Concluding Chapter

Supplementary Remarks and Proposals[1]

1. From the Asian Crisis to a World Crisis

In this section, I would like to elucidate some noteworthy developments among recent events in terms of their relation to the East Asian economic crisis.

A number of major events occurred in quick succession during August and September of 1998. Hong Kong's intervention in the stock market and Malaysia's exchange control were major events in themselves (see Chapter 2), but the most important incident was Russia's declaration of a moratorium, a de facto default on its international debt. Compared to the world economy and to the Asian economies, the Russian economy is small, so why did it have such a grave influence?

Even though banks in the developed countries incurred their respective losses during the Asian crisis, the losses were generally within a range that international investors could anticipate. Thus, for the most active investors (typified by the hedge funds), the crisis was, in fact, an opportunity for profit. This is because they are capable of profiting from a downturn in the market.

In contrast, the situation in Russia was completely exceeded anything that investors could have predicted. There were hardly any investors who were able to discern that the Russian government would give up just one month after the IMF decided to provide support. For this reason, it is estimated that many investors lost huge amounts of money. This does not include only direct losses. One example is the failure of the bond arbitration type hedge fund LTCM. This company did not have a large amount directly invested in Russian bonds. Indeed, most of its investments were in bonds from industrial countries, which are usually considered safer. The company gambled on changes in yield differentials among the bonds of different nations. It seems to have gambled on the fact that as long as the market shifts according to expectations, there are sufficient opportunities for making money. But with the unexpected "Russia shock," the yield differentials among the bonds moved in directions that LTCM could not have predicted.

Thus **what the (financial) markets fear is not mere ups and downs in prices**. It is unexpected events. Therefore, the recent unusual appreciation of the yen (at the beginning of October 1998) could possibly throw the market into serious confusion, and I see nothing to celebrate.

The massive failures of the hedge funds may have been an occasion for gloating on the part of the Asian countries, which felt as if they had been victimized by these funds, but these failures may have triggered a global financial crisis and a concomitant global credit crunch.

The contagion of the crisis into Latin America is also an extremely serious matter. At present, attention is focused on the question of whether Brazil can protect its currency, the real. Confronting this problem directly, the United States has suddenly begun advocating immediate loan arrangements from the IMF. Some in Asia have reacted by noting that the United States was cool to the similar AMF concept last year. However, we ought to be able to see that the situation was becoming acute, to the extent that the United States had to change its attitude suddenly, even at the risk of appearing inconsistent. Brazil's collapse would immediately spread throughout Latin America, most likely leading to a global panic.

Even so, underestimating the East Asian currency crisis brought about this chain of events in the first place. This has already been pointed out by many others, but the recent events **are due to a drop in prices for primary products, especially petroleum, because of a decrease in demand in the Asian region and a worldwide surplus of industrial goods. Russia and the countries of Latin America were particularly adversely affected by the fall in prices for primary products.** Thus we must first acknowledge global impacts of the sudden collapse of demand in the East Asia.

Table 1 shows changes in imports for the countries of East Asia. As of 1997, Japan was responsible for about 6 percent, or 338 billion dollars, of the world's total of 5.6 trillion dollars worth of imports. On the other hand, Thailand, Indonesia, Malaysia, and South Korea together accounted for 328.2 billion dollars, an amount nearly equal to Japan alone. All together, they amount to just under 12 percent of world imports. The deflationary pressures that result when these economies are allowed to collapse is an extremely serious matter. In fact, the amount of imports to Japan and the four other countries decreased a total of 25 billion dollars, when compared to the previous year, 1996. This is equal to approximately 10 percent of the increase in world imports for the same period.

The figures above are from 1997, and the economies of these countries really began to deteriorate in the second half of 1997. Yet since the beginning of this year, conditions have continued to worsen, and not only in the aforementioned four countries and Japan, but also in Hong Kong, Singapore, and the Philippines, all of which recorded increases in imports in 1997. When we consider this fact, there is no doubt that a further significant decline in imports throughout Asia in 1998. For example, according to newspaper reports, it is expected that the Asian countries involved in the crisis will post a 70 percent drop in the number of automobiles purchased in 1998.

There is no reason to assume that this collapse in demand in East Asia will not influence the supply and demand relations for raw materials worldwide. I will be accused of hindsight for saying this, but **the recovery of economic growth in the East Asian region was (and is) the most urgent problem**. The "outside world" that forced punitive "necessary adjustments" on the countries of East Asia may, in the end, have to pay the bill. Indeed, the time may have come.

