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THE ASIAN ECONOMIC CRISIS AND JAPAN

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I. INTRODUCTION

FOR a decade until mid-1997 the East Asian economies continued to experience miraculous growth. Since July 1997, however, a speculative run on the Thai baht has developed into a currency crisis throughout East Asia and stopped its rapid growth. Thailand, Indonesia, and the Republic of Korea, which sought rescue from the International Monetary Fund, have had to resort to severe contractionary policies and have fallen into slow growth. Other economies have responded to the currency crisis by constraining their budgets, suspending development plans, and reducing their growth rates considerably. The East Asian miracle has suddenly disappeared as the twentieth century comes to a close, and the situation now is better called an "economic crisis" rather than a "currency crisis."

A year has passed since the economic crisis started, but the recovery of economic growth has been slow and no clear direction has yet become visible regarding how to resolve it. Many express their optimistic views that the Asian economies will resume their high growth, not as rapid as 8 to 9 per cent but at least 5 to 6 per cent growth annually, in the mid and long term. However, no scenario has been provided of how to guide these economies back from lingering turmoil into high growth. Current cross exchange rates of Asian currencies have changed drastically from those of the pre-crisis level which has impeded their recovery toward the steady expansion of trade and investment in Asia. Individual governments have tried hard to break out of this trap which is affecting the region as a whole.

Japan is in the middle of the Asian economic crisis. It suffers from its own severe deflationary pressure and prolonged undervaluation of its own currency. As the major industrialized economy in the region, Japan is expected by its fellow Asian economies to play a leading role in getting over the current crisis. The prosperous U.S. economy has absorbed Asian products for the past several years, but we cannot be optimistic and assume that it will continue to do so indefinitely. This paper

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intends to convey a Japanese diagnosis and prescription of the current crisis; and how the Japanese perceive the current crisis, its causes and its spread throughout the region. The paper also will deal with how to get over the crisis and what role should Japan play in it. The paper will conclude with a strong case for strengthening economic cooperation in Asia and the Pacific in trade and investment as well as furthering financial and currency cooperation in order to bring back steady growth to the Asian economies in the new millennium.

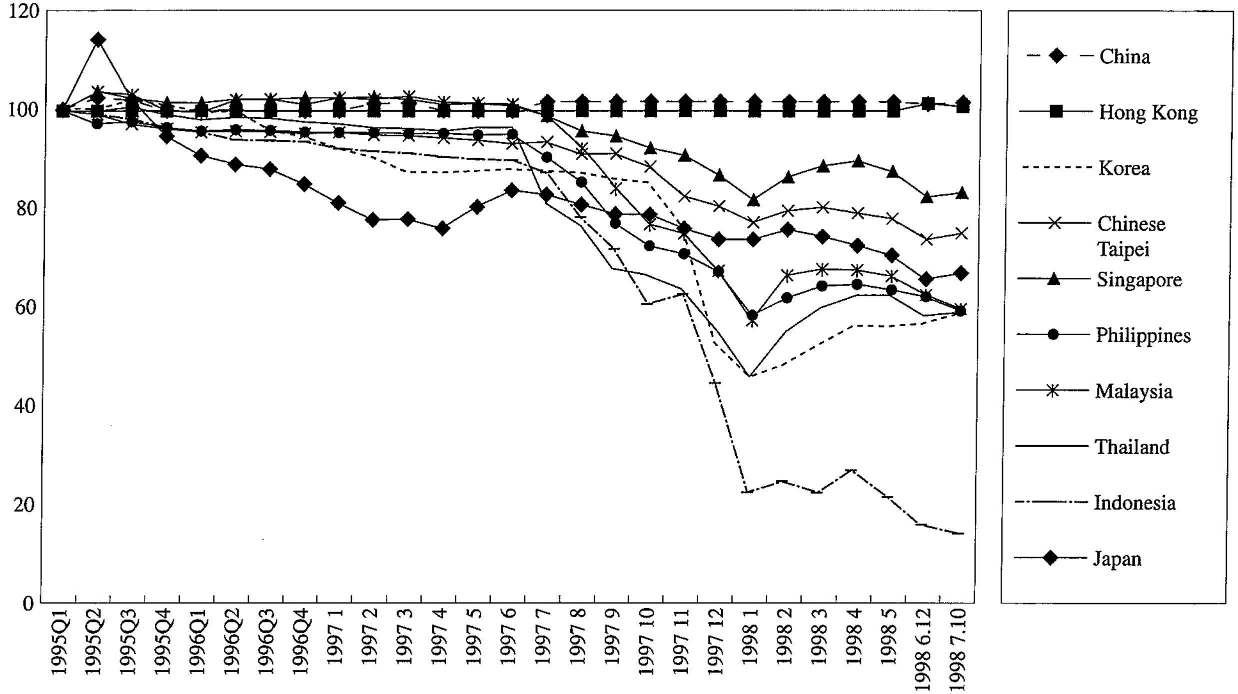
II. SPREAD OF THE CURRENCY CRISIS

How did the currency crisis occur in Thailand in July 1997 and then spread to neighbor ASEAN (Association of Southeast Asian Nations) economies and finally to other East Asian economies? Figure 1 shows changes in the nominal exchange rates of East Asian currencies vis-à-vis the U.S. dollar since the first quarter of 1995 (1995Q1). They are indicated in an index form with the base year of 1995Q1. The base period is set so that the stable rates before the crisis and volatile fluctuation thereafter are contrasted. Quarterly averages are taken for 1995 and 1996, monthly averages are taken throughout 1997 and the first five months of 1998, and exchange rates on specific dates are taken for June and July 1998 because of the unavailability of monthly averages. They are denominated in the U.S. dollar per individual currency units so that a downward movement indicates depreciation in the Asian currencies while an upward movement indicates their appreciation against the U.S. dollar.

