

〔共同研究：現代経済理論とその応用 II〕

# JAPAN IN THE ASIAN ECONOMIC CRISIS

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## 1. INTRODUCTION

Under normal circumstances, the Asian economic crisis of 1997 would have provided Japan with an ideal opportunity to promote the goals of its economic diplomacy in East Asia. Its massive economic assistance, as well as its direct and portfolio investments, could readily be used as leverage in weaning the region away from its “dollar obsession” and toward a regional yen bloc amenable to the pursuit of Japan’s long-frustrated objective of the “internationalization of the yen,” an objective which would clearly be invested with new urgency with the imminent launching of the euro. In fact, many of the widely recognized problems of the crisis (the dangers of a dollar-pegged exchange regime, the allegedly destructive behavior of Western hedge funds, and the IMF’s application of conditionalities patterned after the more familiar Latin American models) suited Japan eminently well for re-directing the agenda for regional discussion away from the frustrating and domestically unpalatable issues of freer trade in the ASEAN and APEC forums toward the far more domestically innocuous goal of the internationalization of the yen with a similar payoff in increased voice in regional matters.

In reality however, Japan was forced to take a defensive stance for the most part, countering various allegations that it was in some way responsible for triggering the collapse of financial and monetary systems throughout the Asian region. In this critical view, it was Japan’s monetary policies of ultra-low interest rates which had fueled the Asian bubble in the first place, and it was the “rush to safety” by the beleaguered Japanese banks after the summer of 1997 which had opened up the channels of contagion and sealed the fate of the region. Over the ensuing two years, Japan expended a considerable amount of political capital and committed some \$80 billion to Asian support as it endeavored to re-define the parameters of regional discussion.

Against this background, two separate lines of action emerged within the framework of Japan’s economic diplomacy. The first line comprised a short-term “re-active program” formulated primarily by the Ministry of Finance and other economic-related ministries and agencies. The second line was set in a longer time frame and consisted of a “pro-active program” sponsored primarily by the Economic Bureau of the Ministry of Foreign Affairs. Epitomized in the New Miyazawa Initiative and the provision of approximately \$80 billion in financing to the affected Asian countries, the re-active program can be viewed as containing some clear elements of defensive actions designed to contain collateral damage to the domestic Japanese economy on two vital fronts. Firstly, the infusion of fresh funds, with an initial focus on trade

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financing, was geared to buoying Asian trade and supporting Japanese exports to Asia. Secondly, and more importantly, the provision of credit facilitated and provided cover for the exit of Japanese financial institutions from Asian markets as they scrambled to prevent a further erosion in their capital base and a deepening of the domestic crisis in confidence. As oblique as it may have been, this latter initiative may be viewed as an injection of public funds to salvage the sinking Japanese banking sector activated in tandem with the ¥25 trillion recapitalization fund mandated under the Financial Revitalization Law and Financial Early Strengthening Law enacted in October 1998.<sup>1)</sup>

The pro-active program, Japan's second line of diplomatic response to the Asian crisis, features proposals for the creation of an Asian Monetary Fund (AMF) as set within a broader framework of the internationalization of the yen. Formally proposed as early as the August 1997 Tokyo meeting of countries in support of Thailand, the AMF concept thereafter languished under American criticism and a lukewarm Asian reception. The AMF cause further receded during most of 1998 as the IMF showed itself capable of making key strategic adjustments in its policy prescriptions for the affected Asian economies. However, with the general success of the re-active program, Japan is once again turning its attention to promoting the AMF concept. Combined with the largely symbolic candidacy of Eisuke Sakakibara for Managing Director of the IMF, the more recent call for rectifying the under-representation of Asian countries in the IMF's voting structure, and the creation of a short-term swap framework for Asian currency reserves, Japan stands poised to pursue its long-term objectives of promoting its regional and global standing.

The purpose of this paper is to consider the inadvertent role that Japan may have played in setting the stage and exacerbating the Asian currency and financial crisis, and to examine its responses to the crisis within the framework of its policies of regional economic diplomacy. The presentation of the analysis is structured as follows. Section 2 surveys the causes of the Asian currency crisis, including a review of the mechanism of contagion. Section 3 considers the impact of the trends and developments in Japan's foreign exchange markets, imports, foreign direct investments, and financial markets on the Asian crisis. Section 4 presents a summary of Japan's responses to the Asian crisis. The paper concludes with a section entitled "Japanese Economic Diplomacy in Post-Crisis Asia" focusing on the Asian Monetary Fund, Japan's pursuit of the internationalization of the yen and the viability of Japan's regional play against the tide of globalization.

## 2. REVISITING THE CAUSES OF THE ASIAN CRISIS

However complicated the origins and causes of the Asian crisis may have been, the actual phenomena of this "21st century type crisis" are quite clear cut. After serving as the leading destination of international capital flows throughout the decade of the 1990s and registering a net inflow of private funds amounting to \$97.1 billion in 1996, the Asian economies suffered a capital exodus of approximately \$100 billion, with \$45.3 billion leaving during 1998 alone.

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1) The New Miyazawa Initiative was announced in the same month. Perhaps by coincidence, its \$30 billion budget closely approximates the \$33 billion withdrawn by Japanese banks from the Asian region during the crisis.

These violent swings are untenable for any system, least of all a region with banking systems already weakened by massive volumes of nonperforming assets and economic policies centered on a commitment to a *de facto* fixed exchange rate regime. Nevertheless, the severity of the meltdown exceeded all initial expectations. The currencies of Thailand, South Korea, Malaysia and the Philippines had lost approximately 40 percent of their value by the summer of 1998, while the Indonesian rupiah finally bottomed out with a 80 percent loss. GDP growth rates for the same "five core countries" dropped from a 6-8 percent range in 1996 to a similar negative range in 1998. Other indicators of the degree of devastation and social cost include a three-fold increase in unemployment over the same period.

