

Revitalization of East Asia and Japan's Role in It

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1. Lessons of the crisis

One of the fundamental causes of the East Asian crisis was that governments and corporations in the region have failed to adapt themselves to the changing environment of the global economy.

In the 1980's the world economy experienced two changes of historic magnitude. The first was the emergence of the worldwide market, as the result of deregulation of trade and international capital flow, a phenomenon now called "globalization." The essence of the globalization is that competition is no longer conducted within national boundaries, but always on a world-wide scale. For instance, although real estate is not internationally transferable, when customers can migrate freely worldwide, even the real estate business faces global competition. Equally, national tax system, social security, and education cannot escape global competition.

The second change was the revolutionary progress of information and communication technology. This IT revolution enabled the creation of an unlimited variety of goods, services, and industries of global use. It has not only brought a profound change to existing industries and companies, but also altered the shape of the industrial world. At the same time, it has also broken down the traditional concentration of information

in a few hands, enabling all consumers, shareholders, voters, and employees to share the same information simultaneously. Governments and corporate management are now obliged to run national economies or companies on the assumption that they have no advantage of secrecy, and thus transparency and accountability have become the most important ingredients of their respective areas of governance.

National economic policies, market structures, and corporate management styles which were followed in East Asian economies have proved to be extremely effective in the pre-crisis environment. There was a mechanism of collaboration between politicians, businessmen, and bureaucrats, supported by national consensus, which aimed at fostering development of the national economy. International competition was discouraged, in order to protect domestic industries, and governments controlled the allocation of funds for the purpose of fostering export industries and creating jobs. Banks were expected to serve the national objective as such, and were subjected to governmental controls and protections. The purpose of such regulation, however, was not to enhance the soundness and efficiency of banks, but simply to secure the necessary flow of funds. Indeed, in many cases, policy loans and policy investments were given out at the expense of the soundness and efficiency of banks.

Core industries were controlled by certain families who had close connections with government, and there was little conflict between corporate management and shareholders. The primary goal of management was to maximize its own profit, and to win in competition with other domestic companies. Companies were run under the strong influence of paternalism, in which workers were generally not speak against the management. Traditionally, the majority of the population were hardworking, docile, and easily subject to control by the government.

The developmental policies pursued by governments in the environment of the 1980's produced phenomenal results in many East Asian countries. Supported by sustained high growth, absolute poverty was eliminated and income gaps were narrowed. It was indeed a miracle of East Asia.

Globalization and the IT revolution transformed the situation surrounding East Asian economies. First of all, the volume of internationally investable funds expanded enormously, as a result of global disequilibrium triggered by the oil crises in the 1970's; the aging of populations in industrialized countries also increased financial assets such as pension funds.

In the 1990's, the global trend toward financial deregulation and technological

revolution turned the world into a huge whirlpool of investment funds with all maturities. It was inevitable that East Asian economies become an attractive destination for investment, because they were relatively small, fast-growing, and eager to receive foreign investment. Unfortunately, East Asian nations failed to fully understand the risks accompanying the benefits of becoming targets of such investment, and little effort was made to eliminate the risk.

Blame should also be put on investors, however, primarily those from developed countries. They were simply driven by greed, and gave very little thought to how best to contribute to balanced and sustainable development of East Asia.

I mentioned earlier that, as the result of the IT revolution, transparency and accountability have become key to the governance of corporations and governments. The market tends to evaluate the quality of corporations and governments not only by the prospects of their long-term development, but also by the extent of fulfillment of these two key requirements. Indeed, governments and corporations in industrialized countries have realized the importance of transparency and accountability, and have tried a great cost to respond to it, sometimes at the sacrifice of efficiency.

Unfortunately, East Asia had a serious handicap in this area. Past circumstances in East Asia did not require transparency and accountability. Indeed, the management style which was so successful there was, rather, the opposite. As a result, even when the environment changed rapidly, East Asia failed to fundamentally alter their traditional ways of doing things. They simply could not do it.

The gap between the rapidly changing environment and the inertia of East Asian corporations and governments widened gradually, and the market grew uncomfortable and suspicious. As we all know well, once the sentiment became negative, the market began searching for any clue to vindicate its concerns. The market eventually discovered, as if for the first time, that East Asia was plagued by deterioration of current accounts, mismatch of foreign-currency debts, and fragile banks. Investors fled in stampedes.

