May 17, 1999
No.5, 1999

IIMA

Institute for International Monetary Affairs

Newsletter

The Role of Japan in the Recovery of Asian Economies

(Speech on April 7, 1999, at the Gov. Jose B. Fernandes, Jr., Annual Memorial Lecture Series, Asian Institute of Management, Manila, Philippines)

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Brief History of the East Asian Financial Crisis

The East Asian financial crisis was a traumatic experience for all who were affected by its devastating impact. The currency crisis which erupted in Thailand quickly spread to other countries of the region, and in a 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. Shrunken demand for imports in the region affected producers of manufactured goods and energy resources all over the world. Growing business failures have caused deterioration of the balance sheets of lenders and investors from industrial economies. The hardest hit were, of course, the millions of people living in the region, who had to suffer a severe drop in employment, income, and living standards. Although the worst seems to be behind us by now, it is certain that East Asia needs at least a few more years to recover fully from the damage; the situation in some countries is still precarious, and all countries in the region are still in the process of painful restructuring.

We should recall that the crisis was brought about by compounded factors. At the most fundamental level, there was the failure to recognize and adapt to changes in the global economy. More specifically, since the 1980's the international financial flow became so enormous, rapid, and free that no economy could remain immune to its impact. Also, progress made in communications technology has enabled millions of voters, taxpayers, shareholders, and consumers to access the same information instantaneously. The information revolution, as such, has extensively altered the nature and mechanism of governance in the corporation and in the government. Transparency and accountability became key words.

Unfortunately, East Asians were blinded by the glory of past success, and failed to change their traditional way of running the economy. The financial sector and regulatory regime were left impaired and opaque. Business was conducted on the unwarranted assumption that high growth would continue forever. Exchange rate policy remained rigid. As a result, East Asia lagged behind the global trend, and the gap thus created heightened the potential risk of incompatibility with the market.

The immediate cause of the currency crisis in Thailand and its rapid contagion to other economies in the region was the sharp reversal of the short‐term capital flow triggered by the sudden turnaround of market sentiment toward East Asian economies. The market participants had long been mesmerized by the East Asian miracle, but when they were forced to realize their mistake they rushed to the other extreme.

The crisis developed in various shapes: Acute shortage of foreign currency liquidity, sharp increase of external debt burden as a result of currency depreciation; crippling of trade finance; collapse of the equity market, etc.

It is obvious that, since the factors behind the crisis were compounded and its symptoms varied, the response to it needed to come in a package of various measures. At the very outset, emergency injections of foreign currency liquidity were necessary to replenish official reserves and sustain trade flow. Then, the improvement of market sentiment was crucial. In this respect, agreement with the IMF on austere macroeconomic policy did have a positive impact. However, because the IMF started to argue that the East Asian problem was of more of a structural nature, improvement of market sentiment was stalled half‐way. It is fair to say, however, that the initial shock of the foreign currency crisis was somehow brought under control.

Prescriptions for Further Recovery

The affected East Asian economies are now in the second stage of their battle for recovery. The goal of this stage is to put the economy on a viable and sustainable growth track. For that purpose, the improvement of the balance sheets of banks and businesses is a prerequisite, which will not be an easy task, as it requires the simultaneous implementation of extensive corporate restructuring and improvement in overall business condition. Restructuring is a painful surgical operation, but it must be carried out. At the same time, economic, social, and political shocks should be avoided by fiscal and monetary policies which are not stifling. They should be growth‐friendly. However, it cannot be stressed too much that corporate restructuring must proceed in earnest, as it is the only way to maintain the confidence of the market. The simultaneous attainment of these goals will be the most difficult part of the whole process.

The third stage is to carry out reform of the economic, social, and political infrastructures which all of the affected East Asian economies failed to tackle in time.

It is obvious that the East Asian crisis has left many lessons to be learned by all Asian nations, including Japan. It was a sobering revelation for the Japanese to be reminded of the close interdependence between Japan and East Asia, and also of the similarity of the problems they shared. Unfortunately, all of us were guilty of complacence and negligence.

Now the challenge before us is to cooperate to expedite recovery and prevent the recurrence of a crisis, and Japan is fully aware of the role it has to play in this joint endeavor. In my view, there are five major areas where Japan must make its utmost efforts.

