

## Asian Recovery and Financial Reforms after the 1997 Crises: Japanese Contribution to Restoring Stability in the Region

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### Introduction

After their currency and financial crises in 1997, succeeded by economic recession in 1998, the Asian countries of ASAEN have as a whole shown considerable recovery. Some economists said that the Asian economy would continue economic growth in the new century, based on a solid fundamental structure, by analyzing their industrial capabilities, by retracing their efforts for reforming the financial and monetary systems, and by other measures. The record of recovery as well as structural reform will be presented in the following chapter.

However, it shall be noted that the traditional way of economic growth, based on the export-oriented industrialization strategy followed by these countries during the past 20 years, which will be explained later, should be changed to a large extent. Another point, which is remarkably observed, is that after this crisis, the movement by the Asian countries toward cooperation or regional integration has become active. Particularly Japan, which had been politically and economically dependent only on the United States, and which the Asian countries had considered as a small American, turned its head toward its neighboring countries for the first time recently.

In the following chapters, some movements on this subject will be explained. The author has the conviction that even though Asian countries have got some results in reform which will be retraced further, such improvement will not be satisfactory for protection against international speculation in the future, since the latter can find much more deliberated methods to attack the weak points of its targeted economies. Hereby, the only solution to keep on the track of sustainable development will be found in cooperation between the countries in the region.

The movement of rapprochement amongst Asian countries might be initiated by the successful advancement of the European Union, but first of all, the interregional trade as well as investment has progressed during the last ten years and these tendencies have continued

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even after the period of crisis. It is observed that the amount of Japanese direct investment in the ASEAN countries has decreased, for instance by turning to target the China market, and because of Japan's economic recession, but Japan's share of reinvestment in its partner countries has increased.

As a conclusion of this introduction, it might be said that the severe experience in the Asian countries has resulted in a necessity for cooperation amongst them, much more visibly than during the preceding two decades.

## 1. Asian countries' movement toward reform and analysis of the causes of crisis.

### 1-1 The Asian economy's prospects and essential issues

Although the high growth of the Asian economy up to the time of the currency crisis was lauded as the "East Asian Miracle", the Asian currency and financial crisis has given rise to cautious views about the future prospects of the Asian economy.

However, the Asian economy will be able to maintain relatively high growth rates, considering the following points: (a) the strength of the fundamentals of the Asian economy, which supported high growth over the past 30 years (e.g. the high saving ratio and continuous investment in education), has basically remained unchanged since the Asian currency crisis, (b) Asia has a possibility to use the advantages offered by the IT revolution effectively, (c) given factors such as the strength of the entrepreneurial spirit in Asia, it should be possible for Asian economies to transform their growth patterns from an input-dependent type to an industrialized-country type, by strengthening market functions through reforming the financial and corporate structures, and by formulating measures such as research and development and human capital development, (d) the dynamic upgrading of the industrial structure in Asian countries, and its interregional linkages demonstrate that Asia as a region has the ability to change its industrial structure in accordance with changes in comparative advantage.

### 1-2 The deepening of interdependence in the Asian economy

The pattern of trade in 1997 of ten Asian countries and regions (4 ASEAN countries, the NIEs, China, and Japan) shows that 46% of exports and 50% of imports were interregional. As a result of the chain of upgrading of industrial structures in the Asian region, very close trading and investment relationships have arisen in a multilateral form, and this is creating a cyclical structure of trade and investment within the region. It is forecast that the degree of interregional dependence in Asia will increase still further in the future as a result of the expansion of the world market and the progress of free-trade agreements such as the ASEAN Free Trade Area (AFTA). The Asian economy has been shifting into a new stage in which there is vertical and then horizontal division of labor, based upon the expansion of Asian countries' domestic markets or the formation of industrial-technology networks. The Asian economy has attained strong interdependence never experienced before, and economic and social unity is being strengthened. Recent economic recovery is also attributed to an increase of exports to Asian region.

### 1-3 Causes of crisis (in case of Thailand)

In this chapter, the author tries to summarize the causes of Asian crisis and the process of its recovery, which has been considered officially as more rapid than expected.

