The Developing Economies, XXXVII-4 (December 1999): 385–94

INTRODUCTION

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Signs are evident everywhere in East Asia that the economies are recovering from their crisis. But the question now is whether they can get back onto the growth paths they were experiencing before the crisis, and also whether we can build a financial regime that can prevent the recurrence of another currency crisis. Although having intensified trade and investment between themselves before the crisis, the East Asian economies had not built a framework for currency or financial cooperation to support this intensified interaction. They were totally unprepared for a currency crisis. With the onset of the crisis, many Asian economies switched from de facto dollar-pegged to floating exchange rates, and for the past year the fluctuations of their exchange rates have tended to narrow and converge at rates depreciated from their pre-crisis levels, which has supported their current economic recovery. A variety of reform programs have been implemented to revive the real economies. But it is still to be seen if they are back on a path toward sustainable growth. Two years after the outbreak of the currency crisis in East Asia, we will review the impact on the financial and real economies of the region, and the prospect for them recovering steady sustainable growth.

We have invited academic economists from four crisis-hit economies, Thailand, Malaysia, the Philippines, and the Republic of Korea, to analyze the impact of crisis on their economies, assess their governments' policies, and try to draw some conclusions about their future prospects for restoring steady stable growth. The Institute of Developing Economies organized an international conference on the Asian crisis in Tokyo in November 1998 and some authors of the present volume participated as panel discussants. They all have been long-time watchers of their own economies and have advised their own governments on development planning. We invited a paper from Indonesia but none was forthcoming. Indonesia has been the most seriously hit. The crisis triggered political disorder leading to the retirement of President Suharto and the present ongoing struggle to build a new stable government. Meanwhile the International Monetary Fund prescription has only been partially implemented. We also invited a paper on the Japanese experience from one of the members of the Institute's research staff, although Japan was not directly hit by the crisis. However, the financial and real economy difficulties Japan has suffered during the 1990s have similarities with those of other East Asian

economies, and its experience will add to our analyses of the Asian crisis.

East Asian Economic Crisis in Retrospect

Two years have passed since the baht crisis hit Thailand in July 1997. During the next six months there took place competitive devaluations of other ASEAN currencies along with the Korean won and Taiwan dollar against the U.S. dollar, but these have rebounded since their trough in January 1998. Indonesian political disturbances between March and May 1998, and the rapid depreciation of the yen in June and July tended to delay the recovery. But since August 1998 we have witnessed the convergence of the Asian currencies. The exchange rates of the baht, ringgit, won, and peso have been converging to a level 30–35 per cent below their precrisis values, and the Taiwan and Singapore dollars to a 10–15 per cent lower value (see Figure 1). Except for the much speculated prospect of a devaluation of the Chinese renminbi, we may be over the currency crisis in Asia.

However, their real economies continued to contract throughout 1998. Both production and employment kept deteriorating. Throughout last year, Indonesia, Thailand, Korea, Malaysia, and Hong Kong recorded minus growth, and the Philippines and Singapore fell to a 1 per cent growth rate. All the economies with depreciated currencies suffered from the increased burden of debt payments. In all the economies banks are still heavily afflicted with bad loans, and their efforts to collect them in order to improve their own capital asset ratios have caused a serious credit crunch. All the above factors have tended to impede the quick recovery of domestic demand in the region.

Intra-regional trade and investment have also shrunk. The depreciated currencies tended to boost exports in the beginning, but the regionwide depression also tended to decrease their income and imports, thereby decreasing intra-regional exports. Direct investment by foreign firms did not cease but tended to stagnate due to the delayed recovery of markets.

At first all the Asian governments implemented contractionary policies such as raising interest rates and cutting government budgets either in accordance with the IMF's prescription or independently, all resulting in the deep depression of their real economies. But later they move away from these contractionary measures toward policies to revitalize their real economies. Some economies implemented fiscal expansion based on debt-financing but with little effect due to the severe credit crunch. The recovery of domestic demand has remained weak and slow. Only exports to areas outside the region have been active and have stimulated the export-supporting sectors which could lead to an export-led recovery. Many governments also planned to attract foreign direct investment to revitalize their domestic economies. Some have temporarily abolished regulations and restrictions on foreign investment. Foreign firms have also seen it as a good opportunity to invest in East Asia taking advantage of depreciated currencies and deregulation. Whether through

Fig. 1. Nominal Exchange Rates of Asian Currencies against U.S. Dollar
(1997 Jan.=100, in U.S. Dollar per Own Currency)

expanded exports or foreign investment, the developing economies in East Asia have tended to expect outside forces to be major factors in helping to overcome their economic difficulties.