The earlier surge in capital inflows and their uses are well documented. During the ten-year stretch between the mid-1980s and the mid-1990s, the share of Asia in total private capital flows to developing countries jumped from approximately 10 percent to more than 40 percent. In terms of capital flows as a percentage of GDP, the Asian region averaged 7.1 percent between 1990 and 1996, as compared to 3.9 percent in the case of Latin America.<sup>2)</sup> Unusually high levels of inflow were recorded during this period, such as 23.2 percent of GDP in the case of Malaysia in 1993. On a cumulative basis, capital inflows (beginning in 1988) on the eve of the crisis amounted to 51.5 percent of GDP in Thailand, 45.8 percent in Malaysia, 9.3 percent in Korea, and 8.3 percent in Indonesia. The vulnerability of these positions was steadily heightened by the transformation of the funding mix. Although starting out with a healthy reliance on foreign direct investment (FDI), the flow was increasingly co-opted by short-term loans from foreign banks. Thus, on the eve of the crisis, the above-mentioned five core countries owed a total of \$326 billion to foreign banks, of which some \$117 billion was owed by Korea, followed by Thailand with \$99 billion, Indonesia with \$61 billion, Malaysia with \$33 billion, and the Philippines with \$17 billion (Table 1). Even more ominously, on the eve of the crisis, the ratio of short-term debt to foreign reserves exceeded 200 percent in the case of Korea, and hovered around the 150-percent mark in Indonesia and Thailand.<sup>3)</sup>

The deterioration in the funding mix reflected a combination of "pull" and "push" factors. On the pull side, region-wide programs of capital-account liberalization under conditions of poorly-developed regulatory and prudential controls triggered sharp inflationary trends in asset values which initially appeared to underscore the foresight and wisdom of domestic speculators fearless of exposure to foreign liabilities. The most poorly supervised money markets were the offshore financial markets allowed to expand in the absence of countervailing safeguards, among which Thailand's Bangkok International Banking Facility (BIIF) is frequently cited as an object lesson. Launched in 1993 with the ambitious aim of creating a regional financial center specializing in out-out intermediation, BIIF quickly succumbed to the siren call of voracious domestic demand for speculative funds bound for the purchase of real estate and other assets. In the process, BIIF went from intermediating \$8 billion in out-out financing in 1993 to handling \$30 billion in out-in deals in 1996. In another instance of sequential failure in capital-account liberalization, Korea expanded the ability of domestic banks to borrow abroad in step with its entry into the OECD.<sup>4)</sup> Meanwhile, little was done to upgrade supervisory and

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2) Montiel and Reinart (1999).

3) World Bank (1999).

Table 1: Economic Fundamentals in Pre-Crisis Asia

	Indonesia				Rep. of Korea				Malaysia				Philippines				Thailand			
	94	95	96	97	94	95	96	97	94	95	96	97	94	95	96	97	94	95	96	97
Real GDP Growth	7.5	8.2	8.0	5.0	8.6	8.9	7.1	5.5	9.2	9.5	8.6	7.8	4.4	4.8	5.7	5.1	8.9	8.7	5.5	-0.4
CPI	8.5	9.4	7.9	6.6	6.3	4.5	4.9	4.5	3.7	3.4	3.5	2.7	9.0	8.1	8.4	5.1	5.1	5.8	5.9	5.6
Savings GDP Ratio	29.2	29.0	28.8	27.3	34.6	35.1	33.3	32.9	32.7	33.5	36.7	37.0	19.4	17.8	19.7	21.0	34.9	34.3	33.1	31.8
Fiscal GDP Ratio	0.0	0.8	1.4	2.0	1.0	0.0	0.0	0.0	2.5	3.8	4.2	1.6	-1.6	-1.4	-0.4	-0.9	2.0	2.6	1.6	-0.4
Current Acc/GDP Ratio	-1.7	-3.3	-3.3	-2.6	-1.2	-2.0	-4.9	-2.0	-7.8	-10.0	-4.9	-4.8	-4.6	-4.4	-4.7	-5.4	-5.6	-7.9	-7.9	-2.2
Foreign Liabilities GDP Ratio	61.0	61.5	56.7	-	14.9	17.2	21.6	-	40.4	39.3	40.1	-	62.4	53.2	49.2	-	45.8	49.7	49.3	-
Short - Term Liabilities Ratio	18.0	20.9	25.0	-	-	-	58.3	42.4	21.1	21.2	27.8	-	14.3	13.4	19.3	-	44.5	49.4	41.4	-

Source: IMF, *World Economic Outlook*

prudential controls, nor did it relax its restrictions on incoming foreign direct investments which arguably could have provided a counter-weight to the short-term liabilities which were quickly accumulated by Korean banks. No less powerful forces were in operation on the push side. The combination of de facto fixed exchange rates and the “implicit guarantees” of financing Asian growth produced a powerful illusion of safety among international lenders. Incentives for unhedged foreign financing were further boosted by substantial interest rate differentials which persisted as a result of widespread success in the implementation of sterilization policies.<sup>5)</sup> Opportunities for massive volumes of “yen carry trade,” or the provision of liquidity via swaps in international capital markets, took a quantum leap with the adoption of very low interest rates in Japan following the prolongation of the Japanese recession. Subsequently, anemic domestic demand for funds and the overhang of troubled loans combined with sheer geographic proximity to establish the Tokyo interbank markets as the center of an extensive carry trade which could be readily tapped by foreign (most prominently Hong Kong and U. S.) financial institutions.<sup>6)</sup>

Aside from its financial aspects and the failure of proper supervision and sequencing of capital-account liberalization, the Asian crisis is best defined in terms of what it was not, and what it certainly was not is a typical “first generation” crisis on the Latin American model where irresponsible expansionary monetary and fiscal policies generated massive imbalances in the

4) Interestingly enough, the Mexican currency crisis has also been linked to its accession to OECD membership.

5) In the decade preceding the crisis, cumulative capital inflows amounted to as much as 50 percent of GDP in Malaysia and Thailand. Active sterilization measures were implemented to contain inflation and current account deficits. Consequently, domestic interest rates remained relatively high throughout the inflow episode and served to attract additional volumes of short-term funds. See Takagi and Esaka (2000).