#### (1) The causes of crisis in the case of Thailand<sup>N.B.1</sup>

- Southeast Asian countries, hereby limited to the four ASEAN countries, which encountered the crisis, had marked up a remarkable growth record from the beginning of the '80s to the middle of the '90s by following the experience of the so-called Newly Industrializing Economies (NIEs) of Asia (Hong Kong, Republic of Korea, Singapore and Taiwan). In the report of IBRD entitled "Miracle of East Asia" their growth by a mixed policy of market economy mechanisms together with government regulatory intervention were appreciated by the economists, even the so-called neoclassical theoreticians, especially monetarists<sup>N.B.2</sup>.
- The four afflicted ASEAN countries' trading partner countries, such as the USA, Japan and China, have markets or productive structures, which are characterized by rapid growth or decline, and are not stable or steady. Influenced by these characteristics of their partner countries, the four crisis ASEAN countries have also marked fluctuations between high-speed growth and decline.
- A typical example among these countries is found in Thailand, which has made remarkable growth from the beginning of the '90s owing to its industrialization concentrating on heavy industry during the decade of the '80s. However, it is noted that Thailand's balance of payments has been continually in deficit from the beginning of the '90s on, since its traditional exports of light industries products have been reduced by competition with China.
- Under such circumstances, Thailand was obliged to obtain foreign currency from overseas banks, and also complied with recommendations made by the IMF group for liberalization of capital movements.
- A rapid overflow of external capital into the emerging Thai market has resulted in the bubble economy from 1993 to 1996.
- An international speculative group targeted the Thai Baht from the beginning of 1997 and attained their purpose in the summer of that year.
- Fundamentally, it shall be admitted that there were basically composite factors comprising macroeconomic factors relating to international finance (abrupt and large-scale international capital movements), microeconomic factors, and domestic structural factors (the vulnerability of the financial and corporate sectors), meaning that the crises were "twin crises".
- Even though the international organizations such as the IMF, World Bank and OECD emphasized as causes of crisis the existence of immature financial and monetary systems, including crony capitalism, the crisis did not arrive without the attack by the international speculators' group. The IMF explained that the government of Thailand did not follow the

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N.B.1 Summing up every kind of report in Japan.

N.B.2 Miracle of East Asia (1993), and East Asia, the Road to Recovery (1998) The world Bank.

IMF's warning made in advance about the possible risk<sup>N.B.3</sup>, but it is doubtful why the IMF could make the recommendation for liberalization of capital movements, even though the vulnerability of Thailand's financial system was well known. No economist dared to criticize the contradiction in IMF's behavior from the beginning. The following measures headed by the IMF were neither appreciated nor satisfactory for resolving the crisis. On the contrary several conditionality enforced by the IMF, based on traditional methods of reducing the total demand, have caused more confusion and deepened the recession.

## 2. Path to recovery and items to be improved

In order to build stable economic and financial systems that will make sustainable economic growth possible, approaches must be made from three levels: (a) domestic efforts at the national level, (b) global efforts to strengthen the international financial system, and (c) regional efforts within the Asian region.

### 2-1 Reform of financial and monetary sectors

It is essential for Asian countries not simply to satisfy themselves in the recovery of their economies, but also to make vigorous use of the opportunity this creates to further accelerate structural reform. To adduce specific measures, the following are all important:

- (a) strengthening the functions of financial institutions
- (b) promotion of finance to small and medium-sized enterprises
- (c) development of domestic bond markets
- (d) strengthening the operation of bankruptcy laws
- (e) strengthening corporate governance

### 2-2 Liberalization and/ or control of capital movements

Appropriately sequenced capital liberalization is important for emerging market economies. Capital control is not a substitute for sound macroeconomic and structural policies, but it could be a possible option in the event of sudden large-scale short-term capital inflows in economies in which financial systems are insufficiently developed. Malaysia is an example of a country, which adopted capital control together with credit control on their banking sector right after the crisis. Success was achieved in preventing massive outflow of capital by regulating the exchange of the Malaysian ringgit to other currencies by persons not resident in Malaysia.

