2008.9.1（No.18，2008）

Newsletter

Institute for International Monetary Affairs
（財）国際通貨研究所

Strategy for the East Asian Economies in the New Environment (Part I)

Hajime Shinohara
Advisor
Institute for International Monetary Affairs

I. Foreword

For the past several years, I have had the pleasure of being invited to chair intensive seminars that aim to deepen the general understanding in liberal arts by encouraging debate on classics. These seminars use literatures old and new from around the world ranging widely from human science to social and natural sciences. Faith and religion is an important category. The Old and the New Testaments, Shobogenzo (the Way of the Buddha), La Divina Commedia (The Divine Comedy) and the Theory of Consciousness of India's 13th century Mahayanist Buddhism are included among the list of required reading.

As a typical Japanese "salaried man", many of the titles of the books are familiar as those I came across when studying world history for university entrance exams. But for most of these books, it was a novel experience to actually dip into them. This was especially true for books related to religion, which I only observed from a distance for many years. I discovered that answering the very basic question – what does man believes in? – was mind boggling, but an infinitely attractive intellectual exercise. Thanks to this experience, books and articles which used to fail to make any impression began registering in my mind. Let me introduce a few such examples.

・ A book explaining that the United States is a religious country. This book leads me to think that the New England states have this characteristic in abundance. The Jewish lobby that draws our attention now and then, as well as the fact that some States take extra caution in teaching Darwin's Origin of Species, probably have their roots in some aspect of this tradition.

· The Televangelicals. Their existence seems to have a close relation to the above and many of the TV channels in the US televise religious services on Sundays. The clergy that lead such services are called Televangelicals, the Evangelicals that preach through television. The core of the broadcast is their preaching. They are not centered on teachings like "Thou art the salt of the earth" nor "love thy neighbour". The most common theme is by far "repent, the end of the world is near". A report concludes that the Americans seem to be the people that are highly drawn to the concept of the End of the World and the Last Judgement.

According to some that have intimate knowledge of the United States, some Americans seriously think that "the last judgement is being delayed because God is preoccupied. We should play our part to help God in bringing the end of the world." Some say this is on the weird side. I am not about to suggest that President Bush's decision to invade Afghanistan and Iraq had anything to do with this kind of thinking. But it does make me wonder whether there had been some being that imposed its will when thinking about the sub prime problem. Why else should the United States make the same mistake ten years after the Asian financial crisis that occurred in 1997 (In the case of Japan, it began even before then)?

Were there some people who thought that they only have to create a myth that "the real estate prices would only go up" backed by rumours and analysis that sounded highly sophisticated? (I cannot emphasize enough how quickly information using the latest statistics and taking full advantage of computer graphics can spread over the internet and how effective that can be.) As the myth spread into the economic and social systems, individual spending on real estates shot up and the economy enjoyed long-term growth based on private consumption. But, at the same time, more and more air was pumped into the real estate bubble, growing ever closer to the point of burst.

Concurrently, securitization, which cuts the direct connection between the lenders and borrowers of funds, developed out of all proportion in the financial markets supported by financial techniques of the highest global level that manufactured fictitious control of risks. This enabled the excess funds to be utilized as capital to enlarge the bubble. This is the quick overview of how things stood before the current turmoil began. The Asian crisis was a clear lesson that bubbles burst at some point, and that is exactly what happened in the United States. The factors that supported the largest and strongest financial market in the world proved only to be the shadows of the "myth". The crumbling perception of the financial markets which could be seen as the most significant achievement of America’s dominance of the world could have given an extra reality to the sermons on Sunday television that “the end of the world is near” and one should “repent”.

Looking at the situation in Japan, studies and comments about the economy is concentrating on the collapse of the Japanese economy. Some having said that “Japan will sink in the seas of cheap yen” soon afterwards would say “Japan will burn in the heat of expensive yen”. They are very adept at seriously arguing the complete opposite case in almost the same breath. I do not wish to be the boy calling wolf amongst these competent commentators. But I do worry that some unexpected confusion, though not quite a recurrence of the crisis, may be unavoidable in view of what is now taking place in East Asia.

This article will develop around these concerns.

II. The Developments in the Region in the Ten Years since the Crisis

There were many things that were pointed out to the region by the rest of the world regarding the Asian financial crisis. Here I would like to review the discussions in the region dividing the issues into the categories of international finance, currency system and regional financial cooperation after the crisis.

(a) Dollar-peg policy as the culprit

The dollar-peg foreign exchange policy that Asian countries had pursued before the crisis was seen as the major culprit once the crisis erupted and long afterwards. There are, of course, benefits and drawbacks to the dollar-peg policy and both aspects must be understood objectively.

