November 27, 1998
No.6, 1998

IIMA
Institute for International Monetary Affairs
Newsletter

An Asian Perspective on International Monetary Affairs

Hajime Shinohara
Managing Director, IIMA

Introduction

Time appears to have condensed. Until only two years ago, the theme of the tripolar international monetary system of United States, Europe, and Asia was considered one befitting idlers or the discontented uttering grandiose but futile principles. For most, however－whether in public, private, or academic sectors－settling daily and more realistic affairs was of far greater importance, and almost without exception they appeared indifferent to discussions related to this subject. The unpegging of the Thai baht from the US dollar in July 1997, initially considered a very minor incident from the grand perspective of the international monetary system, spread to several countries in a manner which can only be described as a “contagion." In mid‐1998, the crisis spread to Russia, and is now casting a dark shadow on Latin America. Meanwhile, the advanced economies centering on the G7 have not been spared from damage either. While Japan, whose recovery from its recession has been painfully slow, is yet to see light at the end of the tunnel; the US economy also seems to be entering an adjustment phase. In Europe, although the process toward monetary union is apparently progressing with conviction, or *Uberzeugungsverbrechen*, the fact that political leadership in several countries is being forced out could be seen as epitomizing a certain anxiety and dissatisfaction there.

As a result, the way the international monetary system ought to be, is now beginning to be discussed, with urgency and a very strong sense of crisis. Since approaches to this grandiose theme are diverse, it is hardly thinkable that discussions could cross meaningfully. If the plethora of agendas and thoughts can be put in order in this paper, thereby contributing even partially to future discussion of the subject, it would be far more than expected.

The Meaning of the Asian Currency Crisis

It is an indisputable fact that the Thai crisis of 1997 (or, for that matter, the Mexican crisis of 1994‐95) took the form of a foreign exchange liquidity crisis brought on by failures in foreign exchange policy, particularly concerning rates. In Thailand's case, it was explained

that the baht's foreign exchange rate was pegged to a currency basket. Despite the technical aspect of this explanation, the extreme stability of the exchange rate against the dollar since 1986 was sufficient to allow Thailand's industrial and financial sectors to take it as an unspoken commitment of the authorities that the baht would remain stable. It was inevitable, then, that a massive amount of foreign capital would flow in—in the form of short - term money—as the current account deficit, brisk economic activity, and high domestic interest rates continued, and, at the same time, stable and long - term capital inflow, as represented by foreign aid(such as ODA) or foreign direct investment, diminished. Because of this short - term capital inflow, foreign exchange reserves generally increased, the foreign exchange rate remained powerfully stable, and excess domestic liquidity led to the overheating of economic activities, a so - called bubble economy. This circle was then reversed, sparking a liquidity crisis with a rapid capital outflow against the backdrop of a simplistic inference of comparing the total amount of liabilities with the that of foreign exchange reserves. Then, the above logic was completely reversed and a liquidity crisis emerged in Thailand. Although I believe the cases of Korea, Indonesia and Malaysia should also be analyzed, they are left out from this paper due to the length requirement.

If the background of what happened in Thailand is to be summarized in such a manner, we soon run into the unexpected turbulence of exchange rates among the currencies of the advanced countries.

The US dollar stood at one to 240's against the Japanese yen at the time of the Plaza Accord in 1985. (Hereafter, the exchange rate referred to in this paper will be centering on the dollar - yen rate to simplify the argument. However, it is hoped that the movements of the DM and other European currencies are also implied.) The U.S. dollar has steadily depreciated since then, with occasional fluctuations. The Bush Administration—inheriting the twin deficits of Reaganomics—and the first Clinton Administration loosed particularly bizarre policies, brandishing the responsibility of countries with surpluses as though to prove that the more they can force appreciation of currencies against the dollar, the more points they can gain in international monetary diplomacy. The dollar - yen exchange rates during this period showed a general trend toward the yen's appreciation. According to general media analysis, the instability of Japan's political scene caused a situation in which the yen was bought from the viewpoint that no effective step could be taken to prevent it from appreciating. If we only stop for a moment to reflect on this market view and the stance of the media, which convey such a view, they were unquestionably also a very curious phenomenon difficult to understand.