For the first two and a half years Asian currencies were pegged with the U.S. dollar and were stable. To be exact, the Asian economies determined their exchange rates with currency baskets composed of the U.S. dollar, the Japanese yen, the German mark, and other European currencies, but the weight of the U.S. dollar was so dominant that they were often regarded de facto as pegged to the U.S. dollar. The exchange rate indices of Asian currencies were almost flat at 100 and stable until July 1997. There were only two exceptions. The Chinese renminbi was devalued by 33 per cent in January 1994, and the Japanese yen floated against the U.S. dollar all through the period—fluctuating widely from 14 per cent appreciation (up to 84 yen per dollar) in 1995Q2 to 23 per cent depreciation (down to 121 yen per dollar) in February to April 1997.

However, price increases continued in those Asian economies that had stable exchange rates pegged to the U.S. dollar. Consumer prices in China, the Philippines, Indonesia, Thailand, and Hong Kong (relative to that of the United States in the same index form as the nominal exchange rates) increased by 5 to 10 per cent for the first two and a half years. Korean, Malaysian, and Chinese Taipei's prices were almost flat, while Singapore and Japanese prices decreased by 3 to 5 per cent for the same period. The currencies with increased relative prices were overvalued

Fig.1. Nominal Exchange Rates of Asian Currencies vis-à-vis the U.S. Dollar



Sources: For 1995Q1–May 1998: Japan, Economic Planning Agency (1998). For June 12 and July 10, 1998: *Asian Wall Street Journal*, June 13 and July 11, 1998.
Note: Index form of 1995Q1 = 100, in terms of the U.S. dollar per individual currency.

in real terms even though the nominal rates remained unchanged. Many Asian currencies became overvalued and tended to weaken the international competitiveness of their production. Nevertheless, trade and investment expanded steadily during this period, and nobody predicted a sudden stop in the high growth of East Asia.

But this high growth was interrupted abruptly. Let us follow the changes in Asian exchange rates after July 1997 in Figure 1. During the run on the baht on July 2, the Thai government abandoned its peg with the U.S. dollar and moved to a floating rate. The baht depreciated in the market by 14 per cent within a month and depreciated further by 33 per cent by November. A similar run took place on the Indonesian rupiah, Philippine peso, Malaysian ringgit, and Singapore dollar, and they depreciated by 27 per cent, 24 per cent, 26 per cent, and 10 per cent respectively by November. The Taiwan dollar and Korean won were also affected in October and November. In December and January another round of currency runs attacked the rupiah, baht, and won causing the rupiah to depreciate by 68 per cent, the baht by 56 per cent, the won by 42 per cent, the ringgit by 43 per cent, and the peso by 36 per cent in seven months.

The devaluation of the Hong Kong dollar and renminbi was anticipated by the market following the other Asian currency depreciations in October and November, but both governments resolutely kept their exchange rates unchanged. The yen depreciated during the seven months and was 29 per cent lower in February 1998. This whole shift in currency rates reflects the strong position of the U.S. economy and U.S. dollar. The European currency (ECU) also depreciated by 15 per cent, as did the German mark by 22 per cent during the same period.

The Asian currency crisis seemed to have passed its peak in January 1998 when all Asian currencies recorded their lowest levels and turned upward in February to April (Figure 1). The baht regained 16.6 per cent of its value, the won 10.6 per cent, and the ringgit 10.2 per cent. However, domestic political instability caused further depreciation of the Indonesian rupiah in May, which impeded the recovery of other Asian currencies thereafter. Furthermore, the continued depreciation of the yen since February has also prolonged their recovery in spite of repeated consultations at the meetings of the Group of Seven and APEC (Asia-Pacific Economic Cooperation) finance ministers and the Japan-U.S. joint intervention in the exchange market in the middle of June.

III. IMPACTS ON THE ASIAN ECONOMIES

For a decade before the crisis, the Asian economies continued their miraculous growth. The World Bank report (1993) pointed out that it was due to such good fundamentals as high savings ratios, keen interest in education, diligent work habits, and active entrepreneurship in East Asia. However, it is important to note that almost all the East Asian developing economies achieved 7–10 per cent growth of

GDP together; they did not grow independently but their growth was interrelated with each other through steady expansion of trade and investment. The export and import trade of these East Asian economies expanded at 15–20 per cent annually and the inflow of foreign direct investment (FDI) continued at 18 per cent annually.

The steady expansion of trade and investment was attributed to the open economic policy adopted by the East Asian economies since the 1970s (Yamazawa 1992). These economies participated in the Uruguay Round negotiations and were also active in unilateral liberalization of their import trade (GATT 1993; Yamazawa 1996). The six original members of ASEAN jointly started to implement the ASEAN Free Trade Agreement (AFTA) under which many tariffs were to be reduced to 0 to 5 per cent by 2003. They also participated in the liberalization program under APEC. It was inspired by the ambitious Bogor declaration for achieving "free and open trade in the region" by 2010 and 2020 and provided a unique modality of liberalization by the Osaka Action Agenda. The program has a comprehensive coverage including not only the reduction of tariffs and non-tariff measures, elimination of regulations on services and investment but also calls for the harmonization of rules and standards and other facilitation measures. All eighteen members announced their individual action plans (IAPs) at Manila APEC in 1996 and started to implement them in January 1997 (Yamazawa 1997, 1998). This favorable policy environment certainly supported the steady expansion of trade and investment in the region.

