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Asia's Economic Crisis
－Japan and the Region's Future－

Toyoo Gyohten
President, IIMA

The East Asian currency crisis which erupted in Thailand last April quickly spread to other countries of the region, and in rapid succession currency and stock markets were inundated with tremendous waves of selling. Some currencies lost as much as two-thirds of their value and stock prices fell by more than one-third. Since this crisis has persisted, region's economic growth has been slowing down markedly, unemployment rising, and imports shrinking, and there is now mounting concern that East Asian turmoil may inflict more than negligible damage upon the American, Japanese, and European economies, and may even disrupt the global financial market.

In light of this, efforts are being made to quell the turbulence. The IMF, collaborating with other multilateral agencies and industrialized countries, has provided emergency financing under the condition of macro-economic and structural reforms. Further, creditor banks of industrial countries are refinancing or rescheduling their credit. However, as of today, we are still miles away from a point at which we can declare that the crisis is behind us.

It is nothing new for developing countries to experience occasional economic crises. In Latin America and in Central and Eastern Europe there were severe crises in the recent past. It should be noted, however, that the current East Asian crisis, while sharing some features common with the others, is distinctive in several respects, four of which I would like to touch upon here.

First, the East Asian crisis was prompted by an incompatible and inflexible exchange rate system. Countries which fell a victim to currency turmoil failed to adjust their traditionally dollar-pegged systems to changing circumstances. Second, the crisis was not induced primarily by poor fiscal and monetary policies, as most of the effected countries were not suffering from rampant inflation or excessive budget deficits. Third, the primary cause of the crisis was the structural deficiencies particularly in the financial sector. A lack of soundness and transparency of financial institutions, flawed financial supervision, and the absence of a solid financial market structure were clear evidences of this. Fourth, the fact that East Asia had enjoyed two decades of global fame as an exemplar of economic development inevitably created great disillusionment in the market when the crisis occurred, severely damaging the region's credibility. The market, which previously tended to view East Asia with a certain positive bias, suddenly shifted in the opposite direction, today viewing it with suspicion and distrust. Unfortunately, solutions to structural problems take much more time to achieve than corrections to macro-economic policies, and it is therefore likely that the recovery of market confidence may not come soon.

Let me now talk a bit about the dollar-peg system which triggered the East Asian currency crisis. Indeed, there was enough reason for East Asian countries to virtually all peg their currencies to the US dollar: In a broad range of commodities international trade was denominated in dollars; much trade financing was provided in dollars; the dollar was the predominant currency in the international capital transactions. There is no question that the dollar is the most usable currency for both financing and investment.

It should also be noted that the dollar-peg system provided considerable economic benefits. Assurance of the stability of exchange rate with dollar boosted the credibility of not only the pegged currency, but also its issuing country, and the absence of exchange risk encouraged foreign investors to make vigorous investments in that country.

More importantly, the dollar was on a ten-year decline following the Plaza Accord of 1985, its real effective exchange rate falling by almost 40% during that period. In other words, currencies pegged to the dollar depreciated that much vis-à-vis non-dollar currencies, thereby enhancing their price competitiveness. This was an important factor which contributed to the strong exports and high growth of East Asian counties.

However, the dollar-peg system had drawbacks as well. When there is no exchange risk and a wide interest rate differential robust capital inflow will take place, inevitably creating excess liquidity and a bubble in stock and property markets. Countries which did not practice a prudent and effective supervision easily acquiesced in the ballooning dollar-denominated short-term borrowing by their banks and businesses.

Making the situation worse, China devalued its currency by 40% in the spring of 1994, while the US dollar made a remarkable rebound, particularly against the yen, beginning in the summer of 1995. This exchange rate realignment brought a considerable amount of uncertainty upon the East Asian economy. Between 1995 and October 1997 the real effective exchange rate of the US dollar rose by 20%, while that of the yen fell by 32%. East Asian currencies which were pegged to the US dollar suffered a de facto appreciation; their exports lost competitiveness and their current accounts deteriorated.

Though the market watched these developments with growing concern, a strong belief in the viability and vitality of the East Asian economy, supported by a relatively sound macro-economy and the mesmerizing effect of the myth of the East Asian miracle, blinded otherwise critical observers. No international agencies, public or private think-tanks, or rating agencies hoisted a clear warning sign. It is quite interesting to observe that the market, which is said to be the best judge of economic performance, can have become so totally biased once it is locked into a certain mind-set. More interestingly, as happened often, when the market recognizes its mistake it turns around abruptly and rushes in the opposite direction. When the deterioration of the current account and the accumulation of short-term dollar debt passed a critical level the market decided that the situation was no longer sustainable and started to dump Thai bahts.

