THE WALL STREET JOURNAL.
WSJ.com

OPINION | NOVEMBER 14, 2008

Restoring Financial Stability

Use Japan's experience as a guide to near-term problems – then think bigger.

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TOKYO

As leaders of the Group of 20 nations meet this weekend in Washington, we are faced with the financial crisis of the century. The leaders of major economies and international organizations must hammer out realistic yet substantive countermeasures.

One thing is clear: The stability of financial and capital markets must be the first priority of economic policy today. Whatever solution is proposed, it is clear that competition and capital flows based on free market principles should continue to serve as the foundations of growth. Yet we must also address the failure of government regulators around the world to keep pace with the innovation and globalization of financial products. Concerted action to coordinate various countries' policy efforts has now become an unavoidable challenge.

In the near term, Japan's own experience with the bursting of a bubble economy, a subsequent financial crisis and a recovery process could serve as a useful guide on how to contain the immediate impact of the financial crisis on the real economy and restore the stability of the financial system.

First, an early and thorough disclosure of nonperforming loans held by banks, based on fair valuation and reliable standards, and the removal of those loans from their balance sheets must be the first priority. Slow and insufficient disclosure prolonged the bad debt problem in Japan.

Second, capital injections into banks with public funds must be accompanied by proper mechanisms to provide sufficient credit and to limit actions against management in the event the losses were caused by factors outside their control. In Japan, state authority to nationalize banks in the event of systemic risk also helped to resolve the problem.

Third, the supply of liquidity from central banks -- in particular, the smooth and ample supply of U.S. dollar liquidity -- must be maintained. In addition to global arrangements, further development of such regional mechanisms as the Chiang Mai Initiative -- a foreign-exchange swap mechanism in East Asia -- will be significantly helpful.

While the short-term challenges are conquered, the G-20 will also need to consider the medium-term issues at hand. I see at least seven areas to discuss.

First, so long as the global imbalances persist, the international currency system will remain vulnerable. Countries with excess consumption and dependent on external debt should rein in that consumption. Meanwhile, countries heavily dependent on exports for their growth should adopt self-sustaining, domestic demand-led growth models.

Second, the International Monetary Fund's role in monitoring financial markets and its early-warning functions to detect financial and economic crises in their initial stages need to be improved. Also, the Fund's financial resources must be increased to enable it to extend necessary assistance to emerging economies that drive world growth. Japan is prepared to lend up to $100 billion to the Fund as an interim measure before a capital increase takes place.

Third, international developmental financial institutions should also play an active role in stabilizing the world economy. In particular, a general capital increase should be implemented at an early stage for the Asian Development Bank, which currently has limited scope for new lending.

Fourth, the governance structures of the IMF, World Bank and other bodies -- including the issues of quota shares and share of voting rights -- need to be reviewed, to reflect properly the economic realities of the world today.

Fifth, the Financial Stability Forum -- an assembly of the financial supervisory authorities, fiscal authorities and central bankers of various countries -- should be given a status above standard-setting international institutions such as the Basel Committee. The Forum's functions and joint work with the IMF should be reinforced and the group should be reorganized to include membership from emerging economies.

Sixth, the International Accounting Standards Board now stands at the center of work which aims to achieve convergence in the accounting standards of various countries. Government authorities, companies, investors and others should be involved in this effort so that an objective and fair set of standards is prepared expeditiously.

Lastly, rules governing credit rating agencies are being tightened, mainly through the International Organization of Securities Commissions. I propose that discussions be held with a view to giving various countries legal authority over these agencies. Nurturing local credit rating agencies in each region in addition to global agencies is important for the development of regional bond markets.

In the long run, there are questions being raised about the very structure of the U.S. dollar-based international monetary system, and whether that structure is sustainable, given the changes in the U.S.'s global economic standing and the fact that the U.S. is the world's largest debtor nation. The fact is, however, that there is no feasible currency anchor other than the U.S. dollar under the current monetary system. We should be making efforts to support the dollar-based currency system, on which today's international economic and financial systems rely.

That doesn't mean that the world should count on the U.S. to solve all its problems. It is important for each region to move forward with regional economic cooperation. Regional cooperation in East Asia, for example, in the area of trade and finance, complement global initiatives very positively. Such efforts, coupled with global talks like the G-20 meeting this weekend, will lay the foundation for a more stable international financial system in the future.

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