

The Yen, the Yuan, and the Asian Currency Crisis
Changing Fortune between Japan and China

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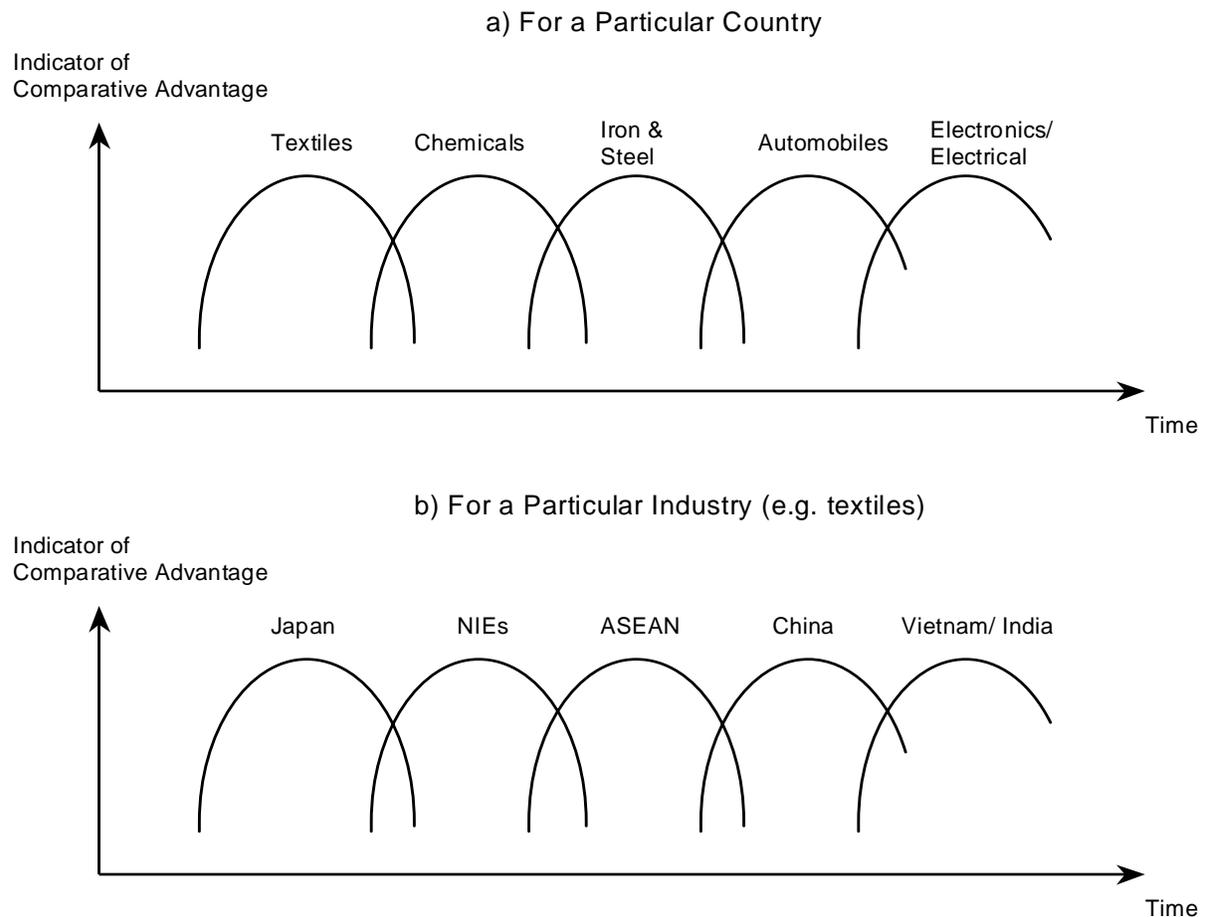
The Yen, the Yuan, and the Asian Currency Crisis

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The currency crisis that started in Thailand in the summer of 1997 was followed by repercussions on the currencies of neighboring countries, culminating in a crisis infecting most countries in East Asia. Japan and China, which have developed strong ties with the rest of Asia through trade and investment, have not been exempted from this contagion. This paper looks at the latest currency crisis in Asia from the perspectives of these two regional giants.

Growing competition with Japan and China was one of the triggers of the crisis in Asia centering on the ASEAN countries. In the “flying geese” pattern of economic development, the ASEAN countries have come to be sandwiched between Japan, a leader that has stopped moving ahead, and China, a follower that is fast catching up from behind (Figure 1).

Figure 1. Asia’s “Flying Geese” Pattern of Economic Development

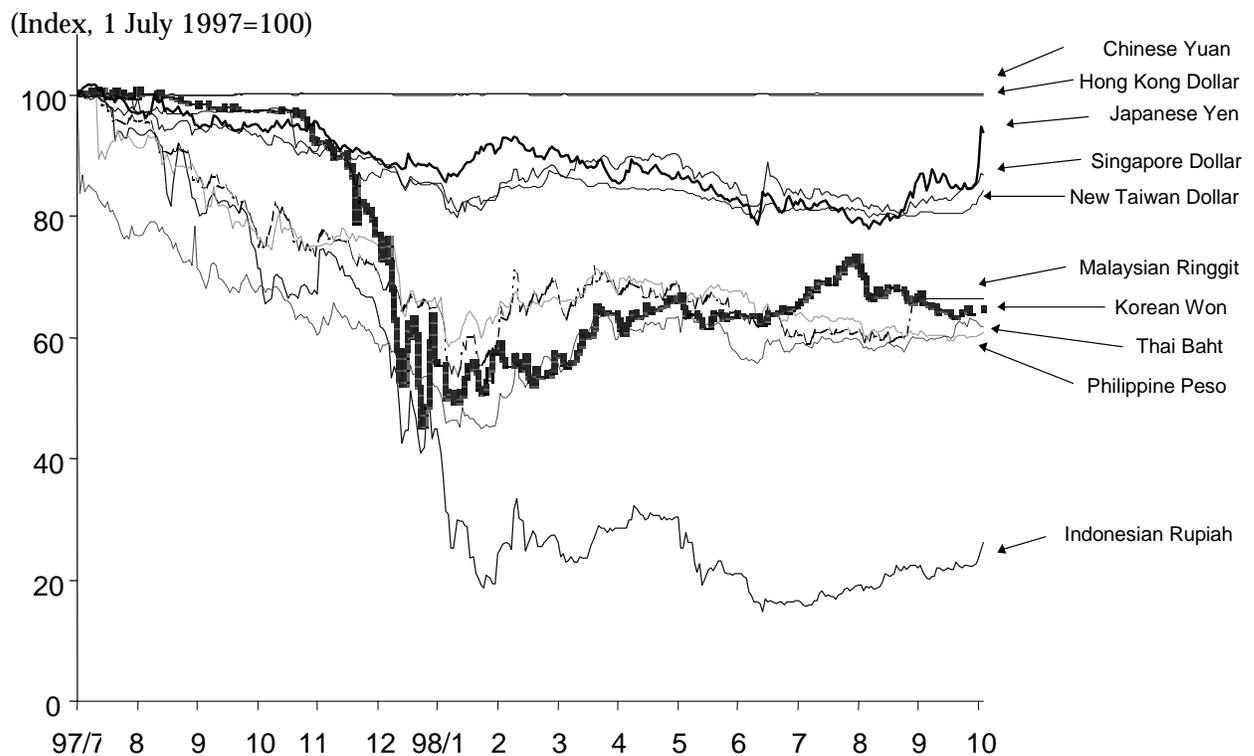


Source: Nomura Research Institute.

The subsequent deepening and widening of the Asian crisis have in turn hurt the Japanese and Chinese economies, putting downward pressure on the Japanese yen and the Chinese yuan. Japan, which has stronger links than China with the ASEAN countries, has been more adversely affected. The crisis occurred at a time when the Japanese economy is in its deepest recession since the end of the Second World War. For China, sound economic fundamentals, coupled with tight regulation on capital account transactions, have helped minimize the negative repercussions of the crisis.

As a result, the Japanese yen has fallen further since the elapse of the crisis, in sharp contrast to the stability of the Chinese yuan (Figure 2). China's commitment to not devalue the yuan has greatly enhanced its credibility and bargaining power in international economic and political affairs, largely at Japan's expense.

