論　　文

Ten Years After the Asian Currency Crisis: Disruptions via Capital Flows and Asia's Search for Remedies

Kiyohiko Fukushima

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Synopsis

The massive capital flow has a disruptive effect on exchange rates and domestic demand management. The Asian currency crisis of 1997-1998 was in fact a capital account crisis. In order to restore the stability of the exchange rate and the workability of economic policy, many proposals were made over the past 10 years but no substantial action has been taken on a global scale, mainly due to the lack of interest by the U.S. on international monetary reform. Against this background, East Asian countries have, taking lessons from Europe, intensified the regional currency cooperation. Though several solid steps have been taken, particularly in the

swap agreements of exchange reserves, East Asia still has a log way to go for establishing some stability in the exchange rate and developing a robust regional bond market. It seems the global reform to come in the future must be based on at least 1) some formula for control on capital flow, 2) stricter surpervision of fund management companies, 3) reliable lender of the last resort in a currency crisis, 4) creation of a new global reserve to finance the growth of world trade. In the absence of American initiatives for building a new global financial architecture, the other major countries, the EU, Japan and China are using much of their energy for furthering regional currency cooperation. We must wait for the United States to change the current neglect and take the lead in the global financial reform.

Introduction

The current international financial system has a fundamental flaw. Ten years ago, it has almost destroyed many developing economies in Asia. Now in 2007, China, still a low income country, has accumulated more than one trillion dollars in foreign exchange reserves, most of it sent to the United States, the richest country on earth, for helping the American consumers keep going on a frenzy spending spree. The total sum of foreign exchange reserve of the APT (ASEAN plus three) countries has risen to some $2.5 trillion at the end of 2006. (Exhibit 1) Most of the reserves are held in the form of US Treasury securities, in essence a loan to the US government.

As a result, the net international debt of the United States has risen to some $ 2.7 trillion at the end of 2005. The poor is lending to the rich for more excessive consumption. This is not the way how an international capital flow should move.

Exhibit 1 : Foreign Exchange Reserve of the ASEAN+3
(At the end of 2006, $billion, Source : IMF)

China	1,068.5	Philippines	20.0
Japan	879.7	Vietnam	10.7
Korea	239.0	Myanmar	1.1
Singapore	136.7	Cambodia	1.1
Malaysia	82.1	Brunei	0.5
Thailand	65.3	Laos	0.3
Indonesia	40.9	Total Sum of APT	2,545.9

Why did the world create such a distortion and a huge imbalance and what can be done about it? That is the starting point of discussion in this short treatise.

1. The Logic of Perverse Effects

The floating exchange rate and the massive international capital flow can distort the real economy toward severe contraction and substantially reduce the efficacy of monetary policy for domestic demand management. These two factors, floating rate and capital flow, which reached $ 1.9 trillion per day in 2004 according to the BIS, Bank for International Settlement, tend to exert deflationary pressures on the world economy by making the exchange rate more unpredictable and creating greater imbalances in trade account and capital account.

The current international exchange rate regime has been creating greater uncertainty and volatility.

To safeguard themselves from the disruptive effects of the floating rate and the capital flow, many countries have no choice but to curtail expenditure and keep the current account in surplus, thereby lowering their actual growth rates from the potential ones.

Looking back, it has become clear that the Asian currency crisis of 1997-98 was the first, dramatic example that exemplified the flaw of the current international economic system that makes the traditional demand management by monetary policy unworkable. Under the current system, a sudden change in capital flow can change the fundamentals of a nation's economy (growth rate, inflation, terms of trade and the like). The monetary side of the economy, which should be a reflection of the real side of the economy, coerces drastic changes in the real side of the economy. This is the tail-moves-the-dog situations, rather than the normal the other way around. The international capital flow, that can bolster economic growth by providing funds to a growing sector, can have perverse effects on a nation's economic growth and monetary policy.

The perverse logic of the huge capital flow works its way in the following manners.