2. Summary of Our Survey

Instead of a literal summarization, I would like to present my own way of understanding the problem, with reference to the analyses in each chapter.

2-1. The persistent belief that "the economies will not recover unless financial reform occurs" was over simplified and mischievous.

As we saw in **the chapters devoted to each country** and in **Chapter 3**, dealing with a financial crisis takes a long time, and it is extremely difficult to carry it out in a deteriorated economic environment. Furthermore, carrying out financial sector restructuring with high-interest policy leads not to financial reform but to financial ruin. The combination is a fundamentally erroneous prescription.

Table 1 World imports

	(billion dollars)			(world share)	
	1997	1996	increment 96 to 97	1997	1996
Thailand	62.9	72.3	-9.5	1.1%	1.3%
Indonesia	41.7	42.9	-1.2	0.7%	0.8%
South Korea	144.6	150.3	-5.7	2.6%	2.8%
Malaysia	79.0	78.4	0.6	1.4%	1.5%
(subtotal)	328.2	344.0	-15.8	5.8%	6.4%
Philippines	38.3	34.1	4.2	0.7%	0.6%
China	142.2	138.9	3.2	2.5%	2.6%
Asia	1059.9	1039.9	20.0	18.9%	19.4%
Hong Kong	208.6	198.6	10.1	3.7%	3.7%
Singapore	132.4	131.3	1.1	2.4%	2.4%
U.S.A.	899.0	822.0	77.0	16.0%	15.3%
Japan	338.8	349.2	-10.4	6.0%	6.5%
World	5614.6	5367.5	247.1	100.0%	100.0%

Source: *International Financial Statistics*, IMF

No matter what, the results take a long time to manifest themselves, and emphasizing structural reforms with adverse short-term effects on the economy and then setting them up as conditions for recovery of confidence in that economy can become the impetus for self-fulfilling prophecies and "herd like behavior," as we saw in **Chapter 2**. In other words, the way in which the IMF and the big-name investors view the situation can in itself change reality by changing the expectations of the majority of other investors.

2-2. Insistence on the prescription of "exchange rate stabilization first and lower interest rates only after that" also deepened the crisis by allowing the economies to deteriorate.

As seen in **Chapter 4**, there were choices other than high interest rates available, including exchange rate controls and letting the exchange rates fall. To keep insisting on "the free movement of capital" as if it were an ideology is probably not very intelligent. On this point, I think that Krugman's proposal deserves serious study. Moreover, instead of jumping to criticize Malaysia's introduction of exchange rate controls, I would like to take a cautious, wait-and-see position.

2-3. The essential point for dealing with the balance of payments problem is improving current accounts. Policies should be reexamined from this point of view.

As seen in **Chapter 1**, current accounts have greatly improved in the East Asian countries. Viewed overall, the improvement is just enough to allow repayment of the debts. (Indonesia is in a somewhat delicate position.) Therefore, if we are talking about "restoring investors' confidence," we should emphasize this side of the picture instead of just pointing out delays in financial reforms. Note, however, that a close look at the nature of the debt shows that we still have the nagging problem of foreign borrowing by private companies. My next point will deal with this.

2-4. Solving the problem of private foreign debt is important, but not enough has been done about it.

Indonesia's INDRA scheme was explained in **Chapter 3**, and its limitations were pointed out. Then, in **Chapter 4**, it was suggested that the IMF strengthen its role as an intermediary in solving the debt problem. The problem of private debt ought to take priority, but oddly enough, it has received insufficient attention, and there has not been sufficient discussion of possible courses of action.

3. Economic Reconstruction as a Part of Worldwide Reflation Policies

As seen in Section 1, the problem has not limited itself to East Asia but is becoming a global problem, a problem of insufficient demand on a global scale. Thus the measures needed now are **policies for worldwide reflation**. We must not let the problems of excess supply and insufficient demand continue unabated. It seems obvious that **we ought to give the countries of East Asia room to pursue reflationary policies**. Building upon my understanding of the problem as laid out so far, I would like to summarize my suggestions rather boldly in four points.

(1) We need to supply enough funds to the East Asian countries.

Japan has, in fact, taken on this task. Despite its own shaky economy, Japan has been asked for massive amounts of funds, and we must maintain this role with full awareness of its importance. **Yet we must avoid providing easy financing.** I will touch on this point at the end of the next section.

(2) We ought to reconsider the policies that the IMF has pursued and take decisive action to lower interest rates.