Another important factor contributing to the steady expansion of trade and investment in the region was the stable exchange rates of Asian currencies vis-à-vis the U.S. dollar. It reduced uncertainty associated with foreign transactions and assured foreign investors of the U.S. dollar value of their invested assets in the region.

The currency crisis disrupted this trade and investment and abruptly stopped the economic growth. Thailand, Indonesia, and Korea, which sought help from the IMF, had to resort to severe contractionary policies and have fallen into slow growth. Other economies in the region have responded to the currency crisis by constraining their budgets, suspending development plans, and reducing their growth rates considerably. The East Asian miracle has disappeared abruptly. China and Hong Kong have maintained their exchange rates, but both have suffered from the same severe impact of the currency crisis on their real economies. Its impact has been so profound that it would be better to call it an economic crisis.

Big fluctuation of exchange rates never leave trade and investment unaffected. In Thailand and Korea, export prices decreased abruptly and boosted manufactured exports. Exports of primary products were boosted in Malaysia and Indonesia. Exports have increased in other Asian economies as well. To be sure, manufactured export prices have not decreased fully as much as their exchange rate depreciation. Manufacturing production in the Asian economies depends highly on imported parts and materials whose prices have increased under the depreciation. Exchange rate depreciation has tended to increase the import prices of industrial materials, and foodstuffs in case of Indonesia, and tended to raise domestic prices and discourage exports. Furthermore, a depressed domestic economy has dampened imports and a trade deficit has changed to a surplus in many economies. On the other hand, exports from China and Hong Kong, which have maintained exchange rates and export prices, have been depressed, and exporters are crying for help from their governments. The impact of big depreciations has a strong "beggar thy neighbor" element and inevitably tends to aggravate conflicts among Asian exporters and between Asian exporters and their main market, the United States.

The foreign trade of East Asia is characterized by its high intra-regional trade, 35 per cent of its total trade (JETRO 1998). In 1998 it has become evident that, because of the prolonged depression in the whole region, the exports of all East Asian economies have been dampened, which has come on top of the impact of their currency changes. Both their exports and imports have shrunk and their trade imbalances aggravated (IDE 1998).[1] The depressed Asian market has already been reflected in decreased exports by American and European firms and it is increasingly worried that their deteriorated yields will cause declines in their stock prices and eventually lead to a downturn in the global economy.

What about the impact of the currency crisis on foreign investment in these economies? Big depreciation tends to decrease the acquisition prices of assets in the affected countries and encourage foreign investment. However, only Mr. Soros and a few American and European investors are reported to be seeking profitable investments, while Japanese and other Asian investors have become so defensive that they are intending to delay their investment until stable exchange rates are restored. This does not, however, reflect a change in the FDI strategy of Japanese firms. The Japan External Trade Organization (1998) shows that a majority of Japanese firms are maintaining their strategy of relocating their productive capacity to East Asia and increasing the local content of their production there. Nevertheless their FDI in East Asia will decrease in 1998 because of the downturn of the East Asian economy as a whole and the unstable yen rate. Without the return to stable exchange rates, a steady expansion of trade and investment will not resume in the Asia-Pacific region.

The growth of industrial production of Asian economies in the 1998Q1 decelerated further from the preceding quarter 1997Q4. In Thailand it decreased from −10.4 to −17.4 per cent, in Indonesia from 7.7 per cent to −10.3 per cent, in Korea from 5.4 per cent to −7.3 per cent, in Hong Kong from −0.2 per cent to −3.9 per

[1] The total exports of East Asia (excluding Japan) increased by 7.1 per cent and its total imports by 2.8 per cent in 1997 (JETRO 1998). However, the changes in the U.S. dollar values reflect the depreciation of the Asian currencies against the U.S. dollar and overestimate the depressed state of trade in East Asia.

cent, in Malaysia from 10.9 per cent to −1.9 per cent, in the Philippines from 11.4 per cent to −4.6 per cent, in Singapore from 8.8 per cent to 6.1 per cent, and in Chinese Taipei from 9.4 per cent to 5.0 per cent. The first six economies anticipate minus growth throughout 1998, while the last two anticipate much slower growth.[2]

East Asian economies as a whole have fallen in a trap. During their rapid growth they benefited from a virtuous circle of exports and investment; exports led growth while the high prospect of growth encouraged investment in capacity expansion and improved competitiveness. Today this has changed to a vicious circle of depressed exports and discouraged investment; the depression spread over the region dampens exports which, together with inactive consumption resulting from uncertain economic prospects, has decreased aggregate demand and discouraged investment for the future. Individual governments have tried hard to get out of this trap but thus far in vain. Strong stimulus by external demand could draw them out of the trap, together with resumed currency stability and the recovery of a functioning financial system.

IV. CAUSES OF THE ASIAN CURRENCY AND ECONOMIC CRISIS

What has caused the currency and economic crisis in East Asia? How can we get over this crisis and prevent it from hitting the region again? Much literature has analyzed the causes of this crisis which can be summarized in the following four elements.

A. *Liquidity Crisis Resulting from the Rapid Outflow of Foreign Capital*

The currency crisis was for the most part triggered by a liquidity crisis which resulted from a large and rapid outflow of foreign short-term capital. Large amounts of short-term capital flowed into Asian emerging markets in the 1990s. This inflow was attracted by promising high returns, liberalized markets, and the apparently stable values of the host currencies under the dollar peg. However, as signals increased of weakened financial systems, accumulated external debts, and possible defaults, this capital rapidly flowed out through the liberalized market channels.

