

# JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

## Post-Crisis Economic Recovery In Asia Remains Uncertain

by Makoto Ebina

Three and a half years ago, Asia was in the throes of a currency crisis that had a significant impact on all countries in the region, including Japan. Although Thailand was the first hit, the currency crisis subsequently spread to neighboring countries, ultimately culminating in economic turmoil throughout most of Asia. Moreover, in countries such as Indonesia, the massive and rapid devaluation of exchange rates sparked social and political instability.

### Understanding Currency Crises

The term “currency crisis” refers to a sudden collapse in the exchange rate of a country’s currency resulting in a deterioration of the terms of trade. For most economies, it is important for the currency to remain stable against the U.S. dollar. Americans may overlook this point since the dollar is the key currency used in global commerce and finance.

The currency crisis that hit Asia in July 1997 actually began in Thailand. For many years, Bangkok effectively pegged the nation’s currency—the baht—to the U.S. dollar ostensibly to minimize exchange rate fluctuations. However, the linking of the baht to the dollar was nothing more than an “artificial arrangement” decided by the Thai government, which was not based on the strength of the real economy.

Under this system, the baht exchange rate was calculated daily based on a weighted-average of a basket of currencies. The basket was comprised of 80 percent U.S. dollars and 10 percent Japanese yen, with the remaining 10 percent divided between German marks and British pounds. As such, the baht fluctuated largely in accord with the U.S. dollar.

During this time, Thailand ran current account deficits. Countries with chronic current account deficits can only cover those shortfalls either by dipping into their foreign currency reserves or by encouraging foreign investment. The Thai government covered the gap by using higher interest rates to induce inflows of foreign capital.

However, foreign capital typically flows to countries that offer the lowest exchange rate risk and the highest rate of return. In 1996, Thailand’s current account deficit exceeded 8 percent of gross domestic product (GDP), which suggested that the exchange rate was highly vulnerable to fluctuation. Overseas investors reacted accordingly, and foreign capital inflows decreased sharply.

### Massive Capital Outflows

In general, when foreign investors perceive that a country’s investment environment has deteriorated, they tend to withdraw capital in unison from that country. This, indeed, was the case in Thailand three and a half years ago. However, what distinguished the Asian currency crisis from other instances of exchange rate collapse was that the resulting instability spread beyond Thailand to the rest of the region. The “Asian contagion,” as it came to be known, stemmed from foreign investors’ fears that the risk of exchange rate instability had increased for all of the countries in the region.

Without a doubt, the economic structures of the countries that comprise the Association of Southeast Asian Nations (ASEAN) share several common features. Most notably, they have fragile financial systems. But there are important differences in the political systems and the general soundness of individual ASEAN economies. Nevertheless, foreign investors indiscriminately pulled funds out of the entire region at an alarming pace.

### IMF Emergency Assistance

Most developing countries—not just Asian nations—rely on foreign capital for economic development. When countries run high current account deficits, they have no choice but to exhaust their foreign currency reserves. Capital flows out of the country, which, in turn, makes it difficult for high-deficit countries to pay down

