

The East Asian Crisis: What Must Be Done?

PATRICK ARTUS:

Diverging Ills – Diverging Remedies

Between 1991–92 and the beginning of 1997, most Asian countries have experienced a real appreciation of their currencies, vis-à-vis the US dollar or vis-à-vis a trade weighted basket on the currencies of trading partners, as shown below in Table 1.

Table 1:
Real appreciation between January 1992 and the beginning of 1997

	Vis-à-vis the dollar	Vis-à-vis the trade weighted basket of currencies
Malaysia	10	18
Thailand	8	13
Philippines	23	16
Indonesia	7	9
Singapore	10	10
Hong Kong	22	18
South Korea*	– 4	– 5
Taiwan*	– 7	– 5
China	–10	n.a.

* real depreciation

Real appreciation is not systematically linked to currency crisis

In most cases, real parities have fluctuated quite wildly from 1992–93 onwards. Countries can be classified into several groups.

► *Moderate deterioration (10–15 %) of competitiveness:* Malaysia, Thailand, Indonesia and Singapore belong to this group. In Malaysia and Thailand, the nominal exchange rate against the dollar has remained stable since 1992: in Indonesia it has de-

preciated and in Singapore it has appreciated. In all cases, there has been a real appreciation. In the first three countries, excess inflation in relation to the United States has been such that trends in the nominal parity have been incompatible with the currency's stability. In all countries, the situation in terms of the trade-weighted parity has been worsened by the dollar's rise since 1995.

► *Sharp deterioration (15–25%) of competitiveness: Philippines, Hong Kong.* In Hong Kong, the nominal parity has been pegged to the dollar. In the Philippines, it has fluctuated within a narrow range. But in both countries, average inflation has substantially exceeded inflation in the United States by some 5 to 6 per centage points p.a.

► *Near-stability of competitiveness, or slight improvement: South Korea, Taiwan.* In South Korea, the won has been depreciating against the dollar since the US currency began to rise in 1995 and has therefore not undergone the real appreciation experienced by the other countries. In Taiwan, the nominal exchange rate has also been flexible and, in addition, inflation has been as low as in the United States over the period.

China is a case apart because of the unification of exchange rates in 1993. This led to a very sharp devaluation and boosted competitiveness substantially. Since that point in time, the exchange rate has experienced a real appreciation.

Among the 10 countries, only China and Hong Kong have not experienced a visible depreciation against the dollar since the summer of 1997. The seven other countries have seen their currency depreciate massively against the dollar since the end of the first half of 1997. Note that the depreciation has been automatic in Singapore since the Singapore dollar is pegged to a basket of currencies weighted in terms of exports. It therefore includes neighbouring countries whose currencies have been attacked.

If the analysis is restricted to the six countries

whose currencies have come under attack (Malaysia, Thailand, Philippines, Indonesia, South Korea and Taiwan), it is noteworthy that the last two had not been subject to real appreciation. Another point of interest is that the real appreciation in Hong Kong and Singapore has not resulted in the currency dropping below the level desired by the authorities. If real appreciation is a frequent occurrence, there is no systematic link between an excessively strong currency and the breakout of exchange rate crises.

Except in the case of South Korea, external deficits are consistent with the trends in competitiveness

When analyzing the evolution of the external deficits, one can again divide the countries into three groups:

► *Countries which have current-account surpluses or are close to current-account equilibrium:* Taiwan and China enjoy substantial trade surpluses in 1996 (USD 18 bn for Taiwan and USD 12 bn for China): Indonesia has a large trade surplus (3 % of GDP) and a bearable current-account deficit.

► *Hong Kong and Singapore* are in an odd situation as they have a large trade deficit but no problems with their current-account balance, notably because of interest payments received on external assets, including their foreign reserves. Singapore even has a significant current-account surplus.

► *Countries with excessively high current-account deficits:* Malaysia (6 % of GDP in 1996), Thailand (8 % of GDP), Philippines (4,5 % of GDP) and, to a lesser extent, South Korea (with a current-account deficit of nearly 5 % of GDP in 1996 but correcting rapidly as soon as in 1997).

Is there a link between a country's competitive position and its current-account balance? Countries having suffered from a sharp drop in competitiveness (Philippines and Hong Kong) have substantial trade deficits (in 1996, 14 % of GDP in the Philippines, 10 % of GDP in Hong Kong) even though their current-account balances are far smaller. Countries with a moderate deterioration in competitiveness (Malaysia, Thailand, Indonesia and Singapore) all have trade deficits, although Singapore's is masked by capital income. Countries with steady or sound competitiveness (Taiwan

and China) enjoy trade surpluses. Only South Korea displays an »abnormal« configuration: trade deficits but favourable competitiveness, as has been seen above. We will later link this situation to trends in domestic demand.

In nearly all cases, the expected link between competitiveness (real exchange rate) and trade balance is found: deficits in the event of real appreciation, surpluses in the event of favourable competitiveness.