The sustained economic development of the region which began in the 80s owes much to this policy. The World Bank once published a report titled the “East Asian Miracle”. In the period covered in the report, the policy adopted by the regional economies was the dollar-peg system. Beginning with trade and commercial transactions, and extending to non-trade payments and most foreign currency transactions such as various forms of borrowing from abroad, foreign currency risk was concentrated in the dollar risk. The dollar-peg policy was adopted under these conditions, and it was highly efficient and in line with the national interest to do so.

Another important incentive for the policy was to gain easy access to the all-important American market. The country that has been making good use of the benefits of this policy up until now is China and the country that re-adopted it during the crisis with great success is Malaysia. Why were these countries able to avoid the downside of the policy?

It is, in effect, too simplistic to put the blame on the dollar-peg system itself. The real culprit is not the foreign exchange policy itself but the ill-planned market deregulation, especially the liberalization of capital account transactions which allowed short-term funds to move easily. As a result of liberalization, short-term funds generated by relatively buoyant economies outside the region flowed into the markets of these Asian countries. On the one hand, this stabilized the home currencies of these countries against the dollar quite firmly but, on the other, the funds converted into home currencies were invested long-term and created bubble-like economic growth and also created a mismatch in maturity between the funds coming in and their use.

As a result, once the bubble had burst, misgivings arose on the position of short-term international liquidity (foreign exchange reserve) and the countries as a whole faced a run on their cash reserves. This is the picture of the last crisis. In other words, the accurate interpretation is that the real culprit was not the dollar-peg foreign exchange policy itself but that some of the foreign currency policies that were adopted alongside the dollar-peg policy invited the crisis.

What did the countries that were affected do when they were told of the “dollar-peg culprit” theory? Many countries justified their policy by saying that they are “not really applying a dollar-peg system” while explaining to the markets that the policy is a “managed float using basket indices”. They have not changed their basic position up until now. China and Malaysia which have accumulated a huge current account surplus in recent years and have been asked by the United States to ease their foreign exchange policy (i.e. to increase the value of their currencies against the dollar), have been using the same argument. None of the countries have revealed the components and weight of the basket used as the index, and the applied logic varies from something almost theological– that there is such a thing as sovereign rights of a currency – to wanting to avoid unnecessary speculation.

But an overall study of the market exchange rate of the East Asian currencies reveals that they tend to be linked strongly to a dollar. When a currency exchange rate is increased by several percentage points, the monetary authorities would explain that the weighted components of the basket have been adjusted slightly but the basket is still used as the Merkmal. Should a basket as an index have such characteristics?

For example, the Japanese yen was relatively cheap and stable against the dollar until the summer of last year. Regardless of whether the dollar or the yen was included in the basket, the weight of the basket would not have changed in any significant way, and would have pointed to the same place on the index. If the component of a basket is changed when revaluation against the dollar is explained, then the components could be calculated backwards to fit the explanation. This would mean that as long as a tendency of strong linkage to a dollar is observed, nothing had changed in reality from how things were before the crisis even if explanations might change.

This can also be proved from the following point. The only transaction that has been functioning in the regional foreign exchange markets is still the transactions against the dollar. All foreign exchange transactions of the home currency against any currency besides the dollar, whether it be the yen or the euro, are arbitrary with the dollar as the medium. This also means that the use of foreign currencies has not gone beyond the dollar in these countries.

Let us now look at what is the current status of liberalization of capital transactions. It is not too much to say that such liberalization policy invited the Asian financial crisis. There are indications that the IMF pushed for the liberalization of capital transactions during the crisis based on its unique philosophy. However, after the dust settled down, the management of capital transactions became even stricter than before the crisis. This is a good sign that the lessons learnt from the crisis are being applied.

The liberalization of capital transactions has two aspects: eliminating borders for foreign currencies and eliminating borders for the home currency. The former allows foreign capital flowing in like a huge tide then disappear in a flash after having collected the interest difference. Typically, this is what happened to Thailand in the last crisis. The latter means the internationalization of the home currency which could serve as fuel on a fire when the speculative movement of the home currency occurs in the foreign exchange market.

Japan was extremely careful in the liberalization of such transactions. It took 30 years to complete the process, culminating in the revision of the Foreign Exchange Control Law in 1997. This pattern could be an ideal precedent for many of the countries in the region. Liberalization of capital transactions will remain a process that should be taken gradually when the domestic environment is ready and when there is enough confidence that such an environment is sustainable.

(b) ABMI and ACU

A lot of possibilities were floated around these two ideas when they first began to be discussed, but somehow there is now an impression that not much is being done about them. One reason could be that the whole world, including Asia, has moved from the era of economics to politics.

