

CHAPTER IV

## The Asian Financial Crisis and the Trilateral Relationship

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THE ASIAN FINANCIAL CRISIS, which began in July 1997 in Thailand and now affects the whole of East Asia, has brought into relief three popular national images: China as the good guy, Japan as the bad guy, and the United States as the smugly prosperous arbiter of events. These characterizations were amplified by President Bill Clinton's historic visit to China. To the extent that these images contribute to improved relations between China and the United States, Japan should welcome them. But it would be disturbing—not only for Japan but also for East Asia as a whole—if such an improvement in China-U.S. relations was to take place at the cost of a deterioration in Japan-U.S. relations.

### CHINA SPURNS DEVALUATION

China has behaved commendably so far in the face of the Asian financial crisis, and there is no reason to believe that China will act differently in the future, given the determination expressed by Chinese leaders, particularly Premier Zhu Rongji. As U.S. Treasury Secretary Robert Rubin said recently, "One continues to be impressed

by the vision of [China's] leaders and by the understanding they express of the issues they face. They continue to express a determination to move along at a good pace."

This determination on the part of the Chinese government in executing policies has two components. First, despite the undeniable effect on China of the Asian financial crisis, China is committed to pursuing its more open, pro-reform policies, particularly the three-pronged reforms of state-owned enterprises, financial institutions, and government administration. Second, China has said that it will not devalue the renminbi, an expression of determination greatly appreciated by Japan and other countries around the world.

It is important to note, however, that the Chinese decision not to devalue the renminbi was made not primarily in the interest of the East Asian and world economies but, more significantly, in China's own interest. What is remarkable is the skill with which the Chinese presented the country's determination not to devalue its currency as a display of their strongly felt sense of responsibility as a great Asian power and the enthusiasm with which Americans praised it, implicitly contrasting China's statesmanship with what they decry as the "too little, too late" behavior of Japanese leaders.

Indeed, devaluation is neither necessary nor appropriate for China at this juncture. First, China's trade surplus is huge, amounting to more than US\$40 billion in 1997. The surplus for January–May of 1998 was US\$22 billion, a substantial increase over the same period in 1997. Second, China is a net importer of capital, with foreign exchange reserves of US\$140 billion, the second largest figure after Japan. Third, the effects of devaluation would not adequately serve the intended purpose because more than 50 percent of China's exports are in the form of processed trade and, significantly, a major Chinese export category, textile products, would not accrue substantial benefits from devaluation because it is subject to import quotas in virtually all developed countries, with the exception of Japan. Fourth, devaluation would have a negative effect because Chinese foreign currency denominated debt stands at US\$130 billion, with an annual repayment obligation of US\$32.4 billion. Finally, should China perceive the need to maintain export price competitiveness vis-à-vis devalued currencies, which could be a real possibility, the government would most likely increase the amount and expand the coverage of its

domestic tax rebate for exporters, from 9 percent of the value of textile exports to 17 percent of all export items.

Furthermore, the Chinese yuan is not fully convertible, and therefore China can maintain a stable currency much more easily than other countries, should it so desire. For example, Chinese nationals in China cannot buy foreign currencies due to tight restrictions on foreign exchange capital transactions. Therefore, it is relatively easy for the Chinese authorities to fend off speculative short-term capital movements.

This does not imply, of course, that the Chinese need not be concerned about the Japanese economy and the value of the yen. Concern on the part of China is legitimate and, in a sense, appreciated. Japan should value the role allegedly played by the Chinese in persuading the reluctant Americans to join with Japan to intervene in the currency markets to stabilize the yen on June 17, 1998. If the yen had tumbled further, the consequences would have been most serious for the regional economy. China itself, notwithstanding the above arguments, would also have suffered enormously, particularly through Hong Kong.