Since then, all East Asian currencies

have discarded the dollar-peg system, except for the Chinese Yuan and Hong Kong dollar. It should be noted that the collapse of market confidence and misgivings about East Asian economic management and policy-making were decisive factors in expanding the Thai crisis to the entire region in only a matter of months.

It is certainly premature to make a full assessment of the current East Asian crisis or to predict the future of the region. One thing clear, however, is that the region will have to go through several years of painful adjustment and reform, the bottom-line of which will be to make the structure of economic management, both in government and in private business, more able to withstand external shocks.

At this point, I would like to discuss briefly about five relevant issues which, in my view, have emerged as important challenges as a result of the East Asian financial crisis.

First of all, the stability of exchange rates among major currencies, particularly between the yen and the dollar, is important. The yen-dollar exchange rate has long been a matter of great concern for Japan. Indeed, since the collapse of the 360-yen-to-the-dollar regime in 1971, Japanese economic management has been dominated by fluctuations of the yen-dollar exchange rate. For instance, in the latter half of 1980s, in the face of the rapid appreciation of yen after the Plaza Accord, Japan pursued a very expansionary monetary policy in an effort to halt the rise of yen. In hindsight, the overly long and excessively easy monetary policy prepared a feeding ground for the bubble economy which followed. It cannot be denied that Japan has always viewed the yen-dollar exchange rate as primarily a problem for Japan. However, the outbreak of the East Asian crisis has shown this to be incorrect. As I discussed, one important cause of the crisis was the dollar-peg system followed by East Asian countries. The reason that the dollar-peg system was wrong was that it could not remain compatible with wide fluctuations of the yen-dollar exchange rate occurring in the market. This inflexibility has created an almost capricious fluctuation of the international competitiveness of the countries concerned, regardless of changes in domestic economies, and affected trade and capital flow.

I share the view that it is unrealistic to hope for the reestablishment of a Bretton Woods type fixed exchange rate regime in the foreseeable future. Unrealistic because, unlike in the Bretton Woods days, we now have an enormous and uncontrolled flow of capital around the world. We do not have an overwhelmingly mighty economy such as the US's. in those days. Even so, however, we still have to do something about the situation in which the yen-dollar exchange rate repeatedly goes through excessive fluctuations which cannot be justified by changes in economic fundamentals. If we are running a business producing internationally tradable goods it takes months or years to cut costs even by a few percentage points. The exchange rate, however, may change by that much in a matter of days or weeks, thus nullifying our efforts. It should not be forgotten also that wide fluctuations of exchange rates and volatile flows of speculative money are mutually reinforcing. In general, exchange rate volatility increases the risk to stable productive investment. Therefore, it is now quite desirable and necessary for Japan to initiate an international campaign for the stabilization of the yen-dollar exchange rate. Japan should mobilize the support of East Asian countries and secure the cooperation of the U.S. to establish a broad framework for an agreement by which the yen-dollar exchange rate could be stabilized within a reasonable and predicable range over the medium-term. Such an agreement may include constant monitoring and consultation, coordination of monetary policy, and concerted intervention in the market when necessary. As I said earlier, it is not realistic to try to fix the yen-dollar rate, and in fact exchange rates should change following changes of economic fundamentals. What we can and should aim at is to prevent and correct overshooting of exchange rates in either direction. If the U.S. and Japan can agree to such an idea, and make a public commitment to cooperation, it will certainly mark a significant first step toward a credible stability in the yen-dollar relationship. If and when the yen-dollar exchange rate is stabilized, East Asian countries will then be able to reestablish a viable exchange rate regime for their currencies, one conducive to sustainable economic development.

Secondly, the steady expansion of Japan's domestic demand is vital to the development of the East Asian economy. Although the East Asian economy has achieved phenomenal growth over the past two decades, its aggregate size－including ASEAN, the Asian NIES and China － amounts to just one-half of the Japanese economy. The Japanese market absorbs 35% of East Asia's out-of-region exports, and East Asia owes 37% of its external debt to Japan. Japan should recognize that the stable expansion of the Japanese market for East Asian goods and services and an efficient, uninterrupted recycling of capital to East Asia through the Japanese financial system is extremely important for the East Asian economy.