Figure 2. The Falling Yen Contrasted with the Stable Chinese Yuan (Against the U.S. Dollar)



Source: Compiled by Nomura Research Institute based on Bloomberg data.

I. The Japan and China Factors Triggering the Crisis

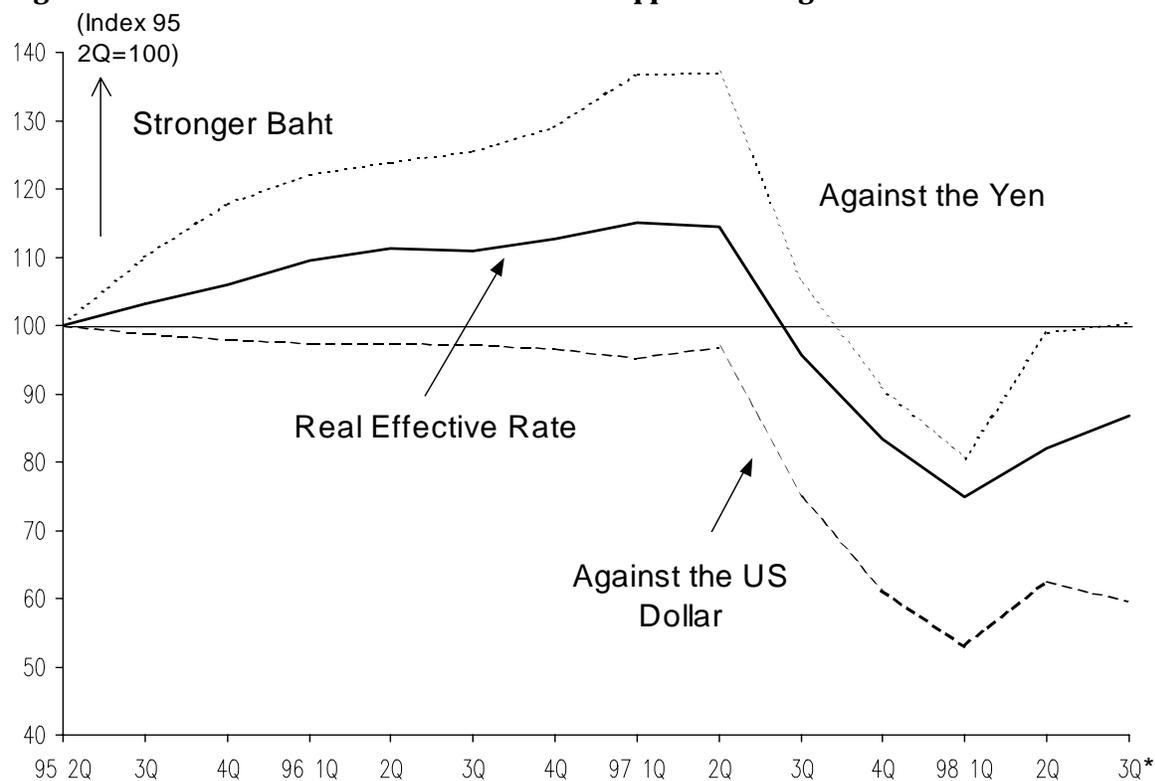
The sharp deterioration in the trade performance of the ASEAN countries in the period immediately preceding the crisis can largely be attributed to the weakness of the Japanese yen and the high productivity growth in China. While the former reflects Japan's economic plight, the latter reflects China's growing economic might.

A. The Weakening Yen

After hitting a historical high of ¥80 to the dollar in the spring of 1995, the yen has experienced a downward trend, falling to ¥115 to the dollar immediately before the Asian crisis in mid-1997. This has taken place against a backdrop of deteriorating economic fundamentals at home (falling asset prices, massive accumulation of bad debt in the banking sector, rising deflationary pressure) and a widening differential between U.S. and domestic interest rates (reflecting the gap in the pace of economic growth).

The yen's sharp depreciation since mid-1995 led to a marked deterioration in Asia's export performance and current account balances in 1996, paving the way for the currency crisis. A country's export competitiveness depends on its exchange rate not only against the dollar but also against other major currencies (currencies of competitors in particular). In the case of Thailand, where the latest crisis started, although the baht had edged down by about 4 percent against the dollar in the two years leading up to the devaluation on July 2, 1997, its real effective exchange rate (trade-weighted) had appreciated by about 15 percent over the same period (Figure 3). This largely reflected its sharp appreciation of about 35 percent against the Japanese yen. As a result, export growth decelerated sharply from over 20 percent in 1995 to virtually zero in 1996, with the current account deficit reaching 7.9 percent of GDP. The exchange-rate policy of pegging to a basket of currencies in which the dollar was weighted heavily had constrained the government from allowing the baht to depreciate against the dollar at a faster pace to stimulate exports. Similarly, other Asian countries, which had also pegged their currencies loosely to the dollar, suffered a sharp slowdown in exports on the back of the weakening yen.

Figure 3. Overvaluation of Thai Baht Reflected Appreciation against Yen



Note: *July and August only.

Source: Compiled by Nomura Research Institute based on official statistics and J.P. Morgan's *Trade Weighted Currency Index*.

A weaker yen affects economic growth in the Asian economies mainly through the following four channels: a slowdown in capital inflow from Japan, a decline in export competitiveness against Japanese products, lower cost of imports from Japan, and lower cost of financing yen-denominated external debt. While the effects of the first two factors on the Asian economies are negative, they are partly offset (and, in some cases, more than offset) by the positive effects of the last two factors.

First, a weaker yen lowers capital flow from Japan to Asia. With the cost of production in Japan relative to the Asian countries falling, the incentive for Japanese companies to relocate production facilities overseas is reduced. The resulting slowdown of foreign direct investment has the effect of depressing the Asian economies not only on the demand side but also on the supply side. In addition to foreign direct investment, Japanese bank lending to Asia also tends to decrease when the yen is weak because of the need to meet the BIS capital adequacy requirement (see Section II below).

Second, a depreciation of the yen against the dollar, by reducing Japanese export prices in dollar terms, makes Japanese exports less expensive relative to those of the Asian countries. As a result, the competitiveness of Asian exports against Japanese products in international markets deteriorates. The recovery in Japanese exports since 1996 on the back of the yen's depreciation has contrasted sharply with the slowdown in Asian exports.

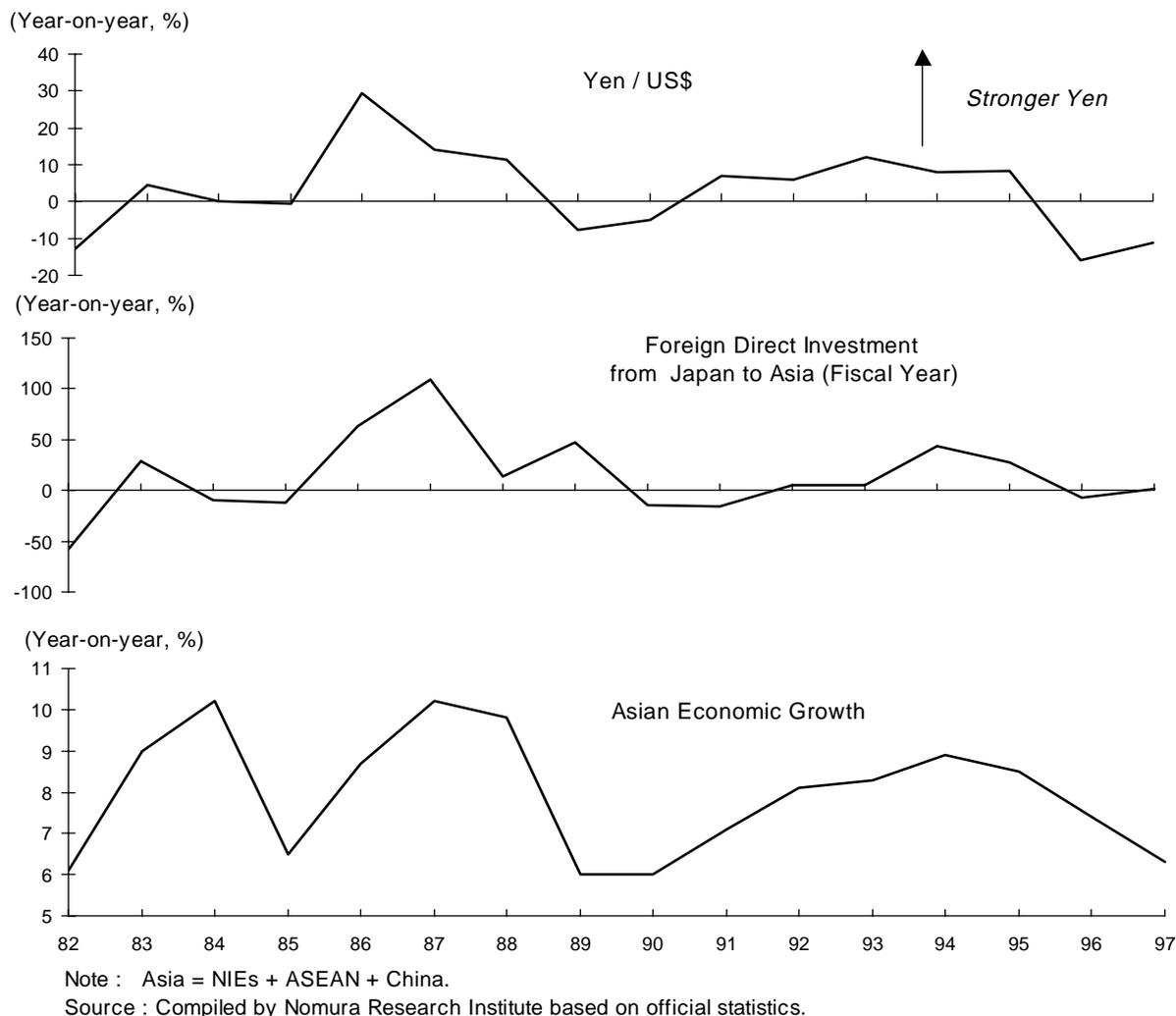
On the positive side, a weaker yen reduces import prices in Asian countries as they are heavily dependent on Japan as a source of capital and intermediate goods. Lower import prices, which usually mean lower input prices, in turn boost profit and output for the Asian countries.

