

## **JAPAN SEMINAR—SPEAKING NOTES FOR MR. FISCHER**

(Tuesday, May 1, HQ 2-530 @ 9.30 a.m.)

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Good morning and welcome to this seminar on Japan.

I would particularly like to extend a warm welcome to our guests from outside the IMF. We appreciate you coming and we are very much looking forward to hearing the insights you have to offer on the policy issues facing Japan today.

With the Fund's annual Article IV consultation discussions with Japan beginning in Tokyo next week, we felt this was an opportune time to hold a seminar with outside experts to share with us their views on how to meet the economic challenges Japan now faces.

The last time we held such a seminar on Japan was almost exactly four years ago, on April 1, 1997. At that time, it seemed to us and most other observers, that Japan was finally managing to achieve a self sustaining recovery and escape the doldrums that had dogged the

period since the collapse of the asset price bubble in 1990-91. Well, with the advantage of hindsight, we see that April 1 marked the first day of the deepest and longest recession in Japan's post-war history. During this period, Japan suffered an unprecedented series of financial collapses of major banks and insurance companies, as well as the bankruptcy of many large construction and retail companies. And the recession occurred despite massive fiscal stimulus that has put Japan in a difficult fiscal situation, and a virtually unprecedented zero-interest rate policy by the Bank of Japan.

Following a brief period of recovery, the situation in Japan has again deteriorated in recent months. The high-tech sector, the principal driver of growth in 2000, has succumbed to the U.S. and global electronics slowdown. Moreover, slow progress with bank and corporate restructuring have exacerbated the adverse impact of external developments on confidence. Plunging stock prices and a decline in asset quality have again raised doubts about the financial stability of Japanese banks.

The deterioration in economic conditions has led us to mark down our growth forecast for 2001. We are now anticipating growth of only around  $\frac{1}{2}$  percent this year compared to the  $1\frac{3}{4}$  percent we forecast at the time of the October 2000 World Economic Outlook. Moreover, there is considerable uncertainty about the outlook given the possibility of a more protracted downturn in the U.S. economy and weaknesses in the domestic financial sector, and a return to recession in Japan cannot be ruled out.

This in a nutshell is the situation. What should be the policy response? We hope that today's sessions will help flesh out ideas on the strategy. To start the ball rolling, let me sketch out our preliminary thinking on a four pillar approach, to restore sustainable growth in Japan.

First and foremost, banking system weaknesses need finally to be dealt with. The recent initiative in this area is welcome, but does not go nearly far enough. The authorities must push banks hard to ensure they adequately recognize and provision against problem loans, that they dispose of the bulk of these loans over the next 1-2 years, and

that they institute credible business plans to improve their core profitability. The impact on regulatory capital of appropriate loan classification and provisioning is likely to require another round of public capital injections. These injections will need to be tied to well-structured conditionality to deal with moral hazard concerns.

Second, corporate restructuring needs to be accelerated. A framework for corporate restructuring, including the corporate reorganization legislation passed last year, is mostly in place. But the actual work of restructuring has barely begun. It is thus critically important that the authorities push banks hard to ensure sufficiently deep corporate restructuring in the context of debt workouts that will be negotiated under the recent policy package. At the same time, complementary efforts—including broad deregulation, corporate tax reform, labor market reforms, and enactment of private pension legislation—would help to expand investment opportunities as the old economy downsizes and ease the impact of accelerated restructuring on household confidence and spending.

Third, the new monetary policy framework needs to be aggressively implemented to overcome deflation. The BoJ must not delay in raising its target for current account balances, and complementing this with aggressive measures to provide liquidity including expanded *rinban* operations. We must recognize that such an aggressive approach is likely to result in a further weakening of the yen. This is certainly a concern from a multilateral perspective. However, the regional impact should be more contained than in 1997-98 given the greater prevalence of flexible exchange rate regimes, healthier debt profiles, and reduced reliance on financing from Japan.