The host governments tried to stop this outflow by selling dollars to maintain their exchange rates. This quickly drained their U.S. dollar reserves giving them no choice but to quit the dollar peg and let their currencies depreciate on the market. External debts falling due became an incessantly growing burden as local currencies depreciated thereby pushing banks and firms into genuine default. Some governments sought relief from the IMF to ease their liquidity crisis. The IMF, however, was originally designed to help finance current account deficits and not

[2] Individual country statistics compiled by the JETRO Economic Information Division.

prepared for disruptive capital outflows. The IMF money came only on condition of severe reform for restoring current account balances and not in time for defaults.

B. *Excessive Inflow of Short-Term Capital Caused a Bubble in Host Markets*

In the 1990s there emerged a huge loanable fund in industrialized economies ready for profitable investment abroad. On the other hand developing economies needed funds for further development. They required foreign funds so as to fill the excess of domestic investment over high domestic savings and also to finance deficits in the current accounts which emerged over the past few years. Meanwhile some East Asian economies made haste to liberalize their capital market in order to attract portfolio investment while leaving their foreign direct investment incompletely liberalized, especially their right of establishment and other aspects of national treatment (Yamazawa 1998). The rapid inflow of short-term capital caused excess liquidity in host markets which could not be absorbed into long-term and productive investment projects but flowed into risky investment in real estate and other incompetitive businesses which resulted in non-performing loans at local banks and aggravated financial weakness in the host economy.

This was an unlucky mismatch between demand and supply. Few foreign investors, except shrewd professional speculators, must have gained from the hasty inflow and outflow of their funds in the currency crisis. If foreign funds were invested in an orderly manner, they would have contributed to efficient industrialization of the host economies and brought investors high and stable dividends. No developing economies are perfect in their economic system and conduct. Only if foreign investors had been provided with sufficient information about host economies and conducted their investment with appropriate caution, could there have been no excessive inflow and abrupt outflow, thereby avoiding the Asian economic crisis. There is no way to stop market forces, but are investor country governments not partly responsible for guiding their public investors with information and understanding of host developing economies?

C. *Deficiency in Economic Structure*

East Asian economies still maintain the economic fundamentals which supported rapid growth during the last decade. Their savings ratios are as high as 32.7 per cent on average compared with 26.1 per cent in other developing economies and 20.4 per cent in industrialized economies. However, their investment ratios were even higher, 38.3 per cent on average, reflecting their active entrepreneurship and the difference was filled by the inflow of foreign capital. East Asian economies have been known for the prudent management of their macroeconomic policies, and they have kept their public debt and current account deficits at a minimum until recent years.

However, this does not mean that all fundamentals were valid. There were a few major deficiencies in economic structure and performance. Their financial system has developed uncompetitively under governmental protection, and unsound government-business relationships have sometimes been aggravated by paternalistic industrial policies. These structural deficiencies were concealed during rapid growth but were revealed all at once by the current crisis. They afflicted the arteries of economic growth and quickly stopped the rapid growth. These structural deficiencies should be corrected in order to prevent the resurgence of the crisis.

Problems with the industrial structure in developing economies should also be addressed. Many developing economies in East Asia successfully expanded their production and export of labor-intensive products in a relatively short period. However, their production has relied heavily on imported parts and materials which in turn made these economies vulnerable to currency instability and frequent current account deficits. The upgrading of their industrialization in order to substitute these imports has not made significant progress. This has been due not to the lack of funds but to the lack of capacity for absorbing technology and to the insufficient availability of skilled personnel. This structural deficiency would have stopped the East Asian miracle sooner or later even in the absence of the currency crisis.

D. *Insufficient Efforts for Currency and Financial Cooperation*

Increased interdependence between East Asian economies through steady expansion of trade and investment has been accompanied by rapid financial integration in terms of the increased flow of foreign capital across money and capital markets in the region. The dollar peg and capital account liberalization supported this integration process. Financial cooperation started to facilitate this integration but did not work in time to prevent the crisis.

Major efforts for financial cooperation include the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP), APEC Finance Ministers' Meeting (FMM), and Pacific Economic Cooperation Council (PECC) Financial Market Development (FMD) Taskforce. The EMEAP started in the 1980s and has been conducting frequent exchanges of information but also has aimed at building a network of repurchase arrangements in order to cope with the currency and financial crisis. APEC/FMM started only in 1994 and has had regular exchanges of information and policy forums regarding financial development in the region (APEC 1995). PECC/FMD has organized an expert group on developing financial markets and promotes personnel training so that its analyses and recommendations are inputted into the APEC/FMM (PECC 1997; Kawai 1998).

The proposal for an Asian Monetary Fund came out of these dialogues in the region. The proposal was for Asian members to establish a common fund in order to better prepare for a liquidity crisis in the region. But it failed to materialize because of the strong objection from some non-Asian members which did not want to see an increase of fund pooling outside the IMF. For the last decade the East

Asian economies have been watching over the financial aspects of rapid growth mainly through their individual efforts of maintaining the dollar peg and their prudent management of macroeconomic policies, but they all were caught by the current crisis. This should be contrasted with the progress in trade and investment liberalization and facilitation (TILF) and economic and technical cooperation (Ecotech) projects in APEC. As the APEC leaders suggested in their Vancouver statement (APEC 1997), both financial and real sector cooperation should be promoted in parallel and incorporated into the full APEC process.