Let us first review the Asian Bond Market Initiative (ABMI). This was discussed with much vigor partly to counteract the criticism that "there is a constant discrepancy in maturity of funds because there is no bond market even within the long-term capital market in Asia" and partly to realize a legitimate dream of "being able to utilize the local savings in the same region".

Two following preconditions were thought necessary to realize the latter: the issuance of bonds denominated in Asian currencies and the local savings in local Asian currencies to be utilized in financial instruments denominated in local currencies in the region. (Bonds denominated in ACU, which consists of Asian currencies, will be discussed in the next section) This would require the cultivation of issuers whose names would be attractive in Asia and the nurturing of institutional investors who would value Asian currencies as operational currencies. Although such transactions could be conducted either in an international market in Asia (similar to the euro bond market in London) or in the domestic markets as they become internationalized (something like the Samurai bond market in Japan), it is important to keep in mind that there would be differences in the infrastructure that support such transactions depending on the market.

Regardless of what kind of market would be used, there is a huge significance in promoting such bond transactions that ignore international borders while keeping a firm eye on the regional economies. But currently there are regulations each step of the way in these transactions, for this is precisely the capital account transaction that was discussed in the previous section of this paper. If such capital transactions should be liberalized only when the environment was prepared, it would mean that progress would be slow and the high expectations that the media aroused would not have been possible to meet to begin with.

If that is the case, then the current criticisms such as that there are not enough discussions going on or that the achievements so far do not meet expectations can be put aside as being within assumption. It is worth noting that intense discussions had been conducted and I am sure some of the arguments will come to surface in the future. It is important not to forget those discussions but to further deepen the debates. By doing so, when the time is ripe, it would be easier to provide the framework of infrastructure and support to internationalize the domestic bond markets or the kinds of system and infrastructure to organically combine various markets.

Next, let me discuss the Asian Currency Unit (ACU).

At the Finance Ministers' meeting of the ASEAN + 3 (APT) at Hyderabad in May 2006, the concept of a common currency unit for the region was approved, the unit was given the name of ACU and promises were made to seriously study the concept so as to bring it to reality. Many will remember that there were high expectations and dreams then. Compared to the excitement of the time, nothing seems to have happened especially in the last year.

The concept of the ACU has arisen influenced by the creation of the Euro as the common currency in Europe in 1999, which was right after the Asian crisis, and its relative success. In addition, there were the debates on the basket of currencies to replace the dollar-peg system. The concept of creating a basket of regional currencies and stabilizing the exchange rate of the home currencies by linking them to the basket was created as an amalgamation of these other developments.

The ABMI concept came on top of all these so as to promote the bond transactions in the region and then the issuance and distribution of the ACU denominated bonds were discussed. The creation of the ACU would definitely change the foreign currency and exchange policies of the region fundamentally, and the ABMI could achieve the promised potential. There may be a common currency like the Euro on the horizon. All this is undoubtedly a big dream for the region.

Why did the debates die down? One reason is that the technical details concerning the components of the ACU and their composition ratio dominated the initial debates. The other is the clash between the theory on the "significance of public usage" of the ACU, that public usage would contribute to a wider usage, and the "private sector dynamism", that more expectation can be placed in the dynamism of the private sector when it came to the actual utilization of the ACU in the various aspects that were debated. Putting aside the argument that the ratio would reflect national power, arguments on the utilization and the ease with which it can be used were issues that seem not to have been contemplated at the beginning.

The ECU, which was the precursor of the Euro, was used in the private markets, and I remember trading actively in the ECU denominated bonds. What supported this transaction were the various ECU denominated transactions in the markets (foreign exchange with the ECU on one side, ECU denominated capital transactions, and capital settlement of the ECU), which were made possible by securing a firm basis that the component currencies could be exchanged. Securing the assurance of exchange of the currencies means the internationalization of those currencies and the complete liberalization of capital account transactions including short-term capital.

To put it in another way, this means that if a borrower of ECU denominated funds needs to liquidate, he has the choice to buy the individual currencies that constitute the ECU in the markets, create his own ECU and use it for payment. Looking at the currencies of the APT and the customs and regulations of the markets that deal with those currencies, the only currency that can promise such flexibility is the yen. Since the internationalization of a home currency is at the heart of the lessons learnt from the crisis, and there is awareness that the liberalization of capital account transactions should not be conducted out of sequence, creating the ACU is not an issue that can be realized overnight. So although various ways to use such a unit were floated, because of the practical difficulties in its usage and the lack of ease with which it could be used, the idea has been temporarily put on the shelf.