In the midst of this development, the US dollar gradually depreciated, until it reached less than ¥80 to the yen in April 1995. During this time, many developing countries' currencies were pegged in some manner to the US dollar, and they spoke of the stability of their national currencies only in terms of their exchange rates against it. The majority of Japan's foreign aid(ODA) to Asia takes the form of yen loans provided by the Overseas Economic Cooperation Fund, and not long ago these loans created exchange risk debates in many countries as the dollar depreciated against the yen. Actually, on the backside of this yen - denominated position, there existed the dollar pegging system. It meant that in the process of dollar depreciation, many of these currencies were steadily depreciating against the yen and other major advanced countries' currencies. When the American argument of the "responsibility of surplus countries" revalued, one way or the other, the currencies of Korea, Taiwan, and Singapore against the US dollar, it also resulted in their appreciation vis - a - vis the currencies of countries—such as Thailand—which were not subject to such US criticism. It is easily understandable that such moves strengthened the external competitiveness of these currencies, i.e. the price competitiveness of their goods and services. In fact, many of these countries attained high growth, sustained by exports. It should also be pointed out that there were at this

time financial practices biased in favor of the US dollar in many of these countries. This was only a logical consequence in light of the exchange rate policy so far discussed; i.e., all international trade of goods and services mostly continued to be dollar-denominated and settled in dollars, and most private sector foreign currency financing such as trade financing was done in US dollars.

A typical example of the heavy bias in favor of the dollar was the fact that yen-denominated financial transactions—not only euro-yen bond issues by private sector corporations of these countries, but also many government yen loans were ultimately used and recognized in the form of dollar-denominated liabilities, after being swapped with the US dollar.

Exchange rate policy pegged to the dollar and international monetary policy heavily biased to the US dollar continued to function effectively, sustaining the macroeconomic policies of many countries during the process of the steady depreciation of the dollar. This process itself was a naturally logical consequence, considering the macroeconomic balance of the United States, which maintains current account deficits in the absence of a balance between domestic savings and investments.

A Solitary Dollar Strength

The turning point for dollar depreciation as a trend was mid-1995. The international monetary diplomacy which only sought the benefit of letting the currencies of other countries appreciate was criticized by the monetary authorities of many countries which held a large portion of their foreign exchange reserves in dollars. This censure was expressed by the shift of some dollar assets into the yen and other currencies. Such a move revealed itself in a pure and simple increase in dollar selling and yen purchasing on the foreign exchange market. Its effect on exchange rates is greater compared with the actual amount of funds mobilized. Dollar selling caused more dollar selling, and the US dollar depreciated to less than ¥80 to the yen. The monetary authorities of advanced countries must have been not only astonished, but even frightened by this rapid change in exchange rates. Japan felt that its scenario to settle the aftermath of the bubble and restore its economy to a normal path in the 1990's would inevitably have to be substantially revised by the rapid pace of the yen appreciation, which seemed endless. Fear on the US side, which took the policy of letting other currencies freely revalue, must have been that the progress of dollar devaluation in the situation—where there was no apparent possibility of improving the current account balance, even after falling into a net debtor position—would not only call into question the future foreign capital inflow toward financing its current account deficit, but also that capital might begin to flow out of the United States. In other words, the argument that the final consequence would be a crash—a drastic fall of the dollar exchange rate—began to acquire a certain amount of truth. Therefore, at around this level, the U.S. began to dramatically shift its policy from a weak-dollar to a strong-dollar policy.

The U.S. thinking behind this shift must have been something like this:

During the mid-1990s, the only brisk economy among advanced countries was the United States. Even though its current account was in deficit, capital to offset this was flowing in from all over the world. As a result of market intervention in the foreign exchange market by surplus countries—led by Japan in the form of market intervention to counter excessive appreciation of the yen—their foreign exchange reserves would automatically flow into the United States. Many developing countries took the exchange policy of pegging their currencies to the dollar, and their foreign asset holdings as a logical consequence became dollar-denominated. It was the same for portfolio investment by the private sector. Interest rates,

as the "body temperature" of a normal economic entity, were at the normal levels only in the United States, thereby attracting sufficient investment. Thus, the world's surplus funds would be flowing into the United States. If that is the case, the stronger the US dollar exchange rate, the better it is. A strong dollar meant that the United States would be able to purchase goods and services from all over the world more cheaply, which would work effectively against inflation. In other words, the dollar should be kept strong, as long as the inflow of funds does not seriously affect corporate earnings and employment in the United States.

