

# **Sustainable Growth in the World and the Recovery of the Japanese Economy**

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The topic today is on sustainable growth and the recovery of the Japanese economy. For sustainable growth, what is the issue that we need to address? That is frankly the topic that we need to look at. For sustainable growth of the world, we of course need to look at the risk factors that really cause instability. We have crises and also the North South issue. So that's another crisis area. And another area is the transition from the controlled economy to the market-based economy. And also from another dimension, it is necessary to look at the failure of the market and the failure of the government and also the relationship between the public sector and the private sector. And from another point of view, it is necessary to think about the imbalance between the real economy and the financial economy and the crisis generated as a result. Now I would like to talk about the issues that I myself was related to, and also I would like to talk about the Japanese role in providing stability to the global market.

And also I would like to talk about what kind of expectation we have toward the Summit. However, because of the time limitation, I will not talk about the transition from the command economy to the market economy. I think it is also necessary to analyze EU, NAFTA and ASEAN to see if such regional treaties can progress without hindering global economic exchanges. As for the EU, in 1962, I had an opportunity to listen to Prime Minister Macmillan's declaration of starting the negotiation at British parliament, and I was and I am still following the EU progress at each stage. However it will take enormous time to speak about this. Therefore I will not talk in details. However, I think EU is still a stabilizing factor in global market and is useful in maintaining the balance of power.

Now I would like to move on to the analysis of the uncertainties and the crises in the developed countries. I would like to talk about the examples from Britain and also from Japan as well as the revitalization of Japan and development as a whole. However, because there is such a limited time, I will make it very brief.

## **1)-1**

In September 1992, at the Queen Elizabeth's the Second International Conference Center in London, 500 participations within and from abroad gathered under the theme "UK Presidency and the World after 1992" for a two-day conference organized by the Royal Institute of International Affairs Chatam House. I also attended the meeting.

At the beginning of this conference, the then Prime Minister Major said that Britain would exercise its leadership to promote EU unification as the EU President at the time. But only 10 days later on September 16<sup>th</sup>, Britain had to withdraw from the ERM, the Exchange Rate Mechanism. And at the time, the British pound plummeted to 160 yen from 220 yen. And it was reported sensationally that Mr. Soros had defeated the Bank of England. Mr. Soros had studied in LSE, and at the time he was the most favorite pupil of Dr. Karl Popper who wrote the “Open Society and its Enemy” who was a famous philosopher of the 20<sup>th</sup> century. So you do not know what may happen in one’s life. Mr. Soros moved to the US and had a great success. I had an opportunity to meet Mr. Soros at LSE, and after that Mr. Soros made a huge donation to his mother country Hungary and to LSE also.

By the way, LSE produced 27 Prime Ministers in overseas countries and many Nobel Laureates. When it was time great Cultural Revolution in China that people couldn’t receive any higher education, Zhiu On Lai sent deliberately several bureaucrats on annual basis to study at LSE . Whereas the former Prime Minister of Taiwan had also studied in LSE, and Mr. Chen Shui-bian had commenced his election campaign at LSE though at that time most of the people thought Mr. Chen Shui-bian would be defeated in the Taiwan election.

Now talking back to the main theme, in the latter part of the year 1992, because the U.K. was the EU president country, Mr. Major had emphasized the importance of the EU. But in only 10 days, the situation moved in the opposite direction from what Mr. Major had in mind. It was not just that the Hedge Fund had defeated the Bank of England. I think there was an inconsistency between the British macroeconomic policy based on the domestic fundamentals and external economic policy toward the EU. Moreover, there was some failure in Britain’s overall strategy which should integrate economic policy and financial policy including exchange rate. And at that time, Britain was making severe structural reform, and the unemployment rate was around 11%. If Britain were to stay in ERM, it had to continue its high interest rate, and that was very problematic to England. On the other hand, in Germany, it was right after the East-West reunification. The rate of exchange between the currencies of West and East should have been 1 to 5. But Mr. Kohl, the Chancellor at the time from political consideration made it one to one. Even today, the productivity gap between East and West Germany is said to be about 1 to 7. And I think this can be the cause of the slow down of the German economy of recent. In any case, the government of Germany had to sustain some part of East Germans by providing pension keeping the value.. Therefore, it had to maintain the value of the currency, meaning it had to keep the interest rate high.