Currently No. 5 February 2001

Japan As Okay 4

Japan Business Dialogue 6

# Post-Crisis Economic Recovery In Asia Remains Uncertain

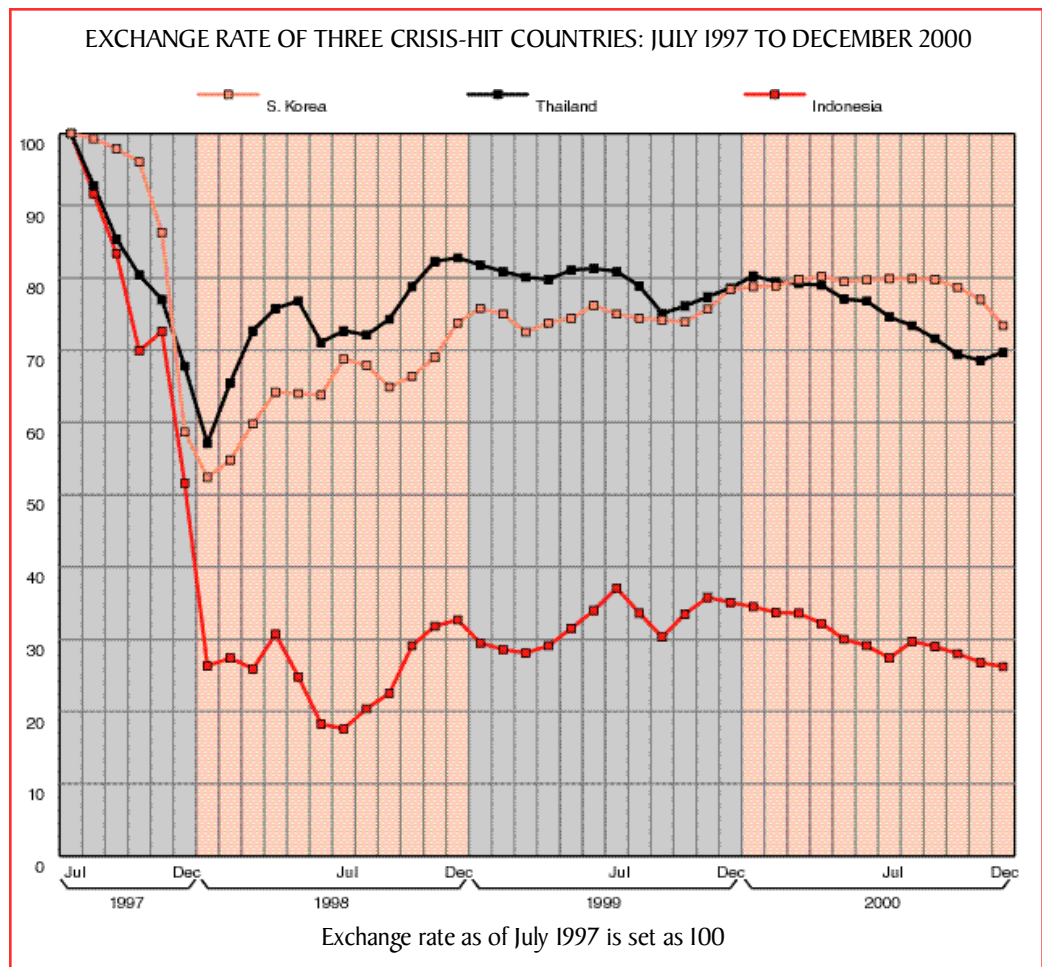
by Makoto Ebina

external debt and finance imports. To avoid the inevitable drying up of their foreign currency reserves, Thailand, South Korea, and Indonesia requested emergency economic assistance from the International Monetary Fund (IMF).

The IMF responded quickly. The Fund provided \$17.2 billion to Thailand, \$58.4 billion to South Korea, and \$41.2 billion to Indonesia. Notwithstanding this assistance, the economic situation in these countries did not improve immediately. Quite the contrary occurred. In 1998, Thailand's GDP contracted by 10.2 percent, South Korea's fell by 6.8 percent, and Indonesia's plunged by 13.2 percent. Some commentators subsequently have attributed this downturn to the excessive nature of the broad-ranging structural reforms that the IMF had demanded as a condition for financial assistance.

## Japanese Financial Assistance

Japan also responded quickly to the Asian currency crisis by giving huge sums of financial assistance. Specifically, Tokyo contributed \$19 billion of the total \$116.8 billion extended by the IMF to Thailand, South Korea, and Indonesia—the largest amount of any individual country. This compares with Washington's \$8 billion contribution.



In addition, Japan extended \$25.2 billion in bilateral aid to the three countries as well as created a \$50 billion fund called the "New Miyazawa Initiative," named for its originator, Finance Minister Kiichi Miyazawa. The crisis-hit countries used a portion of the Miyazawa fund to guarantee government bonds that they had issued.

Furthermore, Japan provided \$5 billion-worth of "Special Drawing Rights" in yen and another \$600 million in various forms of aid. All told, Japan channeled a massive \$99.8 billion in financial assistance to its

beleaguered Asian neighbors. This sum is nearly equivalent to the amount of foreign capital that fled the region between 1997 and 1998.