Capital inflows account for the accumulation of foreign reserves

Let us begin with countries suffering from a persistent current-account deficit. In Malaysia, foreign reserves grew markedly until end-1993 before ebbing at virtually the same pace as the current-account deficit. In Thailand, despite very high deficits, reserves increased until mid-1996 before plummeting. In the Philippines, despite the deficits, reserves have been rising slowly. In Indonesia, despite the worsening current-account deficit from 1995 onwards, foreign reserves have ballooned. South Korea's current-account deficits in 1994–96 (a cumulative USD 37 bn) grew even as foreign reserves rose by USD 15 bn.

Let us now look at countries with surpluses: Singapore's foreign reserves have grown at the same pace as its current-account surpluses, Hong Kong's twice as fast. Taiwan has accumulated fewer reserves than cumulative current-account surpluses (USD 30 bn against USD 59 bn from 1990 to 1996). China's foreign reserves have risen dramatically since 1994, up by USD 105 bn, whereas its cumulative current-account surplus was only USD 26 bn. The most blatant anomalies therefore concern Thailand, the Philippines, Indonesia and South Korea – where current-account deficits have been recorded even as foreign reserves grew – and Hong Kong and China, where the rise in foreign reserves has outstripped the current-account surplus significantly. The situations of Malaysia, Singapore and even Taiwan are far more normal.

In a high number of cases (Thailand, Philippines, Indonesia and Hong Kong), the fact that capital inflows enabled foreign reserves to rise even at a time of current-account deficit is due to the pegging of the nominal exchange rate to the

dollar: In China, the nominal exchange rate can be said to have been fixed since mid-1994, and this coincides with a surge in foreign reserves. In South Korea, the nominal exchange rate has not been fixed but foreign reserves have nevertheless grown very rapidly.

When the balances on capital flows are examined (Tables 2 and 3), it can be seen that this is due to direct investments in China, which have been substantial since 1993. In the case of South Korea, this is due in particular to financial inflows from the banking sector. When one looks at the other countries with an »abnormal« accumulation of foreign reserves (Thailand, Philippines and Indonesia), it can be seen that direct investment has been low and financial capital inflows very high (notably in Thailand).

Countries which have accumulated foreign reserves despite current-account deficits are coun-

tries that have received substantial financial capital inflows while direct investment has been weak.

What is the link between capital flows and the level of interest rates? Most of the countries (Philippines, Indonesia, Thailand, South Korea and China) have experienced, during the 1990s, short term interest rates well above the level of US rates: around 10% in the Philippines and in Thailand, 15% in Indonesia, 9% in Korea, 11% in China, but China's case is different since there is no convertibility.

Not surprisingly, Thailand, Philippines, Indonesia and South Korea have had large financial capital inflows, drawn by high returns. In all these countries, the nominal exchange rate has remained virtually pegged to the dollar (in South Korea only until early 1995). When the nominal rate is pegged and interest rates are high in relation to US rates, financial capital is attracted as the country's cur-

Table 2:
Net direct investment inflows (USD bn)

	1990	1991	1992	1993	1994	1995
China	2.6	3.4	7.2	23.1	31.8	33.8
Indonesia	1.1	1.5	1.8	1.7	1.5	3.8
Japan	-46.3	-31.1	-14.7	-13.7	-17.2	-22.7
South Korea	- 0.3	- 0.4	- 0.5	- 0.8	- 1.7	- 1.8
Malaysia	2.3	4.0	5.2	5.0	4.3	n.d.
Philippines	0.5	0.5	0.2	0.9	1.2	1.1
Singapore	3.5	4.3	0.9	2.6	2.3	3.0
Thailand	2.3	1.8	1.9	1.6	0.9	1.2

(Source: INF)

Table 3:
Net capital inflows (USD bn)

	1990	1991	1992	1993	1994	1995
China	0.6	4.0	- 0.8	5.5	3.1	4.7
Indonesia	3.5	4.2	4.4	4.0	2.4	6.6
Japan	24.8	-36.4	-85.2	-88.9	-68.3	-41.7
South Korea	3.2	7.1	7.5	4.0	12.3	19.0
Malaysia	-0.5	1.6	3.5	5.8	- 2.8	n.d.
Philippines	1.6	2.4	3.0	2.4	3.9	4.2
Singapore	0.4	- 2.0	0.9	- 3.7	- 6.8	- 3.8
Thailand	6.8	10.0	7.6	8.9	11.3	20.7

rency is deemed similar to the dollar but with a higher return. In Singapore and Malaysia, conversely, interest rates have been low and speculative capital inflows have not appeared. On the contrary, capital outflows have been recorded in Singapore.

Investment and growth: very rapid increase has been the rule

A distinction can be drawn between countries in which a substantial investment drive has promoted very rapid growth and the others. Malaysia, Thailand, Indonesia, Singapore, South Korea and China are in the former group, with average growth rates of 8–11% and investment growth often exceeding 10% per year.