V. JAPAN'S POSITION AND ROLE

Where does Japan stand in the Asian currency and economic crisis and what role will it play in overcoming it? Basically the Japanese tended to regard the Asian crisis as "a fire in the other bank." They were heavily engaged in dealing with their own domestic problems such as reviving the Japanese economy from depression following the bursting of the bubble and implementation of six big structural reform programs. Of course, they perceived correctly that the crisis was hitting their major markets and investment destination, and they moved quickly to rescue ASEAN economies. Being the world biggest creditor nation with 100 trillion yen (equivalent to U.S.$710 billion and around 20 per cent of its GDP), and equipped with its exchange reserves of U.S.$218 billion (at the end of 1996), Japan has provided U.S.$37 billion in rescue funds to Thailand, Korea, and Indonesia, much bigger than such funds from any other single nation.

However, it was toward the end of 1997 when the yen depreciation accelerated that the Japanese came to realize themselves severely affected by the crisis. In fact, however, Japan has for some time been in the middle of the Asian economic crisis. First the yen depreciated in advance of other Asian currencies. It depreciated by 26 per cent between 1995Q2 and July 1997, which, together with the 33 per cent devaluation of renminbi in 1994Q1, caused the overvaluation of other Asian currencies. Second, the Japanese economy shares with other Asian economies major deficiencies in economic structure and performance such as a weak financial system and protected incompetitive primary and tertiary sectors. Although being free from the constraint of foreign exchange reserves, the prolonged settlement of non-performing loans has made banks reluctant to extend loans even to sound debtors and has aggravated Japan's deflationary pressure. Thirdly its stagnant domestic demand and low growth of GDP has not been helping the recovery of the Asian economies as a whole.

The current Japanese economy and its impact on other Asian economies should be contrasted with the Japanese economy in the latter half of the 1980s and its strong impact on the recovery of Asian economies from their setback in the mid-1980s. Prices of petroleum and other primary products reached their peaks in

TABLE I

MACROECONOMIC PERFORMANCE OF JAPAN, 1987–97

	Real GDP Growth (%)	Growth due to Domestic Demand (%)	Growth due to Foreign Demand (%)	Current Account Balance (¥ Billion)	Exchange Rates (¥/$)
1987	4.2	4.9	–0.7	13,069	138.33
1988	6.2	7.2	–1.0	10,720	128.27
1989	4.8	5.5	–0.7	8,433	142.82
1990	5.1	5.1	0	5,980	141.29
1991	3.8	2.9	0.9	10,791	133.18
1992	1.0	0.4	0.6	14,761	124.80
1993	0.3	0.1	0.2	15,234	107.83
1994	0.6	0.9	–0.3	13,964	99.39
1995	1.4	2.1	–0.8	11,112	96.45
1996	3.5	4.4	–0.9	8,135	112.65
1997	–0.7	–2.2	1.5	13,362	122.71

Sources: Bank of Japan (1992, 1998a).
Note: Contributions of domestic and foreign demands are calculated based on gross domestic expenditure (GDE) statistics.

1980–82 after the second oil shock and declined sharply thereafter. Malaysia, Singapore, and Indonesia experienced a serious setback of their economic growth, even showing zero growth, as their export earnings decreased in 1984–86. However, they recovered strongly toward the late 1980s and continued rapid growth through the 1990s until the current crisis started.

Table I shows the macroeconomic performance of Japan for 1987–97. The Japanese economy grew at around 3 per cent during the first half of 1980s but gained 4–6 per cent growth in 1987–91. This was preceded by the accumulation of the twin deficits in the United States, aggravated trade conflicts between the United States and Japan, and the Plaza agreement on multiple currency alignment. The yen-dollar rate doubled from 265 to 138 yen per dollar in two years then leveled off. Japanese production at home quickly became less competitive on the world market and its exports decreased. The Japanese government boosted domestic demand through expansionary monetary and fiscal policies so that the 4–6 per cent growth of GDP was contributed wholly by domestic demand while foreign demand decreased and tended to offset the domestic demand. Imports increased and the current account surplus more than halved from the record-high 13 trillion yen (U.S.$ 94 billion) for 1987–90. Japanese manufacturing firms in automobiles and electronics relocated their production capacity abroad to North America, Western Europe, and East Asia. East Asia's exports to Japan doubled between 1986 and 1991 and its accumulated sum for the period amounted to U.S.$342 billion. East Asia also received U.S.$28 billion of Japanese FDI during 1986–90. The medium growth of Japan thus contributed to the strong recovery of ASEAN members during this period.

The medium growth of Japan in 1987–91 included elements of a bubble economy which showed up in skyrocketing land prices and a boom in real estate investment. The bubble broke in 1992 and brought everything down. Almost all financial institutions suffered from decreased prices in their mortgage assets and huge nonperforming loans. Manufacturing firms too suffered from decreased asset values and reduced their investment both at home and abroad. Domestic demand stagnated and was assisted by export increases which pushed the current account surplus up again to 15 trillion yen (U.S.$141 billion) in 1993 which aggravated U.S.-Japan trade relations. The GDP growth rate went as low as 0–1 per cent in 1992–95, while the yen-dollar rate continued to appreciate to 79 yen per dollar in February 1995. In 1996 the growth was regained through increased domestic demand because of the government's strong burst of fiscal expansion, and the current account surplus almost halved again.

However, the recovery did not last long and the Japanese economy fell back into minus growth in 1997, −0.7 per cent, the lowest since World War II. Personal consumption, housing investment, and government consumption decreased and the contribution of domestic demand turned out to be −2.2 per cent, which was offset by a foreign demand contribution of 1.5 per cent. The current account surplus increased again from 1.4 per cent of GDP up to 2.6 per cent, while the yen-dollar rate continued to depreciate. The impact of the Japanese economy on its Asian neighbors has decreased from that of the 1980s.