### 2-3 Global efforts to strengthen the international monetary system

#### (1) Reform of the IMF

Reform of the IMF is essential for building an international financial system that will not succumb easily to currency crises. The IMF proposed to Thailand, Indonesia and South

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N.B.3 Shirai, 1999, page 103-105.

Korea to raise their domestic interest rates to prevent capital outflow from those nations. However, the high interest rate policy caused suffering in their domestic economies, causing their companies to face difficulties in borrowing from banks. At the same time, despite high domestic interest rates, the capital outflow did not stop. As a result, some strongly doubted the policy proposals made by the IMF, and Korea eventually decided not to follow the IMF proposal.

(2) Subjects to be improved urgently

The main subjects in carrying out reform of the IMF are:

- (a) to improve the conditionality
- (b) to pay greater attention to large-scale and abrupt international capital movement when conducting IMF surveillance and formulating programs
- (c) to give greater attention to crisis prevention than to crisis management
- (d) to strengthen the accountability of the IMF by enhancing its transparency and improving its policy-making procedures
- (e) to improve the contingent credit line (CCL)
- (f) to review the allocation of quotas
- (g) to develop a mechanism for complementing IMF assistance

Over half a century has passed since the establishment of the IMF. Despite the fact that many emerging economies, including those in Asia, have become important economic powers, the allocation of quota shares; voting shares and Board representation of emerging market economies have remained limited. A review of quota allocation, voting shares, and number of Executive Directors to more appropriately reflect the economic realities of member countries is an important issue related to the IMF's governance and accountability.

Such a kind of proposal has not yet arisen from inside the IMF, or in the critiques of former IMF staff members<sup>N.B.4</sup>.

## 2-4 Asia's interregional efforts

(1) Understanding the importance of cooperation

The currency crisis showed that, as a result of the increasing interdependence in trade and investment in the Asian region, if a currency crisis occurs in the region it spreads instantly to many countries, and there is a risk that this will cause interregional economic activity to contract with a multiplier effect. To build stable economic and financial systems that will make it possible to achieve sustainable economic growth, region-wide efforts are indispensable.

During the period of the currency and financial crisis, common recognition of the importance of regional cooperation has grown up among Asian countries. Based on this common

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N.B.4 Shirai's critique on the IMF's renovation doesn't include any such proposal. The author proposed several technical reforms of the IMF, but with an assumption of free movement of capital in the international market. (Shirai 1999)

recognition, an informal ASEAN + 3 (Japan, China, Republic of Korea) summit was held in Manila in November 2000. In a joint statement on East Asian cooperation, representatives of those countries agreed to "strengthen policy dialogue, coordination and collaboration on the financial, monetary and fiscal issues of common interest." That was an extremely important first step towards strengthening regional cooperation in Asia.

(2) Free-trade creation

Given factors such as the substantial differences in the stages of economic development of Asian countries and the existence of delicate domestic political problems, in forming a free-trade area in Asia it would be both effective and realistic to adopt a multi-layered and phased approach in which bilateral free trade agreements are combined with AFTA.

In any case, it is necessary to vigorously pursue regional integration in concert with the strengthening of the multilateral trading system and the furtherance of regional cooperation.

(3) Creation of bond markets

In order to establish a mechanism for the recycling of long-term capital from countries with surplus capital to those with shortages in the region, it is necessary to make region-wide efforts to develop regional bond markets, by means including invigorating the region's existing international bond markets in Tokyo, Hong Kong and Singapore.

(4) Mechanism for maintaining exchange-rate stability within the region

The dependence of many Asian countries on trade is considerably higher than in Europe, and as referred to above, interregional trade has grown to account for nearly 50% of total trade. In view of this, Asia is reaching the stage at which it should study the establishment of a regional currency stability mechanism that will ensure that exchange rates within Asia reflect economic fundamentals and move in a stable manner.

In view of factors such as the substantial differences in stage of development among the countries of Asia, when considering a regional exchange-rate stability mechanism, it would—as in the case of formation of a free-trade area—be both effective and realistic to adopt a multilateral and phased approach in which bilateral agreements and regional agreements are combined.