Luckily, the East Asian economy has been recovering strongly since the second half of last year. This recovery was supported by a strong demand for IC products, a robust US economy, an increase in Japanese imports, enhanced price competitiveness, and stronger domestic demand stimulated by fiscal and monetary policy. Since the decline in 1998 was so large, and because the operating ratio fell so low, recovery from the bottom was sharp. By now, most of East Asian economies have recovered to pre-

crisis levels.

In the wake of the East Asian crises, serious efforts were launched to address the problems of governance and banking system, although the extent of progress differs considerably from country to country. It is encouraging to note that the most serious efforts are being made in countries which were hardest hit. At present, the market is responding positively to such efforts, and displays a strong sense of expectation. However, if economic recovery generates a sense of complacency, resulting in a suspension or reversal of reform efforts, the risk of a recurrence of crisis will remain uncured.

2. Approach to the market

It is widely argued that democracy and market-oriented economy have become the global paradigm since the collapse of the Soviet-style communist political system and its centrally-planned economy. The concept of a market economy has played a key role in the flourishing debates about the East Asian crisis. In many cases, debate focuses on the comparison between a laissez-faire policy, on the one hand, and government intervention on the other.

It seems to me that such debates are conducted on the tacit assumption that the market is a private entity which exists and operates autonomously. However, such assumption is too simplistic because it lacks a full understanding of the nature of the market. We must ask first what the market actually is. In my view, it is the aggregate of judgments by all participants who can influence the performance of the economy. What is especially important here is the recognition that the composition of market participants and their judgments change constantly.

In the initial creation of a market there were only producers and consumers. Then many new members joined: intermediaries, managers, investors, public entities, etc. A particularly important group today is the providers of information. It is obvious that the most powerful motive at work in the formulation of judgment of the ever-growing and ever-changing group of market participants is the maximization of economic benefits in their respective interest. It should not be forgotten, however, that individual judgments are affected by individual circumstances. Also, when one considers profit-maximization in the long run, a set of totally different considerations, such as environmental protection, support of the under-privileged, equality, and other factors, must come into the picture.

After all, the market is a dynamic and ever-changing creature. In the process of constant transformation, the market is often exposed to the risks of herd mentality, misjudgment, fallacy of composition, overshooting, and irrationality. It is absolutely true that the market is not always right. The theory of the “invisible hand” tells us simply that the judgment of the market will eventually swing back to the base of rationality. In other words, the market is not an established private entity. If such an understanding of the nature of the market is correct, then it follows that no government or corporation can afford to ignore or antagonize the market. What they should do is correctly understand the composition and judgment of the market’s participants, and try to establish compatibility with the market through two-way interaction. The right approach to the market, therefore, is not to try to suppress it as an adversary, but to try to permute it as a member who belongs to it. In the aftermath of the East Asian crisis, there are some who regard the market as a villain, and urge their governments to try to isolate national economies from it by way of intervention and regulation. I have to argue that such a reaction is rubbish.

3. Regional cooperation

The most important lesson of the East Asian crisis is the painful discovery that the region was not equipped for the prevention and management of crisis. As globalization means intensified competition on a global scale, it is quite natural for governments and corporations to strengthen collaboration and grouping with others in order to win the competition. What has been happening in the Western Hemisphere and Europe are exactly such developments. If East Asian economies agree that it is desirable and necessary to enhance intra-regional trade and investment, then they should commence the study of what sort of arrangements are needed. It is gratifying to note that there is now a stronger and broader recognition of the need for such regional effort.

Compared with North America and Europe, however, it is undeniable that the East Asia faces many difficulties in the process of strengthening regional cooperation. Regional cooperation in North America is vertical and uni-polar, centering around the United States’ hegemonic economic and military might. Furthermore, the U.S. is capable of providing the region with a standard of monetary and fiscal policy; the dollar is the de facto common currency of the region. Regional cooperation in Europe is horizontal and multi-polar. Although Germany and France carry relatively larger importance, the European Union is still a group of many countries which are more or

less homogeneous in tradition, culture, and economic standards. Importantly, they share the common aspiration of eventual political integration.

East Asia is different from both North America and Europe: it has no single pole; in the long run, there is a risk of rivalry between China and Japan; at present there is no economic and political homogeneity comparable to that of the EU; due to its historical background, East Asia is much less self-sufficient than North America and EU. Therefore, regional cooperation needs to proceed while the region remains open to outside.