## Rapid Recovery

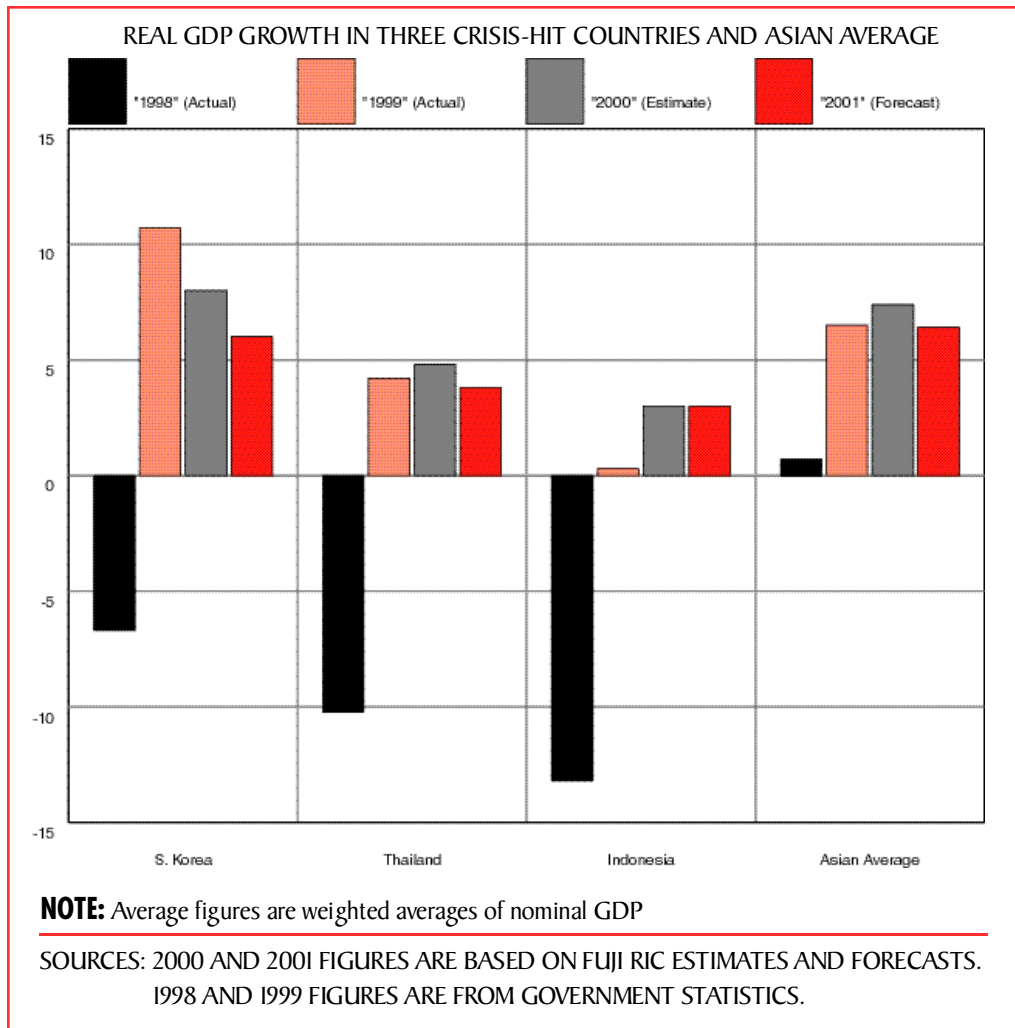
While hit hard in 1997 and 1998, all of the Asian economies achieved positive growth in 1999. Even the Indonesian economy, which was the most severely shaken by the crisis, grew by 0.3 percent in 1999.

The quick turnaround in the region can be attributed to the following three factors:

# Post-Crisis Economic Recovery In Asia Remains Uncertain

by Makoto Ebina

JAPAN  
ECONOMIC  
CURRENTS



on the continued efforts of Indonesia, South Korea, Thailand, and others to implement structural reforms.

The main drivers of the Asian recovery—massive injections of financial assistance and strong growth in exports on the back of a boom in information technology-related industries, particularly in the United States—have been external in nature. Moreover, the region's economic rebound has bred a complacent attitude in some countries about the importance of following through on difficult but necessary economic reforms.

This is worrisome in view of the uncertain outlook for Asia's U.S.-bound exports in 2001. In fact, some analysts fear that this year Asian export growth could be negative, depending on the nature and extent of the U.S. economic slowdown. Asia has no choice but to abandon a growth strategy that has depended excessively on external demand. The countries of the region instead should pursue policies that encourage domestic demand-led expansion. The coming 12 months will be a crucial period for Asian economies.

- The provision of large-scale aid by the IMF, Japan and others;
- The efforts of the affected countries to implement various far-reaching economic reforms; and
- The solid expansion of exports due to strong growth in information technology-related industries worldwide.

In 2000, analysts anticipate that the major economies of Asia will have grown by

an average of about 7.4 percent, exceeding the previous year's level by nearly 1 percent.

## Looking Ahead

Can the Asian economy maintain this high growth into the future? Unfortunately, the answer to this question is not overly positive. Fuji Research Institute Corporation forecasts a 6.4 percent average growth rate for the Asian region in 2001. However, this is contingent to a large degree

on the continued efforts of Indonesia, South Korea, Thailand, and others to implement structural reforms.

Makoto Ebina is Executive Fellow at Fuji Research Institute Corporation, Tokyo, Japan.