6) Schinasi, Drees, and Lee (1999).

form of fiscal deficits, excess demand, currency overvaluations, and unsustainable current account deficits. The macroeconomic picture which emerges is one of general soundness on the domestic front. (Table 1) The five core countries averaged a real GDP growth rate of 7.2 percent in 1996 (down from 7.7 percent and 8.0 percent in 1994 and 1995, respectively). Inflation was generally under control, while four out of five countries were registering fiscal surpluses (the Philippines being the exception). By the same token, savings ratios remained exceptionally high throughout most of the region.

On the other hand, external sector balances were more problematic. First of all, current-account deficits persisted in all five countries, and deficit levels were alarmingly high in specific instances, such as Thailand in 1995 and 1996 (7.9 percent) and Malaysia in 1994 and 1995 (7.8 percent and 10.0 percent). In all other instances, current-account deficits represented a nagging concern which could be held in abeyance as long as export growth momentum was maintained. However, this momentum was clearly broken in 1996 with the five-country average dropping down to 7.4 percent from the previous year's average of 25.0 percent. This precipitous drop has been blamed on various specific factors, including the global slowdown in the sale of semiconductors and electronic products, and the failed recovery of the Japanese economy.

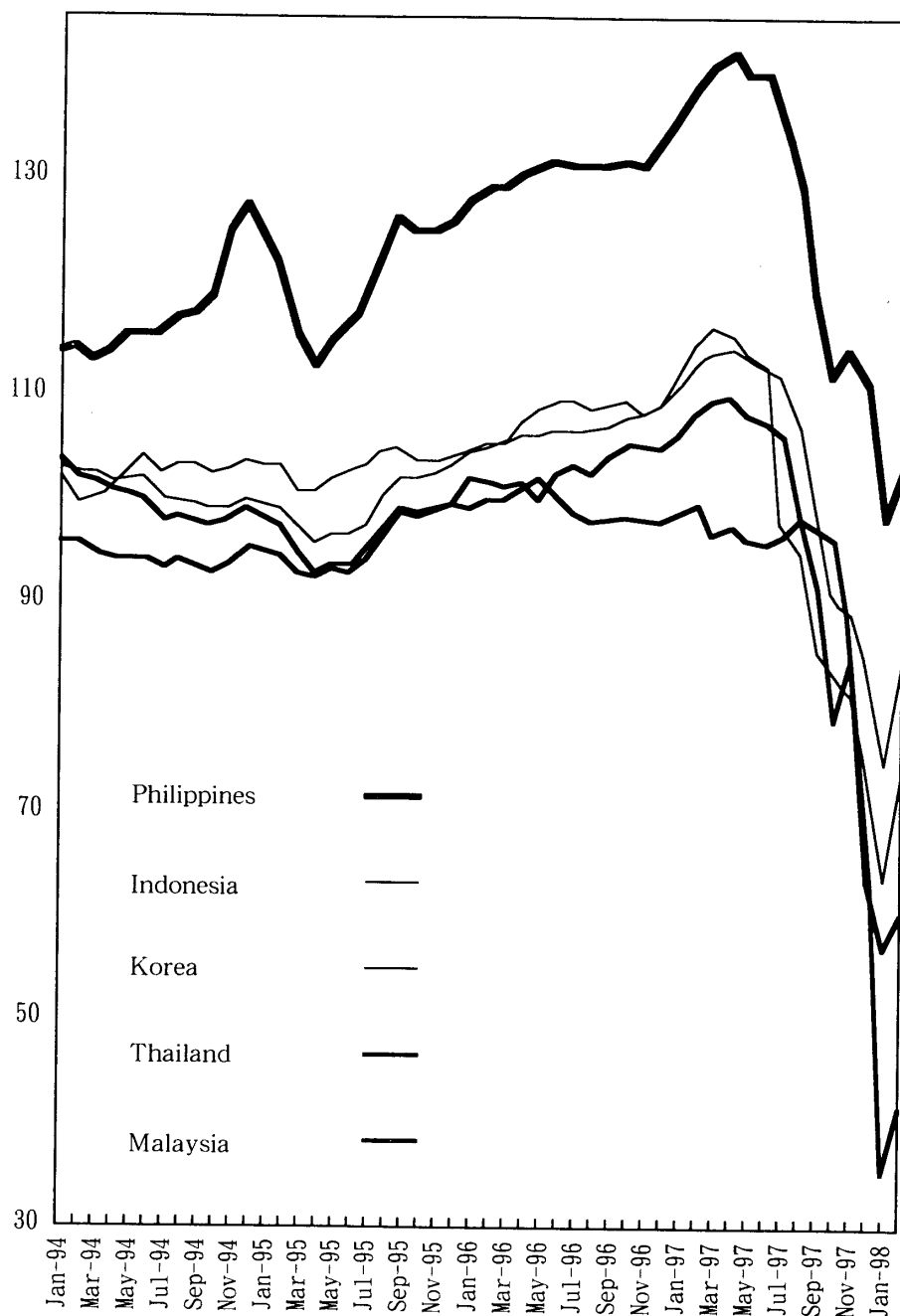
Concerning this loss of export growth momentum, considerable attention has been given to the question of whether the region was suffering from real exchange rate overvaluation which historically has tended to outperform other leading macroeconomic indicators of currency and economic crises in emerging economies. A relatively strong *ex ante* case can in fact be made for the emergence of overvaluation for the dollar-pegged Asian currencies. After all, the Japanese yen had depreciated by approximately 50 percent since peak levels marked in the spring of 1995. Similarly, China had devalued its currency by more than 30 percent in January 1994 by unifying the official and floating exchange rates. Presumably, the former development had impacted the top end of Asia's export structure, while the Chinese move had undermined or otherwise challenged the bottom end of the region's export structure. Various empirical studies tend to discount the impact of overvaluation and the Chinese challenge, concluding in the latter case that any competitive advantage enjoyed by China after devaluation was brief and quickly gave way to the yuan's real exchange rate appreciation due to significantly higher rates of inflation.<sup>7)</sup> The impact of the yen's devaluation is clearer. (Figure 1) When the sharp depreciation of the yen boosted the real effective rate of exchange for the region, exports to Japan underwent a wrenching about-face. (Table 2) The most seriously affected were the Asian NIEs whose rate of growth of exports to Japan tumbled from 32.7 percent in 1995 to minus 0.5 percent in 1996. Though the ASEAN-4 were in general less seriously hurt by this contraction, it is notable that Thailand bore the brunt of the decline among these countries. In addition to the yen's depreciation, the shrinkage in Japanese imports reflected the severity of Japan's mounting deflationary pressures. The yen's post-1995 depreciation also affected the performance of the Asian economies by encouraging a departure from Japan's conventional perceptions of FDI strategies. Specifically, the weakening of the yen coincided with the pursuit of

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7) Fernald, Edison and Loungani (1999).

