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Revitalization of the Japanese Economy and the Future of Asia

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The Institute for International Monetary Affairs sponsored a symposium on the "Revitalization of the Japanese Economy and the Future of Asia" on June 2, 1998 in Tokyo. This symposium was moderated by Toyoo Gyohten, President of the Institute for International Monetary Affairs, with Dato' Seri Dr. Mahathir Mohamad, Prime Minister of Malaysia, Dr. Stanley Fischer, First Deputy Managing Director of the International Monetary Fund, Dr. Edward J. Lincoln, Senior Fellow, Foreign Policy Studies of The Brookings Institution in Washington, D.C. and Mr. Eisuke Sakakibara, Vice Minister of Finance for International Affairs at the Ministry of Finance of Japan, as panelists. Discussions covered the financial crisis in Asia, the revitalization of the Japanese financial and economic situation, the outlook for the Asian economy, Japan's contribution, and other related subjects.

This symposium was planned immediately following the symposium, "The Financial System and Stability in Asia," held last December under the co-sponsorship of the Institute for International Monetary Affairs and the International Monetary Fund. Japan has been defined as the key to solving the financial crisis in Asia, but at the same time there has been much criticism that the recovery of Japan's economy and restructuring of its financial systems has shown little progress. Since its establishment, the Institute for

International Monetary Affairs has dealt with key questions in the area of international monetary affairs. We designed this symposium to discuss the Japanese economy and the Japanese financial system, primarily in the context of their relation to Asia.

Asian Financial Crisis

Prime Minister Mahathir commented, in relation to the current Asian financial crisis, that if Malaysia adopted a restrictive monetary policy simultaneously with a tax increase, the country itself would go bankrupt. Furthermore, he pointed out that if the country accepted the IMF program, it would be obliged to pursue further market deregulation and other conditions which would lead to further difficulties, and asserted the wisdom of reconstructing the economy in a manner different from the IMF scheme. The Prime Minister, who is himself a medical doctor, pointed out that there are medicines that are too strong for an ailment, and as a doctor he could not accept them.

Prime Minister Mahathir also remarked that the only way to "overcome the instability in the exchange rate and to rebuild our economy is to do away with currency trading as much as possible." He went on to suggest that the country will "revert to bartering." Some specific ideas he mentioned were that the country will try to balance trade with countries which have a trade surplus with it, and when it had to pay, it would do so "in the currency of the trading partner concerned." As for trade among ASEAN countries, he pointed out that the devaluation of currencies in the region is "approximately at the same rate," and the members are in agreement on enhancing trade among them using "our own currencies and balance our trade." He predicted that "this arrangement will probably be permanent," unless "a new international financial system is put in place which would reduce violent fluctuations of exchange rate."

He went on to say that if the exchange rate is stable, it will only be necessary to concentrate on the domestic economy. He pointed out that the system for stabilizing currency values had contributed to the world's economic development after the Second World War, and even though a complete stabilization of the exchange rate is not possible, because of the differences in the performance of individual countries at different times, he feels it necessary to limit the fluctuation of exchange rates to a minimum. He concluded by saying that the global economy would thrive further if there were an international financial system which could avoid volatile fluctuations of exchange rates.

Dr. Stanley Fischer, First Deputy Managing Director of the IMF, responded that Asia has enjoyed huge, unprecedented benefits from the international free trade system for the past 40 years, and the region would not succeed in solving the current financial crisis by "retreating" from the system. He also commented that even if the volatility of currencies is a problem, there must be no consideration of exchange rates returning to the pre-World War system of bilateral trade.

It was noted that Mr. Eisuke Sakakibara, Vice Minister of Finance for International Affairs of the Japanese Ministry of Finance, defined the current Asian financial crisis as not merely an Asian problem but a problem or crisis of global capitalism, and presented a proposition that since there have been about 100 such financial crises in the past 20 years, including those in developed countries, such crises could be regarded as an illness that markets are inflicted with from time to time. He remarked that globalization is an outcome of revolutionary progress in information and communications technology and has enabled virtual markets to play the central role. Saying that a vast number of transactions are carried out over national borders instantaneously and that a system to offset the volatility created by globalization must be devised, he strongly emphasized the need to study such areas as monitoring and sharing of burdens.