In the Philippines (average growth of 2.9% p.a.), Hong Kong (5.1%) and Taiwan (6.3%), real growth has been more moderate with investment rising by what could be called a mere 5–10% p.a.

Note that rapid growth does not always entail the appearance of a trade deficit: this has not occurred in China and Indonesia. Conversely, moderate growth can coincide with trade deficits, as in the Philippines and Hong Kong. In the Philippines, however, growth and investment have accelerated since economic reforms were implemented in 1994.

Although China is in the high-growth group, its export capacity has prevented any deficit from appearing. In cases where deficits occur despite modest growth, real appreciation in the exchange rate is the main cause.

Real overvaluation as a way to finance unbalanced growth

Table 4 summarizes the results we have obtained. What does it show about the origin of the currency crisis and the role of real appreciation?

China, Singapore and Hong Kong are the only countries so far to have been spared a currency depreciation. China displays none of the worrisome characteristics of the other countries. Even though growth is rapid, there is no trade deficit and capital inflows are direct investments. In Singapore, there is both real overvaluation and a trade deficit, but no current-account deficit thanks to capital income. There is no sign of unstable external financing – quite the contrary in fact.

The situation is slightly more worrisome in Hong Kong as its currency is highly overvalued and its trade deficit is substantial but it has not run up a current-account deficit. The authorities' strategy seems to be to try to curb the deficit by discouraging capital imports in driving down pri-

Table 4:
Synopsis

Country	Currency crisis in 1997	Real appreciation in the 1990s	External deficit	Increase in foreign reserves**	Low direct investment and significant financial capital inflows	Interest rates higher than US rates	Very rapid growth (> 8 % p.a.)
Malaysia	yes	yes	yes	no	no	no	yes
Thailand	yes	yes	yes	yes	yes	yes	yes
Philippines	yes	yes	yes	yes	yes	yes	no
Indonesia	yes	yes	no	yes	yes	yes	yes
Singapore	no	yes	yes*	no	no	no	yes
Hong Kong	no	yes	yes	yes	n.a.	no	no
South Korea	yes	no	yes	yes	yes	yes	yes
Taiwan	yes	no	no	no	n.a.	no***	no
China	no	yes (94)	no	yes	no	yes	yes

* Not in the current account balance.

** In relation to the cumulative current-account balance.

*** Since 1995.

ces of assets (stock market and real estate). The authorities also undeniably enjoy great credibility.

Some of the countries show most of the possible unfavourable characteristics: overvalued currency, external deficit, financing by short-term or speculative capital attracted by high returns and very rapid growth. This applies especially to Thailand, the Philippines and Indonesia.

In these countries, the economy has been financed by short-term or speculative capital. The strategy to attract this type of capital has been quite straightforward: propose an attractive return with high interest rates and peg the currency nominally. Real overvaluation was therefore a prerequisite for them to attract indispensable external financing of growth. In the long term, the strategy proved to be disastrous since it hurt foreign trade and triggered a pullout of foreign investors.

In South Korea, there has been no real appreciation, at least in recent years, thanks to the exchange rate's relative flexibility. Nevertheless, after two years of very robust growth (1994 and 1995), a substantial trade deficit appeared along with huge financial capital inflows. Apparently, foreign lenders were sufficiently confident to obviate the need to let the currency appreciate in real terms, unlike what occurred in other Southeast Asian countries.

Lastly, Malaysia and Taiwan seem to have suffered more from contagion effects than pronounced macroeconomic imbalances. Malaysia's external deficit is entirely covered by direct investments and Taiwan has avoided currency overvaluation, deficits and an influx of capital.

There is therefore no systematic link between real appreciation and currency crisis. Some countries were affected by contagion, others can cope with real appreciation thanks to other sources of income. Conversely, the financing structure can be unbalanced, like in South Korea, without entailing overvaluation of the currency. However, stability in the nominal exchange rate against the dollar has enabled several Asian countries to attract the capital required to underpin robust growth when domestic savings were insufficient. Overvaluation permitted an unstable financing of excessively robust growth.

Diverging paths out of the crisis

The analysis implies that, in a medium-term perspective, the situations of the different Asian countries will probably diverge.

► In South Korea, the crisis has been caused by the combination of the depreciation of the won, due mostly to a contagion mechanism, and the fact that banks and corporations had been massively borrowing abroad without hedging for currency risk. The high degree of leverage of the economy proved disastrous when the won collapsed. A global and painful recapitalization will therefore be necessary.

► Malaysia, Taiwan and Singapore will mostly benefit from the crisis; they have no serious domestic macroeconomic or financial imbalance, and their competitiveness is now well above normal, which should imply a robust growth in the future.