Fourth, developing a credible medium-term fiscal consolidation strategy is the key in my view to enhancing confidence in Japan's longer-term growth prospects and reducing risks of unstable conditions in the JGB market. The strategy, however, must be gradual to avoid compounding downside risks for growth, as well as flexible and responsive to evolving economic conditions. It must be transparent, credible, and clearly communicated to the public in order to maximize its impact on confidence. And it must be accompanied by

fiscal reforms aimed at easing the transition, including scaling back low quality public works spending, measures to broaden the tax base, and further pension and health care reforms.

With these brief observations, I suggest we begin the seminar which is divided into four sessions. This morning we have sessions on the impediments to sustained growth in Japan, which will be followed after the coffee break by a discussion of bank and corporate restructuring, and then monetary policy. After lunch, we will turn our attention to fiscal policy. For each session, we have two outside experts as lead speakers. Their presentations will be followed by a general discussion.





Stanley Fischer

## IMF/World Bank International Reserves: Policy Issues Forum

Opening Remarks by Stanley Fischer  
First Deputy Managing Director  
International Monetary Fund  
Washington DC, April 28, 2001

### Introduction

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Good morning and welcome to this forum on international reserves, hosted jointly by the IMF and the World Bank. The aim of the event is to bring together officials from national authorities and the Bretton Woods institutions to share their wisdom and experience in this important policy area. We are fortunate to have representatives here from more than 50 countries, who will give us a wide variety of perspectives to draw upon.

The management and use of foreign exchange reserves is of course a very serious matter. Back in the early 1970s, Britain's reserves were in the hands of a gentleman called Roy Bridge, an eminent central banker in whose honor there is now an annual memorial lecture. On one occasion he rang down to the Bank's trading room in order to give the dealers some instructions. "Bridge here!", he barked at the official who picked up the phone. "Engine room here!", came back the reply. The Bank of England was an excessively serious place in those days, and the unfortunate dealer was removed from his post shortly afterwards.

Well, we are all expected to speak out here.

Our discussions will focus on three topics:

- First, how can we best judge the adequacy of a country's reserves?
- Second, how should a country structure its reserves, in terms of the currency denomination, type, and duration of the instruments it holds?
- Third, reserve management guidelines - what are the principles that underlie good reserves management, and how can they best be promoted?

I want to talk briefly about each of these in turn, but let me first put these issues in a slightly broader context.

## **Crisis Prevention**

Reserves matter because they are a key determinant of a country's ability to avoid economic and financial crisis. This is true of all countries, but especially of emerging markets open to volatile international capital flows. Following the turmoil of the last few years, crisis prevention has emerged as a central priority for the international community.

The Fund's new contribution takes two forms: the strengthening of surveillance and improvements in our armory of lending instruments.

On surveillance: we are focusing more on those policy areas that can leave a country vulnerable to crises. The management of reserves is one. Others include macroeconomic policies, exchange rate regimes, financial sector soundness, and debt management.

Two factors have made surveillance much more powerful as a spur to good policies in recent years. First, a revolution in favor of greater transparency, including the publication of many IMF staff reports on national policies and prospects. Second, a proliferation of international standards and codes of conduct in different policy areas, monitored in their respective areas of expertise by the Fund, the Bank, and other relevant bodies. By stimulating better policies and reducing market uncertainties, these initiatives should help more countries get access to the capital they need at lower cost.

The Fund is also doing more to predict crises. We are strengthening the methodology for our early warning systems. We are creating an International Capital Markets Department, which will help us collect and analyze information. And we are meeting regularly with key players from private sector financial institutions through the Capital Markets Consultative Group.

On our lending instruments: we are giving countries a greater financial incentive to adopt crisis-resistant policies by offering those that do Contingent Credit Lines to protect them from contagion effects. I believe the CCL will in later years be seen as one of the most important innovations introduced by the Fund as a result of recent crises - and I also believe we will see the CCL coming into active use within a few months.