Figure 1: Trends in Real Effective Exchange Rates

(1990=100)



Source : Ministry of Finance

“new horizons” for more competitive export platforms in China and beyond.

One of the salient features of the Asian crisis has been the phenomenon of contagion whose virulence and scope exceeded all initial expectations, as well as previous experiences with the “Tequila effect” in the Mexican crisis. The Asian crisis was also notable in that it appeared to reverse the conventional wisdom that contagions were spread from large countries to smaller ones. Here instead was a contagion spawned in a relatively small country (Thailand) and spreading to considerably larger economies, such as South Korea, and eventually affecting the economic performance and flow of funds to countries as far afield as Russia and Brazil. Vari-

Table 2: Japanese Imports from Asia  
Annual Change (%)\*

	1995	1996	1997 1st Half	1997 2nd Half	1998	1999 1st Half
ASEAN -4	20.2	9.0	4.1	-8.7	-21.6	2.9
Asian NIEs	32.7	-0.5	-14.4	-13.0	-18.9	10.5
Indonesia	27.0	7.3	4.5	-11.1	-26.6	-0.9
Rep. Korea	32.0	-7.2	-10.1	-6.9	-17.7	12.2
Thailand	29.9	1.2	-4.8	-7.6	-15.5	2.9

\* Percentage change in value of imports in dollars.

Source: JETRO, *White Paper on International Trade* (1999)

ous attempts to analyze the spread of the contagion within the Asian region have focused on two possible channels of infection: trade linkages among affected countries, and the psychological basis of the perceptions and behavior of foreign creditors and investors.<sup>8)</sup>

The trade-channel approach provides mixed signals. Bilateral trade relations with Thailand, the epicenter of the crisis, are simply too minor to support such a contention. This in itself lends some credence to the position that the Asian crisis encompasses a series of self-contained and largely unavoidable domestic crises which would have occurred even in the absence of precedent. While immediately applicable to the Korean case, this approach remains unconvincing in the Indonesian and other cases where no major macroeconomic imbalances were looming. On the other hand, inter-regional trade and the concentration of exports to Japan are large enough to point an accusing finger to the mechanism of dynamic competition in common export markets.

The second channel of contagion focuses on creditor sentiments as summarized in the "wake-up call theorem" which argues that a major dislocation in even a small country can encourage international investors to critically reassess other existing regional exposures. Goldstein and Hawkins<sup>9)</sup> suggest that, having received their wake-up call in Thailand, international investors then set out to identify neighboring countries which shared the same markers of fundamental weakness. This process of "guilt by association" quickly implicated Indonesia which exhibited similar markers of vulnerability. In this context, it is argued that the process of reassessment in the case of Asia led to particularly violent reactions because of several unfortunate circumstances. First, international investors were operating in a relative "information vacuum" where either key information remained undisclosed or was thought to be incomplete, unreliable or misleading when made available. This situation was highly conducive to "herding behavior" where poorly informed investors watched each other closely and were particularly sensitive to the perceived decisions of "exemplary investors" assumed to be privy

8) See Goldstein (1998) and Kaminsky and Reinhart (1999) for representative discussions of the impact of the wake-up call effect in the Asian contagion.

9) Goldstein and Hawkins (1998) compare a group of 14 markers of economic fundamentals against an index of bilateral inter-dependence to show that the path of the contagion was determined by similarity in fundamental markers rather than by the weight of bilateral relations.

to higher quality information. In many instances during the early days of the crisis, and even later when the Korean crisis erupted during November and December 1997, Japanese financial institutions with by far the largest and longest-standing exposures to the region were widely recognized as exemplary investors. Their decisions to cut and run, though heavily influenced by primarily domestic considerations, certainly was an important factor in triggering the region-wide chain reaction of the reassessment of creditworthiness which led to the dramatic exit of funds. Second, Asian loans were buttressed by the assumption of fixed exchange rates and implicit guarantees of quasi-sovereign loan status. The Thai experience of the draining of foreign reserves, the move to floating rates and the exposure of the vulnerability of the domestic financial system shattered the illusion of security throughout the region. Awakening to the fact that a large portion of the short-term positions were unhedged, both creditors and debtors scrambled to take cover. A third factor exacerbating the wake-up call syndrome was the general inadequacy of bankruptcy laws and other orderly-exit mechanisms. Faced with the possibility of growing financial distress and insolvency in the Asian markets, and lacking confidence in the legal processes of recourse and repossession, foreign investors were prompted to liquidate their claims in advance of real trouble.<sup>10)</sup>

### 3. IMPLICATING JAPAN IN THE ASIAN CRISIS

Since the start of the Asian crisis, Japanese authorities have taken pains to rebut allegations that Japan was in some way responsible for the onset of the crisis. The standard position has been to emphasize the scale of Japanese contributions in support of the region and to argue that assignment of blame is counter-productive.<sup>11)</sup> Though there certainly are no grounds for holding Japan in any way responsible for what occurred, given the importance of the economic ties between Japan and Asia, it is difficult to deny that various developments in Japan may have been instrumental in augmenting the vulnerability of the region and setting the stage for the crisis. Moreover, it can be fairly argued that once the crisis was started the severity of its contagion could have been more effectively curtailed were it not for the fact that Japan itself was concurrently mired in its own worst postwar financial crisis and recession.

These negative linkages originating in Japan cover the areas of trade, foreign direct investment, and international lending. In the area of trade, as previously noted, the rapid depreciation of the yen after the spring of 1995 pushed up the real effective exchange rates of the Asian currencies and undermined the competitiveness of Asian exports to Japan. As could be expected, the first to be affected were the Asian NIEs with industrial structures closer to that of Japan's import-competing sector. In dollar terms, the growth rate of ASEAN-4 exports to Ja-

10) Eichengreen (1999).