Nevertheless Japan's imports from East Asia increased steadily, although at a decelerated rate from the 1980s, due partly to intra-firm trade between parent companies in Japan and their subsidiaries in Asia. Japan's FDI decreased to Europe and North America, but it increased to China and ASEAN reflecting Japanese manufacturers' continued strategy of relocating production capacity to other parts of Asia until the current crisis occurred.

What macroeconomic policies has the Japanese government conducted so far and why have they not achieved quick effect on revitalizing the Japanese economy?

The Japanese government implemented a variety of stimulus measures. In the context of Group of Seven cooperation, it has maintained an easy monetary stance at the record-low official discount rate of 0.5 per cent and a 3 per cent long-term interest rate. It implemented fiscal pumping six times totaling 65 trillion yen in 1992–95 mainly on public works. As regards tax reform, the government reduced the income tax in 1994 while postponing the increase of the consumption tax until 1997. As a result, the budget deficit expanded reaching 3 per cent of GNP, and the outstanding government debt amounted to 221 trillion yen, over 50 per cent of GNP in 1996. Concern about the future course of this mounting debt became widespread and led to the increase of the consumption tax from 3 per cent to 5 per cent in April

1997, and enactment of the "Balanced Budget Act" by the Parliament in April 1998 obliging the government to restore a balanced budget by 2001. In retrospect, these prudential efforts shriveled the buds of recovery in 1997.

It is widely shared by economists that macroeconomic policy alone will not boost the Japanese economy. Labor-intensive production has already been relocated abroad, while new businesses will not emerge from the heavily regulated and protected market. Structural reform was attempted through the deregulation of conventional administrative measures and the encouragement of venture businesses. Seven promising areas have been suggested including medi-care, leisure, telecommunication, lease/advertising, housing, and environment. The removal of restrictions and bans on holding companies, job replacement services, and large-scale retail stores is also being implemented.[3]

The Hashimoto administration (1996–98) tackled administrative reform as well. The privatization of national railways, Nippon Telephone and Telegram (NTT), and National Tobacco were the successful precedents in the 1980s. In 1998 the Hashimoto government enacted the reshuffling and downsizing of the central government to seventeen ministries and two agencies. It also implemented a Big Bang of financial reforms starting with the deregulation of the foreign exchange market in April 1998. Tax reform is also on the agenda as part of its Six Structural Reforms Program.[4]

The prolonged stagnation of the Japanese economy in the middle of the Asian economic crisis invited criticism from other industrialized countries and a cry for rescue from "helpless Japan" has become louder in Asia. Japan as the major economy in the region has to play a more active role in getting over the current crisis.

There are two top priority policy issues for Japan. The first is to boost domestic demand and restore a medium growth of 2 to 3 per cent so as to encourage other Asian economies. The government has enacted a supplementary budget for 1998 by freezing the Balanced Budget Act and financing its Overall Economic Policy with 16 trillion yen. This will be strengthened further under the new Obuchi administration to provide a "strong sustained fiscal stimulus" through a special tax reduction and public work programs.

Another issue is to implement a decisive "Total Plan for Financial Restructuring" and promote a market selection of banks and other financial institutions by means of "bridge bank" instruments so that the Japanese financial system is strengthened in order to provide sufficient financial services to revitalize the Japanese economy. Only with the implementation of these two priority issues can Japan take the initiative among the Asian economies in overcoming the current crisis and organize

[3] See Japan, Economic Planning Agency, *Kōzō kaikaku no tameno keizai shakai keikaku* [Economic and social planning for restructuring], 1996.

[4] Another two reforms are concerned with social welfare and education.

an efficient cooperative framework to pursue needed policies. One such policy is to restore a stable currency regime on which trade and investment can reestablish a steady expansion in the region. Another is to build a network of currency and financial cooperation to support the stable currency regime.

However, structural reform consists of destruction of the old system and construction of a new system. The negative impact of breaking up the old system has already become evident, while the positive impact of constructing a new system has not yet emerged. It will take several months before we see Japan's new fiscal stimulus yield results. In the meantime Japan has to persuade the market by showing that all necessary policy measures are being visibly implemented. At the same time other industrialized economies should keep their markets open to East Asian products so that East Asia can get back onto a stable growth path.

VI. HOW TO OVERCOME THE ASIAN ECONOMIC CRISIS

To come to grips with the Asian economic crisis, we must first clearly define the stable exchange rate. Considering that Asian trade and investment expanded steadily under stable exchange rates pegged to the U.S. dollar from 1995Q1 to June 1997, it will be safe to assume as the first step that production conditions of individual East Asian economies were reflected in their exchange rates. This is confined only to the currency transactions based on trade and direct investment. Nowadays, portfolio investment and short-term capital flows dominate the foreign exchange market and determine equilibrium rates in the market. The currency crisis itself was caused by the abrupt outflow of these funds from Asian economies.

Do the current exchange rates of individual Asian economies, departed so much from their rates before the current crisis started, reflect correctly the stable exchange rates which would support a steady expansion of trade and investment? Their current rates are affected by volatile flows of short-term foreign funds and do not reflect correctly the actual production cost in individual Asian economies. Many economists observe that market forces have greatly overshot their mark and far over-depreciated the rupiah, baht, and won. Of course, market forces will correct their overshot position in the long run. Indeed, Asian currencies returned for a few months by 10 to 17 per cent from their January trough. However, the market adjustment of these overshot currencies seems to be proceeding too slow to restore stable exchange rates in a timely manner. The currency crisis has caused financial crisis in many Asian economies, where reported big losses among major commercial banks have continued to cause runs on some currencies in foreign exchange markets.