Japanese Economic and Financial Revitalization

Prime Minister Mahathir described Japan as "the richest depressed country in the world," with "the capacity to grow and to be the locomotive of growth for the region." He asked that Japan "invest in the countries of East Asia" as it had before, and that it "buy their products in order to enrich them." He said that Malaysia is "still looking East," though Japan has failed in several areas, and that "even failures provide lessons for us." He encouraged Japan by saying that "there are many things we can learn," pointing to Japan's exceptional skills, technology, discipline, and work ethic, which "are still worth copying." He did point out, though, that with regard to dealing with bad debts, Malaysia will "look Far East," indicating that they will learn from the American methods, and not from the Japanese.

Dr. Edward Lincoln of the Brookings Institution described several factors that produced "a more pessimistic view" of

Japan, beginning with the decision to raise taxes and medical fees in the spring of 1997. Although they were prescribed out of the necessity to control Japan's fiscal deficit, the moves "were too much too soon," and "the government was slow to recognize the real and psychological damage" inflicted by the tax increases of 1997. Also, policy responses were "small and taken one at a time" and too slow.

Dr. Lincoln referred to the inefficiency of public works. He mentioned how perplexing it was, after hearing for two to three years about the corruption associated with public works spending, to learn that the new stimulus package would rely mainly on public works. He said additionally that even though the Americans have been hearing from Japan of the "need to accompany macroeconomic stimulus with extensive deregulation of the economy," it is observed that "general deregulation and administrative reform has been slow and weak," leaving "people worried that the current macroeconomic stimulus package will only have a temporary effect on the economy."

He stated that besides the above, American observers are worried about the continuing problems in the financial sector. Although moves to protect depositors is welcomed on one side, he pointed out that "weeding out weak institutions that are a drag on the economy" is a necessary prerequisite to restoring a healthy financial system.

Dr. Lincoln also commented as regards the Japanese macroeconomic and financial situation, that the current 16 trillion stimulus package will "certainly have a positive effect on the economy over the next year," and that "government policies towards the financial sector will prevent any disastrous collapse of financial flows." However, he believed that a "somewhat different set of policies" is necessary and suggested the following policies.

- "Announce an economic emergency to the public to convince them that the government understands the severity of the economic situation."

- "Proclaim a substantial, permanent income tax cut." This should include "the increased personal exemption method of the current tax cut" and "a sharp drop in the top marginal tax rates." It is necessary to promise that any future action to reduce "fiscal deficits would take the form of decreased government spending rather than a reversal of the tax cuts."

- "Mobilize all Ministry of Finance

and Bank of Japan officials with expertise in accounting to begin a systematic inspection of all banks, securities firms, and insurance companies. These inspectors would be empowered to shut all institutions considered too weak to save."

- "Move forward dramatically with deregulation, including action on the many zoning and tax problems concerning real estate so that it would be easier to actually sell the real estate collateral behind bad debts. Other actions should include accelerating and strengthening the "big bang" reforms, as well as substantial deregulation of telecommunications, construction, domestic transportation, agriculture, and other areas."

Despite these suggestions, Dr. Lincoln said that he has "confidence in the entrepreneurial spirit of Japan," and predicted that there will be those enterprises freed from regulatory restraints that "will grow and bring Japan into a new era of expansion."

Dr. Lincoln emphasized that a critical component of Asian recovery lies in reforming the financial system into one that is "accompanied by stronger rules on disclosure, to convince outsiders" that "prudent lending decisions are occurring." He continued that "Japan could set a good example" to other Asian countries "by bringing about reform of its own financial sector." He concluded that the "economic problems in Japan and elsewhere in the Asian region are serious." However, he ended with a relatively positive observation by saying that "many of the economic fundamentals—high levels of education, strong work ethic, entrepreneurial spirit—remain in place," and "if Japan and other countries successfully address their current problems, I believe that they should be able to return to a path of healthy economic growth."

Vice Minister Sakakibara presented an optimistic view, saying that he is far more relaxed about Japan than he was five or six months ago. This is because the government has done, or at least has clearly drawn a picture of, what needs to be done, and he believed that views about Japan will begin to change.

Touching on the subject of the current fiscal package, he explained that although there has been criticism, there is now a wider acceptance, even in the international community, that public works are more effective than tax cuts. In addition, under current circumstances, a strong multiplier effect can be expected, and he predicted that the current policy will have the effect of raising the GDP by 2%.