Britain, before leaving the ERM, requested Germany to lower their interest rate, but Germany had experienced hyperinflation after the First World War. Therefore, with such a kind of uptight inflation sentiment, the Germans rejected right to the end. Therefore, Britain had to leave ERM. At that time, Britain had suffered a huge damage, but for the sake of Britain, I must add that Prime Minister Major did not resolve the cabinet but served until the end of the term. And also the ability of Mr. Clarke as Chancellor of the Exchequer revived its economy. Therefore the economic deterioration was not the

reason for the defeat of the ruling party at the time.(1997 Election) And after that, Mr. Gordon Brown of Blair Administration had improved the economy further, thus making the British economy more prosperous. So the lesson we learned is that there is such an economic element as Mr. Soros that reads the fundamentals of the economy in running what was the world's largest hedge fund, and that such an element can greatly influence the global economy.

### 1)-2

So far, I have touched on the crises regarding the exchange rate and the macroeconomic policy. But now I would like to move on to issues regarding the securities market. In the first half of 1992, 400 Japanese securities companies reported 230 billion yen of operating loss. However, the Japanese branches of foreign affiliated securities companies made a 40 billion-yen profit in Branch account. It was the time when market capitalization of the Japanese security market shrank from 680 trillion yen to 280 trillion yen. As they were using methods such as derivatives that were relatively new in Japan, foreign clients were able to make huge profits out of the Japanese securities market and take them outside of Japan. It was after the Bubble had burst in Japan, and the government was taking a tight monetary policy with regard to asset values including real estate taxation. Therefore, even though public works projects were kept at a high level, the overseas investors had figured that securities market and real asset value would show a downward trend. I will not elaborate on this subject. But since Japanese financial system was based on land as collateral, this was the main cause of the non-performing loans still lingering on today. Therefore, Japan has suffered the so-called lost decade for the past 10 years.

### 1)-3

On November 18, 1997, at conference titled, "Japan's Role in the World ", convened at Britain's think tank at Wilton Park, I was asked to deliver a speech titled "Where is Japan's Economy Really Going?" The British Embassy in Tokyo had made the request to me six months in advance. On the vary day of the speech, I was listening to BBC radio. It was the 18<sup>th</sup> morning in England that I heard the news about the collapse of the Hokkaido Takushoku Bank on the 17<sup>th</sup>. And two days after the 4 days conference, the newspapers in UK reported that Yamaichi Shoken securities company, one of the four major securities firms in Japan, had announced it had stopped operating. This could be considered a part of the sixth reforms promoted by Prime Minister Hashimoto's cabinet. But from the beginning of 1997 to 1998, the Asian crisis surfaced. The IMF had evaluated the fundamentals of the Asian NIES (newly industrialized economies) highly until then. However, these countries went through a rapid deterioration of capital account, and the huge foreign capital, which had amounted to 43% of GDP in Thailand and South Korea, changed course in a short period of time. Ultimately, by the transaction of the hedge fund, the Asian crisis was triggered.

The Japanese development since the 19<sup>th</sup> century was based on the accumulation of assets. However some countries in Asia they wanted to expand the economy even by too much borrowing money. After the crash, Japanese government proposed a special fund for Asia, but couldn't have the consent from the developed countries and positive

support of IMF. It took China two years to agree on this initiative. In the meantime, South Korea and others began to sell Russian bonds, and the Russian ruble plummeted. Russia's economy used to be huge, but its economy had shrunk to the same level as Switzerland. So you can see how the economy fluctuates during the times. The Russian ruble plummeted, and this had a contagious effect on Brazil. The famous U.S. Hedge Fund in which two Nobel Economics laureates working collapsed, and at last the US gave consent to the initiative though not in exact forms. In the Mexican crisis of 1995, the U.S. reacted in less than a month and contributed about 50 billion dollars to which Japan made cooperation.

I think Asian crisis in 1997-1998s could be an utmost example of international monetary crisis having a ripple effect on the global market. I actually had an opportunity to give a speech in June titled "Managing Global Economy: What Asia and Europe Can Do". again at British government thinktank Wilton Park in 1988. So this is still fresh in my memory.