Finally, a depreciation of the yen reduces the burden of debt repayment for the Asian countries. The positive impact on economic growth is proportional to the size of a country's external debt denominated in yen. Since the bulk of the Asian countries' yen-denominated debt is in the form of official development assistance (ODA) from the Japanese government, poorer countries are more likely to benefit.

The effect of a weaker yen on Asian economic growth depends on the relative magnitude of these four forces. A weaker yen is more likely to dampen economic growth in higher-income countries with trade structures competitive with Japan's (South Korea, for example) than in lower-income countries with trade structures that complement Japan's (Indonesia, for example). While some countries will be hurt more than others and some may actually benefit, the impact on the Asian NIEs, the ASEAN countries, and China as a group is certainly a negative one.

In more general terms, fluctuations in the yen-dollar rate have replaced the U.S. economic growth rate as the major factor determining short-term macroeconomic performance in the Asian countries since the Plaza Accord in 1985. With their currencies pegged loosely to the dollar, economic growth has been highly vulnerable to fluctuations in the yen-dollar rate. Every time the yen appreciates against the dollar, the economic growth rate in Asia outside Japan picks up, as happened between 1986 and 1988 and again between 1991 and 1995 (Figure 4). These periods were also accompanied by an expansion of the bubble economy, with asset prices rising sharply. The reverse was true when economic growth in Asia decelerated and the bubble economy burst on the back of a weaker yen in 1989–90 and again since 1996. The slowdown in Asian economic growth since 1996 (even before the currency crisis), which has taken place against a background of robust growth in the United States, can largely be explained by the yen's sharp depreciation against the dollar (and thus against the Asian currencies).

Figure 4. The Yen-Dollar Rate and Asian Economic Growth



The relation between the yen-dollar rate and Asian economic growth can be confirmed by simple regression analysis (Table 1). Estimation for the period 1982–97 shows that a 1 percent appreciation (depreciation) of the yen against the dollar tends to raise (reduce) GDP in Asia by 0.109 percent (0.066 percent in the current year, and a further 0.043 percent in the following year), explaining 41.3 percent of Asian economic growth (in terms of adjusted R^2). When the U.S. economic growth rate is also included as an independent variable, the explanatory power increases to 60.6 percent in terms of adjusted R^2 , although the elasticity drops marginally to 0.099 percent (0.059 percent plus 0.040 percent).

Table 1. Estimation of Asian GDP Growth

Dependent variables	Independent variables			Adjusted R ²	D.W.
	Yen/Dollar Rate		US GDP growth		
	Current	Lagged one year			
GDP growth	-	-	0.39 (2.42)	0.245	1.576
GDP growth	-0.077 (-3.00)	-	-	0.347	1.799
GDP growth	-0.066 (-2.61)	-0.043 (-1.60)	-	0.413	1.668
GDP growth	-0.069 (-3.15)	-	0.33 (2.60)	0.539	1.822
GDP growth	-0.059 (-2.82)	-0.040 (-1.80)	0.32 (2.71)	0.606	1.691

Notes: (1) Asia= ASEAN+NIEs+China, Sample period: 1982–97. (2) Figures in () denote t-values. (3) Both dependent and independent variables are measured in terms of rate of change so that the coefficients correspond to elasticities. (4) Since a larger number for the yen-dollar rate denotes a weaker yen, the negative coefficients show the negative impact of a weaker yen (or the positive impact of a stronger yen) on Asian economic growth.

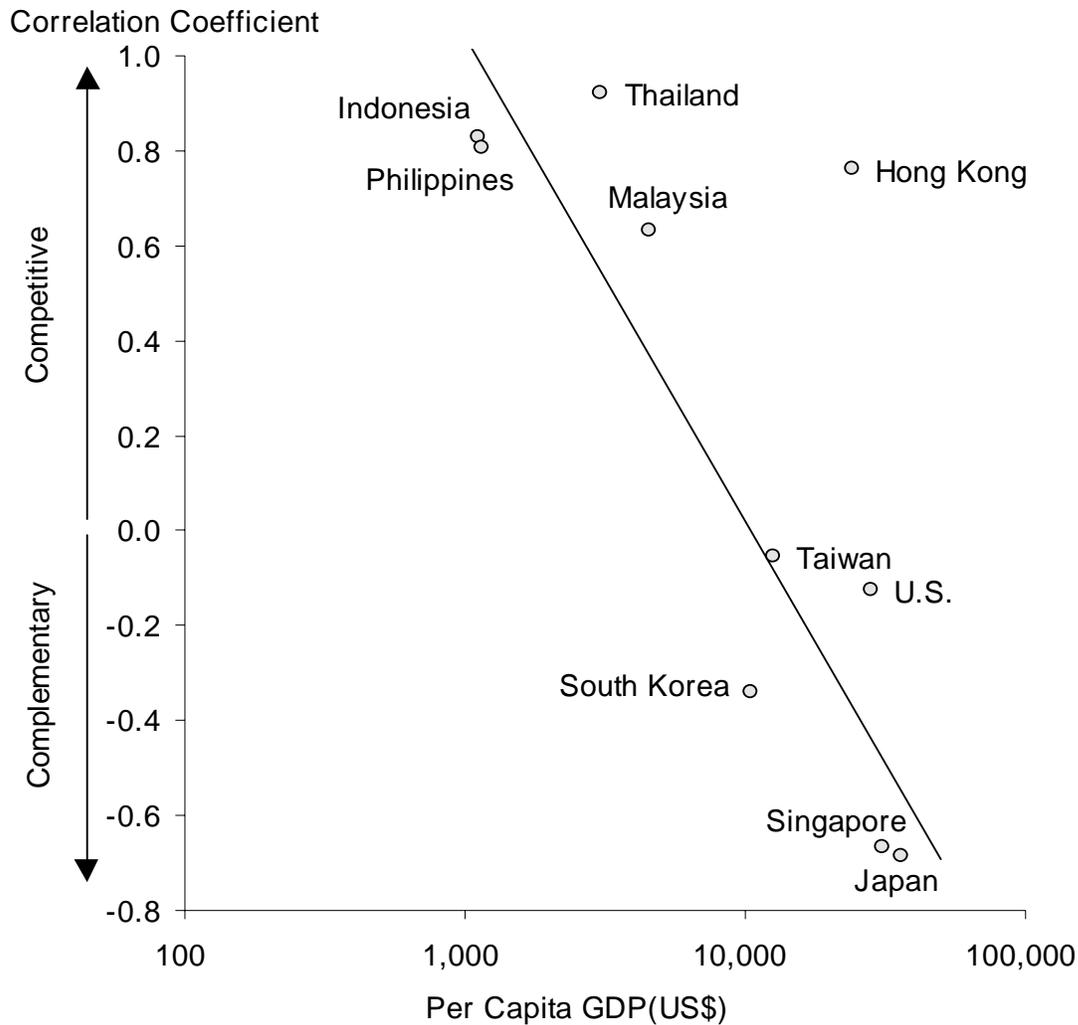
Source: Nomura Research Institute.