For example, the ASEAN countries have already agreed to eliminate tariffs within the AFTA by the year 2018, thereby completing the creation of a free-trade area. The EU's experience suggests that to foster trade and investment in a free-trade area, the stability of exchange rates in the area is as important as the level of tariffs. Therefore a possible option for the ASEAN countries is to link their exchange rates to a common currency basket, while maintaining a sufficiently wide band.

(5) Promoting policy dialogue in the region

In order to build a currency stabilization system within Asia, it is important to promote policy dialogue within the region, so as to ensure that individual countries' macroeconomic

and other policies are not managed in a way that is inconsistent with exchange rate harmonization.

It is important to develop relationships of mutual trust and ones in which frank and constructive opinions can be shared, by utilizing existing frameworks and building networks for multilateral policy dialogue in various sectors, at various levels, and in various forms.

At the ASEAN + 3 (ASEAN, China Japan and the Republic of Korea) summit held in Manila in November 1999, it was agreed to strengthen policy dialogue. Based on a Japanese proposal, the ASEAN +3 finance ministers' meeting in May 2000 began a review of the economic circumstances of the countries of the region.

#### (6) Financial cooperation network in the region

There are already a number of cooperative relationships between monetary authorities in the ASEAN region, for example swap agreements between Japan and the Republic of Korea, and between Japan and Malaysia under the New Miyazawa Initiative.

There are also dollar repurchase agreement facilities among various Asian countries, including Japan, and swap agreement within ASEAN. For the purpose of strengthening the framework for regional cooperation between monetary authorities, it would be both effective and realistic to build networks for multilateral financial cooperation by expanding and combining the bilateral and multilateral cooperation.

At the ASEAN + 3 finance ministers' meeting in Chiang Mai in May 2000, agreement was reached on the following matters:

- (a) To use the ASEAN + 3 framework to promote exchanges of consistent and timely data and information on capital flows.
- (b) To expand the ASEAN Swap Arrangement and to build a network of bilateral swap and repurchase agreement facilities between ASEAN, China, Japan and the Republic of Korea (the Chiang Mai initiative).

The official reserves of the ASEAN + 3 countries totaled more than US\$700 billion at the end of 1999. It would be highly meaningful for the stability of the region's currency and financial markets, if the countries participating in this framework were to engage in closer monetary cooperation by using a portion of their mutual foreign currency reserves. Swaps among currencies of the Asian countries and repurchase agreements for Asian bonds could help to expand transactions between Asian currencies, if done in conjunction with developing direct foreign exchange markets and settlement systems. Such swap agreements could help prevent speculative attacks on currency markets in the Asian region.

### 3. Japanese position, role and duty in the Asian region

#### 3-1 Initiatives taken by Japan for international monetary stability

##### (1) Proposal of an Asian Monetary Fund in 1997

Just after the Asian financial crisis, Japan proposed in August 1997 to create an Asian Monetary Fund (AMF) to rescue crisis-hit countries by providing emergency funds. However it was not at all well received by the IMF and the United States, for three reasons:

- (a) The AMF would create a second international organization for the same purpose the IMF has served since World War II.
- (b) The AMF would create a moral hazard problem in recipient countries because they could obtain emergency funds even if their policies were failures, leading to irresponsible policy formulation in the region.
- (c) There was no detailed written plan for the AMF. The 1997 AMF proposal was originally started by Japan and Thailand but the details were not well explained to other Asian countries.

(2) New Miyazawa Initiative in the fall of 1998

Japan's Finance Minister Kiichi Miyazawa's September 1998 proposal to provide emergency assistance to crisis-hit countries was not much different from the 1997 AMF idea, but even the United States had requested it to be brought up.

There are at least two reasons why Miyazawa's plan was not opposed (Shinohara, 31 March 1999, Institute for International Monetary Affairs News Letter, in Japanese). Firstly, the Asian financial crisis was contagious to Russia and Brazil in the summer of 1998, and the US government started to worry about worldwide spread of it. China also explicitly agreed to support Miyazawa's idea because the Asian financial crisis was much deeper than originally thought.