For Japan, it was a policy task to somehow induce yen depreciation—or to at least to divert it from the ¥80 level—due to recessionary economic activity, and in order to gain time to formulate a scenario for resurrecting its financial sector, which was unable to find any fundamental solution to their problems in any amount of time. It was believed that a ¥100 level exchange rate would have a positive effect on corporate earnings, and it is surmised that the authorities saw this as bringing about economic growth which would stop falling real estate prices and induce a recovery in stock prices.

Europe experienced currency turbulence in 1992, after agreeing on the Maastricht Treaty. While most non-Europeans questioned the feasibility of monetary unification, European countries were tightening their belts to somehow achieve the initially set economic convergence criteria. During this period, European attention was mostly focused on individual EU countries' domestic equilibriums. External equilibrium and resulting trend in foreign exchange rates were only secondary in policy priority, which even now does not seem to have changed, as the euro is about to make its debut. This situation gave people in other countries the impression that the Europeans were thinking that a somewhat a cheaper-than-actual exchange rate at the starting point of the euro might promise a smooth exchange rate setting thereafter.

It seems that the U.S., Europe, and Japan accepted the solitary strength of the US dollar based on their own logic. This can be seen in coordinated interventions toward this direction, which began in August 1995, as well as in exchange rates thereafter, forming the backbone of exchange rates among advanced countries in the three years since then and still ongoing.

However, the effect of the solitary strength of the US dollar(weak yen and European currencies) on the emerging economies was enormous. In Thailand, for example, the relative exchange rate of the baht vis-a-vis currencies other than the dollar would continue to rise in the process of dollar appreciation against other currencies, since an extremely rigid pegging of 25 bahts to the dollar was maintained. This is more clear in the exchange rate trend of the baht against the yen.

What must not be forgotten is that speculation caused revaluation of the Malaysian ringgit in 1993-94. Also, the IMF, in its early 1996 consultations with Thailand, recommended the widening of the band of foreign exchange rate movement, which had the possibility of raising the baht's rate against the US dollar. As Malaysia and Thailand faced speculative pressure to revalue their currencies, or because such a possibility was suggested to them, the strength of the US dollar was set on course and progressed, ultimately attacking these countries and leaving huge scars. Taking Malaysia and Thailand as typical examples, this change appeared in the form of enlarging current account deficits from the previous 2% of GDP level to 8-9%.

That these external imbalances induced many of these countries to rapidly increase external liabilities, and that the ensuing rapid capital outflow made them quickly lose balance, are today's currency crisis in a nutshell. It does not seem an exaggeration to say that what emerges from the picture in a tone of thorough-bass is an outrageous turbulence among the currencies of advanced countries.

Failure of the Trinity

It is a well - known fact that stabilization of a currency by virtue of monetary authorities' promises(no matter which method is taken among fixed rate systems, the US dollar pegging system or the setting of target zone), liberalization of financial markets, and implementation of national monetary policies in response to individual economies cannot coexist. During normal times in Hong Kong, it is assured that the non - regulation of capital flows will continue, supported by the fact that its local currency is pegged to the US dollar and by Hong Kong's role as a international finance center. As a result, in choosing among financial policy schemes, Hong Kong gave up its own interest rate policy and followed the US monetary policy. This is one way.

In China, financial and capital transactions is mostly regulated, in order to guarantee stable foreign exchange rates and protect the freedom of their own monetary policies, which helps domestic policy development. The recent policies implemented by the Malaysian government are very similar to China's method, and so they cannot be blamed for having acted merely on theoretical conclusions.