- Expansion of the Japanese import market
- Revitalization of Japanese banks
- Extension of public financial support
- Stabilization of the exchange rate of the yen
- Creation of a regional self - help arrangement

Expansion and Revitalization

Expanding the import market and revitalizing the banking industry obviously relate to the recovery and sustained growth of the Japanese economy. It should be noted that although the East Asian economy 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 fragility of its financial system since 1992 have inadvertently provided an ominous backdrop to the East Asian crisis. Particularly unfortunate was the severe fiscal contraction imposed in the spring of 1997, 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. Japan's GDP for FY1997 contracted by 0.4%, compared to an expansion by 4.4% in FY1996. For FY1998, which ended just last month, the decline of GDP was further aggravated, to 2.5%. For the current FY1999, although the government hopes to regain a positive growth of 0.5%, I am less optimistic than that.

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 which was favored by regulators and business management, and by 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. It takes years to build confidence, but only a day to demolish it. In November 1997 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 grace. When pessimistic news quickly filled the ears of the market, before the firms themselves 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 liquidity necessary 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 at last came to realize the seriousness of the situation, and decided to take a series of important measures, particularly since the beginning of the present administration last July under Prime Minister Obuchi. Huge public expenditures for infrastructure works were authorized and are being disbursed. A major tax cut, amounting to 8 trillion yen, equivalent to US$65 billion, was implemented. The highest marginal rate of personal income tax was lowered from 65% to 50%. Corporate tax rate was cut from 47% to 40%.

For the revitalization of banks, two ailing major banks were nationalized. 7.5 trillion yen in public funds was injected into banks in order to strengthen their capital base, so that they can expedite the cleaning up of bad assets and resume active lending. Under strong pressure from both the regulatory authorities and the market, banks have started the restructuring effort in earnest. Reorganization, including streamlining, divestiture, merger, strategic alliance, etc. is progressing everywhere, and foreign institutions are actively participating in the process actively. It is clear that, within a few years time, the landscape of the Japanese financial service industry will be quite different.

A regulatory overhaul is also progressing. New agencies such as the Financial Restoration Committee, Financial Supervisory Agency, and a Japanese version of the RTC were created, and are already functioning in high gear. Ministry of Finance was divided, and the Bank of Japan became fully independent as the single authority for monetary control. All in all, it is fair to say that the effort to revive the economy and financial sector has made a serious and a promising start.

Though it is true that the Japanese economy is still contracting, there are increasing glimmers of hope emerging in various sectors, including industrial production, housing starts, inventory adjustment, consumption, and the stock market. There is a marked improvement of business confidence. As stated earlier, this year's growth may still be negative, but before the end of the year the slide will be arrested, and the economy will start the process of recovery.

Extension of Public Financial Support

The third area of Japan's role, the expansion of public financial support to the East Asian region, is also important. With its large excess savings and current account surplus, Japan is expected to play a critical role in intermediation to recycle productive capital to the region smoothly and efficiently. Under normal circumstances the private sector should be the major player, but as discussed earlier, Japanese banks are still at the stage of convalescence and unable to fully perform this function. Thus the public sector has to fill the gap until the private sector recovers enough to take over. In this respect Japan has made a remarkable effort. Through the operation of Export Import Bank of Japan(EXIM), Overseas Economic Cooperation Fund(OECF), and with the cooperation of the Asian Development Bank(ADB), the World Bank, and the IMF, since the onset of the East Asian crisis Japan has committed to a variety of financial supports to the affected countries in the region amounting to US$63.7 billion. Such efforts will continue and will expand.

Stabilization of the Exchange Rate of the Yen

The fourth area of Japan's role is the maintenance of yen - dollar exchange rate stability. It is now a commonly held view that the so - called "dollar - peg system" was a major culprit of the East Asian crisis. It is certainly true that affected countries ignored the fundamental disequilibrium emerging in their economies and failed to adjust their currencies' exchange rates accordingly. In that sense rigidity of exchange rate policy was responsible for the crisis.

However, more important was the fact that the dollar itself fluctuated violently vis - a - vis the yen, another important trading currency for affected countries. One dollar's value declined from 246 yen in 1985 to 79 yen in 1995. It recovered to 140 yen in 1998, and then dropped to 109 yen again. The ten - year weakening of the dollar between 1985 and 1995 brought about a windfall trade surplus for the affected countries, but then the sharp reversal starting in 1995 erased the excessive price advantage and weakened their current account position which, in turn, undermined market confidence and prepared a feeding ground for a crisis.