B. Competition with China

In addition to the weakening yen, the failure of Thailand and other ASEAN countries to cope with growing competition with China by upgrading their industrial structures may have been a major contributor to the latest crisis in the region. In line with its level of economic development, Thailand, like other ASEAN countries, has a trade structure similar to and thus competitive with that of China (Figure 5). Competitive relations between nations can be characterized as a zero-sum game in which one's gain is the other's loss.¹

¹ In contrast, the Asian NIEs and Japan, which are at much higher levels of economic development, have trade structures complementary to that of China. These countries should find China an attractive destination for their exports and direct investment. Complementary relations can be characterized as a win-win game in which both sides can benefit through trade and investment. For a discussion of the implications of the emergence of China for the regional economy, see Kwan (1995).

Figure 5. Competitive and Complementary Relations between China and Other Asian Countries (1996)



Note: The vertical axis denotes the correlation coefficient between the vectors showing the specialization indexes of various commodity groups (SITC 10-category classification) for China and for the country concerned. The specialization index of a particular commodity group is defined as its trade balance (that is, exports minus imports) divided by its trade volume (that is, exports plus imports).

Source: Compiled by Nomura Research Institute based on ADB, *Key Indicators of Developing Asian and Pacific Countries*, 1997.

Although China accounts for only about 3 percent of Thailand's total trade, it has become an important factor determining economic performance in Thailand largely because the two countries compete with one another for export markets and inflow of foreign direct investment. Growth in labor productivity in China's industrial sector reached nearly 20 percent a year between 1992 and 1997, far outpacing that in the ASEAN countries. The devaluation of

the yuan at the beginning of 1994 has also helped China expand its exports. Indeed, since 1992, multinationals have favored China over ASEAN as a destination to locate direct investment, while the ASEAN countries are losing share to China in international markets (particularly in labor-intensive products).

The impact of the yuan's devaluation seems to have been grossly exaggerated in the press, however. China had a dual exchange-rate system comprising an official rate and a market-based swap center rate until late 1993. In January 1994, the two rates were unified by adjusting the official rate to the market rate, leading to a devaluation of the official rate by about 35 percent (from \$1 to 5.76 yuan to \$1 to 8.7 yuan). Since the swap center rate already applied to about 80 percent of China's external trade before the devaluation, its impact on China's export competitiveness (and thus the competitiveness of the ASEAN countries) should be much smaller than the magnitude of the devaluation (35 percent \times 20 percent = 7 percent, in effective terms) suggests. Indeed, the slowdown in ASEAN exports has only become apparent since 1996, which can better be explained by the weakening yen.

A better indicator of export competitiveness can be obtained by adjusting the real effective exchange rate to take into account changes in differentials in wages and productivity (that is, unit labor cost). The usefulness of this indicator would be further enhanced if competitors' weight, instead of simple trade weight, is used in the calculation. By putting more emphasis on the China factor, the real effective exchange rate for the Thai baht so adjusted would imply a larger overvaluation than the unadjusted index suggests.

II. Impact of the Crisis on the Japanese Economy

The Japanese economy, which has developed close ties with Asia in recent years through foreign direct investment, trade, and bank lending, has been adversely affected by the latest currency crisis in the region, leading to a further depreciation of the yen to ¥147 to the dollar momentarily in the summer of 1998. Further depreciation of the yen, however, should be avoided, as it will hurt not only the Asian countries but also Japan itself.

A. Japanese Investment in Asia at a Crossroads

Simultaneous currency depreciation in the ASEAN countries since July 1997 has dealt a heavy blow to Japanese companies investing there. They have suffered foreign exchange losses on one hand and shrinking sales on the other.

In terms of balance sheets, subsidiaries of Japanese companies with funding in dollars or yen find their debt burden increased sharply in local currency terms. This capital loss is estimated to be very significant since a large proportion of such foreign exchange exposure was unhedged. Although most Japanese companies are cautious in hedging their yen-dollar positions, they were ill-prepared for such major devaluations, taking for granted that stability between Asian currencies and the dollar would always be maintained.

In terms of their income statements, Japanese subsidiaries in the ASEAN countries are facing shrinking markets and lower profitability. In particular, those aiming to develop local markets in the region but heavily dependent on imported inputs are most adversely affected. Faced with rapidly cooling domestic demand, many subsidiaries of Japanese manufacturers have been forced to curtail production by suspending operations there, and those relying

heavily on parts and components imported from Japan are being exposed to higher production costs (in terms of local currencies).

By contrast, Japanese subsidiaries exporting from the ASEAN countries are benefiting from lower production costs (in terms of foreign currencies) and improved export competitiveness. This is particularly true for those heavily dependent on local sources of supply of primary and intermediate inputs (labor, raw materials, parts and components, etc.).

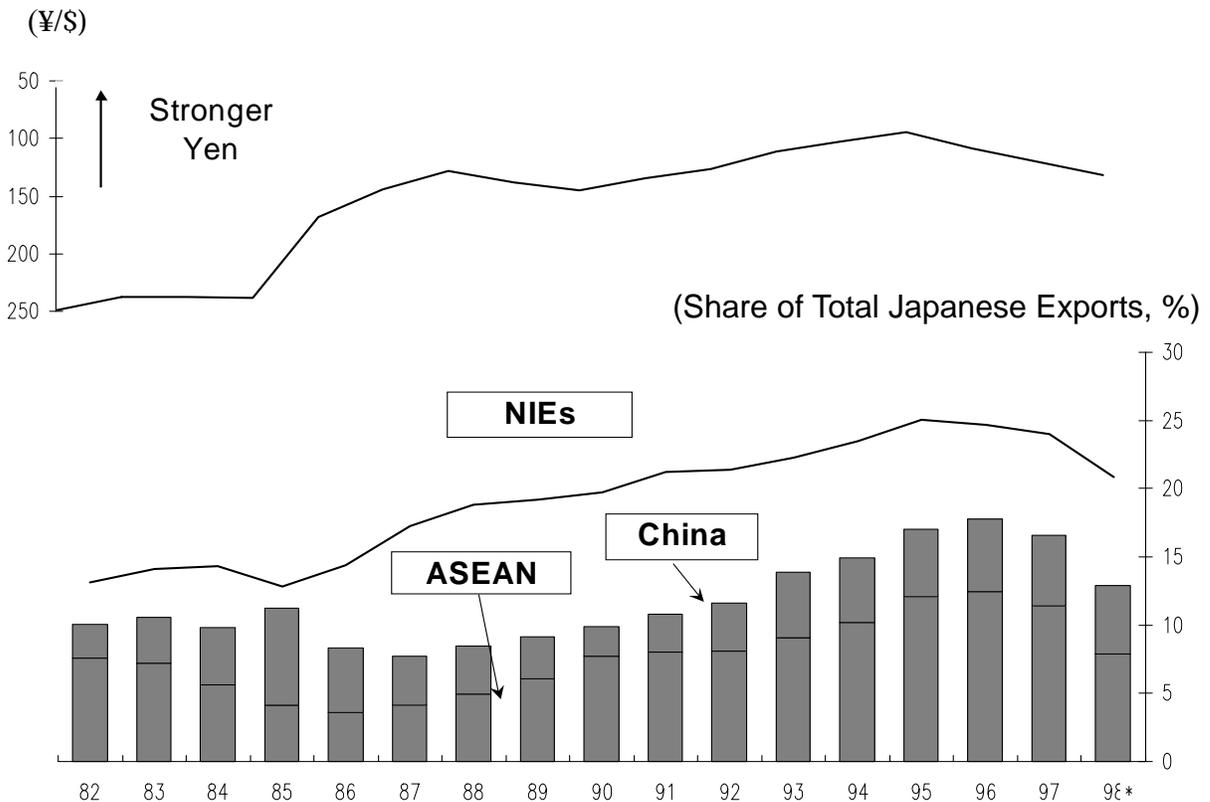
The slowing trend of Japanese foreign direct investment to Asia that accompanied the yen's depreciation since the summer of 1995 has been aggravated by the latest currency crisis in Asia. Faced with this new environment, Japanese companies have become more cautious when considering investment in Asia. The ASEAN countries are likely to gain at the expense of China in receiving direct investment from Japan, particularly for investors taking advantage of the region as an export base, reversing the trend seen in the first half of the 1990s when Japanese investment in Asia was concentrated in China to penetrate the local Chinese market.