► Thailand, Indonesia and the Philippines are textbook cases of a bad macroeconomic strategy: pegging the nominal exchange rate and using high interest rates to obtain the (short-term) capital inflows necessary to finance an investment rate above the level domestic savings could permit to obtain. In the future, those countries will have to self-finance growth, which means a permanent reduction in trend growth rates. ◀

STEPHAN SCHULMEISTER:

Reform the International Monetary System!

The common-sense explanation of the East-Asian currency crisis runs as follows: A speculative bubble on stock and property markets in the Tiger states had finally burst. The bubble was a result of banks lending recklessly, largely because their liquidity was effectively guaranteed by the state. This gave them cheap access to funds that they lent out at high interest rates for speculative investment – a classic case of moral hazard: massive winnings beckoned if the speculations paid off; if not, the taxpayer would meet the loss.

But this plausible reconstruction of the crisis has one weakness: the claimed asset price bubbles never existed – at least, not on the stock markets. In fact, East Asian stocks had performed unusually

badly. From 1993 to mid 1997 – just before the financial crisis – share prices fell by 68.7% in Thailand, 13.9% in South Korea, 18.1% in Singapore and 5.6% in Malaysia. In Indonesia and Hong Kong they rose by 23.2% and 27.8% respectively.

So rapid adoption of the »speculative boom« theory must be partly explained in terms of perceived interests, as it places much of the blame for the debacle on profit-hungry banks, other speculators and their respective governments. Also, the common-sense theory belies much »projection« to avoid »cognitive dissonance«, because the true share price bubbles arose in the industrialized nations themselves: from late 1993 to September 1997, share prices rose by 116.4% in the US, by 53.4% in the UK and by 84.2% in Germany, while real productive capital grew far more slowly in these countries than in the East.

Dollar Appreciation as the Origin of the Crisis

What, then, are the real reasons why such different countries as South Korea, Thailand and Indonesia became insolvent over a short period of months? Two developments are common to (almost) all the Tiger states: First, their current account deficits have worsened markedly since 1993/94 and, second, they have funded these deficits chiefly with dollar loans from Western banks, notably in Germany and Japan. The main cause of current account deficits in the East-Asian developing countries have been growth gaps between them, Europe and Japan: since the early 90s, sustained high interest rates, the collapse of stable exchange rates within the EMS, the ensuing monetary division of Europe, and concerted belt-tightening policies in the wake of Maastricht have slowed economic growth in Europe. Over the same period, real investment and production in East Asia continued their rapid expansion. As a result, East Asian demand for EU (and Japanese) imports grew far faster than the other way round. That is, demand from the Tiger states fueled export-driven growth and mitigated the »home-made« crisis in the EU.

Faced with budgetary discipline, restrictive fiscal policy and a low propensity to borrow in industry, Western banks were only too pleased to lend surplus liquidity to banks and firms in the dynamic countries of East Asia. Considering the sustained,

rapid economic growth in East Asia (which remained around 6% up to 1997), the great majority of foreign loans may be assumed to have funded real investment projects rather than short-term stock market or property speculation.

What triggered the financial crisis was neither the level of foreign debt nor the rate of its growth, but the fact that it was valued in dollars and that from early 1995 onwards, the dollar began appreciating faster than it ever had since the early 80s. By mid 1997, the dollar exchange rate had risen from DM 1.40 to DM 1.80 and from ¥ 85 to ¥ 115 (i.e., by 30% and 35% respectively). This cut the dollar export revenues needed to service foreign debt: for example, a car exported to Germany and sold at DM 20,000 earned Hyundai about \$ 14,400 in mid-1995. Two years later, this was down to around \$ 11,100 – solely because the dollar had risen against the D-mark (in the short term at least, a country's ability to service dollar-denominated foreign debt depends not on the exchange rate between the dollar and its own currency, but on that between the dollar and other currencies in which it earns export revenues).

We can state the general rule as follows: If the dollar goes up, the dollar price of exports falls and the real interest rate on dollar-denominated debt rises. Here is another example: Assume that South Korea exports half to the USA and half to Germany, and the dollar and D-mark prices of exports in the two countries remain constant. If the dollar rises 30% against the D-mark, the total dollar value of South Korean exports (and revenue from them) falls and the real interest rate on dollar-denominated debt rises, in both cases by 15%.

As the dollar is the world currency and most international debt is denominated in it, the real cost (i.e., the real interest rate) of such debt can only be found by calculating nominal interest rates and price changes in dollars. A glance at the IMF World Economic Outlook shows that in dollar terms, the world economy has undergone deflation for the last two years. In 1995, world market prices for industrial goods were still rising, by 10.3% over the year. In 1996 they fell by 3.1% and in 1997 by 7.3% (the dollar was still falling in 1995; since then the world currency became rapidly dearer). Thus, at near-constant nominal interest (LIBOR) rates, real interest on international dollar-denominated debt rose by 17% between 1995 and 1997. This is the

main cause of the debt crisis among the Tiger states.