1) Disruption by Capital Flow under Recession

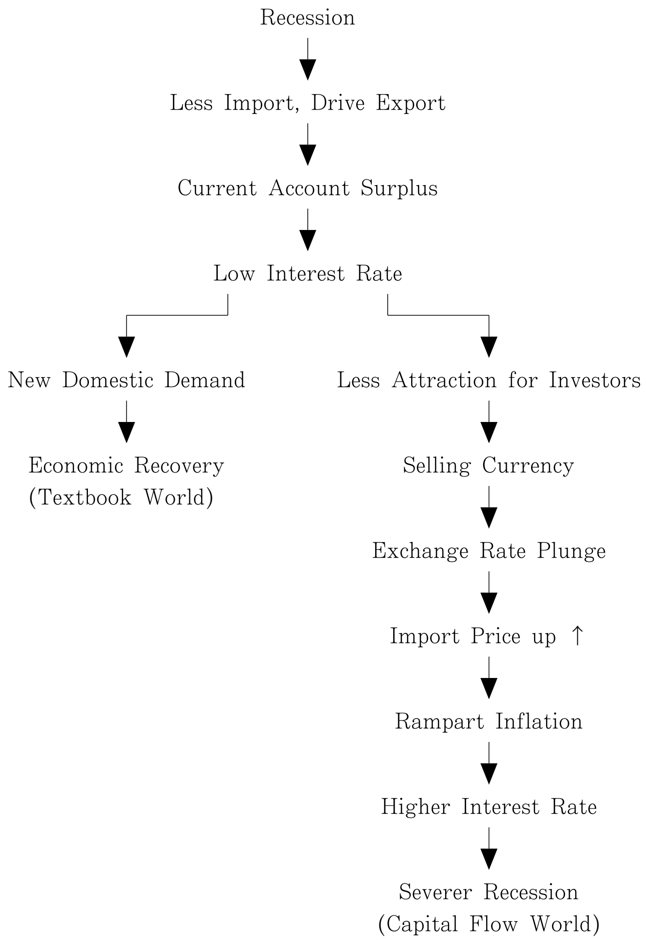
As the left-hand side of the exhibit 2 shows, when a country's economy runs into a recession, that country will import less, due to the weak domestic demand. The manufacturers will try to export more to foreign markets to compensate for the loss of domestic sales (the export drive under recession). The less import and more export tend to create a surplus in the current account. The government usually reduces the discount rate in order to stimulate domestic demand under such economic conditions.

(Textbook World)

In the traditional world described in the economic text books, lower interest rate creates more domestic demand. This is because the business sector will make more investment and the household will spend more for consumer durables and houses, lured by the less interest cost in borrowing. The new domestic demand will

Exhibit 2: Disruption by Capital Flow (1)

Under Recession



be thus created and the natural economic recovery caused by lower interest rate will ensue. This is the textbook scenario of a recession turning into a recovery by the effects of lower interest rate in the monetary policy.

(Capital Flow World)

However, in the today's world of capital market liberalization and the floating exchange rate, the easing of monetary policy to stimulate domestic demand can have perverse effects. The economic logic of the reverse effects takes the following route, shown on the right-hand side of the exhibit 2.

Lower interest rate in that country means the bond issued in that country becomes less attractive to foreign investors because the bond yields less interest income than before. The global investors will react by selling those bonds and converting them into US dollar (or dollar denominated US Treasury securities). This transaction is a massive selling of that country's currency in the exchange market. The exchange rate of that currency will plunge, the import price in that country will rise sharply, and rampant inflation will be created. The central bank of that country has no choice but to reverse the course : to raise the interest rate drastically for the purpose of curbing inflation. Higher interest will create a severe contraction in domestic demand ; a recession, severer than before lowering the interest rate, will follow. Due to the drastic contraction in domestic demand, the current account, which used to be in a deficit, will turn into a solid surplus.

A drastic change in the capital account (from a substantial inflow to a huge

Exhibit 3 : Violent Adjustment in Current Account

1994–99, $bil, ( ) is % of GDP

Source : Yoshitomi "The Reality in the Asian Economy" (Ajia Keizai no Shinjitsu in Japanese) Toyo Keizai Shinpo, Japan, 2000)

	1994	1995	1996	1997	1998	1999
Current Account	−24.6	−41.0 (−4.06)	−54.6 (−5.03)	−26.3 (−4.12)	58.5 (7.7)	43.2 (5.03)
Capital Account	47.4	81.5 (8.07)	100.6 (9.27)	28.8 (4.52)	−0.5 (−0.07)	−1.2 (−0.14)
Private	40.5	79.0	103.2	−1.1	−28.3	−4.8
Official	7.0	2.5 (0.25)	−2.6 (−0.24)	29.9 (4.69)	27.8 (3.66)	3.5 (0.41)
Errata	−17.5	−26.5	−26.8	−35.0	−16.9	−14.9
Increase in Forex Reserve	5.4	14.0	19.3	−32.5	41.1	27.0

outflow) will force a drastic change in the current account (from a deficit in ordinary times to a surplus under extraordinary conditions). As Exhibit 3 shows this is what happened during and after that Asian currency crisis of 1997-98.