This same year in Japan, Long-Term Capital Bank under financial revitalization law was nationalized temporarily. And during that time, 1.8 trillion yen of tax was injected. However, in February 2000, an investment association of U.S. Ripplewood was able to have the ownership, and the transfer price was 0.06 percent of the injected tax amount. Furthermore, a special buy back clause was attached stating that if the credit deteriorates to a certain extent, the government will buy back that credit or loan at original price, and this amounted to about 700 billion yen. And after that, Nippon Credit Bank Ltd. was bought by a domestic syndicate and transferred in the name of Aozora Bank.

So far, I have mentioned the British and Japanese examples to highlight uncertainties of global economy, but what does this signify? One of the objectives of global economy is to have a healthy and competitive economy. But current global economy, as referred to "Casino Capitalism by the late Professor Susan Strange of LSE, shows the financialization of economy. This means that the borderless economy has affected both negatively and positively the economy of each country. The amount of money used in international trade or, in other words, money necessary for interaction of the substantial economy is said to be about 7.8 trillion dollars a year. And yet, the amount of money used in finance going around the world seeking profit is said to be 1.0 or even 1.2 trillion dollars a day. In his lecture on April 18 at Keio University, Professor. Anthony Giddens, Director of LSE, said that this could be 2 trillion dollars now. This implies that fifty or 100 times the amount of money circulates globally, and in some cases through FDI helps provide growth money and also promotes acquisition of companies. Also looking at capital account, if one's capital account is becoming negative, sometimes the money creates a boom of securities market, and sometimes could trigger a crisis. I therefore believe that the realization of fair leadership in global economy is a critical role of the Summit.

Here, I would like you to refer to my paper on globalization and the role of the Summit, written at the time of the Okinawa Summit, and I have prepared the English translation in a book for the G8 Research Group. If you can refer to pages 9 to 10 in the distributed

papers and also a copy of the interview to me during the Okinawa Summit published in the Ryuku Shimpo, you can understand what I have emphasized at the time. I talked about world security including measures to counter terrorism, IT Revolution as well as my opinions regarding the global economy. I think the G8 countries, which account for over 60 % of world's GDP, can take leadership in areas such as policies, reforms and measures by international institutions, and collaboration among international economic organizations. My view is that it is desirable to set up a working group within the G8 countries that focus particularly on cooperation among international economic organizations.

2)

I strongly believe that the Japanese economy will revitalize in the future. But before I touch on that, let us look at the second disturbance to the global economy which is the North-South issue.

On April 2, a long-time friend of mine, Mr. Stern Senior Vice President of World Bank addressed as follows. Even in the developing countries, in the past four decades, life expectancy rose from mid 40s to mid 60s, and thus was prolonged by 20 some years. In the past 30 years, illiteracy rate dropped from 50 to 25 %, and people living on less than a dollar a day dropped from 1.4 billion to 1.2 billion. However, still half of the world's population lives with less than 2 dollars a day, and the global population is expected to increase in 25 to 30 years by 2 billion. But this increase will occur in developing countries. And Professor Stern emphasized the importance of strategies for development and effective assistance in his speech. I myself think as follows. In the past 20 years, the global wealth expanded. However the disparity or the gap between developed countries and developing countries has widened—the issue of the light and shadow of globalization. The gap between the rich and the poor is expressed in Gini coefficient. The income distribution is most leveled in Japan while the largest income gap is found in the US. However, looking at the disparity between developed and developing nations, the GDP of G8 countries is about 65 % of total world GDP. And the remaining 180 countries or so occupy 30 some % . Therefore in order to stabilize certain societies or countries, the key is how to fulfill the defects or the disadvantages of those societies. It is the same for the global society. Moreover, from a humanistic perspective, the developed countries should cooperate in fulfilling basic human needs. According to Prof. Stern, about 1.5 trillion dollars are needed per year in the entire developing world. 90% is financed within the country and 10% is funded from overseas, of which 1% or 15 to 16 billion dollars are loaned from the World Bank.

In the 1990s, the UN, OECD, IMF and the World Bank formulated the International Development Goals. In 2000, the year of the Okinawa Summit, they were expanded to the Millennium Development Goals (MDGs) at the UN General Assembly. The aims were, by 2015 to, 1)reduce the rate of population who live a day with less than 1 dollar to half; cut the rate of starving population by half, 2)provide primary education for all, 3)realize gender equality, 4)reduce the mortality rate of children 5 years or younger to 2/3, 5)reduce the mortality rate of pregnant and parturient women by 3/4, 6)prevent the

spread of HIV/AIDS, malaria and other diseases, 7)create sustainable environments  
8)search for global partnership for development, increase ODAs and expand market access.