Creditors see the process as follows: Assume that in mid 1995, a German bank granted South Korea a \$ 1 billion (DM 1.4 billion) loan for which interest but no capital was payable in the ensuing period. By mid 1997 the amount owed to the German bank would be worth DM 1.8 billion: the creditor had made an extra profit, the debtor an extra loss (of DM 400 million each). Were the debtor unable (or unwilling) to pay for this appreciation of the debt, the bank would have to make suitable provision and, eventually, write it off. On the bottom line, everyone loses out, the hardest hit being industrial firms and their employees.

In other words, in an economic system where the exchange rate of the world currency fluctuates (particularly) strongly, international lending and borrowing is speculative in character (unless loans are fully hedged).

The debt crisis in Latin America developed by the same logic as the current crisis in East Asia. From 1980 to 1982, the recession in the industrialized countries had been softened by dynamic import demand from the Tiger states of the time, such as Argentina and Brazil, whose current account deficits grew rapidly. At the same time, a high interest rate policy pursued by the USA triggered a dramatic appreciation of the dollar and a consequent deflation in world trade: from 1980 to 1982, the real interest rate for Latin American dollar-denominated debt rose by 30 % (from -10 % to +20 %). In 1982, the debt crisis broke.

But Latin America had far more foreign debt in the early 80s than East Asian developing countries have now, so the effects of the current debt crisis will be correspondingly less severe than those of the last one. Whereas the Tiger states' current account deficits and hence their foreign debt increased markedly but in the last few years, the developing countries of Latin America had maintained high current account deficits from the early 70s onwards. The differing lengths of the debt accumulation periods are reflected in the amount of foreign debt and the funds needed to service it. In 1983, Latin America's foreign debt reached 290.7 % and its debt service ratio 43.2 % of total exports. In 1997, the foreign debt of the Asian developing nations was 107.3 % and their debt service ratio 15.7 % of total exports.

The Dual Role of the Dollar

All events that have shaped the world economy since 1945 have been directly linked to the dollar's dual role as the US national currency and as standard tender for all raw materials (flows) and most international debts and financial assets (stocks): the »dollar shortage« in the immediate postwar period and its relief through dollar loans (under the Marshall Plan); US exploitation of its world banker status during the Vietnam War (dollar exports); the resultant loss in credibility of the dollar's gold parity and hence of the fixed exchange rate system; this system's collapse in 1971, the ensuing dollar devaluations, the oil price shocks and the recessions they triggered; the 1980/81 US monetary policy of high interest rates and the 1982 dollar appreciation and debt crisis; dollar interest rate cuts beginning in the mid-80s and the dollar devaluation till 1995, the growth of US export's world market share by one third since 1985 and the corresponding loss by European hard-currency countries and Japan; the dollar's recent appreciation since 1995, and finally the 1997 debt crisis in the Tiger states.

The wild swings of exchange rates – and particularly dollar rates – between overvaluation and undervaluation result from the prevalence of short-term speculation based on chart techniques. If a price rises past a set limit, these computer models generate »buy« signals that, once heeded, drive the price up yet further, causing other models with a longer »fuse« to generate buying orders in turn, and so on. This produces upward or downward bubbles systematically. With the expansion of derivatives markets, these »games« are increasingly destabilizing not only exchange rates, but also interest rates, raw materials prices (particularly oil) and share prices. At the same time, market prices are increasingly deviating from their fundamental equilibria: according to the Federal Reserve Bank, the nominal value of real capital has risen by 130 % since 1980, while its market value, expressed in share prices, has increased by about 700 %.

Effects of the Financial Crisis

The growth-slowing effects of the current financial crisis on the affected region and the world economy as a whole will be less severe than the one of the 1980s debt crisis, not only because the foreign debt of the countries concerned is far lower than in 1982/83, but for three additional reasons:

- ▶ The economies of the industrialized nations are far healthier than they were in 1982/83 (though we cannot expect a single country or group of countries to switch to expansionary fiscal policy to the same extent as the USA did in 1983).
- ▶ If at all, the dollar exchange rate will probably not continue to rise as strongly as between 1982 and 1985.
- ▶ Not least in consideration of the 80s debt crisis, the currently negligible rate of inflation and the attendant danger of »toppling« into a (slight) deflation, the US appears willing to cut dollar interest rates should the crisis worsen appreciably.

While such a slackening of the monetary policy reins by the reserve currency nation may somewhat relieve the effects of the crisis on the world economy, it may also slow economic growth in the EU if the ECB is unwilling to deliver a matching cut in euro interest rates and the euro consequently appreciates against the dollar.