He reminded the audience that it had been announced that tax reform would be carried out. He himself did not agree that there was a need to cut taxes on a net basis, but he said that it was true that tax reform was being carried out.

Specific plans for financial restructuring and revitalization of the Japanese economy had been drawn up, and it was expected that they would be set in motion after the Upper House election.

Mr. Sakakibara regarded the capital tie-up between Travellers and Nikko Securities as a symbol of the beginning of the Japanese "big bang," and predicted that other such developments would follow. What had been witnessed in New York and London was now occurring in Tokyo, and it would be beneficial to the Japanese economy if such a tendency was taken further.

Mr. Toyoo Gyohten, President of IIMA, moderating the symposium, compared the difference in perception in and out of Japan regarding the present Japanese economy. There were observations outside Japan that its economy was about to collapse whereas such a sense of crisis was missing in Japan, which meant that there was a gap between what was perceived and what was felt. He posed a question as to whether what was occurring was a truly "Titanic Syndrome," one as grave as depicted overseas, or whether it was something that could be solved once current measures took effect.

Dr. Lincoln responded that the Japanese economy had not collapsed, its growth rate was flat, and though it would not recover it would not fall further either. Japan was a rich country and the situation would not be grave even if the unemployment rate were to increase. However, people feel insecure about their future, and even if they have not lost their jobs there would be anxieties about securing jobs if the economy did not revive. He pointed out the lack of the sense of crisis in Japan, and said that there should be more concern.

Mr. Sakakibara said that even though the Japanese tend to be self-satisfied, they are on the other hand quite masochistic, so it was likely that the pessimistic views were coming from the Japanese themselves. He also noted that Japan, including its administration and the government, had not learned to cope with the fact that financial markets are becoming more virtual. He mentioned the challenges the government faced in public relations activities, and pointed out that Japan did not run a "road show" periodically, which was normal for countries that are placed under IMF programs. He also commented that there should be some "surprise" elements to policy announcements.

However, he also remarked that such issues should not be confused with weakness in the fundamentals of Japan. According to Mr. Sakakibara, structural reform should not be confused with business conditions, and public works were most effective for stimulating the economy. He also criticized the tendency of IMF policies to be based on the assumption that Asian economies would not revive unless they were reformed into a Western style structure, saying that the argument was a form of restructuring syndrome and not necessarily correct.

The Future of the Asian Economy

Dr. David C. L. Nellor, Deputy to the Director, Regional Office for Asia and the Pacific at the IMF, who participated in the second half of the symposium in place of Dr. Fischer, commented that it would take time for the Asian economies to regain their credibility, and that it would be necessary for them to continue a sustained effort for reform. In the case of Thailand and Korea, markets began to react favorably and funds began flowing back into them once those countries expressed their commitment to reform. He used this example to point out that although it may take time to earn back credibility, it was possible to do so by applying adequate reform measures. The reform of financial systems would take time, he said, because, besides the legal aspects, there were areas such as supervision, which required accompanying human capabilities. His forecast for Thailand and Malaysia was that because there still are issues to be solved, such as capital participation in the banking sector, it would be the second half of this year or the beginning of next year before their economies revived.

Mr. Sakakibara added his analysis by saying that credibility was hard to regain once it was lost. In the three to four years after 1993 it could be said that a kind of a bubble had burst in Asia, and regardless of the efficacy of the policy measures, it would take some time for recovery.

Dr. Lincoln pointed out that the situation varied to a great extent in each country. For example, for Indonesia the priority was to stabilize its political climate, whereas in Malaysia the fundamentals were relatively good and the country's credibility would recover in the near future.

Japan's Contributions to Asia

As moderator, Mr. Gyohten posed a question as to what the Japanese economy could do, since the recovery of the Asian economy as a whole and that of the Japanese economy were closely related. This question was especially relevant as East Asian exports seemed unlikely to increase to any significant degree, judging from the outlook for the Japanese economy and foreign exchange rate trends. Mr. Sakakibara followed by touching on the internationalization of the yen. He reflected on the problems in the currency system that Prime Minister Mahathir pointed to, and commented that there seemed to be two related issues that were discussed in recent international debates, and confirmed the points. One was the question of how to deal with the large scale and drastic movement of short term funds. The other was how to deal with the volatility of the exchange rate.