11) For instance, see 『アジア経済危機の原因』(外務省). In meetings with Japanese government officials in early January 1998, U. S. Deputy Secretary of Finance Summers presented the standard case against Japan arguing that Asia was threatened by Japan's financial crisis and recession, and the continued weakness of the yen. (Mainichi Shimbun, Jan. 10, 1998) Reportedly, this argument also surfaced in the Davos Conference of January 1998 where China's promise to not to devalue was met with applause and quickly turned into criticism of Japan's pursuit of a cheaper yen. This set the tone for the subsequent criticisms of Japan as a "source of the crisis" which persisted throughout the year. (See 『国際経済・金融システム研究会審議記録』(外務省)).



pan tumbled from 20.0 percent in 1995 to 9.0 percent in 1996. Even prior to the Asian crisis, export growth was almost flat (at 4.1 percent, as compared to a decline of 14.4 percent for the Asian NIEs) by the first half of 1997. Throughout this period, Thailand was the most seriously affected of the ASEAN-4, with the growth of its exports to Japan completely stalled in 1996 and suffering a 4.8 percent drop as early as in the first half of 1997. But much worse was soon to come. Beginning in the second half of 1997, Asian exports to Japan went into free fall. Although with the onset of the Asian crisis, currency realignments were now proceeding in favor of the Asian countries, exports to Japan were pummeled by the Hashimoto Cabinet's fiscal tightening of the spring of 1997, followed by a string of major financial institution failures through the summer and fall of 1997. By the end of the year, consumer confidence was at panic levels and the national purse-tightening was reflected in a 8.7 percent drop in imports for the ASEAN-4 in the second half of 1997, followed by a 21.6 percent drop in 1998. The recovery in exports was effectively delayed until the first half of 1999. Fortunately, however, exports to the U. S. and EU markets continued to expand throughout most the crisis, thus allowing the Asian region to redirect its export capacities relatively quickly.

Similar patterns are observable in Japan's foreign direct investments in the Asian region. The depreciation of the yen after 1995 appears to have marked a turning point in Japan's FDI strategies and prompted stepped-up efforts to seek out cheaper export platforms to replace those in the ASEAN-4 which could not be operated profitably in an environment of rapidly rising wages and asset inflation. The obvious first choice was China which the newly devalued yuan rendered particularly attractive.<sup>12)</sup> Thus, in FY1995 China received a total of \$4.5 billion in Japanese FDI, representing a 74.4 percent increase over the previous year. At this level, Japanese FDI flows to China exceeded the total volume of flows to the ASEAN-4 for the first time. Simultaneously, Japanese corporations were turning eagerly to Vietnam and even India as new FDI candidates to replace the bottom end of their ASEAN-4 export platforms. As it turned out, the Chinese investment fever could not be sustained and the investments in Vietnam and India never really materialized. But a psychologically important signal had been given that Japanese investments in the ASEAN countries were reaching a plateau. It has been argued that, ironically, the onset of the Asian crisis may have delayed the exodus of Japanese FDI, but it could not stop the sharp downturn in new flows. Thus, in the first half of FY1998, Japanese FDI flows to the ASEAN-4 dropped by 48.5 percent. Here again, as in the case of trade, the slack was compensated in part by the growth of U. S. and EU investments in the region allowing total incoming FDI to remain unusually steady throughout the crisis.<sup>13)</sup> In the process, U. S. and European investors did not hesitate to capitalize on emerging opportunities for the acquisition of low-priced distressed assets, particularly in areas where legal barriers to foreign participation and ownership were dismantled after the crisis. On the other hand, Japanese investors have largely absented themselves from this regional M&A boom.<sup>14)</sup>

12) It has been argued that the January 1994 realignment (devaluation) of the Chinese currency did not significantly affect China's export competitiveness because up to 80 percent of its trade was already being conducted on the basis of the cheaper floating rate. Presumably, the devaluation had a larger impact on the local cost of foreign direct investments.

13) OECD (1999).

14) This so-called process of the "billion dollar fire sales" started at a relatively early stage in the crisis.

The third negative linkage, and arguably the most destructive one, concerns the behavior of Japanese financial institutions before and after the Asian crisis. The picture which emerges is one of aggressive lending by Japanese banks prior to the crisis coupled with an equally aggressive pull-out at an early stage of the crisis. The lending behavior can be easily explained in terms of ultra-low Japanese interest rates which inundated the region with cheap credit, the impact of sterilization policies on maintaining sizable interest rate differentials notwithstanding the huge influx of funds, and the false sense of security perpetrated by the dollar-pegged foreign exchange regimes. Furthermore, given the continued weakness of the yen, the Japanese carry trade of arbitrage lending to Asian financial markets was proving to be particularly lucrative during this period. The combination of these factors supported a "buildup of leverage and position-taking in international markets beyond prudent levels."<sup>15)</sup> The suddenness of the Japanese pull-out, on the other hand, derives from a series of concurrent developments. Certainly the relatively recent memory of the collapse of Japan's own speculative bubble was very much alive in the minds of Japanese lenders who rushed to exit. Secondly, the Asian crisis coincided with a period of deep malaise in Japan's domestic financial system. Financial institutions, both large and small, were closing their doors in quick succession and pressure was mounting to finally face up to the problem of nonperforming loans. Tangible evidence of the weakness of Japanese financial institutions abounded: equity prices in the banking sector were breaching crisis levels, the Japan premium stood at prohibitive heights, the credit ratings of six out of the seven Japanese city banks were downgraded between 1996 and 1997, and weakened financial institutions were being hit by dangerously high levels of deposit withdrawals. Political paralysis worsened matters. The extreme public reaction to the injection of public funds in the resolution of the jusen crisis in 1996 postponed fundamental action by the authorities until after the summer of 1998 when a new administrative framework was finally installed with the passage of the Financial Revitalization Law and the Financial Early Strengthening Law. Throughout this period, however, an extremely serious credit crunch was brewing as financial institutions squeezed their balance sheets to meet the Basle Standards of capital adequacy, or in the worst case to avoid "prompt correction action." In the final analysis, the fragility of the Japanese financial institutions on the eve of the Asian crisis allowed them too little margin for error in overseas markets. After the Thai debacle, Japanese financial institutions did not wait for evidence of trouble to withdraw their funds from other countries of the region.<sup>16)</sup>

Table 3 shows the sources of bank borrowing of the five core countries. Prior to the Asian crisis, as of the end of June 1997, lending by Japanese financial institutions totaled \$97 billion, equivalent to 30 percent of all bank borrowing by the five countries. Moreover, these positions had remained steady throughout the first half of the year. This positioned Japan as by far the largest single creditor nation to the region.<sup>17)</sup> By the end of the year, Japanese banks had withdrawn \$11 billion from the region while the position of U. S. banks remained essentially

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For instance, an investment group with ties to George Soros reportedly acquired a newly-created Thai manufacturer of steel sheets as early as in March 1998.