This eventuality points to a trilemma: First, as the US national currency, the dollar has been heavily undervalued relative to the ecu and the yen since the mid-80s – the main reason for the continuous growth in US market share. Second, as a world currency, it has already appreciated too far since 1995 because, as we have seen, a rising dollar inflates dollar-denominated debt. Third, the dollar's dual role enables the US to take out unlimited foreign debt. It has exploited this ability to an exorbitant degree for the last 15 years: US foreign debt has almost reached \$ 1,500 billion, and is growing by some \$ 150 billion a year (about the same amount as the US current account deficit). Thus, the world's richest economy is simultaneously its biggest debtor and the greatest net consumer of goods and services from the rest of the world. As the annual uptake of new foreign debt by the US far exceeds its interest payments on existing debt, the creditor countries (primarily the EU and Japan) are effectively paying the interest

themselves. In return for this and the real transfer of resources, they merely receive credit notes from the USA in ever-increasing value.

The main reason why the US balance of payments remains in deficit despite the undervalued dollar is not just that the reserve currency country (and only this country) can borrow entirely in a single currency, but that many US imports (particularly those from Europe) are luxury goods, from Porsches to noble French wines: demand for such goods mostly stems from the best-placed US households and so is barely sensitive to price and exchange rates.

For these reasons, the dollar would have to be undervalued even more if the amounts owed to creditors, especially the EU and Japan, are ever to be at least partly repaid in US-made goods (this presupposes a US current account surplus). Note, though, that this would drive European unemployment even higher.

Towards a Systemic Therapy

The main systemic reason for international financial crises, and also of »excessive« US indebtedness, is that a global economy needs a true world currency. Failing this, the dollar plays a dual role: as the US national currency and as (substitute) tender for all raw materials and most international debt. The dollar exchange rate fluctuates the most (as luck would have it), not only because of the conflict between US national interests and the global need for a stable world currency, but also because the dollar serves as a standard »token« on currency markets, all transactions being done vis-à-vis the dollar. It is everyday speculation on these markets that accumulates to the bubble-like upward and downward sprints by the world currency, redistributing income and purchasing power on a global scale – between raw materials and industrial goods, and between creditor and debtor countries.

Because of this, the coming of the euro should also be taken as an opportunity to stabilize exchange rates between the three main currencies – the dollar, the euro and the yen – analogously to EMU's forerunner, the EMS. This would be a first step towards a new world monetary system under which, instead of the national currency of one industrialized nation – the leading one at that – serv-

ing simultaneously as the world currency, the numeraire for stocks and flows in the global economy would be a basket of the main national currencies (like the ecu in the EMS).

The coming of the euro would make exchange rates much easier to stabilize in the transitional period, because there would only be two exchange rates left to fix – between the dollar, the euro and the yen. Standard commodities such as raw materials, and also international financial stocks, should also be denominated not in dollars, but in a basket of the three main currencies. This would greatly reduce the incentive to realign exchange rates, and if it did come to a realignment, at least its price and redistribution effects on the global economy would be mitigated.

The provision of low-interest funds, to be repaid only slowly, to improve infrastructure and environmental conditions in developing and transition countries would speed their development and, via imports, also stimulate production and employment growth in the industrialized world (the historical precedent for such a global cooperative strategy being the Marshall Plan).

A systemic therapy of this kind may appear utopian today, but financial crises like that in East Asia together with their consequences will make it increasingly clear that the global economic framework needs radical restructuring. After all, we came very close to creating a stable world monetary system once before: In negotiations on the new world monetary order, Keynes proposed the following in 1943/44 based on the experiences of the Great Depression:

- ▶ No national currency serves as a world currency any more. Instead, a genuine world currency is created as a basket of the main national currencies (he called the basket currency »Bancor«).
- ▶ International settlements are handled at fixed exchange rates by a »Clearing Union«.
- ▶ Temporary disequilibria in the global economic goods and financing cycle are corrected by expansionary policies in the surplus country and not by belt-tightening measures in the deficit country, so that equilibrium is restored at a higher rather than a lower level of activity (the IMF still fails to grasp this logic today).

Keynes was unable to push through these proposals at Bretton Woods in 1944. The new world power, the US, wanted its own currency to take on

the role of the world currency (as sterling had before). In view of the experience of the dollar standard and urged on by further financial crises, we may yet succeed, at a second attempt, in creating a world monetary system that complements the globalization of markets with a globalization of (economic) policy. In this respect, we need not less globalization, but more. ◀

MICHAEL EHRKE:

Needed: Domestic Modernization and an Asian Currency System

Most Asian states are now past the worst of the crisis. They had only a limited hand in its management: The IMF prevailed in its attempt to use its conventional strategy, designed for current account crises cum public sector debt, to overcome an unconventional crisis, i.e. a capital account crisis cum private sector debt. In doing so it probably increased the costs of the crisis in terms of growth and employment. Yet it is the Asian states who now face the question of how to rekindle growth and development.