## Japan As Okay

by Arthur Alexander

In 1978, Harvard University's Ezra Vogel published a forward-looking book entitled, *Japan as Number One*. By the early 1990s, the Chinese economy was becoming so large that I wrote an article called, "Japan as Number Three." Today, after a decade of economic stagnation and serious questions about Japan's ability to compete in a fast-moving world, many Japanese and observers elsewhere have lost confidence in the nation's future. Nevertheless, there are compelling reasons to believe that a title for a future book could be, *Japan As Okay*.

At a January 2001 conference in Washington, D.C. sponsored by the Japan Economic Institute, Georgetown University, and the Keizai Koho Center several speakers predicted a gloomy future for Japan. They described a country with a banking system that is collapsing, business management that has neglected strategic thinking, industrial overcapacity, and a persistent lack of profits in the automobile industry, which has been one of Japan's most successful sectors.

However, other participants noted positive forces. Although these analysts acknowledged serious and long-lasting problems, they stressed that Japan possesses institutions, processes, and capabilities that will provide a solid foundation for the future.

The political system is an important brick in the foundation. Japan is a

democracy. Its political parties respond to political forces. The Liberal Democratic Party (LDP), in particular, has remained in power for the better part of 50 years because it has developed policies that responded to changing conditions. According to T.J.

"...Japan possesses institutions, processes, and capabilities that will provide a solid foundation for the future."

Pempel of the University of Washington, the LDP sought support from two different constituencies: (1) large, internationally competitive businesses; and (2) inefficient, subsidized, and protected domestic industries, such as small shops, agricultural interests, financial firms, and construction companies.

During the high-growth years, the former support group could absorb the inefficiencies and high costs of the latter. However, as economic growth slowed, the protected sectors became a

drag on globally oriented companies. These firms needed deregulation to lower costs and provide a broader range of services. But the LDP has stalled in pursuing reforms for fear of alienating many of its traditional supporters. At the same time, the size of the protected sector has been shrinking because of

demographic changes, urbanization, and the growth of the white-collar service sector. Consequently, as the LDP stopped supporting one sector, it slowly began to lose the financial backing of the other.

For the moment, economic reform has stalled.

Nevertheless, the forces for political change are present and growing, but they can operate at

the unhurried pace of continental drift. Pempel argued that Japan is in the midst of a shift in regimes. "Ten years from now a new socioeconomic base that is largely pro-deregulation and economically open will have coalesced around a political party that represents these economic interests," he predicted. But Pempel cautioned that the intervening process probably will be a "long and slow moving one."

Another speaker, Seiichiro Yonekura, Director of the Institute of Innovation

"Ten years from now a new socioeconomic base that is largely pro-deregulation and economically open will have coalesced around a political party that represents these economic interests."

Research, Hitotsubashi University, noted that extensive technological developments are underway in Japanese firms. Cutting across information technologies and production processes, many companies, products and even entire industries may be on the verge of major transformations. Yonekura agreed with several

# Japan As Okay

by Arthur Alexander

JAPAN  
ECONOMIC  
CURRENTS

points that I raised about Japan's economic outlook in the October 2000 issue of *Japan Economic Currents*.

"The very capable civil service that developed under the Tokugawa Shogunate and the high literacy rate of Japanese society served as important drivers of economic growth in modern Japan."

First, as compared to the economic experiences of 152 countries over a 40-year period, Japan is unlikely to fall apart—or to grow much more than 2 percent a year for extended periods. Second, Japan is most similar to the United States, the United Kingdom, Canada, and Australia when measured along 46 different dimensions of government-business behavior and institutions of 150 countries. These countries are rich because they have built effective institutions. Japan is not an outlier in this process.

The third issue concerns adaptability. An examination of year-to-year changes in industry-specific shares of employment or GDP reveal that structural change in Japan has paralleled the American experience. The two countries have adjusted at about the same speed.

A 1997 World Bank review of the role of government in development pointed to the importance of basic functions: "An effective state is vital for the provision of the goods and services—and the

rules and institutions—that allow markets to flourish and people to live healthier and happier lives. Without it,

sustainable development, both economic and social, is impossible." Essential functions include the establishment of a foundation of law, the maintenance of a nondistortionary policy environment, and investment in basic social services and infrastructure.

These seemingly routine government functions are extremely complex, however, and can strain the capabilities of most governments. The very capable civil service that developed under the Tokugawa Shogunate and the high literacy rate of Japanese society served as important drivers of economic growth in modern Japan. This institutional heritage provided a basic competence,

which ensured that the mundane tasks of running the government on a daily basis were performed well—even though it may not have provided the best guidance in choosing and nurturing strategic industries.

"...Japan will be okay. But this will require struggles at all levels. Individuals must be shaken from the complacency of lifetime employment."