Signs of Recovery

Over the past three years, by and large three factors have been mentioned as causing the economic crisis. First was a liquidity crisis resulting from a large and rapid outflow of foreign short-term capital which triggered the region's currency crisis. During the 1990s, large amounts of short-term capital had flowed into Asian emerging markets. This inflow was attracted by promising high returns, liberalized markets, and the apparently stable values of the host currencies under the dollar peg. However, as signals increased of weakened financial systems, accumulated external debts, and possible defaults, this capital rapidly flowed out through channels in the liberalized markets.

A second often-mentioned cause of the crisis was the profit-taking and shortsightedness of foreign investors who were also accused of inducing the capital flow volatility by excessively investing in the region and then excessively withdrawing their capital.

A third factor was the structural deficiencies of these Asian economies. Good fundamentals such as high saving rates, an ethic of hard work, and active entrepreneurship, which supported the "miraculous growth" of East Asia, have remained intact. But structural deficiencies such as noncompetitive banking systems, unsound government-business relationships, and systemic intransparency that were concealed during the rapid growth period suddenly were exposed by the currency crisis. They afflicted the arteries of economic growth and put a quick stop to the rapid growth. These three factors affected individual economies to different degrees.

In 1998 six East Asian economies recorded minus growth rates: the Philippines (–0.5 per cent), Korea (–5.4 per cent), Hong Kong (–5.1 per cent), Malaysia (–6.7 per cent), Thailand (–11.1 per cent), and Indonesia (–13.7 per cent). Only China, Taiwan, and Singapore maintained positive economic growth. It was only in May and June of this year that signs appeared indicating recovery in the real economies across East Asia. During the first quarter of 1999 growth performance improved and three countries showed positive growth rates: Korea (4.6 per cent), the Philippines (1.2 per cent), and Thailand (1.0 per cent). Industrial production has started to resume and imports of industrial materials has been increasing. Foreign investments, both direct and portfolio, has accelerated its return to the region. But will these economies be able to resume the growth path they were on before the crisis struck? To answer this question we have to examine whether the factors that caused the crisis have been corrected so that the recurrence of a similar crisis can be prevented.

Summary of Individual Papers

Let me briefly summarize the four papers on the crisis-hit economies in the chronological order that they experienced the crisis; then I would like to summarize the Japan paper.

Thailand triggered the crisis when it floated the baht in July 1997. Medhi Krongkaew focuses on foreign portfolio capital as an indispensable factor in the country's development. He examines its rapid inflow before the crisis and its stampeding outflow after the crisis began and the government's response to both. Thailand requested assistance from the IMF and has faithfully followed the IMF prescription. It has maintained the free movement of foreign capital both in and out of the country. Although the Thai economy has suffered the consequences of this free movement, he believes his country will regain the confidence of foreign investors through its market-oriented policies which will benefit his country's development in the long run.

Malaysia was directly hit by the contagion of the run on the baht, but Mohamed Ariff shows that the Malaysian government responded quite differently than Thailand to the crisis. Malaysia did not resort to a rescue by the IMF but implemented a "home-made" policy. It initially undertook contractionary macroeconomic policies, almost the same as the IMF's prescription, but quickly changed to expansionary measures to mitigate the depression. It then introduced a decisive financial policy in September 1998, returning to the dollar peg and restricting foreign capital outflow. The government is now taking the initiative in such domestic reforms as strengthening the financial system and industrial restructuring.

The Philippines has been less affected by the crisis, but according to Florian Alburo, it might be more seriously affected in the long run. The contagion hit the Philippines quickly, and the peso depreciated as much as the Malaysian ringgit (Figure 1). The crisis affected the financial system and real economy much the same way as in its neighbors. However, the Philippines was late in joining the miraculous pre-crisis growth and thus received less foreign capital than its neighbors, and thereby was less affected by the crisis. Alburo stresses its impact on social aspects such as poverty incidence, education, health and nutrition, and conjectures that these social impacts will impede Philippine economic development in the longer run.

The Republic of Korea was hit by the contagion much later, not until November 1997, and Kim Dohyung indicates that the real cause of the country's serious setback was its domestic structural deficiencies which had accumulated long before the crisis started. Korea requested assistance from the IMF and followed its severe prescription of contractionary policies despite the strong complaint of its citizens. However these policies threatened to break down the fundamentals of the real economy, so the Korean government, in consultation with the IMF, changed to an

expansionary policy to stimulate an early recovery. However, the government has taken strong initiatives to strengthen the financial system and restructure its business groups.