All in all, East Asia must explore a third way. In developing the strategies required to promote closer regional cooperation against the background of such, in my view, the following four points are important.

- First, efforts are needed to strengthen the substantial mutual-interdependence within the region. Intra-regional trade and investment have developed steadily, but the region needs a broader horizontal division of labor through the process of liberalization and comparative advantage. Particularly important is to encourage the flow of human resources and information, in addition to goods and money, which will generate a larger flow of technology and culture, support a better harmonization within the region, and provide a stronger pedestal for cooperation.
- Second, regional cooperation should proceed in a proper sequence. At present, East Asian regional cooperation is still at a very early stage, due to the variety of difficulties I have already touched upon. Recently, the leaders of East Asian economies are developing many ideas for regional cooperation, such as establishment of a mutual monitoring system, free-trade arrangements, investment agreements, emergency financing schemes, currency baskets, a common unit of currency, regional settlement mechanisms, regional social safety nets, and a host of other means, but we have not yet reached a stage where we can engage in a joint study based upon concrete proposals. It is also true that the difference in degree of interest and enthusiasm among different countries is still large. We thus need to start with items on which the majority of them can join in discussing. The best candidate for the first discussion, in my view, would be the establishment of a regional body to conduct mutual monitoring of the economic situation in the economies of the region. We need a forum composed of representatives of governments and central banks, whose role would be to promptly

disclose and exchange accurate information, and conduct study and discussion. We also need some sort of device through which views of private business can effectively be reflected in the deliberation. If we want to make the forum a true foundation of the regional cooperation, it goes without saying that it should be equipped with the institutional authority to provide advice and recommendations. We need a strong political commitment. In this respect, we should never forget that the single most important factor contributing to the success of the EMU was the enforcement of the Solidarity Pact under the Maastricht Treaty.

- Third, it is desirable to launch a kind of core group. East Asian diversity is so vast now that it is unrealistic to consider a substantive arrangement which could cover the entire region. Therefore, to make such an arrangement more workable and credible, it will be practical to form an initial core group of economies which have relatively high degrees of economic and political homogeneity. Japan, Korea, Singapore, Australia and New Zealand, would be candidates, and, if China agrees, Hong Kong and Taiwan may also join.

The greatest significance of such a core group is to verify and demonstrate that East Asia can achieve multilateral cooperation, equipped with the ability of self-discipline, in a manner different from that of North America and Europe. If a group of economies, which share the common respect of the market and possess an open political system, can forge a solid cooperation, it will dramatically improve the global perception of East Asian regional cooperation. It will also have a strong impact throughout the region, and generate enormous momentum toward closer regional cooperation.

- Fourth, strenuous efforts need to be maintained in order to prevent the trilateral relations of Japan-China, China-U.S., and U.S.-Japan from becoming adversarial. It is obvious that the development of East Asia as a whole depends crucially upon the success of this effort. The importance of trilateral relations for East Asia is equal to, or even more than, that of the Franco-German relation in Europe. Only with stability in the trilateral relation can East Asia maintain valuable relations with Europe, Russia, and other regions, and establish a strong presence on the world stage.

4. Japan's role

In conclusion, I would like to stress that we Japanese are fully aware of the role

Japan should and can play in promoting East Asian regional cooperation. While there are many difficult items on the agenda, I would emphasize the following three.

- First, Japan must resolve the economic problems it is still faced with. The major issues involved are the strengthening of the financial industry and financial market, industrial restructuring and reform of corporate governance, and fiscal revitalization through the reform of the expenditure structure and tax system. I must stress that progress made in these areas will ensure the strong recovery of Japan's economy.
- Second, there is a need to carry out a third major opening of Japan to the world, following the Meiji Revolution of the late 19th century and the end of World War II in the middle of the 20th century. Only with success in this effort can Japan become a trusted leader in East Asian cooperation.
- Third, there is a need for Japan to play a positive and creative leadership role in addressing the various practical issues of regional cooperation. For the ideas I listed earlier, the Japanese government and private sector should prepare concrete plans to stimulate regional interest, and encourage study and discussion. No regional cooperation will materialize unless somebody takes the initiative. If Japan can demonstrate fair and constructive initiative and leadership, I am sure East Asia-and the world-will welcome it.

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