We should not regard exchange control (or capital control) as taboo if they create room to lower interest rates and if they can be implemented with care. Note, however, that arguing about capital control as if they were objectives in themselves is putting it backwards. **A flexible attitude is desirable**, and if means other than capital control are feasible (we might imagine a policy of just letting exchange rates fall), we should adopt the more effect measures with fewer side effects.

(3) Structural reform policies, particularly financial sector restructuring, are needed in the East Asian nations.

Financial sector restructuring should be carried out rigorously and rapidly. **However**, as has been repeated many times throughout this book, **it can be carried out only when accompanied by economic stimulus measures**.

In these circumstances, **now is not the time for the industrial countries to engage in recriminations.** These countries not only need to deal with their own economic problems but are also expected to cooperate in halting the progress of a global recession. With this in mind, I would like to devote the next section to pointing out problems with the notion of blaming Japan and to discussing Japan's role.

4. The Japan bashing and Japan's Role

There is no denying that Japan bashing smack of efforts on the part of the Western nations to shift blame. The European countries are looking toward the issuance of the euro in January 1999, and they can no longer afford to pay attention to the world situation. The United States, with its own bubble beginning to collapse, can no longer afford to do so. Moreover, the problem of increasing the IMF's capital has become a bone of contention, and the confusion has lasted nearly a year in U.S. congress. There is also fear that if the economy goes into a recession, growing trade imbalances with the Asian countries will provoke protectionism. At such a time, it is easy to slip into shifting all the blame to Japan as a scapegoat.

Of course, Japan also needs to handle its financial problems and to stimulate its economy. It goes without saying that the prescription that Japan needs is **a combination of (1) rapid and stringent disposition of its financial problems** (minimizing harmful effects on the economy and moral hazards), and **(2) bold economic stimulus measures**[2]. These are **needed, if only as one link in a policy of global reflation**.

However, Japan has participated in all the IMF support for the Asian countries from the beginning. It has committed nearly 45 billion dollars of funds, and the recent "Miyazawa plan" offers for an additional 30 billion dollars of funds. Even in the AMF concept proposed late 1997, which never came about due to opposition from the United States, a large amount of funding was announced. It is quite unfair to blame only Japan.

What is particularly problematic are certain actions with respect to discussions that are going on in Japan, actions that can only be construed as "meddling in internal affairs." For example, at G7 conference in October 1998, pronouncements were issued that promoted infusions of public funds into Japanese banks, but during this time, Japan was right in the middle of deliberations about just such measures. Even if the pronouncement had an appropriate basis, it crossed a line that it should not have crossed. It is **an act of interference that disrupts deliberations within the country and undermines Japan's sovereignty**[3].

Another hidden lesson in the East Asian crisis is that **all countries must begin by standing on their own feet**. In Chapter 4, we learned that one factor that worsened conditions in Indonesia was the IMF's involvement in the domestic political process without knowing it. The same sort of danger is inherent in interference in a country's internal affairs. It seems to me that in Japan, both the ruling and opposition parties sometimes intentionally make use of "external pressure" to push their own agendas. There is no way that this can lead to healthy results[4].

Finally, I would like to close with a point that has not been sufficiently touched on in this book. That is a warning that **there are excessive expectations of financial support *only* from Japan**, especially in places such as Indonesia. For this reason, it seems that they **make light of serious reform efforts** in the expectation that funding from Japan will somehow allow them to muddle through. This is what we might call a type of moral hazard. In order to prevent this, it needs to develop a posture of strategic aid policies based on a rigid purpose and prospects. We can also say that **Japan's leadership is needed**, not just its funds. Of course, this problem is more than I can discuss briefly, and a more detailed inquiry will have to wait for another opportunity.

Notes:

1. See Chapter 4 for proposals concerned with reexamining the role of the IMF.
2. However, there are problems with economic measures that center on the types of public works projects seen in the past, projects with only minimal results. This is where the supply siders come in. What we probably need is a "general mobilization" of all kinds of policies that will encourage private sector activity through tax reductions and deregulation. In addition, we ought to think that we are faced with the desperate choice of either inflationary measures or deflation. We need to take a serious look at inflationary measures based on having the Bank of Japan underwrite national bonds as one choice. This is what Finance Minister Korekiyo Takahashi did during the Showa Depression in 1930's.
3. Criticism and arguments on a private basis are welcome, but political pressure is problematic.
4. For details, see my article "Higashi Ajia de Nihon ga hatasu beki yakuwari wa nani ka," ("What Should Japan's Role in East Asia Be?") in the June 1998 issue of *Keizai Seminaa (Economic Seminar)*

(Kozo KUNIMUNE)