The research program on the "calculating units of regional currencies" which was commissioned by the ASEAN Secretariat for the past three years seems to have finished. We should not forget the conclusions of this program. The final report repeatedly points out that even though there are difficulties in the usage, there are significant meanings in the creation of the ACU. For example, although it may be too awkward to use the unit for commercial transactions in the private sector, it would be an important index for mutual surveillance in the region. It could also be a stepping stone to the next step if the regional economies become accustomed to it as a common computing unit, even if it is only a creation on paper, and seriously study it as an index. So, just as with the debates on an ABMI, discussion on the ACU should continue and not forgotten as merely a passing topic. Europe spent many, many years before a common currency was born. We in Asia should believe in the distant "dream" and its importance, and have the patience to nurture the ideas.

We have reviewed the ideas on regional cooperation in international finance and a foreign exchange system that were contemplated in the region after the crisis. Looking at the current situation, it is surprising that there are many things that have not changed since before the crisis. Let me now discuss what they should keep in mind when planning a medium-term strategy for the regional economies, at a time when the current state of the American economy inplicates future shift to multi-polarization.

III. In view of multi-polarization

The end-of-the-world believers in the United States have the liberty to cry out the demise of America. But since America is such a huge economy, even a little shift in its fortunes immensely affects the global economy. The downturn in the American economy could be a life or death problem for the Asian countries that have long regarded the United States as the most important customer. American economy, which has relied upon private consumption for many years, is now stumbling. This is reflected in the weak dollar in the foreign exchange market over the last few years.

The weak dollar has also been one of the triggers for the soaring prices of primary products. The housing market is in the price adjusting period (bursting of the bubble), domestic financial markets are faltering and have not seen the bottom. The household consumption supported by housing investment has dropped. It will be a while before things turn for the better and settle down.

This means that the export-led strategy which depended on the huge appetite and the purchasing power of American consumers cannot be taken for granted to succeed. But this situation in the United States is not all bad in the eyes of Asia. This is because the domestic macro-economic imbalance, which the country found it difficult to deal with voluntarily for many years, may turn for the better as a result of the economic realities. If the savings and investment balance should improve, it could stop the collapse of the dollar in the foreign exchange market.

Since foreign currency reserves came to be highly appreciated as assets with high international liquidity during the Asian crisis, countries in the region made the effort to increase their reserves at all cost after the crisis. As a result, they now have enough reserves to avoid being threatened by a run whatever may happen in the markets. However, for example in the case of Japan, it is like a bad dream if the dollar was worth only 80 or 60 yen to a dollar at the moment of conversion when the reserves were accumulated at 120 yen.

We would like the United States to bring the dollar back to the 120 yen level at any effort, and it is not as if they do not have an incentive to do so. But for the time being, American purchasing power will decrease and consumption will be slow, which means that the import of goods from Asia will likely decrease. On the other hand, the Euro zone even with all its complicated intra-regional issues is more determined to further establish its own economic sphere. Oil producing countries are busy in nation building, using their abundant capital. It is as if they are creating an economic sphere of their own. The same can be said of the Latin American countries that produce natural resources. All these economic spheres, including the Asian one, though more vague as an economic sphere, are accumulating relatively more power. We may be entering the age of a multi-polar world, where these powerful economic spheres exist in parallel.

Compared to the other economic spheres, I am afraid to say Asia is lacking the awareness of the problems regarding the foreign currency and exchange policies of the regional countries and regional financial cooperation. Many countries still maintain the policy of using the dollar in trade, commercial and non-trade transactions as well as in capital account transactions that have exceptionally been sanctioned (direct investment and public loans such as the ODA). As the other side of the coin, their foreign exchange markets are limited to providing exchange rates against the dollar and the mutual use of the regional currencies has not increased. Such conditions are the same as they were before the crisis, and ever since 2000, the foreign exchange rates of the regional currencies have been closely linked to the dollar. I concern that, despite the potential and real capabilities, these Asian countries would be dragged into difficulties together with the American economy by pursuing such foreign currency and exchange policies.

By reviewing the subjects discussed in these ten years after the crisis, I have tried to pick out where the problems lie. I plan to dedicate the next column to articulate the blueprint for a concrete strategy.

Address: 3-2, Nihonbashi Hongokucho 1-chome, Chuo-ku, Tokyo 103-0021, Japan
Telephone: 81-3-3245-6934, Facsimile: 81-3-3231-5422
〒103-0021　東京都中央区日本橋本石町 1-3-2
電話：03-3235-6934（代）ファックス：03-3231-5422
e-mail: admin@iima.or.jp
URL: http://www.iima.or.jp