Now let me turn from crisis resolution in general, to the role of reserves policy in particular.

## **Adequacy of Reserves**

Let me begin with the question of how best to judge the adequacy of a country's reserves.

For much of the post-war period, the rule of thumb was that reserves should be sufficient to pay for three or four months of imports. Reserve floors in many IMF-supported programs were set at this level, and the median observed reserve levels during the last 50 years were mostly in that range too. This focus on import coverage reflected a preoccupation with the current account that was appropriate at a time when capital flows were limited.

But the growth of capital flows to emerging markets, especially during the 1990s, has prompted a revolution in the way we think about the adequacy of reserves. The availability of capital flows to offset current account shocks should, on the face of it, reduce the amount of reserves a country needs. But access to private capital is often uncertain, and inflows are subject to rapid reversals, as we have seen all too often in recent years.

We have also seen in the recent crises that countries that had big reserves by and large did better in withstanding contagion than those with smaller reserves - to an extent that is hard to account for through our usual analyses of the need for reserves.

It is therefore no surprise that the traditional current account approach has been viewed more skeptically in recent years. There has been a growing conviction that emerging market countries with open capital accounts need more reserves rather than less, and that we should look to the capital account in determining a country's need for reserves. Two years ago Fed Chairman Alan Greenspan and others proposed using short-term debt by remaining maturity as the yardstick against which reserve adequacy should be measured. Empirical tests confirm what the naked eye suspected - that the ratio of short-term external debt to reserves is the single indicator best correlated with the incidence of foreign exchange crises. And that holding reserves in excess of short-term debt reduces the depth of crises in emerging market economies during periods of international contagion.

An IMF staff study discussed by our Executive Board last year agreed that holding reserves equal to short-term debt was an appropriate starting point for a country with significant but uncertain access to capital markets. But it is only a starting point. Countries may need to hold reserves well in excess of this level, depending on a variety of factors: macro-economic fundamentals; the exchange rate regime; the quality of private risk management and financial sector supervision; and the size and currency composition of the external debt.

This analysis is now reflected in the way we treat reserve adequacy in our lending and surveillance activities.

Stress tests also have an important role to play in judging reserve

adequacy. They can be used to evaluate potential variations in line items within the balance of payments in different scenarios. Stress tests are especially suitable for evaluating country-specific factors, and we will hear more about this approach from Mr. Farkas of the National Bank of Hungary.

Holding reserves equal to short-term debt as a starting point has an intuitive appeal in a stress-testing framework. When the current account is in balance and there is no capital flight by residents, this is the level of reserves that would allow a country to hold out for a year in honoring all its debt obligations, if there are no new capital inflows and if creditors refuse to roll over maturing debts.

This change in thinking about reserves adequacy has been matched by what countries are actually doing. Many emerging markets have built up their reserves significantly in the last three or four years. In terms of the traditional measure, import coverage has increased from 6 months in 1997 to 7 months in 2000 for emerging market economies. And on the short-term debt measure, reserve holdings have risen from 125 percent of short term debt in mid-1997 - and much less for the countries worst hit by the crises - to 200 per cent in late-2000.

Judging reserves against a short-term debt yardstick makes sense for emerging market countries, but the approach is less appropriate for the industrialized countries or those without significant access to private capital. For the latter group, reserves are needed to absorb and smooth shocks, such as declining export volumes or increasing import prices. The past volatility of reserves and the current account are useful guides to reserve adequacy for this group.

### **The Composition of Reserves**

The new approach for evaluating the adequacy of reserves has implications for how reserves should be managed, notably their composition in terms of currency, duration, and instruments. One implication is that the currency composition of reserves should broadly reflect the composition of potential capital outflows rather than trade flows.

The desire to maximize the gross value of reserves at the time they are needed also suggests that instruments which tend to suffer disproportionate credit or liquidity risks during periods of international contagion or turmoil are best avoided. And if levels of reserves are judged to be more than adequate given the assessment of the risks facing a country, investment in instruments that have a somewhat longer duration makes sense.