In that respect the stagnation of the Japanese economy and the fragility of its financial system since 1992 have inadvertently prepared an ominous backdrop to the East Asian crisis. Particularly unfortunate was the severe fiscal contraction imposed last spring, a chilling turn of events for the world, although the majority of Japanese at that time were optimistic that the momentum of economic recovery was strong enough to overcome the fiscal drag. Unfortunately, the concerns of the outside world were proved right. Today there are some who genuinely worry about a global depression originating from Japan. It is important for the Japanese government and business to fully understand that without a strong recovery of their own economy the successful implementation of much-needed structural reforms, including the financial big-bang, will be jeopardized and the greater role expected to be played by Japan in the world diplomacy may not be achieved.

In this regard it is encouraging that the Japanese government has started to implement, albeit belatedly, a series of measures to stimulate recovery and to dispel concerns about financial fragility. The recovery of the Japanese economy has faltered since the second quarter of last year. The most serious setback was the collapse of consumer confidence triggered by a tax increase and the growing concern about future job security. Consumption declined. Unwanted inventory increased, forcing curtailment of production. Investment activities lost vigor. It is true that, supported by the weak yen, exports were going strongly. Large, globalized manufacturing firms were performing extremely well. However, financial services, distribution, construction, and real estate were hard hit. Stock prices fell by 25% during the second half of last year, exacerbating the difficulties of financial institutions. GDP growth rate for 1997 was probably close to zero.

The fragility of the Japanese financial system was primarily caused by the large amount of bad loans left behind the bursting of the bubble economy in the early 1990s. The situation was aggravated by the slow, piecemeal approach to resolutions favored by regulators and business management, and the lack of disclosure of the true situation. In hindsight these were serious mistakes, as they inflicted serious damage to the market's confidence in the Japanese financial system. You need years to build confidence, but only a day to demolish it. In November last year a series of failures of large banks and brokerage houses took place. While all had long been rumored to be loaded with difficulties, it was the market which delivered the coup de grâce. When pessimistic news quickly filled the ears of the market, before the firms realized it they were cut off from short-term inter-bank financing and forced to die by suffocation. Indeed, it was a very difficult and tense moment. The market was at the height of nervousness. Everyone was wondering who would be the next victim. The public commitment by the government and the Bank of Japan to provide whatever necessary liquidity to Japanese financial institutions both at home and abroad prevented the spread of panic, but it was a close call.

One positive outcome to this experience, however, was that politicians and the government finally came to realize the seriousness of the situation and decided to take substantive measures: A two trillion yen income tax rebate, and reduction of corporate and securities transaction taxes were announced; thirty trillion yen of public funds was committed for the purpose of providing a full guarantee to all depositors and to boost the capital base of viable banks so that they can increase their credit facilities. By the package of these measures the market seems to have regained a certain stability stock price has recovered, but sustainable recovery of the economy and the strengthening of the financial system will require for greater efforts on the part of both government and business. We need more simulative measures, and I believe they are coming. The financial business, on their part, requires further restructuring at both institutional and industry levels.

The third point I would like to make is that the East Asian crisis taught us the needs to strengthen regional cooperation. It was disappointing to see that, faced with such an extensive, serious crisis, neither Japan, nor China, nor ASEAN could demonstrate the initiative to summon regional and international efforts to cope with the crisis jointly. In other words, East Asia exposed its lack of cohesiveness. In spite of growing intra-regional trade and capital flow, East Asia is still a congregation of diverse national economies. In other parts of the world, Europe is moving rapidly toward creating a collective economic entity, and North America has established a framework to facilitate the convergence of its regional economy. In short, both Europe and America are steadily moving toward achieving an exclusive regional structure, both establishing a variety of institutionalized or de facto arrangements to promote intra-regional mutual support and cooperation. It is obvious that East Asia, in many respects, is quite different from Europe or America, and it is unrealistic, and even undesirable, to rush toward institutionalization of regional solidarity. Given the high degree of inter-dependence, however, to prevent and manage the recurrence of economic crises and ensure stable regional development, it is important for East Asia to have a nuts-and bolts arrangement by which to facilitate self-help efforts. Such an arrangement may include the exchange of accurate information, strict and objective mutual advice, an emergency financing mechanism, stable exchange rate arrangement, efficient settlement system, promotion of the exchange of goods, services, capital, and human resources. The sine qua non for success in this is unanimous acknowledgment by all regional countries of the need for and value of such arrangements. I strongly hope that the current East Asian crisis has produced a positive stimulus for East Asian leaders to seriously discuss ways and means to defend regional economic stability and welfare.