The response to the crisis will depend on how the crisis itself is interpreted. Superficially, it was a currency crisis sparked by excessive private sector borrowing abroad. This in turn was caused by high-risk borrowing and lending strategies. Investors, blinded by the outstanding performance of the East and South-East Asian economies, overestimated future earnings and underestimated the risks. The background was a collusion of firms and banks with governments often paraphrased as golf-course or crony capitalism and seen as a survival guarantee for large firms and banks: The latter took such high risks because they felt sure the state would bail them out if worse came to worst. The appropriate response, prominent among the IMF's demands, is to abolish tacit government guarantees for banks and to reform local financial systems, creating transparency (among other things, by adopting internationally accepted accounting standards), introducing private loan and deposit insurance, and establishing credible bank supervision. If the local financial systems – so the reasoning goes – supply domestic and foreign in-

vestors with reliable information on risks and earnings, the bubbles in the financial and real estate sectors that triggered the crisis will be a thing of the past.

However, the currency crises of 1997 reflected two other, deeper-seated problems. Firstly, the devaluations of the local currencies point at structural deficiencies that restrict the continuation of high-speed growth. Secondly, the currency crises indicated that dollar-pegged local currencies are no longer compatible with the region's real international ties.

Structural Problems of Asian Economies

Structural bottlenecks had been identified as potential growth checks long before the crisis broke. Infrastructure (transport systems and energy supply), education systems (in South-East Asia) and the high concentration of economic activity in a few large firms (Korea) have frequently been singled out. In slightly more general terms, the structural problems are as follows:

- ▶ export-oriented yet import-intensive economies reliant on foreign direct investment;
- ▶ growth based primarily on additional factor input and less on increasing productivity of the combined input;
- ▶ governments collaborating with large firms and large banks, but failing to provide services at a level sufficient to raise efficiency in the economy as a whole.

Away From Simple Export Orientation

The export-oriented industrialization strategy in South-East Asia – less so in Korea – was based on processing components with domestic labor that was cheap in international terms. The components and the required capital goods had to be imported, making export-oriented industrialization import intensive. While exporting locally processed industrial goods (in 1996, 80% of Thailand's and 83% of Malaysia's exports were industrial goods) generated hard-currency reserves, the balance of trade either stayed in deficit or the surpluses remained too small to compensate for the outflows as foreign firms repatriated profits. Malaysia, for

example, has almost always had a trade surplus, but profit outflows regularly pushed the current account into deficit. In addition, South-East Asia's and to a large extent Korea's industrial exports concentrated on a few product groups (notably electronics), where:

- ▶ demand is subject to large fluctuations;
- ▶ there is fierce price competition;
- ▶ Japan being the main competitor, the exchange rate between the dollar and the yen is a particularly critical variable.

The South-East Asian economies cannot and should not replace their export-oriented industrialization strategy with an import substitution strategy on the Latin American model, but they must step it up by extending their industrial base and manufacturing more input products at home, and must boost domestic demand to gradually reduce their reliance on international markets.

Regarding the dominance of foreign direct investment (and outflows of repatriated profits), the South-East Asian countries have no option but to continue attracting foreign firms onto their territory. The situation is different in Korea, where foreign firms have a less important role. True, the IMF has decreed that existing restrictions on foreign investment must be lifted to attract capital. But the positive, one-time effect on the capital account may well be more than compensated by longer-term negative effects on the current account. Also, the indirect effects of foreign direct investment that are otherwise considered more positive – technology transfer, skills and learning processes – are weaker in Korea than in South-East Asia.

Increasing Efficiency

The past boom was largely based on increasing input of labor, capital and land. In the future, efficiently combining these factors will be more important. This means:

Labor Market and Social Security. Future growth will be less based on cheap labor. Firms must be forced to increase labor productivity instead of being subsidized by low wages. Restrictive government labor market policies that limit worker mobility and freedom to unionize must be eased or relinquished altogether. This may require rethinking disincentives to mobility that are perceived as so-

cial provision by firms (such as »life-long employment« in Korea). In addition, workers' capability of being mobile must be increased. Education and training must be improved and expanded, and the focus of social security provision must pass from firms to the state. Provision for unemployment is a key factor here. There was no urgent need for a national unemployment insurance in the past, because high economic growth guaranteed full employment and in some cases made it necessary to import labor. Firms generally never fired employees and the family provided or at least seemed to provide adequate security in the remote event of unemployment. These conditions no longer apply.

Small and Medium-sized Enterprises (SMEs).

Against a background of falling growth rates and harder-to-obtain credit, many SMEs will disappear from the market – unless special programs are developed to help them survive the competition under tighter conditions. Any government enterprise promotion policy will emphasize finance for such firms. Care must be taken here that the expansive credit policies of the past, which artificially sustained a whole range of inefficient economic activities, and in some cases were the only thing that made them viable (as in the financial and real estate sector) are not replaced by state subsidies that do not entail incentives to raise efficiency. The costs of subsidies must be visible, their duration limited and their results measurable.