Japan should also welcome the determination of China's leaders to move forward regarding the three-pronged reforms of state-owned enterprises, financial institutions, and government administration. However, reform in China has just begun, as the result of decisions made at the 15th Party Congress in the autumn of 1997, and some of the problems China is going to confront will be as difficult as, if not more difficult than, those that Japan now faces. In fact, the types of serious challenges entailed by reform of China's financial institutions look strikingly similar to those facing Japanese banks. Japan is prepared to share its hard-won experience and to extend whatever assistance its neighbor requests to support Chinese efforts to carry out reform because the success of these efforts will be important to the future well-being of the whole region, including Japan.

Japan does not claim to be the good guy in the ongoing financial crisis. Its performance has not been commendable. The criticism that Japan has been doing "too little, too late" may be well deserved—but only to a certain extent. It is going too far to criticize Japan as an irresponsible player in the unfolding drama of the Asian financial crisis, particularly in juxtaposition with China.

Japan is hardly the cause of the Asian financial crisis. Certainly, Japan played a crucial role in making East Asia a centerpiece of dynamic growth in the 1970s and 1980s through its direct investment, transfer of technology, and official development assistance. However, Japan can hardly be blamed for being a model for the type of growth that led to the current crisis.

More important, Japan has suffered a prolonged period of stagnation since 1992, when the economic bubble that had prevailed since the mid-1980s finally burst. Even so, many Japanese have assumed that somehow the economy would return to its old growth patterns more or less automatically, but that assumption has turned out to be tragically inaccurate. Because of Japan's remarkable economic success, it took several years to acknowledge reality and to recognize that, as Keidanren (Japan Federation of Economic Organizations) declared in its 1997-1998 annual report, "the social and economic systems that created [Japan's] prosperity are now obsolete" and that "Japan will not be able to cope with the changing circumstances inside and outside the country, such as the competition emerging from the global marketplace and the rapid aging of its population." It has taken so long to realize that the system was not functioning precisely because it had worked so well in the past in propelling Japan to its current status as the world's second largest economy.

It just so happened that the Asian financial crisis started in the latter part of 1997, just as Japan found itself in the midst of its most serious policy dilemma in decades. Forced to choose between adopting a policy aimed at reforming the fiscal deficit on the one hand and a policy of sustaining growth on the other, the government decided in the early months of 1997 that the forces of recovery were strong enough to withstand tight fiscal policy—a judgment that has since proved wrong. But had there been no Asian financial crisis or bankruptcies of major Japanese commercial banks and brokerage firms during the autumn of 1997, revealing the dire fragility of the financial sector, the tight fiscal policy adopted in 1997 might not have resulted in a recession. In such a situation, the economy instead could have registered flat or low-level growth.

Japan continues to play a positive role by assisting East Asian countries, particularly Thailand, Indonesia, and South Korea, in coping with their financial crises. When the crisis began in Thailand,

it was not the United States but Japan that first rang warning bells and joined in the International Monetary Fund's (IMF) package of US\$17.2 billion to defend the Thai baht. Japan pledged US\$4 billion of this total, the same amount offered by the IMF, and China pledged US\$1 billion in its first, and so far only, instance of offering funds to stem the crisis. The United States failed to participate.

Japan pledged US\$5 billion to the US\$40 billion IMF support package to Indonesia, whereas the United States pledged US\$3 billion. Japan also offered US\$10 billion to the IMF support package of US\$57 billion for South Korea, to which the United States contributed US\$5 billion. China did not participate in either the Indonesian or the South Korean rescue scheme.

Japan's aggregate support within the framework of IMF rescue packages for Thailand, Indonesia, and South Korea amounted to US\$19 billion. That was by far the largest amount by an individual nation—more than half the amount of the IMF's own contribution, more than the World Bank's contribution, and more than twice the U.S. contribution of US\$8 billion. Japan claims that its effort to assist these three countries will amount to more than US\$40 billion, including export credits from the Japan Export-Import Bank, special yen credits, and technical assistance for financial training and fostering so-called support industries.

#### JAPAN'S STRUGGLE FOR ITS OWN RECOVERY

Japan has not been able to absorb exports from these financially troubled countries because of its own recession. Japan's global exports from January to May 1998 decreased 4.5 percent compared with the same period the previous year, owing to a sharp drop in exports to East Asian countries. But imports for the same period showed an even larger decline, plunging 17 percent, reflecting the sharp business slowdown.