B. Further Deceleration of Exports to Asia Inevitable

Japan's exports to Asian countries have been decelerating since 1996 despite the yen's sharp depreciation. Normally a lower yen would enhance the international competitiveness of Japanese goods and expand exports of those goods. This simple economic principle applies only to Japanese exports to the United States and Europe, however, not exports to Asia, because a weaker yen causes Asian economies to slow down as discussed earlier.

Reflecting this asymmetric relation, Asia's share of Japanese exports increases when the yen appreciates and decreases as the yen depreciates (Figure 6). Japan's exports to Asia thus had been slowing down even before the currency crisis in Asia because of, rather than despite, the yen's depreciation. This fact, combined with the deepening recession affecting ASEAN economies due to the simultaneous depreciation of their currencies since early July 1997, is likely to hold down Japan's exports to Asia for some time.

Figure 6. Japanese Exports to Asia Follow the Yen Down



Note: * first half only.

Source: Compiled by Nomura Research Institute based on IMF, *International Financial Statistics*, and Japanese trade statistics.

C. Rising Default Risks of Lending to Asia

Japanese lending to Asia amounted to \$271.3 billion at the end of June 1997, accounting for 34.3 percent of total lending to the region by BIS reporting banks (Table 2). Besides going to Hong Kong and Singapore, which function as regional financial centers, Japanese lending tends to concentrate in Thailand, Indonesia, and South Korea, the three countries that have been most adversely affected by the latest crisis. Lending to these countries is usually denominated in foreign currencies so that devaluation of local currencies does not directly imply capital loss for Japanese banks. As borrowers have seen their debt burden increasing sharply in local currency terms as a result of currency depreciation, however, and at the same time have had to face a shrinking market at home, the default risk of loans outstanding has increased accordingly.

Table 2. Position of BIS Reporting Banks vis-à-vis Asian Countries (End of June 1997)

(US\$ bil.)

Borrowers	Lenders					
	Total	Japan	U.S.	Germany	U.K.	France
Thailand	69.4	37.7	4.0	7.6	2.8	5.1
Indonesia	58.7	23.2	4.6	5.6	4.3	4.8
Malaysia	28.8	10.5	2.4	5.7	2.0	2.9
China	57.9	18.7	2.9	7.3	6.9	7.3
Korea South	103.4	23.7	10.0	10.8	6.1	10.0
Taiwan	25.2	3.0	2.5	3.0	3.2	5.2
Philippines	14.1	2.1	2.8	2.0	1.1	1.7
Hong Kong	222.3	87.4	8.8	32.2	30.1	12.8
Singapore	211.2	65.0	5.2	38.4	25.2	15.4
Asia Total	791.0	271.3	43.2	112.6	81.7	65.2
(Share of Total, %)	100.0	34.3	5.5	14.2	10.3	8.2

Source: Compiled by Nomura Research Institute based on BIS "The Maturity, Sectoral and Nationality Distribution of International Bank Lending," first half 1997.

The bulk of lending by Japanese banks in Asia has been concentrated in subsidiaries of Japanese companies, but the share of large local companies has been increasing. The default risk is low for lending to Japanese subsidiaries because they usually have support from their headquarters. The shocks have been so great, however, that local blue-chip companies borrowing from Japanese banks (or finance companies formed as joint ventures with local banks) may have problems repaying as scheduled.

With Asia now trapped in a recession and the default risk on outstanding bank loans rising, Japanese banks have become more and more cautious in expanding loans to the region and in some cases even in rolling over short-term loans. There is now growing concern that this credit crunch may aggravate the financial crisis in Asia, which in turn would boomerang on Japanese banks as their profits suffer. Indeed, Japanese lending to Asia fell to \$244.7 billion at the end of 1997 as banks tried to reduce regional exposure.

D. Avoiding Competitive Devaluation

With domestic demand remaining in the doldrums, Japan may be tempted to export its way out of the recession by allowing the yen to fall further against the dollar. Such a policy, however, is both undesirable and unsustainable for the following reasons.

On the one hand, it is likely to ignite another round of competitive devaluation among the Asian currencies and delay the recovery in Asia, leading to a further deceleration of exports to the region. The expansion of total exports would have to rely more and more on the American and European markets. As a result, Japan's trade surplus with the United States would continue to increase, leading eventually to an intensification of Japan-U.S. trade friction and upward pressure on the yen rate against the dollar.

On the other hand, a weaker yen hurts Japan more directly by forcing Japanese banks to reduce lending in order to meet the minimum BIS capital adequacy ratio (capital/risk assets) of 8 percent. Japanese overseas lending, the bulk of which is counted as risk assets, is largely

denominated in dollar terms while capital of Japanese banks is denominated in yen terms. Other things being equal, a weaker yen, by raising the value of overseas assets (and thus the denominator) in yen terms, reduces the capital adequacy ratio for Japanese banks. In order to restore the ratio, they have to curb lending either at home or abroad, aggravating the credit crunch facing Japan and Asia. In the absence of new capital, every one yen of depreciation against the dollar is estimated to reduce the Japanese banks' lending capability by one trillion yen (Koo, 1998). By extension, the decline of the yen from 80 yen to the dollar in the spring of 1995 to 140 yen in the summer of 1998 should have reduced Japanese lending by 60 trillion yen.

Despite the rising trade imbalance with Japan, so far the United States has not pressed for a stronger yen, largely reflecting the confidence of U.S. authorities in the strength of the U.S. economy. Should turmoil in the Asian economies continue, the deflationary effect will sooner or later be felt in the United States. On the one hand, the dollar has strengthened substantially against the yen and European currencies since 1995 and against most Asian currencies since the summer of 1997. On the other hand, the stark contrast between robust economic growth in the United States and the recession in Asia including Japan has continued. As a result, U.S. exports are expected to slow sharply while imports should remain strong, leading to a deterioration of the U.S. current account balance. The decline in net exports should also place a drag on U.S. economic growth, and it will become more and more difficult for the United States to continue to play the role of locomotive for the global economy.

The United States is likely to put more pressure on Japan when U.S. domestic economic growth starts to show clear signs of deceleration. This may initiate a trade war among economic powers involving competitive devaluation and rising protectionism, and increase the possibility that the global economy will plunge into recession. Instead of pursuing such a beggar-thy-neighbor policy, the major economic powers should seek to sustain economic growth through stimulating domestic demand. For Japan, a full-fledged recovery will hinge not only on fiscal stimulation through tax cuts and expansion of public expenditures, but more importantly on solving the bad-debt problems and the resulting credit crunch plaguing its financial sector. Such policies, through restoring confidence in the Japanese economy and raising domestic interest rates, will also help to strengthen the yen against the U.S. dollar.

Indeed, the passage in the Diet of a series of major bills designed to fix Japan's ailing banking system in early October 1998 has led to a sharp rebound of the yen against the dollar, with significant positive impact on regional stock and foreign exchange markets. A stronger yen, together with recent coordinated efforts by major industrial countries to reduce interest rates and to provide financial support to those emerging economies hit hard by the crisis, have set the stage for the recovery of the Asian economies.² The recent rebound of the yen should also help alleviate Japan's credit crunch problem on the one hand and reduce deflationary pressure on the U.S. economy arising from the Asian crisis on the other.

² According to the estimation in Table 1, a 10 percent appreciation of the yen should push up economic growth in Asia by about 1 percent, far more than a 1 percent increase in U.S. economic growth (about 0.3 percent). This should also have a larger impact than a 1 percent increase in economic growth in Japan, which is a smaller market for the Asian countries compared with the United States.