2) Disruption by Capital Flow under Expansion

The changes in capital flow can also disrupt an economy enjoying a strong expansion. When the economy of a country heats up, that country tends to import more than it can export to the rest of the world ; it creates a deficit in the current account. Since no country can keep on running a current account deficit indefinitely (except the so-called key currency country), that country will raise interest rate to keep the economy from overheating by importing more and more.

(Textbook World)

In the world of economic textbooks, the adjustment in the balance of payment will take place in the following manner.

Higher interest means a higher cost for borrowing money for investment or consumption. It will dampen domestic demand, resulting in less import demand and more drive for export. Less import and more export will create a reduction in the current account deficit or the current account in a rough balance or a mild surplus. By restoring some balance in the current account through the timely changes in monetary policy, the exchange rate of that country will stabilize and steady economic expansion will follow. (Exhibit 4, left hand flow) During the era of high speed growth, monetary policy in Japan functioned more or less on this line.

This is the logic of economic adjustment of a country in economic expansion.

(Capital Flow World)

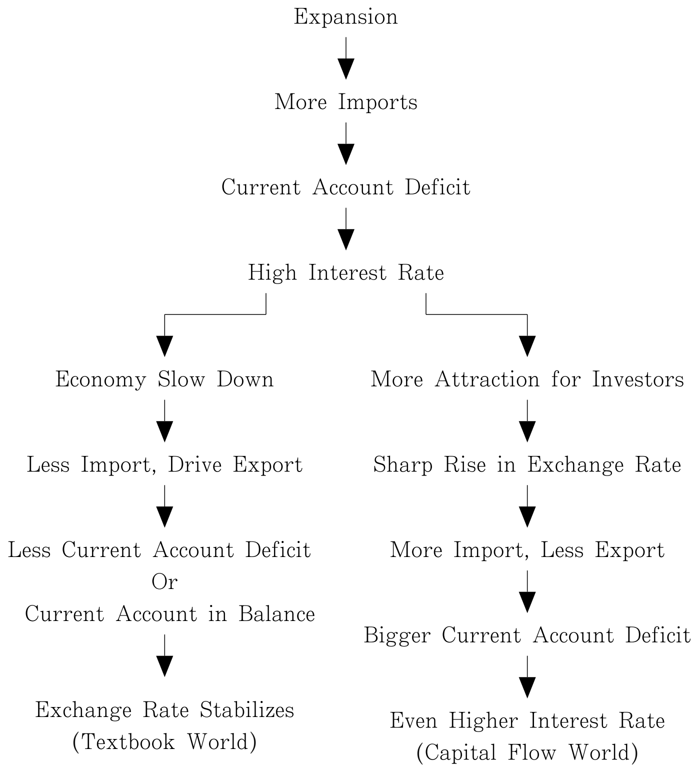
However, in the world of massive capital flow in which we live today, higher interest rate can create a completely different outcome.

Higher interest rate means the bond of that country becomes more attractive to foreign investors, seeking after higher return. The investors will pour more money into that country's security market, thereby buying the country's currency and selling the US dollar in the process. The exchange rate of that country will rise sharply. As a result, import price will fall and export price rise ; that country will import more and export less, resulting in a higher current account deficit.

Less export and more import will reduce the gross domestic product of that country to a greater extent than it would have been necessary in the textbook world

Exhibit 4 : Disruption by Capital Flow (2)

Under Expansion



without massive international capital flow. Thus a country running a healthy expansion and steady rise in import demand can encounter a recession (or a much lower growth) because of the international capital flow. As a matter of general statement, some of this logic worked in Japan when the exchange rate of the yen versus the US dollar hit 99 yen in 1994 (Exhibit 4, right-hand flow).

2. Lessons of the Asian Currency Crisis

The Asian currency crisis of 1997-98 and the painful adjustment that followed was a crisis that moved, more or less, on the trajectory of the "disruption under recession" course, as described on the right hand side in Exhibit 2. The currency crisis that hit Japan in 1995 followed, again more or less, on the course described on the right hand side in Exhibit 4. The two crises stemmed from the current international financial system of floating exchange rate and the massive international capital flow.

If a country can live in a total seclusion from the rest of the world, rejecting any capital flow from and to the outside, that country will never be affected by the whimsical changes in investors' perception. However, with the possible exception of countries like North Korea, no country can pursue a course of economic autarky. All the countries in the world are enjoying the benefit of international capital flow, because foreign capital brings money, and sometimes technology and management know how, that will make the economic growth higher and life better. Every country needs an international capital flow to thrive and compete in the increasingly interdependent and integrating world.