Japan wishes to play a more positive role in supporting the regional economy, and the government unquestionably recognizes the importance of an accelerated economic recovery, but the recession has narrowed the available options. In early 1997, I wrote that "the Japanese are not unhappy about their present lives, but they are

uneasy about the future." I would still assert that the Japanese are not unhappy with their present situation, but they have begun actively worrying about the future, particularly job security, pensions, and the banking sector. Uncertainties about the future have prompted Japanese households to tighten spending, with the result that consumption is falling and inventories are swelling. Negative business prospects have discouraged investment, a situation aggravated by the credit squeeze by commercial banks, which are saddled with the bulk of the domestic nonperforming loans.

The current situation represents a dramatic turnabout from a decade ago. During the bubble economy from 1985 to 1991, the value of real estate assets and stock prices increased ¥1,200 trillion (US\$8.6 trillion at US\$1 = ¥140). When the bubble collapsed, the same amount, ¥1,200 trillion, was lost from 1992 to 1998. The parties that suffered most were the real estate and construction industries and the commercial banks that lent money on the basis of land collateral appraised at its inflated value.

To boost the post-bubble economy, the government has instituted a series of fiscal stimulus packages during the past six years amounting to ¥70 trillion, in the form of public works investment and special tax cuts. The result was gross domestic product real growth rates of 0.4 percent, 0.5 percent, 0.6 percent, 2.8 percent, and 3.2 percent, respectively, from fiscal 1992 to fiscal 1996. Encouraged by the GDP growth recorded in 1995 and 1996, the government launched a fiscal reform program aimed at curtailing the budget deficit from 5.9 percent to 3.0 percent of GDP by the year 2003 and enforced a tight fiscal policy, including raising the consumption tax and abolishing the special income tax reduction, thereby adding ¥9 trillion to the government's coffers. However, this move proved premature, as the government had overestimated the strength of the economic recovery. The Asian financial crisis aggravated the situation, but most damaging were the recent bankruptcies of some of Japan's leading financial institutions, which had the effect of creating doubt about the credibility of Japanese financial institutions in general.

Another factor—banks' capital needs—brought to the fore the fragility of Japan's financial institutions. In the autumn of 1996, then Prime Minister Hashimoto Ryūtarō pledged to effect a Japanese "big bang" of deregulation measures for the banks as part of a larger

financial reform package, and the early implementation of the Bank for International Settlements' requirements for banks' capital adequacy ratios was declared in June 1997. With stock and real estate prices plummeting, banks started tightening credit to borrowers, even to those sound borrowers to whom banks otherwise would have eagerly extended credit. Against this background, the issue of reform of financial institutions—more specifically, the question of how to deal with nonperforming loans—started to become a focus of economic recovery efforts.

The Japanese government has launched three sets of policy measures to reactivate the economy. The first included fiscal stimulus measures amounting to ¥3 trillion implemented in January 1998 and a ¥16 trillion package including a special income tax cut and a large-scale public works program. These measures were expected to inflate the GDP by 2 percent, with the effects becoming evident in the early autumn of 1998. However, these fiscal stimulus measures are just the latest in a series of measures that have totaled ¥70 trillion so far; they will have only a one-time effect.

The second set of measures aims to resolve the problem of nonperforming loans. An outline for these measures was announced in February 1998 bolstered by a fund of ¥30 trillion, of which ¥17 trillion would be used to protect depositors and ¥13 trillion to reinforce capital adequacy. After the House of Councillors election in July 1998, a set of bills for disposing of nonperforming loans and for promoting the liquidation of real estate held as collateral was introduced in the Diet.

The third set focuses on structural reform and deregulation. The government has already made substantial progress in deregulation and now has an organizational structure in place to further advance its efforts. The structural reform efforts center on tax reductions. The government proposes reducing the tax rate for the highest income levels from the current 65 percent to 50 percent and lowering the burden of corporate income taxes from 46.3 percent to 40 percent. Policy debate continues on the best means of compensating for the loss of tax revenue; the probable course will be for the government to both expand the tax base and issue deficit bonds.