III. Impact of the Crisis on the Chinese Economy

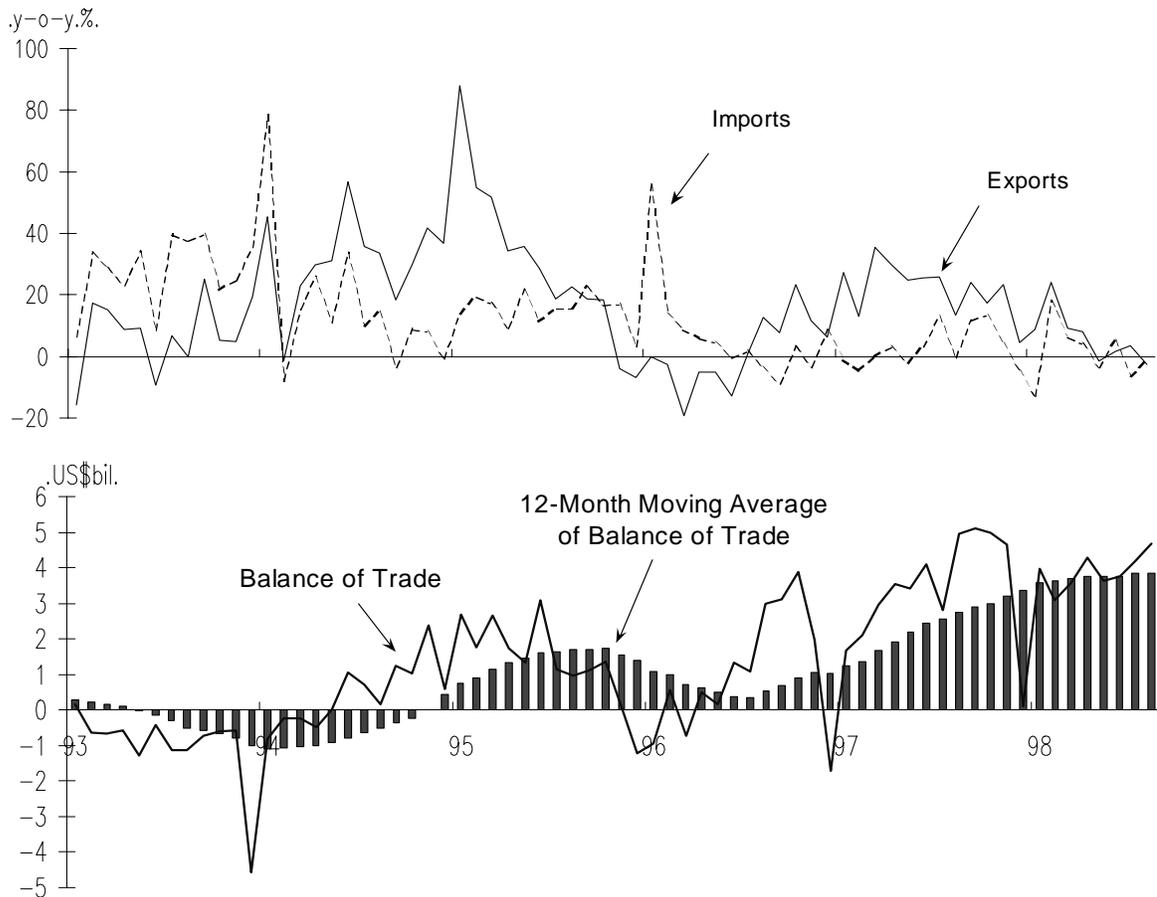
With most Asian currencies, including the yen, tumbling against the dollar, whether China will join the competitive devaluation or act as an embankment preventing the crisis from spreading further has become an important determinant of the economic outlook of the region, if not the global economy. Backed by a healthy balance-of-payments position and tight control over capital account transactions, China has made a firm commitment not to devalue, fully recognizing that devaluation is not conducive to its own national interest.

A. Devaluation of the Chinese Yuan Unlikely

So far, the yuan has held firm despite intense speculation in other Asian currencies. Although the Chinese currency is convertible for current account transactions (since China accepted in December 1996 the obligations stipulated in Article 8 of the IMF's Articles), very tight controls on capital flows have helped shelter the yuan from speculation. China should not and need not devalue the yuan for the following reasons.

First, China's external balance is in good shape. With capital account transactions tightly controlled, the yuan's exchange rate is largely determined by the performance of the current account. Although exports have slowed, imports have weakened even more sharply, so that China's trade surplus is still at a historically high level (Figure 7). China's foreign exchange reserves have risen at a rapid pace in recent years, reaching US\$140 billion (equivalent to twelve months of imports) in mid-1998, thanks to robust trade performance and massive inflow of foreign capital which largely has taken the form of foreign direct investment. On the other hand, China's foreign debt is at a low level compared with other Asian countries, with the debt /GDP ratio at 16.0 percent and the debt service ratio at 8.7 percent in 1996 (Table 3). It also has long maturity, with short-term debt making up only 19.7 percent of total debt in 1996.

Figure 7. China's Trade Surplus at a Historically High Level



Source: Compiled by Nomura Research Institute based on China's trade statistics.

Table 3. Comparison of China's Major Debt Indicators with ASEAN (1996)

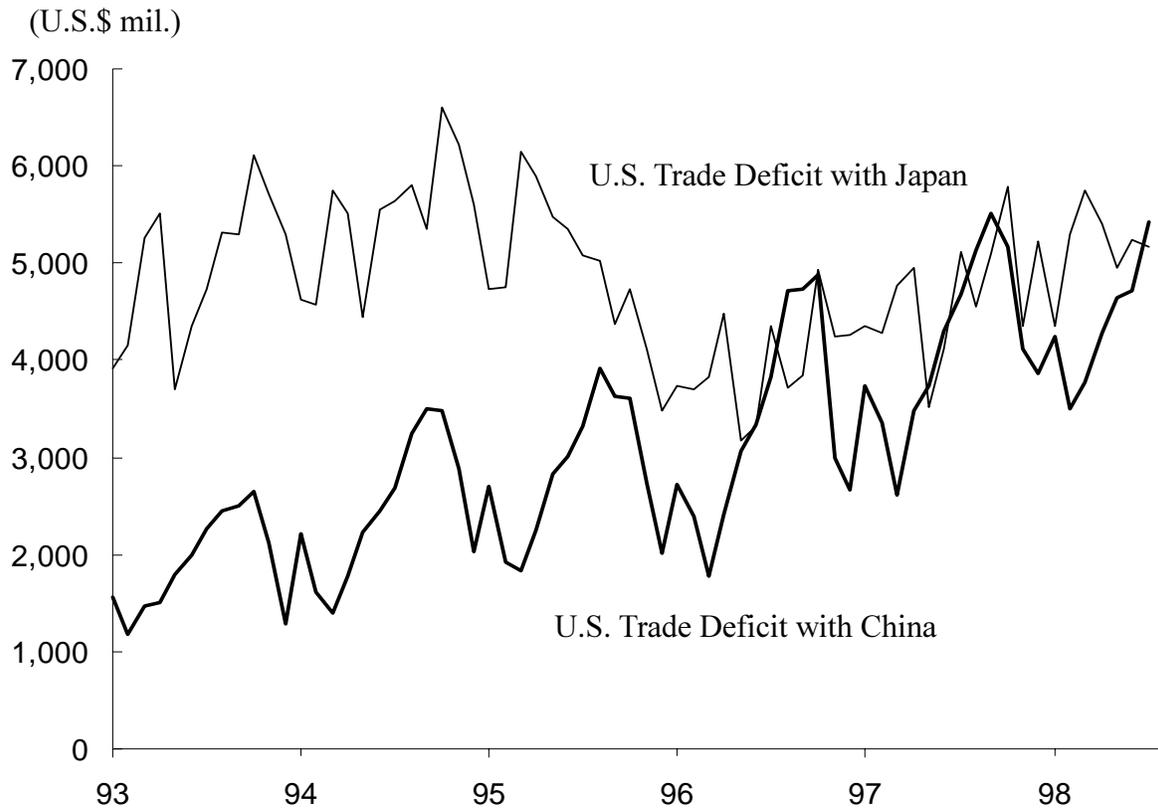
(%)

	Total Debt/ GDP	Debt Service Ratio	Short-Term Debt	
			To Total Debt	To Foreign Reserves
China	16.0	8.7	19.7	22.7
Indonesia	59.7	36.8	25.0	165.7
Malaysia	42.1	8.2	27.8	39.7
Philippines	47.3	13.7	19.3	68.0
Thailand	50.3	11.5	41.4	97.4

Source: World Bank, *Global Development Finance*, 1998.