Japan has remained at a 0 to 1 per cent growth rate since the bubble broke in 1991. It experienced negative growth in 1997 and 1998, indirectly affected by the crisis of its neighbors. Pessimistic views have prevailed throughout the 1990s because of its prolonged depression, indicating delayed disposal of nonperforming loans, a severe credit crunch, ineffective monetary policy due to a liquidity crisis, and troubled corporate governance, some of which are very similar to the domestic deficiencies shared by other East Asian economies. Kunimune examines the pessimist views based on the "five Ds" (debt, deregulation, default, deflation, and demography). He rejects these views with a clear logic and gives a clear direction for resolving these deficiencies. Unlike its Asian neighbors, Japan has the world's largest holdings of net external assets worth 100 trillion yen (equivalent to 710 billion U.S. dollars). Despite its own suffering, it was able to provide a rescue fund of 37 billion dollars to Thailand, Korea, and Indonesia in 1997–98, and since 1998 it has furnished a new Miyazawa fund of 30 billion dollars for assisting East Asian economies to recover from the crisis. However, it has not been able to play the strong locomotive role in the 1990s as it did a decade earlier when it pulled its Asian neighbors up from their serious setback in the mid-1980s and propelled them into their miraculous economic growth.

There are three issues common to all the papers which I would like to highlight. First all the papers admit that the impact of the crisis was aggravated by the structural deficiencies of their own economies such as a weak financial system and underregulation, improper corporate governance, crony government-business relationships, and excessive intervention by the government. Alburo points out the Philippines' insufficient social infrastructure and lack of a social safety-net as factors aggravating the social impact of the crisis. Ariff states that "the economic crisis was a much needed wake-up call for Malaysia" which prior to the crisis was more concerned with achieving quantitative rather than qualitative economic growth.

The second issue in the papers is the failure of government. The contractionary policies prescribed by the IMF aggravated the impact of the crisis. But all the governments adopted the same contractionary policy when first facing the liquidity crisis and decreasing foreign reserves even without the IMF's instructions (although all the governments later changed to expansionary policy to mitigate the depression thus getting back on the right track eventually). Individual governmental policies may be justified to respond to the crisis' direct cause but they lacked coordination with other policies and could not provide an effective policy package as a whole (Alburo). In Japan, the prolonged depression has been attributed to the lack of political leadership in taking necessary measures against vested interest groups.

The third issue is a clear sign of recovery in all these economies in the middle of

1999. But will this recovery really lead to steady growth and avoid the recurrence of another crisis? All the governments are engaged in structural reform and industrial restructuring to acquire a competitive base for surviving in the world market. The Korean government is pursuing its "4 plus 1" reforms covering the financial sector, corporate structure, the public sector, industrial relations, and the liberalization of trade and investment. However, long-term strategies and modalities differ from one economy to another. Thailand is pursuing a market consistent approach with free capital movement, faithful to the IMF (Medhi). In Malaysia the government is taking a strong initiative in agglomerating numerous banks into six competitive bank groups with an anchor bank at the core of each group. Korea will shift emphasis from "Korea-owned industry to Korea-based industry" (Kim), although the government has stepped in to reshuffle the *chaebol* business groups. It took advantage of the external pressure of the IMF prescription to break through resistance at home during the first half of the crisis. But "Korea needs to push forward with its own reform program" (Kim) to get its economy back on the growth path. Japan has introduced its program of Six Big Reforms and recently enacted the Industry Revitalization Act and implemented measures to nurture venture business. All the governments realize the need to make their industries competitive on a global basis, but they will not necessarily converge on the Anglo-Saxon model. Whatever model they may pursue, they have to achieve effective structural reform.

Closer Regional Cooperation

Although often neglected in the literature, I would like to emphasize the better use of regional cooperation in East Asia. The developing East Asian economies stumbled over the currency crisis as they took on the challenge of globalization. Neither ASEAN nor APEC could help them avoid it.

However, after the crisis spread over the whole of East Asia, both APEC and ASEAN as groups have started to overcome the crisis. To fail to do so would negate their raison d'être. In November 1997 APEC leaders suggested in their Vancouver statement that both financial and real sector cooperation should be promoted in parallel and incorporated into the full APEC process. Deputies to finance ministers and central bank governors of fourteen APEC members met a week before the leaders' meeting and set a Manila framework for cooperation in finance and macroeconomic policies to be endorsed by the leaders. The follow-up meeting of the Manila framework was held in late August 1999 to further develop cooperation. APEC has emerged only at this later stage to help East Asia restore its high growth rate.

Regarding liberalization and deregulation, neither ASEAN nor APEC have changed their directions despite the crisis. While a few countries reversed the liberalization of a few sensitive sectors, many APEC members have kept their commitment with the Uruguay Round and have continued to implement the unilateral lib-

eralization expressed in their Individual Action Plans. While the resistance by vested interest groups to reforms increased and protectionism gained momentum in the crisis-hit economies, this joint commitment has helped individual members to keep their liberalization plans advancing.