Some analysts have voiced suspicions that the Japanese government wants the yen to depreciate further to boost exports and thus spur the economic recovery, but nothing could be further from the

truth. Although depreciation of the yen might not hurt Japanese exports, it would seriously damage overall confidence in the economy. When the yen depreciates, stock prices fall. Furthermore, yen depreciation would have the effect of increasing the yen value of overseas assets, thus negatively affecting the banks' ability to satisfy capital adequacy requirements.

Although it is curious that the yen should depreciate vis-à-vis the U.S. dollar despite the substantial—and expanding—current account surplus in Japan's balance of payments, one can argue that as long as there is a sizable difference in interest rates between Tokyo and New York, pressure for yen depreciation will remain.

The question of currency intervention has presumably been a subject of policy debate between Tokyo and Washington. Although little has been revealed about the nature of the debate between the two monetary authorities, one wonders why Washington has been and still is so reluctant to intervene jointly with Japan in the foreign exchange market. Unilateral intervention by Japanese authorities is ineffective, as was clear in mid-April 1998 when the Bank of Japan was reported to have intervened unsuccessfully on a massive scale.

The logic underlying the U.S. reluctance appears to rest on three assumptions:

- It is in the U.S. interest to have a strong dollar vis-à-vis the yen and other currencies. The weaker the yen, the better for the U.S. economy.
- Intervention does not work because the market determines exchange rates.
- It is desirable to force Japan to reform, even if this entails the use of market forces and the expression of dissatisfaction or skepticism.

U.S. Treasury Secretary Rubin, testifying before a Senate subcommittee on June 11, 1998, expressed strong skepticism about the effectiveness of U.S. currency intervention to support the yen. The following day, June 12, Japan's Economic Planning Agency announced that the growth rate for the first quarter was minus 1.2 percent, thus bringing the growth rate for fiscal 1997 to minus 0.7 percent, the first negative growth rate for the Japanese economy in 24 years. The yen



tumbled more than ¥6 to ¥145 = US\$1 after the announcement, and the Tokyo stock market plunged. But one wonders what motivated Rubin to offer such testimony on the eve of Japan's announcement of poorer-than-expected economic results, which prompted international speculators to sell the yen.

Having followed attentively the deterioration of the Japanese economy for the past few years, I have been struck by the overwhelming role played by psychological factors and declining confidence in Japan's economic performance. In that psychological game, the role played by the U.S. Treasury has been of increasing significance. Wall Street is attentive to and respects the Treasury's views, which are fully reported in the U.S. media. One wonders if the Treasury is fully cognizant of its awesome power and responsibility.

#### POSTSCRIPT

One year later, the three popular national images of China as the good guy, Japan as the bad guy, and the United States as the prosperous judge have undergone various changes. Japan is still struggling but seems to be over the worst of the recession thanks to concerted efforts by the newly formed Obuchi cabinet, and the prosperity of the United States appears stable. The most dramatic change can be seen in China and China-U.S. relations. There are signs that China will be confronted with many difficult economic problems that might lead to serious internal policy disputes. Most striking is the change in mutual perceptions between China and the United States. The failure of Zhu Rongji during his trips to the United States to conclude negotiations on China's entry to the World Trade Organization, the accidental bombing of the Chinese Embassy in Belgrade in May 1999 by a U.S. B2 bomber, and the January 1999 report by a U.S. House of Representatives Select Committee of Chinese spy activities at U.S. nuclear weapons research institutes—all these have altered what was once heralded as a constructive strategic partnership.

If some Japanese were concerned a year ago that China-U.S. relations were improving at the expense of Japan-U.S. relations, those

same Japanese are now concerned that China-U.S. relations will deteriorate to the point of negatively affecting Japan-U.S. relations. Both scenarios point to the intrinsic importance of redoubled efforts to maintain and promote communication and dialogue among the three major powers in Asia Pacific.