We must be prepared for it to take a longer period of time for the market to correct for its over-depreciation of exchange rates. However, if this big undervaluation continues in the market, it may lead to two serious situations. First, undervalued currencies will accelerate inflation in domestic markets and cause ill effects on income distribution and social unrest. Second, China may not be able to endure its overvalued currency and may devalue the renminbi, which will cause another competitive devaluation by other Asian currencies, further departing from stable exchange rates. Chinese leaders have repeated that they are determined to continue pegging the renminbi with the U.S. dollar, and they also see economic benefits at home from keeping their dollar peg. But this is their political commitment, and nobody can be sure when their benefit-and-cost balance will be reversed and their political commitment overwhelmed by economic reality.[5]

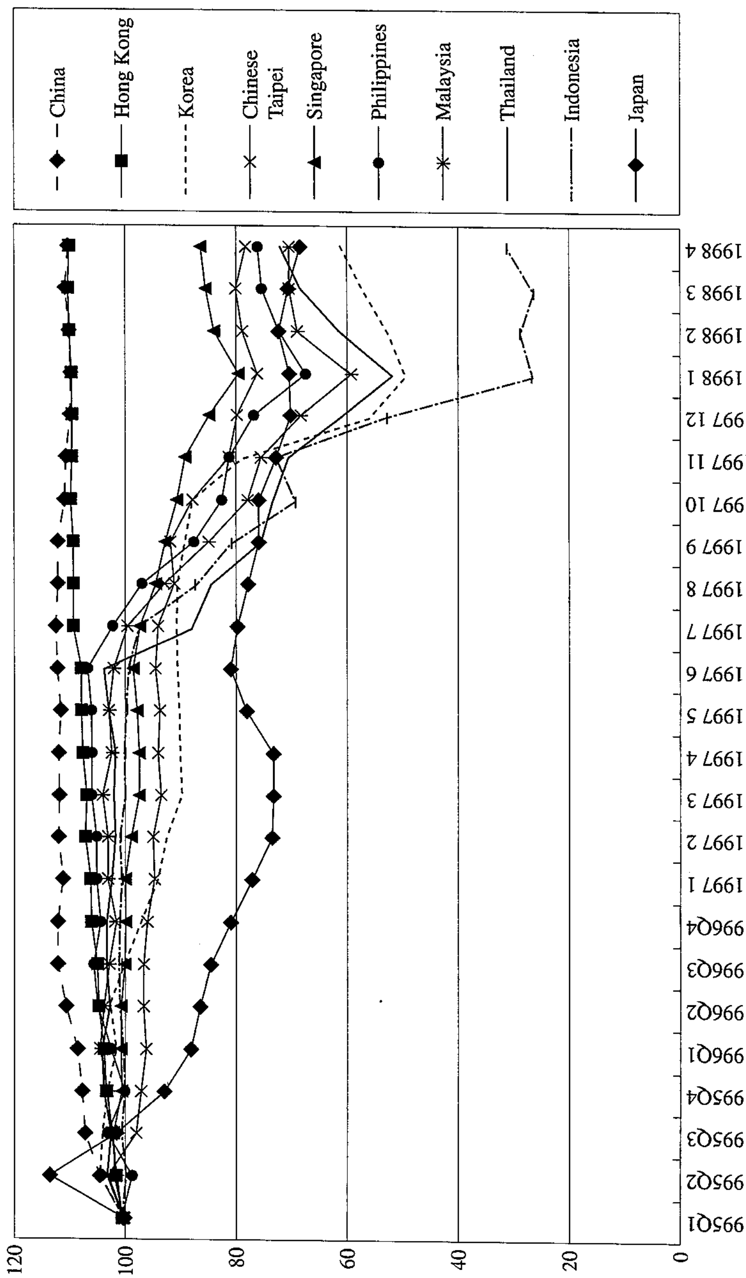
With only market forces at work, we will achieve stabilization of cross exchange rates among Asian currencies only after many trials and errors, and we will not get them corrected in a timely fashion. Therefore, I propose that East Asian governments, together with the United States, jointly conduct a multiple currency realignment à la Plaza agreement of 1985 or Smithsonian agreement of 1971 and restore the stable exchange rates in East Asia.

With the coming of the currency crisis, the East Asian currencies were cut loose from their U.S. dollar peg because it could not be sustained, and they depreciated against the dollar. Is there any rationale for returning to the dollar peg now? The Asian currencies became overvalued under their dollar peg, which indeed triggered the currency crisis. However, should we attribute all fault to the dollar peg and give up the merit of stable currency values for traders and investors? Should we ignore their wish for a return to stable currencies?

Asian currencies became overvalued under their dollar peg for two reasons. One was the appreciation of their real exchange rates against the U.S. dollar because their domestic prices increased faster than those in the United States. (Figure 2 shows smaller changes in their real exchange rates incorporating price changes.) The other was their appreciation together with the U.S. dollar against the yen and European currencies by 15–30 per cent over the past few years. This suggests that it will not work to peg a nominal exchange rate with the U.S. dollar alone. Economists focus on real exchange rates which reflect changes in domestic prices as well. The movement of real exchange rates can be taken into consideration as an indicator of the stable exchange rate directly affecting trade and investment. With nominal exchange rates pegged to the U.S. dollar, price increases in an Asian economy relative to that of the United States will appreciate its real exchange rate. A change in the real exchange rate reflects changes in the relative purchasing power of the two currencies. In other words, if the prices in a particular Asian economy increase more than in the United States, so long as its nominal exchange rate depreciates by the same proportion, its real exchange rate will remain unchanged. If the real

[5] Liu Li-Gang et al. (1998) examines the possible negative impacts of competitive devaluation of Asian currencies including renminbi.