The intent of APEC is to implement facilitation and economic and technical cooperation (Ecotech) together with liberalization. The ASEAN Summit in Hanoi in December 1998 confirmed their commitment to pursuing ASEAN Free Trade Area (AFTA) liberalization. Major commitments include the rationalization of customs procedures, harmonization of rules and standards, and streamlining visa procedures. APEC's Ecotech consists mainly of technical cooperation in human resource development, trade and investment promotion, and environmental protection. These activities need to be implemented in parallel with liberalization measures. Unlike liberalization they do not meet strong resistance from vested interest groups at home, but some developing economies are not capable of implementing them effectively due to the lack of human resources and technological know-how. The Osaka Action Agenda has incorporated both facilitation and Ecotech into APEC's main activities. Furthermore, since facilitation measures need to be implemented jointly in a concerted manner, APEC has been promoting them in Collective Action Plans and it is likely that the facilitation measures will make more progress toward the Bogor target.

Facilitation and Ecotech constitute a "plus element" over World Trade Organization (WTO) and ordinary free trade arrangements. Since its start APEC has been oriented toward facilitation and Ecotech because it contains both developed and developing economies. Regional cooperation groups consisting of only developing economies are not capable of extending such help to other members. ASEAN cannot provide such assistance within the group. Developing East Asian economies should take the best advantage of APEC, their regional cooperation group.

Regional cooperation has been the weakest in the area of currencies and finance. AFTA and APEC were totally unprepared for the Asian currency crisis. Increased interdependence among East Asian economies through the steady expansion of trade and investment has been accompanied by rapid financial integration in terms of the increased flow of foreign capital across money and capital markets in the region. The dollar peg and capital account liberalization supported this integration process. Financial cooperation started to facilitate this integration but did not work in time to prevent the crisis.

Major efforts for financial cooperation include the Executives' Meeting of East Asia and Pacific Central Banks (EMEAP), APEC Finance Ministers' Meeting (FMM), and Pacific Economic Cooperation Council (PECC) Financial Market Development (FMD) Taskforce. The EMEAP started in the 1980s and has conducted frequent exchanges of information but also has aimed at building a network of repurchase arrangements in order to cope with the currency and financial crisis.

APEC/FMM started in 1994 and has had regular exchanges of information and policy forums regarding financial development in the region. PECC/FMD has organized an expert group on developing financial markets and promotes personnel training so that its analyses and recommendations are inputted into the APEC/FMM.

The following five elements can be suggested for closer financial cooperation.

(1) East Asian governments should undertake jointly a realignment of their exchange rates à la Plaza agreement or Smithsonian agreement. It is preferable that the current rate of the renminbi to the U.S. dollar remain unchanged while other Asian currencies be revalued so as to correct the current undervaluation of their real exchange rates. It will correct the current overvaluation of the renminbi and resolve the concern about its possible devaluation.

(2) This regionwide arrangement will result in a stable set of cross exchange rates among East Asian currencies. Individual currencies will be pegged jointly with a currency basket that includes the U.S. dollar, the yen, and the ECU with their composition reflecting their weights in trade and investment in the region. A common wide band of 5–10 per cent should be allowed for individual currencies in order to increase adjustability in response to changes in the market. The crawling peg could be introduced so that their nominal rates can be adjusted automatically to changes in relative prices.

(3) As regards the relationship between the three main currencies, it would be better to keep the exchange rates floating between the three, but some form of currency cooperation is desirable in order to avoid abrupt adjustment in their cross exchange rates in the market. This will be a major task of the Group of Seven toward the global stability of exchange regime.

(4) A routine procedure should be introduced to prevent disruptive capital movements from engendering a liquidity crisis in a member economy. Members will be encouraged to introduce appropriate regulatory measures to control disruptive capital flows. A temporary freeze in the convertibility of capital accounts may be needed to combat a serious speculative attack. The IMF should be strengthened so as to provide a quick rescue fund to a member economy trapped in a liquidity crisis. Some form of regional arrangement for borrowing and repurchase should be worked out in the region to supplement the IMF.

(5) East Asian economies should introduce a minimum of coordination in macroeconomic policies among themselves. This means that they need to introduce a set of maximum ratios for their government debts, balance of payment deficits, external debt to their gross domestic product, and their inflation rate, and sustain these target ratios through mutual surveillance and early warning in order to avoid the recurrence of big macroeconomic disturbances. It is important to make the market believe in the sustainability of the stable currency regime in East Asia for some time to come.

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