On the contrary, as a result of liberalization of money markets and international capital transactions, and maintaining freedom of monetary policy development, no advanced country uses the method of a fixed exchange system promised by their monetary authorities, rather leaving their foreign exchange rates to be determined by the markets. It is still fresh in memory that, in Europe in the fall of 1992, immediately after the Maastricht Treaty adopted the criteria on exchange rate stability in the ERM, the market attacked relatively weaker currencies and fell into serious turmoil. This gives a vivid idea of how difficult it is to attain the mutual stabilization of currencies by virtue of a promise. This is considered to be based on the same reason that, when the Bretton Woods Commission mapped out a target zone system for exchange rates in 1995, the reaction of a majority of government officials from advanced countries was indifference.

Should exchange rates be left to the markets? No. If one looks at the process of the foreign exchange market's efforts toward finding a new equilibrium, it is obvious that it wastes too much time. Moreover, it inevitably repeats extreme ups and downs. This occurs because many foreign exchange dealers, who themselves create the market, follow others blindly, and trade under the principle of, “it's OK to cross at the red light if everybody else does it." In the US, Europe, and Japan, to stabilize their currency rates on authorities' promises remains difficult. On the other hand, to leave exchange rate violently fluctuating should be criticized as irresponsible.

In summary, what is required is market management which functions like a perfectly free market, but produces a stable exchange rate that fluctuates only within 10% in either direction and centers on a rationally balanced point which reflects the fundamentals of a country's economy. To attain this, Europe's experiment in currency unification suggests some important basics.

The EMU represents a consensus in target macroeconomic indicators and member country's efforts to achieve them.

If the U.S., Europe, and Japan could manage their rates of growth and inflation and interest rate levels within a certain range, as a matter of course it could be expected that the exchange rate will lose the tendency of wild movements and stabilize. Before reaching agreements on targeted economic indicators, a sufficient exchange of information and the promotion of mutual understanding is required on those matters, such as the money supply and the expected inflation rate, toward the formation of market psychology and expectations. Of course, the information exchanged among these tripolars, the process of the agreement's formation, and its results should be kept secret for a certain period of time, and information disclosure by insiders must be strictly prohibited. Again, this subject derives from the series of crises, brought on by selfish, nationalistic behavior and use of the theoretical alibi that exchange rates have been completely

left to free market fluctuations, both of which should not be perpetuated among the tripolar system of the U.S., Europe and Japan.

Future Subjects

International Short - term Capital Mobility Control:

Led by the idea that the European currency crisis of 1992, Mexican crisis of 1994, and the latest series of currency crises beginning in Thailand were all initiated by excess amounts of short - term capital movement, an international consensus is emerging regarding the need for some kind of regulation of international capital transactions.

However, it also seems almost impossible to establish simple and effective regulations. For instance, if trying to divide foreign exchange transactions into three categories, that is, real demand transactions, hedging transactions, and speculative transactions, one could probably draw a clear line between real demand and the other two. But to draw a line between hedging and speculating is a classic thesis that has been never solved. It is even worse when it comes to derivatives. So, in summary, lender countries' financial institutions (including banks, which are themselves the direct lenders), should be put under more strict supervision, and controls on them should be strengthened, including imposing soundness criteria, moral standards, and so on. At the same time, in borrower - side countries, the inflow and outflow of external funds should be monitored more closely and judged whether they are manageable or not. When a manageable amount has been exceeded, inflow must be regulated. The regulations in this case can be either the Chilean method, or the Chinese/Malaysian method. What is most important is to build an infrastructure that would enable emergency regulations to work effectively. This would include reforms of foreign exchange control and foreign capital laws.

Indeed, it must not be forgotten that one of the lender countries in which capital flow must be monitored cautiously is the United States.

Even strict regulation of lender countries, however, cannot work effectively for speculative private placement investment trusts such as hedge funds, because they have no specific nationalities, and fall out of their jurisdiction. Their supply lines may have to be cut to fight off speculative positions and, in that sense, the Malaysian method which entirely prohibits outflows of home currency into the euro - market is so logical that it can be a good model for many other countries.