### 3-2 Japanese duty for financial and economic recovery of the Asian region

(1) Internationalization of the yen

The internationalization of the yen has become a serious Japanese target after unofficial discussions dating from the beginning of the '80s. In April 1999 a report by Japan's Council on Foreign Exchange and Other Transactions posed strengthening the role of the yen as an international currency, saying that this would aid stability of international currency markets and national economies, especially in Asia.

Needless to say, in the near future the yen cannot become a key currency in this region, instead of the US Dollar, because other Asian countries, especially China, do not agree. As long ago as 1971, a Vietnamese asked the author if there had been any discussion on the creation of a "yen zone". In 1981, the author proposed to the Japanese government to recommend to the Asian countries to maintain their foreign currency reserves in yen. This kind of delay is due to extreme dependence on the US Dollar.

(2) Recovery of the Japanese economy, and its stable growth

During the 1990s Japan has suffered continuous economic recession. Stable growth of the Japanese economy is greatly important to the other economies of Asia, and Japan is exerting every effort to recover economically through structural renovation. Asian countries particularly hope for revival of Japan's imports.

(3) The roles of Japanese companies and financial institutions

Japanese companies should step up technology transfers and the building of industrial



networks in Asia over the long term. Japanese financial institutions should also improve their financial conditions, and prepare medium to long-term strategies for contributing to restoration and strengthening of financial intermediation in Asia.

### 3-3 Japanese support for efforts made by other Asian countries

#### (1) Assistance for domestic efforts

Institutional and human-resource development are the keys to Asian countries' success in their domestic efforts to reform their financial and corporate sectors and develop social safety nets. Therefore Japan should provide them with technical assistance including the dispatch of experts and human-resource development, especially to assist the staff of financial authorities and other institutions.

#### (2) Assistance for global efforts

Even though the IMF group have made a serious mistake, the role of technical and other assistance by the IMF, World Bank and ADB will continue to be very important to Asian countries' policy management in conformity with international standards and codes, and in reform of their financial and corporate sectors. Japan should continue to give active support to these international financial institutions for these purposes.

#### (3) Assistance for regional efforts

Heeding opinions in the region, Japan should make active initiatives to strengthen cooperation, including trade and investment promotion, developing trade finance and regional bond markets, policy dialogue, and financial cooperation networks. Japan should strengthen its technical and financial assistance for regional efforts of this kind. Policy dialogue will be the most important of all. Japan should also provide aid for regional cooperation projects among other Asian countries, such as the development of the Greater Mekong Sub region.

## Conclusion

As a brief conclusion of this working paper, the following points shall be noted:

1. Even though the Asian economy as a whole marked a trend to recovery more quickly than projected, the severe experience of the currency and monetary crisis followed by the economic depression, which caused so much damage and suffering to tens of millions of people in the affected countries, shall never be forgotten nor underestimated.
2. Each country has adopted the required policy and made structural reforms. It is reported that their efforts have been successful to some extent, but their strategies of economic growth also should be modified or changed so that they could take an orientation toward stable growth based on social welfare, instead of rapid economic growth accompanied by formation of bubble economies as in the past.
3. The most important point, to be realized as quickly as possible, is the reform of the IMF system, and improvement of the present international monetary system. Because at present no other institution exists which could replace the IMF's role, the ratios of

shareholders shall be changed and the organization's bureaucratic character shall be reduced to a large extent. Also, the system for controls on the movements of the international speculative group shall be strengthened, as Britain and Japan have proposed together. Their acts shall be subject to penal law in the International Court of Justice.

Otherwise they will repeat similar actions, by increasing without limit the financial techniques they use on the target country, even after its structure has been reformed. Finally, the casino economy manipulated by American monopoly capitalists, who are undertaking to expand the globalization trend without any order, will bring chaos and terrorism.

4. Despite the fear expressed above, American capitalism promotes globalization, and as the only way to protect themselves, the countries of the Asian region need to promote interregional cooperation, not through APEC which might be only an international festival, but through the new scheme amongst them.
5. Asian countries should now be aware of the fact that the dollar is not an international key-currency, but only the money of the United States.

These opinions might be considered as radical, unrealistic or nationalistic, but the advance of Asian interregional cooperation, supported by the European group, is the only solution for the coming risk brought on by the American global strategy.

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