Second, China now runs a trade surplus with the United States (\$49.7 billion in 1997, according to U.S. statistics) as large as that of Japan (\$55.7 billion for the same year). Since July 1998, China has replaced Japan as the largest source of the U.S. trade deficit (Figure 8). A devaluation of the yuan will aggravate trade friction with the United States and delay China's entry into the World Trade Organization (WTO). This consideration has become all the more important now that the United States has begun to feel negative repercussions from the Asian crisis in terms of slower economic growth, falling equity prices, and a widening trade deficit.

Figure 8. China Overtaking Japan As the Largest Source of the U.S. Trade Deficit



Note: Monthly data.

Source: U.S. Department of Commerce.

Third, a devaluation of the yuan might spark another round of speculation in the Asian currencies that are still under pressure, including the Hong Kong dollar. This certainly would further delay the recovery of the regional economy, with negative repercussions for China itself. Politically, China would also have to take the blame for any adverse consequences on global financial markets. In contrast, by maintaining the value of its currency, China can strengthen its leadership in the region.

Finally, a devaluation of the yuan would hurt the reputation and the popularity of Premier Zhu Rongji, both at home and abroad. Zhu, who replaced Li Peng as China's premier at the National People's Congress in March 1998, has been credited for successfully engineering a soft landing of the overheated Chinese economy since 1993. He has repeatedly confirmed China's commitment to maintaining the stability of the yuan against the dollar.

B. The Weakening Yen Does Not Necessarily Hurt China

China has repeatedly expressed concern that the weakening yen has put downward pressure on the yuan, but this concern seems to be based more on political than (sound) economic reasoning. Chinese officials, notably Governor Dai Xianglong of the People's Bank of China (China's central bank), have even hinted that China may be forced to abandon its commitment not to devalue in the event the yen weakens further. The pitfall of this argument is apparent by noting that Japan and China have economic structures that are complementary to, rather than competitive with, each other.

Depreciation of the yen does not necessarily reduce China's export competitiveness because the commodity mix of China's exports (dominated by labor-intensive products) is very different from that of Japan's exports (dominated by high-technology products). China may suffer some decline in the inflow of foreign direct investment from Japan, but even this will be minimal because Japanese companies have come to look at China more as a market than as an offshore production base. Rather, with a weaker yen, China enjoys lower prices of imports from Japan and a lower burden of financing its yen-denominated debt.

Thus a weakening yen is more likely to benefit than to hurt China's balance of payments, and by extension should act as a factor supporting rather than depressing the yuan. If a weakening yen puts downward pressure on the yuan, it is likely to be the result of investors' behavior based (intentionally or otherwise) on faulty economic reasoning.

C. Targeting 8 Percent Growth

Without devaluation as an option, China will have to rely on other measures to sustain economic growth at the target rate of 8 percent for 1998. There is further room for China to stimulate domestic demand by pursuing more expansionary monetary and fiscal policies, thanks to the very low domestic inflation rate. China has implemented four rounds of interest rate cuts since October 1997, with average lending rates allowed to drop by a cumulative 3.8 percent. China has also cut the reserve requirements for banks and aims to double the amount of loans for home purchases. On the fiscal side, the government intends to increase spending on infrastructure and in high-technology areas, to be funded by the issue of government bonds.

At the same time, China has also sought to improve its investment environment for foreign companies, in a sharp turnaround in the policy of the last few years. For example, in January 1998 the government removed tariffs charged on imported machinery when foreign companies set up operations in China. VAT taxes applicable to certain types of exports have also been reduced. Larger inflow of foreign direct investment should help reduce downward pressure on the yuan by boosting China's export capacity and productivity growth.

China is fortunate to be able to cope with the current situation with its own resources. Otherwise it would have to implement a drastic monetary and fiscal tightening and capital account liberalization similar to the measures imposed by the IMF upon Thailand, Indonesia,

and South Korea. In that case, our concern would have been whether China would become another Russia, not whether it can achieve 8 percent growth—still the highest rate in the world.

IV. Challenges and Opportunities for Japan

All the problems plaguing its economy notwithstanding, Japan, being by far the largest net creditor country in the world and making up more than two-thirds of the regional economy, is expected to play a leading role in helping other Asian countries to overcome the crisis. Japan has provided substantial financial support directly and in concert with the IMF. In addition, it should boost domestic demand, prevent the yen from depreciating, and rebuild confidence in its own financial system as discussed earlier. In the longer term Japan should promote the use of the yen as an international currency and seek a dynamic division of labor with the Asian countries according to evolving comparative advantage.

A. International Financial Support and Cooperation

Japan has played an active role in granting financial support to the troubled countries in Asia, committing a total of US\$42 billion at an early stage of the crisis. This includes \$4 billion for Thailand, \$5 billion for Indonesia, and \$10 billion for South Korea in concert with the IMF and loans by the Export-Import Bank of Japan to help solve the credit crunch facing Asian exporters.

In addition, Japan announced a package of support measures totaling \$30 billion in early October 1998 (the “Miyazawa Initiative”). This includes \$15 billion to meet the medium- to long-term financial needs for economic recovery in Asian countries and another \$15 billion for their possible short-term capital needs during the process of implementing economic reform. Besides providing official direct financial assistance, Japan has committed to support Asian countries in raising funds from international financial markets by guaranteeing bank loans to and bonds issued by Asian countries.

Discussions among monetary authorities in Asia and the United States and international financial institutions to further promote regional financial cooperation led to the Manila Framework reached in November 1997, which presented the following four initiatives: (1) a mechanism for regional surveillance to complement global surveillance by the IMF; (2) enhanced economic and technical cooperation particularly in strengthening domestic financial systems and regulatory capacities; (3) measures to strengthen the IMF’s capacity to respond to financial crises (increased quotas and the New Arrangement to Borrow); and (4) a cooperative financial arrangement that would supplement IMF resources. Before that, Japan had proposed the establishment of a more ambitious “Asian Monetary Fund” with a firmer commitment and more flexible rules, but the initiative failed because of opposition from the United States.

Despite all these efforts, Japan has failed to meet the high expectations of the international community. President Clinton, for example, has repeatedly expressed his disappointment with the slow pace of reform and recovery in Japan. In the opening ceremony of the 1998 International Monetary Fund/World Bank annual meeting held on October 6, he remarked that

“[T]he health of Asia, and indeed the world, depends upon Japan. Just as the United States had to eliminate its deficits and high interest rates which were taking money away from the rest of the world over the last six years, now Japan must take strong steps to restart its economic growth, by addressing problems in the banking system so that lending and investment can begin with renewed energy; and by stimulating, deregulating and opening its economy.”

In addition, Japan’s inability to pull its troubled neighbors out of the current crisis has frequently been contrasted to the leading role the United States played in overcoming the Mexican crisis in early 1995. With its own financial crisis deepening, Japan has to take the blame not only for the failure to help Asia but also for fueling the crisis itself.

B. Promoting the Yen As an International Currency

The latest currency crisis, which occurred against a background of a highly volatile yen-dollar rate, has cast doubt on the conventional wisdom that pegging to the dollar contributes to economic stability. As proposed by Kwan (1992, 1994), Asian countries can achieve more stable economic growth by pegging to a basket of currencies in which the yen carries substantial weight (see box).

Recognizing the limitations of the traditional exchange-rate policy of pegging to the dollar, there is now growing interest among the Asian countries in pegging closer to the yen and making wider use of the yen in denominating trade, capital account transactions, and foreign exchange reserves of central banks.³ Japan should respond by removing barriers that restrain the role of the yen in the region.⁴ As a major step in this direction, in the APEC finance ministers’ meeting held in May 1998 then Japanese minister of finance Hikaru Matsunaga expressed his intention to abolish the withholding tax on interest earnings of nonresidents’ yen assets.