15) Schinasi, Drees, and Lee (1999).

16) Kanaya and Woo (2000).

17) Germany was a distant second with \$32 billion. Claims held by Hong Kong banks amounted to \$53 billion are presumed to reflect the yen carry trade.

Table 3: Nationality of Banks Providing Loans to Asia

	Japan				U. S.				Europe*				All Countries			
	12/96	6/97	12/97	12/98	12/96	6/97	12/97	12/98	12/96	6/97	12/97	12/98	12/96	6/97	12/97	12/98
Indonesia	22	23	22	16	5	5	5	4	14	15	15	13	56	61	58	45
Rep. Korea	24	24	20	17	9	10	10	6	28	27	28	21	100	117	94	65
Malaysia	8	10	9	7	2	2	2	2	9	11	12	9	22	33	28	21
Philippines	2	2	2	2	4	3	3	3	8	5	7	6	13	17	20	16
Thailand	38	38	33	22	5	4	3	1	17	16	13	10	70	99	59	41
Total	94	97	86	64	25	24	23	16	76	74	75	59	261	326	259	118
Five Countries																
Total	119	115	98	86	34	37	29	26	106	177	156	151				
All Asia																

\* Europe consists of total of French, German and U. K. banks.

Source: BIS, *Consolidated International Banking Statistics*.

unchanged. On the other hand, European (German, French and U. K.) banks actually continued to lend into the crisis and increased their total claims on Korea, Malaysia and the Philippines by approximately \$4 billion during the second half of 1997. During this early period of the crisis, Japanese withdrawals were most conspicuous in Thailand and in Korea. Japanese financial institutions continued to withdraw heavily from the region throughout the following year and had reduced their exposure by a further \$22 billion by the end of 1998, most prominently in Thailand (down 33 percent) and in Indonesia (down 27 percent). Consequent to the retrenchment of 1998, the share of Japanese banks in total lending to all emerging markets in Asia slumped to a 14-year low of 29 percent by the end of the year.<sup>18)</sup> It was only in this period that the retrenchment process extended to U. S. and European banks, and even then at a relatively slower pace.

In total, Japanese banks withdrew \$33 billion over an 18-month period. What impact could this relatively modest sum have had on the Asian crisis?<sup>19)</sup> Firstly, it apparently did not take a nail to burst Asia's speculative bubble which was already losing its buoyancy in any case. The prick of a small pin administered by what was widely believed to be an "exemplary investor" in the region was enough to send a powerful message to the global markets creating a cascade of sell-offs and the accelerated exit of portfolio funds. Secondly, whenever Japanese banks stopped rolling over their claims or showed reluctance to do so, this was taken to be a particularly potent signal in the absence of investor confidence in available information. This appears to have been particularly true in the Korean case where critically important information went through radical and rapid revisions in the midst of the crisis.<sup>20)</sup>

18) BIS (1999).

19) The \$33 billion withdrawn was equivalent to 9.2 percent of total lending by all for eight banks to the five core countries as of June 1997, and 15.8 percent of the total withdrawn by all foreign banks by the end of December 1998.

20) In December 1997, the announced volume of Korea's short-term foreign liabilities was revised upward to approximately \$100 billion, roughly double the amount announced in November. During the same period, it was widely rumored that a substantial portion of the Bank of Korea's foreign reserves were actually neutralized by the fact that they had been placed on deposit with the foreign branches of domestic Korean banks, and that actually at the signing of the IMF agreement on December 4, Korea was left with only six day's worth of usable reserves. (Reported in the Washington Post, Dec. 11, 1997.)

#### 4. JAPAN'S RESPONSE TO THE ASIAN CRISIS

With the Asian region absorbing 40 percent of Japan's total exports and 25 percent of its foreign direct investments, Japan clearly needed to act quickly to try to ameliorate the unfolding Asian tragedy. Government action was all the more urgently required in face of Japan's own stalled economy and financial crisis. Particularly frightening was the prospect of major Japanese banks with large Asian exposures collapsing under the strain of added overseas non-performing loans before a proper framework for their relief and rescue could be put in place. And particularly painful was the 25.3 percent drop in Japan's 1998 export to the Asian region.

Acting with an urgency born of enlightened self-interest, Japan committed itself in rapid succession to a series of multilateral and bilateral "Asia support packages" with a total value of approximately \$80 billion. (Table 4) Key multilateral commitments are valued at approximately \$19 billion, while the centerpiece of Japan's bilateral support is the \$30 billion New Miyazawa Initiative announced in October 1998. A second stage of the New Miyazawa Initiative was formulated in May 1999 essentially featuring a series of credit guarantee facilities aimed at mobilizing ¥2 trillion in domestic and foreign private-sector funds for Asia. Japan's support stance focuses on four fundamental challenges in the Asian economies. The first challenge consists of the short-term requirements of revitalizing production and trade. Half of the funds of the New Miyazawa Initiative were earmarked for these immediate and critical needs. The second challenge consists of various social-sector initiatives for improving safety-net features and quelling social unrest. The third challenge falls squarely within the province of Japan's traditional ODA initiatives and features medium to long-term projects for infrastructure development, structural reform and human resources development. The second half of the