Mr. Sakakibara said that, as is often said, the relationship of the economic development of the Japanese economy and the other Asian economies can be described as 'the flying geese formations', meaning that they are complementary. Thus it was necessary for Japanese companies to increase direct investment and commitment to the region, especially now when the Asian economy was at its lowest point. He remarked that direct investment from Japan is more effective for the revitalization of the economies of Asia than Japan's imports from those countries. He went on to the internationalization of the yen, saying that it was necessary to increase the amount of transactions in yen even for Japanese imports including international merchandise. Since the appreciation of the yen has ended, at least as a general trend, he said he hoped yen transactions would increase. The importance of building the necessary infrastructure for, among other things, yen-denominated trade bills was also mentioned.

Dr. Lincoln responded with a stern remark that if Japan wanted to be of help to Asia, it should set an example by restructuring its financial system. He said that even if Japan can make contributions to Asia by direct investment, individual corporations seemed to be cutting back on their investment to Asia.

Prime Minister Mahathir commented in relation to the internationalization of the yen by saying that Malaysia was very vulnerable to the fluctuation of the exchange rate of the US dollar because the amount of dollar-denominated trade transactions was very high. He said that Malaysia was considering using the currency of the trading partner, which means that if Japan was the trading partner, yen could be used in settlement. With these comments, he welcomed the internationalization of the yen. He disregarded the possibility of pegging the ringgit to any currency, but showed a more positive attitude toward linking it to a currency basket. At the same time, Prime Minister Mahathir remarked that if the amount of trade with Japan should increase, Malaysia would increase its foreign currency reserves in yen.

According to Mr. Sakakibara, Japan had been relatively passive about the internationalization of the yen until now, with the basic attitude being that the markets will decide. Although this understanding has not changed, he reported that Japan had expressed a more positive attitude at the last APEC meeting, and said that it was necessary to speed up this movement along with deregulation. He mentioned tax issues and the bankers' acceptance market as areas that must be tackled.

He also pointed out that it was necessary to resolve the two imbalances in stock and flow. Asian countries owe a huge debt in yen but at the same time most of their credits are in dollars. In the case of Japan, about 40% of exports are yen-denominated, but only 20% of imports are so.

There was a comment from the audience that although the introduction of foreign funds seemed to be regarded as the only option for re-establishing a financial system, that could be done through domestic banks as well. There is not much know-how that domestic banks can gain from foreign banks, and it is the foreign banks that were over-extending their loans. To this, Mr. Nellor explained that in Thailand, the introduction of foreign funds was only one of the options. Mr. Sakakibara pointed out the significance of developing a global financial intermediation function and went on to say that bond markets should be developed in Asian countries to absorb the savings. In this field, he admitted that the financial institutions of Europe and the United States are highly developed, but emphasized that Asia should not allow them to dominate.

To the question of whether it was wise to allow completely free capital movement, especially that of short term funds, Mr. Nellor replied that there were circumstances under which a complete freedom of capital movement should not be allowed. However, the benefits of capital movement should not be disregarded, and it was necessary to devise a way to control the movement with more discretion. Dr. Lincoln added that it would not be possible to reverse the trend toward long-term liberalization in the international financial market, and as regards the movement of short term funds, it was necessary to write the rules rather than to prohibit the participation of hedge funds. It was discussed that as a rule, hedge funds stabilize the market, and such transactions should not be suppressed under regulations. However, although the smaller developing countries are in need of international funds, there is the dilemma that they can put themselves at the mercy of those funds.

Mr. Gyohten summed up the symposium as follows. There was not much disagreement among the panelist concerning what the Japanese economy should do. It was true that Japan is suffering from both current business condition and the structural problems, although they were sometimes confused, as Vice Minister Sakakibara pointed out. It was agreed that the pain of the transition period must be shared among all circles, and the Japanese government, the bureaucracy, businesses, and consumers must all become more conscious of the problems and endeavor to solve them. The Asian financial crisis can be said to epitomize the problems of global capitalism in many ways, and it would take a considerable time for Asia and the rest of the world to solve these problems. On the one hand, funds would continue to try to maximize their profits, and on the other, both individuals and nations would try to develop and maximize their national economies. It was most important for the Asian economy to figure out what kind of policy framework would allow both objectives to be achieved.

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