Promoting the use of the yen as a regional currency is also in Japan’s own interest. With Asia now absorbing some 40 percent of Japan’s total exports, stability between the yen and other Asian currencies would undoubtedly make Japan less vulnerable to fluctuations in the yen-dollar rate. In this respect, Germany has set an example for Japan to follow. Through monetary integration with its European neighbors and the establishment of a *de facto* deutsche mark bloc, Germany has been able to minimize the adverse impact on its domestic economy of changes in the deutsche mark’s exchange rate against the U.S. dollar. Thanks to the built-in stabilizing effect of monetary integration, the effective exchange rate of the deutsche mark has been much more stable than that of the yen.

Japan’s expanding role as a net creditor nation also makes wider use of the yen desirable, as it would help Japan stabilize the value of its overseas assets, which amounted to \$960 billion on a net basis at the end of 1997. Japan has suffered immense capital loss in yen terms

³ For a discussion of role of the yen as an international currency, see Tavlas and Ozeki (1992) and Kwan (1996).

⁴ Specifically, the following measures are desirable. First, the market for Japanese treasury bills and other short-term government bonds must be revamped. Second, Japan’s unique system of imposing withholding tax on interest income and tax on securities transactions needs to be revised to conform with international standards. Third, improvements are also needed in financial market infrastructure, including the settlement system and securities rating system. At the same time, to increase the overseas supply of the yen Japan should open its market further to the exports of other Asian countries.

Pegging Closer to the Yen

Given the great impact on economic growth of fluctuations in the yen-dollar rate, stability of the yen-dollar rate is crucial for stability in the regional economy. Since the yen-dollar rate is beyond the control of Asia's developing countries (or even of the major industrial powers, including Japan and the United States), these countries should seek as a second-best solution to stabilize their exchange rates not only against the dollar but also against the yen. So long as the yen-dollar rate fluctuates, however, it is impossible for an Asian currency to achieve stability against both the dollar and the yen at the same time. One way to compromise is to peg to a basket of currencies in which the yen carries substantial weight. The higher the weight assigned to the yen, the stronger the synchronization between the host country's currency and the yen. For example, if the yen carries a weight of 50 percent in Korea's reference basket, the won would be allowed to appreciate by 5 percent when the yen strengthens 10 percent against the U.S. dollar (or to depreciate by 5 percent when the yen weakens 10 percent against the dollar).

The optimal weight assigned to the yen in this currency basket should differ from one country to another, depending largely on how much the host country competes with Japan. Since higher-income countries are more likely to have more competitive relations with Japan than lower-income countries, South Korea should peg closer to the yen than Thailand, which in turn should assign a higher weight to the yen in its reference basket than Indonesia, for example.

Judging by this criterion, the weight assigned to the yen in Thailand's reference currency basket before the change to managed floating in mid-1997 (estimated at 10 percent) was too low (and the weight assigned to the U.S. dollar was too high). Had the yen carried a higher weight in that basket, the baht would have depreciated more sharply against the dollar as the yen depreciated since mid-1995. This, in turn, should have moderated the appreciation of the baht in real effective terms and helped sustain Thai export growth. In that case, the abrupt devaluation of the baht might have been avoided.

since the mid-1980s by investing heavily in dollar-denominated assets, as the dollar has followed a downtrend against the yen. Never before has the world's leading creditor country had most of its overseas assets denominated in the currency of the world's largest debtor country. This unprecedented situation is potentially a major source of instability in the international financial system.

There has also been growing concern that the ongoing erosion of Tokyo's role as an international financial center may hinder wider international use of the yen. Looking at the issue from a more positive perspective, however, it should be recognized that actively promoting wider use of the yen in Asia and elsewhere is just what is needed to enhance the quality and sophistication of the Tokyo financial market. Former prime minister Hashimoto's financial reform program, dubbed the "Big Bang," is unlikely to succeed without assigning a larger role to the yen as an international currency.

C. Whither the Hollowing-Out Problem?

With its ties to Asia strengthening in recent years, Japan's economic fortune hinges more and more on the future of the region. There has been much concern that growing competition with Asia may lead to a hollowing-out of Japan's economy.⁵ The latest crisis, however, clearly shows that it is in Japan's own national interest to be surrounded by prosperous and peaceful countries rather than by poor and unstable ones.

Japan's economic growth has stagnated since the early 1990s, but this should be attributed more to domestic than to international factors. If the market mechanism works properly, international trade and investment should promote the efficient allocation of resources and raise real income in the countries involved. If hollowing-out occurs, it must reflect the existence of market and government failures that lead to distortions in price formation and allocation of resources. Foreign distortions likely to contribute to hollowing-out include excessive exchange-rate volatility and industrial policies that combine protectionist measures on imports with preferences for foreign investors. Domestic distortions include excessive regulations and heavy taxes that raise the cost of production and that prevent the relocation of resources from declining industries to emerging ones.

To achieve a more sophisticated industrial structure to avoid hollowing-out, Japan should promote the relocation of declining industries to Asia on one hand and reduce domestic distortions and regulations hindering productivity growth on the other. This has become all the more important now that Asia needs both funds and technology from Japan to overcome the ongoing crisis.

V. Challenges and Opportunities for China

In contrast to the negative implications for Japan, the crisis in Asia may turn out to be a blessing in disguise for China. By learning from others' mistakes without bearing much of the cost itself, China has recognized the correct sequencing of reform and the importance of maintaining financial stability. By refraining from competitive devaluation, China has regained the respect and trust of the international community that it had lost since the Tiananmen incident in June 1989.

A. The Correct Sequencing of Reform

China's careful stance on liberalization has been a major factor insulating it from the contagion of the Asian crisis. The sharp contrast between China's solid economic growth and the turmoil of its Asian neighbors confirms the conclusion that it has been following the right sequencing in pursuing economic reform. Thus, a developing country should not liberalize capital account transactions at too early a stage when banks' risk appraisal is inadequate and monetary control is difficult.

From now on China should concentrate on strengthening its fragile financial system centering on banks, leaving liberalization of capital account transactions to the reform agenda of the twenty-first century. This would include strengthening supervision of financial institutions and infrastructure of financial markets, solving the bad-debt problem plaguing the

⁵ For a discussion of Japan's hollowing-out problem, see Kwan (1997).

state-owned banks, and granting more independence to the central bank. The pace of financial reform will hinge on progress in other areas, notably state-enterprise reform. The growing sense of urgency has lent support to Premier Zhu Rongji and his team of newly promoted technocrats in implementing their ambitious program of transforming China from a planned economy to one based on the market mechanism.

Indeed, China's sequence of reform has established a model for other Asian countries to follow. In early September 1998, Malaysia introduced drastic measures to tighten control over capital account transactions. By so doing, Malaysia aims to insulate its economy from foreign speculators on one hand and to reclaim autonomy over its monetary policy on the other. The attractiveness of the Chinese approach to reform characterized by gradualism was also enhanced by the meltdown of the Russian economy in the summer of 1998, a vivid illustration of the failure of the IMF's "big bang" approach.

B. International Environment Turning in China's Favor

The economic crisis in Asia has given China a golden opportunity to improve its relations with the United States, which have been in the doldrums since 1989. Indeed, during his visit to China in late June 1998, President Clinton praised China for showing "great statesmanship and strength in making a strong contribution to the stability not only of the Chinese people and their economy, but the entire region, by maintaining the value of its currency." The United States has also softened its stance on unresolved issues between the two countries ranging from the Taiwan problem to human rights. Backed by improved Sino-U.S. relations, China is ready to take a more active role in regional affairs.

Indeed, the Asian currency crisis, together with the return of Hong Kong to Chinese rule, may well mark the emergence of China as a regional economic power. This is apparent when one notes that the gap between China's GDP and the combined GDP of the ASEAN countries is expected to widen from 15 percent in 1996 to 200 percent in 1998 in China's favor. On July 1, 1997, Hong Kong became a Special Administrative Region of China, adding 20 percent to the latter's GDP. The devaluation of the Thai baht on the following day triggered sharp depreciation in other ASEAN currencies. Subsequently, the GDP of the ASEAN countries in terms of U.S. dollars has dropped by more than one-half as a result of the sharp depreciation of the local currencies and the inception of negative economic growth. In this way, thanks to the strong yuan, China stands out in the regional economy, very much like Japan did after the Plaza Accord in 1985 when the yen appreciated sharply against the dollar.

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