Table 4: Japan's Financial Commitments to Asian Countries in Crisis

1. Contributions to IMF Packages (\$19 billion)
  - (1) Thailand : \$4.0 billion (committed August 1997)
  - (2) Indonesia : \$5.0 billion (committed December 1997)
2. Bilateral Support Programs (\$43 billion)
  - (1) Support for Trade and Industrial Activities (\$31. billion)
    - Trade insurance : \$13 billion
    - Support for Japanese affiliated companies in Asia : \$2.7 billion
    - Ex-Im Bank loans and other facilities : \$15.3
  - (2) Support for Structural Adjustment Programs (\$10.8 billion)
    - Low-interest ODA loans : \$2.4 billion
    - Non-project grants in aid : \$0.1 billion
    - ODA loans for infrastructure projects : \$8.3 billion
  - (3) Support for Social Sector Programs : (\$0.8 billion)
  - (4) Support for Human Resources Development : (\$0.4 billion)
3. Contributions to ADB Currency Support Facility : \$3.0 billion

Note: Figures represent allocated commitments as of January 2000. Commitments under the New Miyazawa Initiative are included in 2. Bilateral Support Programs and 3. Contributions to ADB Currency Crisis Support Program

Source: Ministry of Foreign Affairs

funds budgeted under the New Miyazawa Initiative are to be directed to the second and third challenges. Finally, Japan's support stance identifies "Asian currency stabilization" as a critical need and posits the internationalization of the yen as Japan's principal contribution to this objective.<sup>21)</sup> As is frequently the case in such instances, Japan's impressive array of "Asian support packages" contains less than what meets the eye. Outright grants come to about \$170 million, including emergency food and medical aid to Indonesia and aid to Thai and Malaysian foreign students. The remainder consists of low-interest ODA type loans, albeit in many instances extended on special preferential terms. Nevertheless, a review of the projects identified for financing only deepens the impression that a substantial portion of the Asia support packages have been in effect cannibalized from existing ODA programs. Even the grants-in-aid squeezed into these packages reflect this tendency with over \$60 million going to countries unaffected by the crisis. In the final analysis, the infusion of fresh money was probably concentrated in the opening months of the crisis and was expended in support of the IMF relief packages, and the trade financing and insurance facilities which were critically needed to clear the export and import goods virtually stranded on Asian docks and to revitalize regional trade.<sup>22)</sup>

A chronology of Japan participation in international actions in response to the Asian crisis begins with the meeting of the Support Group for Thailand in August 1997. Held in Tokyo under the auspices of the IMF, the meeting was successful in putting together a \$17.2 billion support package for Thailand, of which Japan was to be responsible for \$4.0 billion, or roughly 23 percent. The amount pledged exceeded the initially targeted sum and contained pledges of \$1 billion each from Singapore, Malaysia, China, Hong Kong and Australia. With the United States conspicuously absenting itself from the accord and the specter of contagion yet unrecognized, reports of the meeting betray a self-congratulatory atmosphere of accomplishment among the primarily Asian participants to the extent that "we may have become a little carried away." It was in such an atmosphere that the creation of an Asian Monetary Fund (AMF) was proposed, "ostensibly on the initiative of the ASEAN countries to which Japan responded in support."<sup>23)</sup> When the discussion of creating an AMF was "leaked," the United States promptly launched a campaign of strong opposition. However, the AMF concept was again made the subject of international discussion at the ASEM meeting and G-7 meeting of finance ministers held in Hong Kong in late September. Shortly thereafter, the initiative was effectively torpedoed by the United States when it succeeded in aligning the IMF and China on the side of opposition. This was done before the AMF concept could take on concrete form, and there it would remain dormant for nearly two years before being revived by Japan.<sup>24)</sup>

21) 『アジア経済危機への対応』(外務省).

22) The 25.3 percent drop in Japanese exports to the Asian region in 1998 presented a serious threat to the heavily battered domestic economy under going negative growth. According to the computations of the Economic Planning Agency, the drop in Japan's Asia exports which continued between the fourth quarter of 1997 and the first quarter of 1999 acted to suppress Japan's real GDP by 0.71 percent. Economic Survey of Japan (1999).

23) Reportedly, the ASEAN countries had begun discussions for the creation of a permanent regional monetary institution in meetings held in the spring of 1997. 『アジア通貨危機に学ぶ：短期資金移動のリスクと21世紀型通貨危機』大蔵省。

24) 『国際経済・金融システム研究会審議記録』(外務省) and 『アジア通貨危機に学ぶ：短期資金移動のリスクと21世紀型通貨危機』大蔵省。

The second development of interest has been Japan's uncharacteristic willingness to offer frank and, at times, strident criticism of the IMF regime. This stance was more clearly manifested after the opposition to the AMF proposal and the "Hashimoto intervention" in Indonesia, culminating in the formulation of the New Miyazawa Initiative which was projected as an indication of Japan's preparedness to proceed alone in providing the type of facilities it felt were called for. Similarly, Japan's open criticism of IMF conditionalities which failed to take into consideration the atypical features of the troubled Asian countries may have played a role in the relatively early revision of the IMF relief packages and the IMF's eventual mea culpa issued in January 1999.

The third development of interest was the establishment of the far less ambitious Manila Framework launched in mid-November with the participation of fourteen countries, including the United States, as well as the IMF, World Bank and the Asian Development Bank. Essentially, this was the APEC membership presented with the narrow and technical agenda of "strengthening Asian regional cooperation for financial and currency stabilization" and doing so within the existing confines of the IMF system. The principal mission of the Manila Framework was identified as creating a "mechanisms for regional surveillance to complement the global surveillance of the IMF" and developing "cooperative financing arrangements that would supplement IMF resources."<sup>25)</sup> Other objectives include the provision of technical assistance and support for strengthening the financial sectors of affected countries, and lobbying the IMF and international community to expand the available resources for crisis intervention. With its focus on Asian regional economic and financial monitoring and discussion, the Manila Framework is presented as a less "conspiratorial" and more sanitized version of the AMF committed to developing complementary mechanisms for regional surveillance. As such, its semi-annual meetings have been used so far as forums for the exchange of information concerning current macroeconomic and monetary issues in the region and the exertion of peer pressure. However, a broader interpretation of the provisions for "cooperative financing arrangements" leaves open for the future the possibility of developing the Manila Framework into an embryonic AMF.