The volume of capital flow becomes larger year after year. This is because the financial asset of the household sector in developed countries keeps on accumulating as the population ages and the pension system draws more funds. The institutional investors who run those funds will seek after better investment opportunities in any corner of the world. Funds managed by institutional investors can move into any country at a very fast pace but they can run away very fast, too.

The developing economies in East Asia still needs foreign capital either in the form of loan, direct investment or in the form of indirect investment through the purchase of bond and stock. Though the developing countries in East Asia have changed the current account from deficit to surplus after the crisis of 97-98, the transformations made those countries only slightly less vulnerable to the fluctuations in the international capital flow. East Asia remains essentially vulnerable to currency attacks by foreign speculators.

Summing up, international capital flow is indispensable for East Asia ; that makes East Asia remaining vulnerable to changes in international capital flow caused by the whims of investor psychology and perception.

3. Policy Proposals on a Global Scale

On a global scene, the problems of capital flow and the exchange rate regime have been recognized as major issues. During the 1990s, the world has gone through a serial currency crisis : Mexico in 1994, Asia in 1997, Russia and Brazil in 1998. Finance Ministers and Central Bankers of the major twenty countries (G-20) have met several times since the early 1990s on the crisis prevention and resolution in international finance. President Clinton of the United States, after the Asian crisis, started talking about the need for “building a new international financial architecture”, though he did not propose anything specific.

On the level of official policy discussion on international monetary system, the world has not moved an inch from Mr. Clinton’s talking stage. Five years ago in 2002, the Japanese Senior Vice Minister of Finance, Mr. Koki Kobayashi, made the following statement at the meeting of G-20 held in New Delhi in November 23, 2002.

“In adopting an exchange rate regime, it is important to take into account the pros and cons of each regime as well as economic fundamentals which support such a regime.” (http://www.mof.go.jp/english/if/g20_20021123e.htm) No specific action. Let’s keep on taking into account many things. Most recently, for another instance, in the “Statement of G-7 Finance Ministers and Central Bank Governors” issued in Washington, D.C. on April 13, 2007, no concrete proposals for the reform of the international financial system can be found. The statement makes a only vague and short mention on that subject:

“We continued our discussion on how to develop local currency bond market... . to reduce emerging market economies’ vulnerability to external shocks and financial crises. We look forward to the results of the high level conference..... to identify concrete recommendations to sustain the momentum of reform.”

Well, in fact the “momentum of global reform” has been lost long ago during the decade following the Asian currency crisis.

The government officials in the developed countries have been making just empty talks for the past ten years on international financial reform. The main reason for this seems to be the unwillingness of the United States for any substantial reform. The United States is the major beneficiary of the current international financial system of the floating rate and the free capital flow. The US can finance its current account deficit siphoning money from the rest of the world, seemingly indefinitely, satisfying the need of insatiable consumption demand of its 100 million households. Any effective reform is likely to stem the free flow of capital to the US in one way or another; that could possibly reduce the economic growth in the US. “Any useful proposal on the reform of international monetary system must come from the United States”, as Mr. Paul Volcker, former chairman of the Board of Governors of the Federal Reserve System, has stressed in his article in 2000. (Paul Volcker, “The Sea of International Finance” in Giddens and Hutton, editors, *On the Edge* 2000 London: Polity)

Though he is not an expert on international finance, Mr. Helmut Schmidt, former Chancellor of (the West) Germany believes that the next stage in the international financial system can be a return to the fixed exchange rate system. (Helmut Schmidt *The Age of Globalization* 2000, Tokyo : Shueisha, This is a translation into Japanese from the lecture series which Mr. Schmidt had delivered in Germany at the Heinrich Heine University in Duesseldorf, Germany.)

Prof. Joseph Stiglitz at the Columbia University, former under secretary of the Treasury in the US Government, proposes a global greenback in order to provide new liquidity for international transaction and mitigate the pain of American adjustment as it tries to reduce the current account deficit through economic retrenchment. His proposals include specific amount of the global greenback, ($200 billion, 5% of the world GDP, that is roughly $40 trillion) to be issued annually by some international agency. (Joseph E. Stiglitz *Making Globalization Work* p. 262–264 New York : W. W. Norton 2006)

More useful suggestions might come in the months and years ahead. However, it is unlikely that any serious action for global reform will be taken unless the flaws of the international financial system become very serious for the United States and it decides to take a lead with specific proposals that would be debated in earnest by the major countries. Until such a time comes, possibly in the wake of a major international financial crisis involving the United States, there will be no substantive financial reform on a global scale coming to the international negotiating table.