Institute for Regional Cooperation:

As a result of the historical success of the Tokyo meeting to support Thailand last summer, and the favorable international reaction, it was only natural that an “Asian Monetary Fund" scheme has emerged. Subsequently, however, this has met many complications, and seemes to have been shelved. However, looking to the policies that the IMF has applied in Asia the past year and the current situation where we can see some countries, including Russia, getting into trouble when IMF comes into financial shortfall, it seems that now is the perfect time to seriously consider the scheme. In view of the current situation in Asia, it is unlikely that an “Asian Monetary Fund" could be set up fast enough to work effectively on this crisis, even with quick action. However, so that this serious crisis would never again occur(Economic problems are happening again for Latin American countries in the late 90's as occurred in the 80's), a multifunctional and multinational institutional framework in Asia has to be completed.

Asian Monetary Fund should have many types of functions in this, such as emergency funding ability, an infrastructure enabling mutual utilization and settlement of regional currencies, discussion over macroeconomic and promotion of mutual understanding to avoid

another crisis, short‐term capital control, emergency regulations, and so on. Japan, as a matter of course, is expected to be the leader in this scheme.

Let us turn now to Japan's current situation, which is deplorable. Japan's politicians, who are the ones actually leading the country, lack any sense of emergency, and give the impression both domestically and outside of Japan that they are experimenting with economics measures for political gains. Making matters worse is the mass media's inconsistency, and a group of economists and commentators who are aggravating the situation. The adjustment of macroeconomic policies in the U.S., Europe, and Japan can work only when Japan's economy has regained a healthy pace of economic growth and when Japanese financial institutions have performed their expected roles. For all intents and purposes, the recovery of Japan is being demanded internationally. Particularly, Asian countries are strongly waiting for a recovery by Japan and a resulting appreciation of the yen, as their currencies are pegged only to its recent downward movements(that is, the weak yen has weakened their currencies altogether.) and because the huge direct investment by the Japanese private sector, led by a strong yen, once propped up Asian economies.

I believe that market sentiment toward a stronger yen will be realized easily if both an immediate recovery by the Japanese economy which includes a healthy growth rate and a fulfillment by financial institutions of their expected duties are realized. Moreover, as the U.S. economy slows, it is difficult to imagine that the one‐way flow of capital into the U.S., which has made the dollar the only strong currency on the market, can continue forever. The current account balance between Japan and the U.S., manifested as real demand on the foreign exchange market, will shortly change market sentiment in this direction. In other words, the day of the appreciating yen and depreciating dollar is nearing, even if exchange rates are left to the market. Then, perhaps, economists and the mass media will again make a fuss, saying, “The worst has happened. A strong yen will crush Japan's economy!" However, events will not be swayed by this sort of rhetoric. Actually, appropriate policies could help achieve the 3.6% of growth rate of 1996, which would be reassuring. As mentioned above, Asia is waiting for a recovery of the Japanese economy. Along the way, it is essential, without being swayed by other immediate concerns, to maintain a continuous injection of money and capital into the region. Every effort to do so must be made now, more than ever, including utilizing public funds(Export‐Import Bank of Japan, OECF, trade insurance and so on), direct investment by the private sector, and a flow of funds through financial institutions. Moreover, now is the time to implement new measures, such as shifting of certain proportion of Japan's foreign reserve (20%, or about US$40 billion, for example)into Asian currencies, which can then be utilized in the form of Asian countries' reserve accumulation or public funds for domestic financial system reforms in those countries.

Time appears to have condensed, and it is high time for a definite resolution, especially in Japan.

(This is a translation of an article published in ECO‐FORUM＜Vol.17 No.3＞ on November 4, 1998.)

©1998 Institute for International Monetary Affairs
All rights reserved. Except for brief quotations embodied in articles and reviews, no part of this publication may be reproduced in any form or by any means, including photocopy, without permission from the Institute for International Monetary Affairs.

Address: 1-2-2, Nihombashi Hongokucho 1-chome, Chuo-ku. Tokyo

103-0021, Japan
Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422

e-mail: admin@iima.or.jp
URL: http://www.iima.or..jp /