The forth lesson of the East Asian crisis was that it vindicated the importance of orderly sequencing and appropriate speed of capital liberalization for the developing economies. There is no question that an efficient international distribution of productive capital will accelerate economic growth, and the liberalization of capital transactions is an essential and effective step toward achieving it. However, the speculative flow of enormous amounts of short-term capital amplified instability and increased the cost of the crisis. We often hear the argument that speculators move only when they detect something wrong with a country’s economic situation, therefore what should come first is improvement of economic management.

There is certainly an element of truth to that. Indeed, speculators cannot and will not victimize a genuine innocent, and thus it is incorrect to lay all the blame on speculators. However, if one were to go further, arguing that since the behavior of the speculators is in conformity with market principles, speculation should always be accepted as a constructive activity, I would have to express my strong doubts as to the accuracy of such a statement. Indeed, the market is right, but the righteousness of the market principle will be proven only over time. The market may well be guided by an invisible hand, but that hand is not on duty 24 hours a day. In fact, the market is prone to repeated overshooting in the short term, and speculation exacerbates such volatility. Furthermore, it is a cold reality that speculators are motivated only by short-term profit-making, and not by a desire to support a developing country.

Therefore, developing economies will not benefit by an indiscriminate liberalization of international capital transactions. They need to proceed instead by keeping pace with the creation of sound financial systems and solid financial markets, and with manageable growth in domestic investment. This will require a certain amount of financial regulation, endorsed by the international community, which requires sound behavior by financial institutions and markets.

The fifth point I want to make is the important role to be played by China and Hong Kong. So far, China and Hong Kong have successfully withstood the invasion of Eat Asian financial turmoil. There is no question that the prudent and effective management by the Hong Kong Monetary Authority provided a strong bulwark against the waves of speculative attack. In the case of Chinese Yuan strict exchange control protects the currency from external shock. The strong pledge made by Chinese and Hong Kong authorities to defend their currencies has contributed significantly to prevent the further aggravation of the East Asian crisis.

However, it is also obvious that China and Hong Kong are faced with tough challenges. China is committed to proceed with wide-ranged attack on its internal economic problems notably the restructuring of the loss-making state owned enterprises. To succeed in it Chinese economy needs a continued steady growth supported by strong export and adequate inflow of outside capital. Thriving Hong Kong capital market as a crucial conduit to channel productive foreign capital to the mainland is all the more important. In other words, China has to shoot two birds at once, defending the currency and holding on to growth and reform. Certainly it cannot be an easy job. China needs to maintain its competitiveness not by devaluation but by cutting cost and improving quality of its products. China needs to reform its state-owned enterprises not by easy injection of money but by painful restructuring. I strongly hope for the China’s success in meeting the challenge. The success will greatly enhance China’s credibility in the global market and lay a solid ground for the future development.

As I stated earlier the East Asian crisis is not yet over. Situation in some countries is still precarious. We should also bear in mind that even if we have succeeded in averting immediate financial crisis the real pain of the reform is yet to come. Devalued currency, stringent fiscal and monetary measures and corporate restructuring will inevitably bring about imported inflation, unemployment, and slower growth which will hit the daily life of millions of people. Without strong leadership supported by the people and the willingness of the populace to go through the hardship the task cannot be accomplished. In other words, East Asian tigers will have to spend years licking its wound pondering why it failed, and discovering many lessons to learn. Only through the painful process as such East Asia will be able to reestablish an economic structure which is compatible with the globalized market but at the same time tailored to fit their own environment.

I am the one who trusts in the future of

East Asia because all factors which contributed to the phenomenal development of East Asia during the last quarter century still remain intact. High savings ratio abundant opportunities for investment, youthful population, dedication to education, dynamic entrepreneurship are all there.

So let me conclude now with the words of prophet who told me that wounded tigers of East Asia will come back roaring again with same vigor, but with reduced recklessness and increased wisdom.

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Address: 2-2, Nihombashi Hongokucho 1-chome, Chuo-ku. Tokyo
103-0021, Japan
Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422

e-mail: admiima@ppp.fastnet.or.jp
URL: http://www.fastnet.or.jp/iima/