Seeing that prospect, Europe has gone to a regional approach some thirty years ago and has introduced the euro since 1999. The membership in euro, starting from 11, has reached 13 in 2007 ; the membership will increase more in the near future. In Asia, the efforts for regional currency cooperation have gained momentum after the currency crisis of 1997–98.

4. Slow but Steady Steps in Asia

The regional cooperation in Asia is taking place in the five areas : 1) Chiang Mai Initiative (CMI), 2) Economic Review and Policy Dialogue (ERPD), 3) Asian Bond Market Initiative (ABM), 4) ASEAN＋3 Research Group, and 5) Monitoring of Short-Term Capital Flow.

The CMI and its extension are essentially the framework for providing foreign exchange reserve to a country in need. On April 5th 2007, Finance Ministers of the ASEAN met in Chiang Mai and agreed to build a common pool of foreign exchange reserve (5% of the forex reserve by each country) with the participation of the northern three, Japan, China and Korea.

The Economic Review and Policy Dialogue is to keep a mutual survey on the macro economic conditions and policies of the member countries so that disruptive economic conditions will be unlikely to emerge.

Developing the Asian Bond Market is a project to develop an Asia-wide international bond market in Asia by enabling the issuance of bonds denominated in a basket of different currencies in Asia. Though some attempts have been made with a limited success, this project has not gone too much ahead. This is because, with the exception of the Japanese yen, the other currencies in the region have not yet been

Exhibit 5 Chronology of Currency Cooperation

Source : Ministry of Finance Japan Home Page
http://mof.go.jp/jouhou/kokkin/frame.html

1997-1998	Asian financial crisis
December 1997	The 1st ASEAN+3 Summit (Kuala Lumpur, Malaysia)
April 1999	The 1st ASEAN+3 Finance Ministers' Meeting (Manila, Philippines)
November 1999	The 3rd ASEAN+3 Summit (Manila, Philippines) - Leaders agreed to enhance "self-help and support mechanism in East Asia"
May 2000	The 2nd ASEAN+3 Finance Ministers' Meeting (Chiang Mai, Thailand) - Finance ministers agreed to promote the Chiang Mai Initiative.
May 2004	The 4th ASEAN+3 Finance Ministers' Meeting (Jeju, Korea) - Finance ministers agreed to explore the ways of enhancing its effectiveness of CMI
May 2005	The ASEAN+3 Finance Ministers' Meeting (Istanbul, Turkey) - Finance ministers agreed to take the following measures to enhance effectiveness of the CMI (1) integration and enhancement of ASEAN+3 economic surveillance into the CMI framework, (2) clear-defining of the swap activation process and the adoption of a collective decision-making mechanism, (3) significant increase in the size of swaps, and (4) improvement of the drawdown mechanism.
May 2006	ASEAN+3 Finance Ministers agreed (in Hyderabad, India) to strengthen regional liquidity support network. The total volume of swap is $75.0billion, double from a year ago.
May 2007	ASEAN+3 Finance Ministers agreed (in Kyoto, Japan) to create a joint pool of foreign exchange reserve, a step forward from the network of bilateral swap agreements.

able to become fully convertible international currencies due to a number of factors.

ASEAN＋3 Research Group has taken decisive steps forward, publishing numerous useful research papers with many research institutions from different countries participating in the study. The papers published since 2003 are so numerous that one had better tap the papers at www.aseansec.org/17881.htm to peruse the papers.

Monitoring on a voluntary basis of Short-Term Capital Flow has been conducted by the central banks of the member countries. This should enable the policy makers to know the erratic movement of capital flows at an early stage.

Exhibit 5 is a brief chronology of the CMI and its development afterward.

We the East Asians have taken some important steps forward in regional currency cooperation. The advances are significant in the area of pooling to gether liquidity to help combat another wave of currency attacks and in the area of joint and cooperative studies. However, the specific steps toward creating regional currency units for accounting purposes, not to speak of issuing the actual currency, seem to lie years and or decades away in the future. The reasons for the slowness include, 1) enormous gap in the size and strength of the capital market among member countries, 2) different weight in policy priorities of currency cooperation for each country, and 3) the weakness of political will in furthering the ASEAN＋3 process by the political leaders in the region.

With all the limitations and slowness, the APT has taken solid steps forward during the past ten years since the Asian currency crisis. Encouraging signs are the thawing of ice between Japan and China after the changes in political leadership in Japan and the strengthening of the ties among the northern 3 (Japan, China and Korea), the relatively more powerful group among the APT.

There is no question that the APT will make further steps forward in the years and decades ahead in regional currency cooperation.