consensus of the Japanese people for using public money to help restore the lending capacity of banks with weakened capital bases. It was only after a number of bank failures in late 1997 that political acceptance was obtained to inject public funds into the banking system.

As for the yen exchange rate, heightened concern about the health of the Japanese economy started to put downward pressure on the currency, which in June 1998 declined to 145 yen to the dollar. In a lecture given at Harvard University last year(7), Professor Allan Meltzer of Carnegie-Mellon University made the following observation on this episode.

> "Japan's problems are mainly homemade. Mainly, but not entirely. The U.S. Treasury had a role, too. It recommended publicly, and I am told privately, that Japan should rely on fiscal stimulus and avoid sufficient monetary stimulus to depreciate the yen/dollar exchange rate. ---
> In 1998, monetary stimulus showed signs of depreciating the exchange rate. The yen/dollar exchange rate depreciated to 145 in June from about 100 a few months earlier. Then Deputy Secretary Summers came to Tokyo and ended that policy. The yen soon appreciated to 105, a massive and foolish change in an economy with falling prices and rising unemployment. The policy was mistaken, wrong, and it failed. The major mistake was a failure to recognize that the yen was overvalued. If Japan could not depreciate its nominal exchange rate, prices had to fall until Japan had a real exchange rate that was consistent with steady growth and stable prices. This took time and is still continuing. Where was the strong dollar policy? This failure was extremely costly to Japan, to Asia and to us. A stronger, more rapidly growing Japanese economy would certainly have mitigated, and possibly prevented,

the Asian financial crisis. Japan would serve as source of demand for Asian exports now, when U.S. demand has slowed."

Earlier, in the 1994/1995 period of a sharp yen appreciation, I at the OECD had already argued that the Japanese authorities should not hesitate to intervene to buy US dollars in the foreign exchange market to prevent the yen overshooting and that, in conducting its money market operations, the Bank of Japan should allow the short-term money market rate to fall closer to zero, not trying to offset the monetary consequences of foreign exchange market intervention. I believed that such combination of foreign exchange and domestic money market operations would be in the longer-term interest of the international community. This recommendation was made in a confidential Working Party No. 3 document and discussed at its meetings chaired by Larry Summers, but was not disclosed in OECD publications and not followed by the Japanese authorities at that time. A difficult question remains about whether such a document should be published after a certain lapse of time.

More recently, in the summer of last year, I made a similar recommendation initially privately and later publicly both in Japan and abroad, as there was an imminent risk of further strengthening of the yen undermining Japan's domestic economy and aggravating the already very fragile financial situation with undesirable international ramifications. Around that time, the IMF published the results of economic model simulation exercises with some scenarios of sharp falls in the dollar exchange rate and US stock prices(8). Although there was an unfortunate flaw in the simulations for the Japanese economy(9), they served as a useful reminder about its vulnerability to such an event and gave a clear warning to policy makers in advance of what is happening now in the foreign exchange and stock markets.

As for Japan's tasks for current economic policy management, I also argued that:

by subjecting the hitherto sheltered services and other sectors to global competition and encouraging them to raise their productivity and inefficient firms to exit, structural reform in Japan could over time help correct distortions caused by this abnormal currency situation. The reform process would, however, be painful and politically difficult to implement. It could be smoothened by an export-led recovery

of aggregate demand. But, given international political reality, can Japan be allowed to follow such a course without being accused of adopting the so-called “beggar-thy-neighbour” policy? If not, what policy option is available for Japan – which has the world’s second largest economy and is now undergoing the most rapid process of population ageing with projected huge increases in social expenditure -- after years of fiscal stimuli which have already turned its public sector debt position into the worst among advanced economies?(10)

In the Economic Outlook of December last year(11), the OECD for the first time publicly argued that “In sum, a shift to an inflation target with an explicit commitment to a time frame may not bring much over what is already in place. What is needed is to push the current framework to its limits, via unsterilised exchange rate intervention”. It also stated that “the limited scope for traditional macroeconomic instruments is not a basis for inaction. On the contrary, a vigorous and comprehensive structural reform strategy is urgently needed to establish conditions for renewed growth”.

4. International co-operation in structural policy areas

With these remarks about Japan’s tasks in the macroeconomic and structural policy areas, I now turn to Japan’s involvement in multilateral approaches to structural or microeconomic reform. Until the 1970s, the main focus had been on trade and current payments liberalization. In this context, Japan’s participation in successive GATT rounds had brought the average level of its tariffs below US and EC levels, but a high level of protection has remained for a number of agricultural products in Japan.

In the second half of the 1980s when I was Director of Policy Studies Branch in the OECD Economics Department, my Branch prepared papers to make quantitative assessment of the economy-wide effects of agricultural protection using a general equilibrium model it developed as a pioneer(12). Realising that there was little dialogue between the economic and agricultural ministries in the capitals of OECD Member countries, with the support of Nout Wellink, then Chairman of the Working Party No.1 of the OECD Economic Policy Committee (now governor of the Bank of the Netherlands), I wrote to member countries, asking them to send delegates from the two

wings of the governments for discussion of the Secretariat papers at the Working Party. My letter was received with hostility in some member countries including Japan. In the end, this objective and rigorous analytical work of the OECD was said to have made a positive contribution to the GATT work for the liberalisation of agriculture at its Uruguay round.