These issues will be discussed at greater length during the conference, notably in the presentation by Mr. Grava. Further specifics of the

instruments in which central banks should invest will be taken up inter alia by Ms. Yip.

### **Reserve Management Guidelines**

Crisis prevention requires sound management of reserves. Unfortunately, various deficiencies in reserve management practices came to light during the recent crises. For example, some countries invested reserves with foreign branches of domestic banks. The pledging of reserves as collateral with foreign financial institutions sometimes rendered them illiquid and unusable. In other cases, incorrect measurement of net foreign currency positions exposed entities to large and unintended exchange rate risks. In yet other cases, speculative positions in foreign currencies and investment in derivative instruments resulted in large losses.

These weak or risky reserve management practices restricted the ability of the authorities concerned to respond effectively to financial crises, which may have accentuated the severity of these crises. Furthermore, weak or risky reserve management practices can also have significant financial and reputational costs for a country. Several countries, for example, have incurred large losses that have had significant direct, or indirect, fiscal consequences.

In response to these problems, the Fund and Bank are developing guidelines to help governments strengthen their policy frameworks for reserve management. The aim is to help country authorities articulate appropriate objectives and principles for reserves management and build adequate institutional and operational foundations for good reserves management practices.

The guidelines are voluntary and intended to assist a broad range of countries at different stages of development, and with various institutional structures. In developing the Guidelines, the staff recognizes the fact that there is no unique set of reserve management practices or institutional arrangements that is best for all countries or situations.

The guidelines are being developed with the encouragement and input of practitioners in member countries. An outreach meeting in Washington last summer included participants from other international institutions and reserve managers from about 30 countries. Five regional outreach meetings will be held to follow-up this spring and summer, which should allow the guidelines to be finalized by the time of the annual meetings.

The Reserve Management Guidelines will complement the Debt Management Guidelines elaborated by the Fund, and already endorsed by the Board. Both provide elements of a comprehensive framework for

asset and liability management. Strategies for reserves management need to take into account the management of external debt if they are to reduce a country's external vulnerabilities. Coordination arrangements may be required among the relevant agencies to ensure mutually consistent and supporting policies.

The guidelines will also provide a helpful framework for Fund and Bank technical assistance, and a focal point for informed discussion between national authorities and the Fund on necessary improvements in reserve management. Stefan Ingves, Director of the Monetary and Exchange Affairs Department of the IMF, will have more to say on the guidelines and the role of the Fund later this morning.

### **Better Data on Reserves**

Before concluding, let me remind you of the importance for both market participants and the official sector of having accurate and timely data on reserves. With the help of the G-10 and central banks around the world, the Fund has designed a template for the reporting of reserves data. It is designed to help central banks inspire confidence in their reserve data, and thus reduce uncertainty and volatility. Currently reserve data for 45 countries are posted in this format and can be accessed through the IMF's website. Countries are also expected to use the template when they provide data to the Fund for surveillance purposes. If they wish, they can of course provide us reserves data more frequently than the required once monthly.

### **Conclusion**

I am sure this morning's discussion will be interesting and helpful. The issues are not simple. Substantial and well-managed reserves are crucial to crisis prevention, but they are certainly not costless - indeed that is one of the attractions of the CCL, namely that it is a much cheaper way of gaining access to foreign currency than actually holding reserves. There are trade-offs involved that policymakers confront every day, and I am sure that Mr Fraga will cast interesting light on them in his comments at lunchtime.

Let me close with a few words of thanks. From the Bank I would like to mention Ken Lay and Jennifer Johnson Calari, whose idea it was to hold the conference, and Nonna Ponferrada, for organizational assistance. From the Fund, let me thank Christian Mulder, Ydahlia Metzgen, Arne Petersen, and Peter Dattels. Thanks of course to our distinguished speakers and discussants, and to everyone else for coming.

Enjoy the rest of the day.

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