Fig. 2. Real Exchange Rates of Asian Currencies vis-à-vis the U.S. Dollar



Sources: For nominal exchange rates and consumer price indices: Japan, Economic Planning Agency (1998).
For Japanese consumer price index: Bank of Japan (1998b).
Note: Calculated by deflating nominal exchange rates of Figure 1 by relative consumer prices of the United States to Asian economies (also in index form with 1995Q1 = 100).

exchange rate appreciates, that particular Asian currency becomes overvalued and its export competitiveness will deteriorate.

The depreciation of Asian currencies after the crisis had this element of needed adjustment. However, was this big depreciation of over 40 per cent needed for adjusting to the relative price changes between the United States and Asia? Real exchange rates of Asian currencies have also depreciated greatly, meaning that the Asian currencies have become undervalued. It seems to be necessary to correct this undervaluation and get back to a more stable set of exchange rates in the near future. Japan and the United States should take the initiative in conducting a multilateral currency alignment and realize a stable set of exchange rate regime in the region.

We should compare both the advantages and disadvantages of a stable exchange rate regime with those of the current floating rates in which volatile flows of short-term capital dominate the market and traders and investors always incur a big risk of currency fluctuation. There has been little attempt at cooperation and coordination in currency and financial matters in the Asia Pacific, although interdependence has greatly intensified through trade and investment in the past decades. Is this not the true cause of the currency crisis?

VII. TOWARD CLOSER FINANCIAL COOPERATION IN ASIA

The Asian currency crisis was directly triggered by the liquidity crisis caused by the large and rapid outflow of short-term capital, but a few other major factors were also involved which caused a serious economic crisis to spread over the whole East Asia. No single policy measure can overcome the crisis, but several measures need to be combined.

My proposal consists of the following five elements.

(1) East Asian governments should undertake jointly a realignment of their exchange rates à la Plaza agreement (1985) or Smithsonian agreement (1971). It is preferable that the current U.S. dollar rate of the renminbi remain unchanged while other Asian currencies be revalued so as to correct the undervaluation of their real exchange rates. Individual currencies will be pegged with an agreed on currency basket that includes the U.S. dollar, the yen, and the ECU with their composition reflecting their weights in trade and investment in the region.[6] A common wide band of 5–10 per cent should be allowed for individual currencies in order to increase adjustability in response to changes in the market. The crawling peg could be introduced so that their nominal rates be adjusted automatically to changes in relative prices. It would be

[6] Williamson (1996) proposed pegging nine Asian currencies to a common basket of the U.S. dollar and the yen.

better to keep the Japanese yen floating vis-à-vis the U.S. dollar, but some form of currency cooperation should be introduced between the United States and Japan so as to stabilize the yen-dollar rates in the market.[7] This region-wide arrangement will result in a stable currency regime in East Asia.

(2) A routine procedure should be introduced to prevent disruptive capital movements from engendering a liquidity crisis in a member economy. They will be encouraged to introduce appropriate regulatory measures over disruptive capital flows. A temporary freeze in the convertibility of capital accounts may be needed to combat a serious speculative attack. The IMF should be strengthened so as to provide a quick rescue fund to a member economy trapped in a liquidity crisis. Some form of regional arrangement for borrowing and repurchase should be worked out in the region to supplement the IMF.

(3) East Asian economies should introduce a minimum coordination of macroeconomic policies among themselves. This means that they need to introduce a set of maximum ratios for their government debts, balance of payment deficits, external debt to their GDP, and their inflation rate and sustain these target ratios through mutual surveillance and early warning in order to avoid the recurrence of big macroeconomic disturbances. It is important to make the market believe in the sustainability of the stable currency regime in East Asia for some length of time (Goldstein 1998).

(4) Individual members must be encouraged to effectively rectify deficiencies in economic fundamentals, especially weak financial systems, in order to restore and sustain steady economic growth. Technical cooperation should be arranged for the training of skilled personnel and conveying the best and most effective practices of other members. The Asian Development Bank can serve as a catalyst for such technical cooperation among members so that all East Asian economies adjust their domestic systems to transparent and global standards (ADB Institute 1998).

(5) The steady expansion of trade and investment within and outside of the region is indispensable for restoring rapid growth in the region. The current efforts for liberalization and facilitation under AFTA and APEC should be further strengthened in order to arrange a favorable environment for the steady expansion. The Ecotech projects should also be promoted to strengthen the industrial base of Asian economies. Measures for currency and financial cooperation should be combined effectively with cooperation in promoting trade and investment. Both types of cooperation should be promoted in parallel to restore and sustain the steady growth of the East Asian economies.

[7] McKinnon and Ohno (1998) emphasized the contribution of the long-term currency stability and proposed a Japan-U.S. agreement on currency stability based on the purchasing power parity between the yen and the dollar.

These proposals are not abstract ideas for dealing with the current Asian crisis, and many of them have already been partly implemented. The minimum coordination of macroeconomic policies suggested above is consistent with the Manila framework agreed to by the deputy finance ministers of the Asia-Pacific region in November 1997 (Meeting of Deputies 1997). Japan is expected to take an initiative in making this proposal and to coordinate between the East Asian economies and the United States so that an East Asian Stable Currency Group can be formed in a timely manner. If the yen is increasingly held by East Asian economies both for trade and investment transactions and for foreign exchange reserves, it will help to create a more stable currency regime in East Asia than the current one which relies heavily on the U.S. dollar.

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