In other words, it was not the dollar - peg system per se which is to blame. It was the unheeded fundamental disequilibrium in the country's economy and the wild fluctuation of the dollar - yen exchange rate. It is hardly possible to explain and justify such wild fluctuation by the relative situation of American and Japanese economies during the period. It is a product of the combination of the enormous amount of volatile capital and the herd mentality of market participants, which can be triggered by a capricious flow of information.

I am not advocating a return to a fixed exchange rate, or rigid kind of stability. Exchange rates should change over time, reflecting such fundamentals as balance of payments, inflation, or interest rates. What I am arguing is that unwarranted volatility, which tends to create a prolonged misalignment, destroys the reasonable predictability of exchange rates and thereby distorts trade and investment decisions. I believe it is indisputable that the wild fluctuation of the dollar - yen exchange rate since 1985 has produced a serious distortion not only for the Japanese economy, but also for East Asian economies. If the dollar - yen exchange rate had remained reasonably stable, I suspect the severity of the East Asian crisis could have been mitigated considerably.

Having said that, the way in which to achieve exchange rate stability is clearly a different subject. There is no shortage of arguments disavowing exchange rate stability based upon theoretical analysis, empirical evidence, or realistic resignation.

Though there is not enough space to go into the argument here, if there is broad agreement about the desirability of exchange rate stability, then we should explore the way to achieve it. In my view, the first and most important step to be taken is a joint public commitment by the countries concerned to a recognition of the importance of exchange rate stability and to a willingness to cooperate. Then, we should discuss practical means to agree upon a mutually acceptable range of stability and various instruments to be used to achieve this goal. On this issue also, I

believe Japan is both willing and anxious to cooperate with the IMF and other major‐currency countries
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Creation of a Regional Self‐Help Arrangement

The fifth area of Japan's role is to take the initiative in creating a self‐help arrangement for the region, as the East Asian crisis has taught us the need to strengthen regional cooperation.

It was disappointing to see that, faced with such an extensive and serious crisis, neither ASEAN, Japan, nor China could demonstrate a prompt and strong initiative to summon regional and international efforts to cope with the crisis collectively and effectively. 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 either 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, even undesirable, to rush toward institutionalization of regional solidarity. Given the high degree of inter‐dependence, however, in order 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 exchange of advice, an emergency financing mechanism, practical devices to ameliorate deteriorated balance sheets in the private sector, a stable exchange rate arrangement, an efficient settlement system, etc.

The sine qua non for success in this is a 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.

Creation of an Emergency Financing Mechanism

In this context, I believe it is highly desirable for the region to have an emergency financing mechanism to cope with the onset of a financial crisis.

The East Asian crisis was triggered by the sharp reversal of short‐term capital flow. At first, affected countries tried to counter the movement by market intervention, but reserves were soon depleted and resistance was abandoned. What followed was a sharp depreciation of currencies, the magnitude of which exceeded by far the necessary level of adjustment, and an acute shortage of foreign currency liquidity. As a result, the external debt service burden mounted sharply, and default became prevalent. Industries could not finance the import of necessary materials, parts, and components; exporters could not obtain letter - of - credit facilities. In other words, the vital part of these countries' economies had to suffer serious damage, which left a lasting scar on the balance sheets of their banks and businesses.

To prevent the recurrence of such traumatic developments, it is desirable to create a mechanism which provides quick and ample financing to a country suffering the first blow of a financial crisis. Financing should be used for the purpose of preventing the excessive depreciation of currencies and of keeping trade - related industries running.

Such a mechanism could be established as the IMF's regional vehicle. To ensure a high degree of maneuverability, which is the key to the success of the operation, this vehicle should be accorded with the necessary degree of autonomy, backed by a larger regional contribution and a larger regional voting right.

East Asia will be a suitable place to establish such a new facility. With the much increased recognition of the need for closer regional cooperation and the total of 600 billion dollar official reserves held within the region, the conditions to support such an enterprise appear favorable. I believe Japan is willing to play a leading role.

It is quite obvious that all these roles for Japan are daunting. I do not have even the slightest sense of complacency that Japan can carry them out easily, but Japan knows its role and will make its best effort.

I trust in the future of East Asia because all the factors which contributed to the phenomenal development of East Asia during the last quarter century still remain intact. A high savings ratio, abundant opportunities for investment, youthful population, dedication to education, and dynamic entrepreneurship are all there. If we maintain our strong belief in a better future and the willingness to endure the pain of “ creative destruction", the revival of a strong East Asian economy will come true.

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