The reforms of the financial system demanded by the IMF, which target efficient use of capital as an input factor, must be supplemented by more efficient use of land (the bubbles in the financial sector resulted to a large extent from the financing of real estate investment). As a consequence of rapid economic growth, a special political economy of land has evolved, which was characterized by artificially engineered land shortages and skyrocketing property prices. Land shortage resulted from

- economic policies that tolerated or systematically promoted an extreme spatial concentration of growth and thus of »valuable« land;
- a »political economy of land« in the narrower sense, that is, collusion between politicians, land-owners and the construction industry.

Improving the Supply of Public Goods

Higher efficiency partly depends on an improved supply of public goods. In the long term, restrictive fiscal policies as demanded by the IMF (despite the fact that almost all government budgets in the region were balanced or in surplus) would do great harm. Of course, there are a few prestige projects which ought to be abandoned. But policies that automatically equate public expenditure with profligacy overlook the fact that much government spending is and will remain necessary for projects that cannot be funded privately.

Towards an Asian Currency System

The crisis was caused and triggered by the dollar's appreciation and speculative attacks on several Asian currencies. This points to the problem that governments in the region kept their currencies pegged to the dollar while trade and investment flows became increasingly regionalized. From 1985 to 1996, the US share of South-East Asian imports fell from 16 % to 14 %, while Japan's share rose from 23 % to 27 % and that of the East Asian »tiger« states from 16 % to 21 %. This is shown even more clearly by intra-regional investment flows: since 1985, Japan has been the largest investor in South-East Asia, and in 1995 the »tiger« states drew level with it. In 1995, Japan and the »tiger« states invested \$ 22.2 billion, compared with \$ 6.7 billion by the US. Accordingly, a growing share of South-East Asian exports goes to Japan and the »tiger« states. In addition, other forms of economic ties between countries like Japan and Korea are far more important than direct investment – for example, original equipment manufacturing (OEM), licensing, joint ventures and alliances. Moreover, Japan has long been the largest donor of development aid in the whole of Asia. In other words, an informal, common Asian production zone has emerged between Japan, the »tiger« states, South-East Asia and China (some observers speak of a Japanese-dominated Asian production zone). But the reality of this zone is not mirrored by the currency arrangements. The developing and newly industrialized countries of the region have remained under the umbrella of the dollar and thus reliant

on extraregional developments, while to a great extent the real economy has regionalized.

Enabling local currency systems to adapt to the reality of a regional production zone, and to reduce reliance on the dollar requires a phased approach:

In the first phase, local currencies should be pegged to a basket of reference currencies, in which the dollar is accompanied above all by the yen, but also by strong European currencies or the euro.

South-East Asian countries that already have a regional cooperation platform in ASEAN could form a currency system. For the time being, they will be unable to enter monetary union on the EU model, but they could create a common fund to support local currencies. In the medium term, they could develop a regional reference currency on the pattern of the ECU, and set fluctuation bands for local currencies against the reference currency. On the model of the European Monetary System, their central banks could be obliged to intervene if a currency oversteps the upper or lower limit. This strategy is only realistic, though, if trade and investment barriers between the South-East Asian countries are removed at the same time.

In the long term, the emergence of an Asian production zone dominated by Japanese firms must also be reflected in the currency arrangements. That is, a regional monetary system must also include the yen. In view of Japan's overwhelming economic power – it accounts for more than 70 % of the region's national product – an Asian currency community would automatically be a yen block. However, two things would stand in the way of fast-track monetary union:

Although Japan continues to absorb more and more imports of industrial goods from its neighbors, these mostly represent intracompany trade by Japanese firms. The Japanese market is still too closed for »independent« trade of East Asian countries, so they keep relying on the more open American market.

A currency system for the entire region presupposes liberalization of the financial sector at its center, Japan. Today, only 1 % of transactions on Japanese financial markets are done by foreign banks. The Big Bang – complete deregulation of the financial system by 2001 – aims to change this

fundamentally, but the question is naturally whether this ambitious goal will be achieved.

The initiative to revitalize the region must come from Japan. Yet there is doubt that Japan is ready to take on responsibility for the entire region. Not only is Japan now in the throes of a severe economic crisis itself; there is also its isolationist political tradition. On the other hand, if Japan is precluded from bearing regional responsibility, sooner or later another power will emerge as the protagonist of a regional economic community: the People's Republic of China. China is already considered a stability factor, and the crisis hit the Chinese economies (the People's Republic itself plus Hong Kong and Taiwan) less severely than Korea or South-East Asia. In summer 1997, China, Hong Kong and Taiwan together had \$ 285 billion in foreign currency reserves, compared with Japan's \$ 211 billion. If the yen does not take on greater regional importance soon, it may be replaced by the Chinese yuan in the not all too distant future. In the long term, a regional shift in power at the expense of Japan and in favor of China could be the most important outcome of the Asian crisis. ◀