Including these goals, the UN International Conference on Financing for Development (FfD) held this March in Monterrey, Mexico and the meeting of the Commission on Sustainable Development in Washington DC in April discussed the lessons from the past 50-year efforts on development. 1)Sound policies and quality systems and institutions, 2)integration of developing countries into the global economy through trade and investment, and 3)external assistance to support policies of developing countries were the 3 areas where a consensus was reached on the need for partnership between developed and developing countries.

Of reference would be East Asia. In the past decade, it was the only region in which poverty was almost reduced to half. In his recent lecture, Mr. Kuroda, Vice Minister of Finance for International Affairs of the Ministry of Finance, stated that, 10 years ago, 450 million people in this region were considered to be in extreme poverty which is now down to 260 million. Trade and investment ties among the East Asian nations were strengthened through the 1980s which contributed to mutually beneficial sustainable growth in the region. Japanese import from this region in FY 2000 was 140 billion dollars, or 1/3 of total intra-regional imports. Japan is also a major provider of foreign direct investment in this region, investing 80 billion dollars to East Asia in the 1990s. At the Monterrey conference, it was discussed that to reduce by half the 1.2 billion people living a day with less than 1 dollar, additional 40 to 50 billion dollar in assistance would be needed annually. However, the ODAs received by East Asia was 8 billion dollars a year on average, meaning that about 1/3 of the world's poverty were reduced to half by this amount. Therefore, as was discussed at Monterrey, not just quantitative expansion but efficient and effective assistance such as in the case of Asia is needed. In this region, half of the ODA came from Japan. Along with the World Bank and Asia Development Bank which Japan actively supports, Japan has played an important role.

### **3) Japan's contribution to the international society**

Japan's contribution to the international society, namely in providing global commons, by simply looking at ODA amount was number 1 in the world throughout the past decade except last year. The World Bank and other international institutions aimed to rectify gaps in education, health care and income and thereby reduce the poorest of the poor. For that end, they have been providing global commons. Japan, while contributing to this cause by cooperating with these institutions, also provided ODA to help build infrastructure in the recipient countries with a focus not only on general infrastructure but also roads, ports, hospitals, schools, power utilities, communication including broadcasting which would form the foundation of market economy. I believe that this contributed to the development in East Asian and ASEAN countries as mentioned before.

As for the flow of funds to developing countries in the years to come, market rules and rules of law should be preconditions. For quantity, expanded foreign direct investment

would be desirable. But as mentioned at the onset, controlling the evils of casino capitalism and cooperation of public nature for those at the bottom of the societal pyramid would be desirable.

What led Japan to position international cooperation as a pillar of its national policy?

In the 1960s, Japan's foreign reserves grew from 2 billion to 4 billion dollars, and the basic surplus in balance of payments, which could burden economic growth, was improved. In the early 1970s, together with bankers and other salaried workers of my generation, scholars and government officials in Ministries of Finance, Foreign Affairs, Trade and Industry and Agriculture and Forestry, I organized a group called "Project 80" to discuss on issues facing Japan in the 80s. With assistance from an agency, we also submitted reports for 2 years. One of the issues identified was the expected growth of surplus in the balance of payments. The following is a quote from a long paper I wrote for Japan ITU Association in November 1986 which later became a booklet. It is titled "International Cooperation in Broadcasting: Issues in ODA and Directions for Improvement". The subject period is early 1970s.

"Some private economist groups projected that...if Japan continued business as usual, its foreign reserves would reach 12.8 billion dollars and that Japan's share in world trade would exceed 10%...

As it became clear that Japan's rapid growth would invite trade frictions and currency wars, there was an argument that by mid 70s, Japan had to implement 2 of the following 3: 1) major evaluation of the Yen, 2) complete liberalization of trade, and 3) sharp increase in international cooperation...

As for foreign currency holdings, by the so-called Nixon shock of 1971 in which gold and the dollar were no longer linked, Japan's foreign currency holdings had reached 16 billion dollars. What had been expected in 5 years at the beginning of the 1970s was surpassed within 2 years..."