With a competent state, a functioning democracy, a more profit-oriented business sector, an innovative technological capability, an educated people, and an ability to change, Japan will be okay. But this will require struggles at all levels.

Individuals must be shaken from the complacency of lifetime employment. Politicians must develop effective policies that will also ensure their reelection. Business leaders must grapple with uncertain strategies in a contentious and punishing marketplace. Japan has demonstrated that it has the ability to attain its present highly successful position. These same qualities can support the nation on its path to an okay future.

Arthur J. Alexander is President of the Washington, DC-based Japan Economic Institute.

## Japan Business Dialogue

*KKC's monthly program featuring Japanese experts on the economy.*

### "Improving Financial Infrastructure In Japan"

Tadashi Uhira, Chief Representative,  
Bank of Japan

Tadashi Uhira, Chief Representative of the Bank of Japan's Washington, D.C. office, discussed recent changes in the wholesale payment and settlement system in Japan as well as the state of Japanese banks at the Japan Business Dialogue on December 14, 2000.

Mr. Uhira emphasized the importance of the payment and settlement system as an infrastructure that supports the financial system. He then provided an overview of the function of the BOJ-net (the equivalent of the U.S. Fedwire) and the three main private clearing systems in Japan. These include: (1) the bill and check clearing system; (2) the Zengin system; and (3) the Foreign Exchange Yen Clearing System (FXYCS).

Mr. Uhira noted various systemic improvements. In 1993, the Bank of Japan (BOJ) extended the operating hours of the BOJ-net to accommodate same-day settlement by the Zengin system at 5:00 p.m. In 1998, BOJ introduced new risk control and liquidity supply functions to the FXYCS.

BOJ has been conducting interbank settlement on a designated-time basis. Thus, at a designated time, BOJ would settle the net position of each financial institution and debit or credit their accounts accordingly. Under this approach, financial institutions needed only the funds equivalent to their net debit position at the time of settlement.

There are systemic issues with that approach, however. Payment orders are

accumulated until the settlement time, and if a single bank fails to meet its obligations, BOJ must revoke all payment instructions related to that bank until the settlement obligations of each financial institution are recalculated. Those actions, in turn, could suspend all payments, which could precipitate a series of liquidity shortages or defaults since financial institutions would not be able to receive expected funds.

Under the real-time gross settlement system (RTGS), which is another function of the BOJ-net, the central bank processes every payment in real time. In this way, the entire system will not be disrupted even if a bank is unable to settle its obligations. For this reason, the BOJ decided to abolish DTNS in 2001. It now uses only the RTGS to settle accounts. The BOJ provides intra-day liquidity in the form of fully collateralized overdrafts through the banks' accounts at the central bank.

Mr. Uhira emphasized that the private sector must cooperate as the BOJ changes to the RTGS-only system. It is important for banks to restructure individual systems and operations, create new business practices within the market, adjust over-dependence on overnight calls, and establish efficient intra-day money markets.

Concerning the state of Japanese banks, Mr. Uhira noted that operating profits in April to September 2000 financial statements were about ¥1.5 trillion, which still is relatively high. But the estimated ¥1.5 trillion in non-performing loans is consuming all of the operating profits. Mr. Uhira said that the future of the bad-loan problem depends on the nation's economic recovery, the future financial positions

of borrowers, the extent to which land prices continue to slide, and the will of Japanese banks to write down non-performing loans.

---

Latest Japan Business Dialogue:  
"The Trading Companies' Challenge to the New Economy"

Mr. Yuji Takagi,  
Vice President and General Manager  
Mitsui & Co. (USA), Inc.  
Washington, D.C., February 22, 2001

**Correction** The correct title of the Japan Business Dialogue program reported in the January issue is "U.S.-Japan Relations After The Election-What's Ahead."

---

Publisher, Keizai Koho Center

Director, Hideaki Tanaka  
kkc1@kkc-usa.org

1900 K Street NW  
Suite 1075  
Washington D.C. 20006  
202 293-8430

www.kkc.or.jp

Keizai Koho Center (KKC) is an independent, non-profit organization designed to promote the understanding of Japan's economy and society at home and abroad. Its financial resources are derived entirely from the private sector.

KKC offers numerous programs designed to create a favorable business environment within Japan and worldwide. Its efforts extend to promoting free and stable trade by eliminating sources of friction in the global economic community.

KKC fosters a deeper understanding of Japan's basic social structure. Furthermore, it conducts public affairs activities to improve the Japanese people's recognition of Japan's global role.

The views expressed in this newsletter are of the contributors and do not necessarily represent those of the Keizai Koho Center.