Increased international interlinkages, notably through trade and investment, have widened the scope for direct international spillovers of domestic structural policies. In many structural areas, such as legal and regulatory systems, education systems and much social legislation, there would not appear to be any crucial direct international dimension. Nevertheless, policies in these areas shape macroeconomic developments, and especially the strength of macroeconomic equilibrating forces. Also, such structural policies may affect other areas that do have international spillover effects, which explains the interest in applying multilateral surveillance to apparently domestic issues. For example, when inappropriate domestic structural policies lead to high unemployment, confidence in macroeconomic policies may be undermined. There may, as a result, be turbulence in foreign exchange markets, and fertile ground may be provided for protectionist sentiments. Similarly, changes in tax law may affect saving and investment decisions with international ramifications through trade and current balances and levels of real interest rates.

Over the past decade, multilateral surveillance based on benchmarks and best-practice standards has become increasingly important at the OECD. The Jobs Study, endorsed by OECD Ministers in 1994, laid an analysis of labour markets and other policies and proposed a number of specific recommendations to reduce unemployment and boost employment. These recommendations have been further refined and developed through follow-up analysis of specific policy issues, such as the disincentive effects of certain aspects of the tax-transfer system and the appropriate design of active labour market policies. Moreover, the general recommendations have been used as benchmarks for examining labour market policies in individual OECD countries.

A similar example, in a different field, is the work undertaken in a joint effort by a number of OECD Committees to identify best-practices in the areas of innovation and

technology, and environmental policies as well as regulatory practices. Japan has of course been involved in these exercises.

The coverage of the IMF surveillance has also expanded over the 1990s and several areas now have a prominent part in the Fund's review process of member countries: labour market policies; product market reform; privatisation; and financial sector regulation and supervision. As explained earlier, unlike the surveillance process at the OECD Committees where member countries are represented by delegates coming from capitals, IMF reviews of member countries at the Executive Board are conducted by Executive Directors who are resident in Washington.

Multilateral surveillance on structural policies is inherently difficult. First, the effects of structural policy changes are uncertain. This is particularly because structural policies in different areas are prone to interact with each other, implying that the same structural policy change may have different effects across countries. Also, very little is known about the time profile with which structural policies take effect. Finally, because real economies usually deviate in important respects from textbook models, policy-makers find themselves in the world of the second- or third-best, suggesting the need for caution in applying policy prescriptions based on the theory of the first-best.

Perhaps more important are the distributional conflicts often involved in structural policy making. Implicitly or explicitly, structural policy measures balance efficiency concerns against concerns of equity and social stability. The pain associated with structural reform usually occurs before the gains. Also, the pain is usually concentrated on specific, often homogeneous and well-organised groups, whereas the gains tend to be widely dispersed and accrue to groups that are heterogeneous and not well-organised. Indeed, where reforms benefit firms and jobs not yet in existence, the pro-reform constituency may be difficult to identify. As a result, the constituency against reform is often stronger than the constituency in favour.

Given these problems, it is natural to ask if multilateral surveillance on structural reform in Japan can be effective. Some observers argue that there exists a direct negative correlation between the size of the country examined at multilateral surveillance and the impact of the surveillance. A question has also been raised about

the credibility of the exercise particularly on structural policies as international institutions such as the OECD and the IMF as well as delegates from other member countries may not have sufficient knowledge of domestic political and social problems involved in structural reform.

Japan does not belong to regional institutions like the European Union where peer pressure from the Commission and representatives from other member countries can be more effective. This is so partly because they are more aware of local problems and partly because there are national commitments to peer review. As such commitments do not exist in the OECD and IMF processes, the effectiveness of these processes depends crucially on the willingness of the examined country, in our case Japan, to listen to the advices of these institutions and delegates from other member countries. Somewhat similar observations could be made about the effectiveness of G-7/G-8 in structural surveillance, if the body were to embark on such activity more systematically.

Having said this, the process of publishing the basis for multilateral peer reviews, e.g. economic surveys, etc. can contribute to public debate and discussion. Indeed, we should remember that public debate and the world of ideas are ultimately where most battles have to be won. More generally, information sharing is an important element of structural as well as macroeconomic surveillance. Access to international public goods such as data produced by the OECD on an internationally comparable basis, detailed information it collects about structural policy measures in member countries, its analysis of them and so on is helpful in designing and implementing economic policies in Japan. Japan, as the second financial contributor to the OECD (its contribution is just under the US share of 25 per cent), is expected to play a key role in helping the OECD to continue to secure resources needed for making such products in sufficient quantity and with good quality.

4. Some additional personal notes

I have discussed the evolution of international co-operation/co-ordination and multilateral surveillance on both macroeconomic and structural policies and Japan's involvement broadly. Let me finish my initial remarks with some additional personal

notes about another aspect of Japan's international economic co-operation.

Just ten years ago, the Financial Times wrote an article titled "Japan's turn", which reads:

> "Japan has been better at donating money, rather than its brightest civil servant, to international organizations. So Kumiharu Shigehara's career as the OECD's next chief economist will be watched with more than usual interest. Until now, heads of economics at the Paris-based group have been either British or North Americans."

After my five-year service as OECD chief economist, a European economist, then head of the research department at the Bank of Italy, became my immediate successor, and after his five-year service, a French economist, now Director of the Economics Department at the Ministry of Economy, Finance and Industry, was appointed to assume this post as from August this year. This clearly demonstrates greater flexibility in appointments for key posts at the OECD than at some other international organisations where the chief economist's posts have successively been occupied by the same country men or women.

Having noted this, we Japanese must intelligently tackle the long-pending knotty problems because of which Japan is underrepresented at the professional staff level of international organizations. For example, officials with Japanese nationality currently account for only 3 per cent of total professional members at the OECD, despite considerable efforts made by the Organisation to secure fairer nationality distribution in appointments. Underrepresentation of Japan at the professional staff level of international organisations is very unfortunate not only for Japan but also for the international community. This is because profound local knowledge about the second largest economy is crucial for the good work of international institutions such as the OECD in particular for effective surveillance of economic policy.

Endnotes

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