The Japanese philosophy or way of thinking is "One is a part of a whole". This is to say that one's happiness is found in the whole, meaning the national society. If happiness of a national society exists in the global community, the need for global contribution for the cause of basic human needs I believe is in the subconscious of most Japanese. Behind Japan's becoming number 1 in ODA was its rapid economic growth from the 60s to 1990.

#### **4) Current Status of Japan**

Foreign currency holdings are now 410 billion dollars, highest in the world. Japan ranks first in overseas assets. It owns US bonds worth 310 billion dollars. Financial assets held by Japanese are nearly 1500 trillion yen. The central and local governments' debt amounts to 693 trillion yen, which is equal to half of the financial assets. Government bonds that make up half of the debt are consumed mostly domestically in a steady

manner. The evaluations by Moody's or S&P do not fully grasp these situations, but rather are influenced by pessimistic or negative information about finance heard in or outside of Japan. Japanese tend to grieve first and enjoy later, and are prone to thinking about the future too seriously. This causes more pessimistic information to be sent overseas. We do think we need to be humble in accepting ratings by overseas commercial rating companies and should leverage that for furthering economic reforms. However, ratings by Moody's and S&P are commercial. In the borderless movements of money invested on a global scale based on the "Casino Capitalism" financialisation of economy" mentioned earlier, such ratings base their evaluation on predictions and yet exert influence on the movements of money.

Things may not go as they predict. The level of stability might be high due to the balance of payments. Unemployment rate might not rank so high compared with other developed nations. And the country's global economic contributions in public assets might be very valuable. But these aspects are distorted and not necessarily consistent. During the British currency crisis, the UK's rating did not go down. The level of US twin deficits might have destroyed a normal country's economy, and yet the rating did not suffer. Of course, the US had political and military clout and a status as a superpower. Deficits could be addressed by printing the greenbacks which is the key currency. This is therefore a special situation. The recent Enron scandal which could shake the foundation of capitalism, defective auditing and lack of transparency do not influence America's rating. The US providing a large export market for many countries should be recognized positively, but if that is reflected in the government bond ratings, why not take note of Japan's share in financial support for the UN and other international organizations which is about the same level as the US despite Japan's smaller size of economy. What about its leading ODA spending far ahead of the 3<sup>rd</sup> ranking country? They should all be reflected in the bond rating. Moody's is said to have based its recent evaluation on the scale of government debts vis-a-vis GDP. But whether they looked only at the central governments or also local governments is not clear. Even in case of Japan, the bonds issued by the government alone do not reach the GDP level. Most importantly, they should look at the country's ability to make international payments based on the particular situations of the country. In the first place, to expect this from a commercial rating company based in a particular country is not realistic. That is why we need a rating organization formed by an international public economic institution.

### **5) Revival of the Japanese Economy**

Having said that, the Japanese economy lacks in many things. A German research organization says that the greatest growth in the 20<sup>th</sup> century was experienced by Japan with a growth rate of 1,660%. The 2<sup>nd</sup> highest growth rate was 540%.

But this past decade was a difficult period for Japan's economy. We need to implement structural reforms so that Moody's and others will rate us fairly and also that we can promote international cooperation as quickly as possible.

The true cause of Japan's economic trouble in the past 10 years, I believe, goes back to the late 1980s when our largest ally, the US, asked for expanded domestic demand exceeding 400 trillion yen, almost equaling Japan's GDP. It was then followed by the synchronous "government failure" and "market failure", causing the "lost decade". During this period, there were ups and downs. But through repeated trial and error in discussing the way to carry out economic structural reform and other reforms for the sake of the entire society, I now believe that the overall groundwork for structural reform has been laid in the political, business and government circles.

In economic terms, if the long-term direction for solving the bad debt issue is clarified and if people understand that it is not impossible to lift the economy, the will of the nation could become one quite quickly. Corporate transparency, disclosure and auditing are some areas which have improved to a level almost on a par with other developed countries.

### **Non-performing Loans**

At any rate, we need to write off non-performing loans and transform the banks' revenue structures to revive the Japanese economy. I think there are 2 approaches.

Early this year, Mr. Takenaka, Minister of State for Economic Policy visited the US and UK to explain Japan's economic situation. According to what I heard, many in the US said Japan should quickly address the bad debt issue, whereas, more people in the UK advised that Japan should not rush but take time to solve the problem. If we take the latter approach, it would mean voluntary structural reform and writing off non-performing loans over a longer period. For example, the Nikkei Newspaper on May 24 reported on the book closing by 13 major banks. In summary,

- 1) Write-off of non-performing loans: 8 trillion yen
- 2) Outstanding non-performing loans: 27 trillion yen
- 3) Net operating income: about 4 trillion yen
- 4) Credit to cost ratio: 1-4%

If the average is 2%, it is less than those of major European or American banks. If the spread increased by about 2%, net operating income of over 8 trillion yen can be secured. Provided that the economy does not deteriorate, bad debts can be eliminated in about 3 and a half years at the shortest. This is if companies were left to write off the loans by themselves. As economic upturn and rise of spread for banks are prerequisites, if these are not met, it might take longer to eliminate non-performing loans.

If the former approach of eliminating non-performing loans in a single stroke is desired by other countries as well, it would be necessary to do so by the way Japan prefers without any interference but rather endorsement by other nations. Only the government/Bank of Japan can bear the burden. And that should be done based not on market price but book value of the persistent bad loans. Only if there is a national consensus, political leadership and overseas approval, should this approach be ventured. Otherwise, we would have to take the slower approach.

As I said before, I believe the true cause of the economic difficulty of the past decade was the American request for expanding domestic demand worth more than 400 trillion yen, almost equal to GDP, in late 1980s. That was followed by the simultaneous “government failure” and “market failure”. So it would be ideal for the hardened part of non-performing loans to be eliminated at book value. Issuing government bonds too much could undermine the evaluation of Japan as a country. Instead, the funds should come from increased issuance of the currency by the Bank of Japan. It is the least costly and therefore put the least burden on the general public.

In conclusion, the underwriting by the Bank of Japan should be used to eliminate bad loans so as to help banks and life insurance companies recover as a system and strengthen domestic and international competitiveness, and to assist in the revival and profit growth of various industries and uplift stock prices. The exchange rate should be led to an appropriate level at the right time, and the economy need to get out of deflation as soon as possible. For employment, safety net should be in place, while technological innovation and structural reform to assist growth industries should be promoted. New business areas such as welfare for the elderly should be developed. Financing to grow demand should be conducted as much as long-, mid- and short-term prospects of financial reforms permits, but issuance of new government bonds should be restrained as much as possible.

In either case, if the direction for the bad debt issue is clarified and structural reform is undertaken, Japan will become a country capable of making further international contributions economically.

## **5) Conclusion**

I am a member of the Royal Institute of International Affairs. I wanted to join this institute because, when I graduated from university in 1958, I was drawn to the views by the head of the institute, Dr. Arnold Toynbee. He said that the rise and fall of a people leading a civilization is like climbing a high mountain. During the clime, it rains, storms, snows, and food may run out. They may need to take shelter from wind or snow in caves on a cliff. Some might freeze to death, slip off a cliff, fall ill or be injured. They can go back or go down the mountain. But if they continue the difficult clime, a new world may be waiting on the other side. Depending on the decision by the leader, the team might push against bad weather, or choose to be efficient and save energy, look for safer routes and so on. Many different choices, and that determines the fate of the people and the rise and fall of the civilization. Qualities and leadership of the leaders are the determinant factors.

What we see now is not one people but the entire human race climbing a mountain together. The fates of different peoples and nations are interlinked. When you look at a single people or state, its development or modernization depends on its unique historic, social, cultural, political and economic characteristics. And yet, this also forms a part of the global society being forged. In other words, it is a part of the globalization process.

Then, in the climb of economic globalization, what are the characteristics? What is needed, and what should be improved? As I have been saying, the evils of an expanding gap between real economy and money economy and the evils of the casino capitalism must be eliminated.

Another, I think, is the balance between public and private sectors. Competition should be maintained on the one hand. But for welfare and poverty elimination, cooperation is necessary.

Furthermore, while caring for the global environment, developed and developing countries should keep each other on balance in pursuing economic development with a notion of a global village.

For that end, the leadership by G8 leaders plays a major role, and I believe that is the most effective leadership that can impact the global governance of today's world.