## 5. JAPANESE ECONOMIC DIPLOMACY IN POST-CRISIS ASIA

From the Japanese perspective, the Asian crisis could not have occurred at a more inopportune time. Concomitant to the Asian crisis, Japan's financial system was teetering under the weight of its nonperforming loans and was facing its most serious crisis of confidence in the postwar years, while the several initial measures instituted during the spring of 1997 under the newly enacted Fiscal Restructuring Law were enough to push the Japanese economy dangerously close to the edge of a deflationary spiral by the end of the year. Having earned the sobriquet of the "new Hooverism," the cabinet of Prime Minister Hashimoto found itself expending

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25) The Manila Framework, ADB Web site. The mission statement goes to some length to appease the IMF and to forestall the criticisms which were earlier directed against the AMF concept. For example: "Since the IMF carries the mandate of fostering stability in the global financial system, it was deemed fitting that it take a lead in resolving the Asian financial crisis. In addition, entrusting the assistance program to IMF conditionalities can limit the "moral hazard" problem inherent in bail-out programs."

a considerable amount of political capital in the early months of the Asian crisis on countering allegations and criticisms that somehow Japan stood responsible for triggering the Asian collapse, either through a mercantilist preference for a weaker yen or its reckless and ill-timed pursuit of fiscal rehabilitation. As misconceived as some of these allegations tended to be, that fact did not change the truth that private Japanese lenders were easily identifiable as "leaders of the herd" when the process of exit from the Asian capital markets began. While motivated by understandable domestic considerations, the behavior of the Japanese financial institutions in markets where they were presumed to be better informed than other international participants bordered on the disastrous, given the absence or proven unreliability of disclosed corporate and macroeconomic information in the Asian countries affected by the crisis. The combination of these factors would ensure that Japan, and particularly its private sector, would have to bear the label of "absent savior" well into the crisis, setting the Asian experience apart from the two earlier international financial crises of the 1990s where Germany and later the United States were able to deal from positions of strength in response to Europe's Exchange Rate Mechanism (ERM) crisis and the Mexican crisis, respectively.

As previously noted, Japan's official response to this situation was encapsulated in two lines of economic and diplomatic action: a short-term "re-active program" designed to reinvigorate Asian trade and industrial activity with the quick infusion of funds aimed at restoring liquidity; and, a medium-to long-term "pro-active program" featuring proposals for the creation of an Asian Monetary Fund as set within a broader framework of the internationalization of the yen. Though initially unsuccessful, the pro-active program was ready to be revived by mid-1999, by which time the initial goals of the re-active program were well on the way to realization. Not only were the affected Asian economies (with the exception of Indonesia) marking a "V-shaped recovery," but the Japanese economy itself had passed through the worst of its own crisis. Most importantly, the crisis of confidence in Japan's financial system had clearly receded with the massive infusion of public funds and the completion of a legal framework for dealing with delinquent financial institutions. Reflecting the resurgence in confidence, the Japan premium had largely evaporated by April 1999 from punitive levels of 70-100 basis points marked at the height of the crisis in confidence in 1998. Thus, having set its house in order, Japan was in a better position now to once again direct its attention to forward-looking goals. Japan also felt at this time that its regional leverage had been augmented as a result of its largess during the course of the crisis which stood in stark contrast to some of the obvious errors in judgment made by the IMF and the reluctance of the United States to participate in an Asian bail-out.

What rationale was given by Japan in calling for the creation of an Asian Monetary Fund during the early part of the Asian crisis, and what was being specifically proposed? What emerges from the truncated discussions of 1997 is a thumbnail sketch of a regional lender of last resort and a series of legitimate regional concerns combined with a nebulous array of poorly enunciated reasons and motives. The talk at the time was for a \$100 billion "Asia only" organization with a formal and independent status and secretariat. Japan reportedly was prepared to put up \$50 billion to launch the Asian Monetary Fund, presumably to be rewarded with one-half the voting rights. The war chest was to be augmented with market-procured

funds, loan guarantees and reserve swaps comprising a stand-by line of defense which would be activated without delay in case of crisis. The proposal also contained provisions for rectifying some of the most serious regional problems: the absence of reliable information, mutual surveillance and peer pressure.

What regional interest in the proposal that may have existed outside of Japan was rooted in the feeling that the IMF did not have full knowledge of the conditions and needs in Asia and that its financial resources were simply inadequate to protect the region in crisis. Above all, in the course of the crisis, it was widely felt that the IMF's traditional prescriptions and conditionalities based on antiquated models of "current-account crises" betrayed its Western ethnocentricity and only served to deepen the troubles of the affected countries. There was bickering that then-Deputy Secretary Summers was willing to throw \$50 billion at the Mexican liquidity crisis with no strings attached, but that the IMF was now insisting on intrusive, painful and, most importantly, misguided structural adjustment goals for Asia. Here was evidence of the endemic "U. S. double-standard" which would again surface in the Brazilian crisis and later allow highly-leveraged institutions (hedge funds) to escape multilateral control. In broader terms, the suggestion that Asia was somehow a "victim of globalization" and was being preyed upon by Anglo-American prescriptions for liberalization seemed to ring true in Asian under siege. The unspoken hope was that an Asian Monetary Fund would generally be more friendly to Asians and extract a less painful price in terms of conditionality, and that it would provide a legitimate line of defense against the forces of market-opening and structural adjustment which were now hosting the "billion dollar fire sales" throughout Asia.

As could be expected, the AMF concept came under immediate attack, primarily from the United States which was later able to corral the support of the IMF and China.<sup>26)</sup> The principal line of argument was that a regional fund would threaten the leadership role of the IMF, undermine its funding sources, and would encourage a split between Asia and the West. On more practical grounds, the AMF concept was faulted for "needless duplication" of IMF functions and expertise. Finally, the impression was given that a purely Asian organization would be infected by a "pan-regional cronyism" leading to the implementation of a less stringent set of conditionalities that would magnify moral hazards and set in motion a "competition among monetary funds" where lax conditionalities quickly displace stringent ones. Specifically, the New Miyazawa Initiative has been faulted for instigating such competition with its willingness to supply funds to countries such as Malaysia which has rendered itself ineligible for IMF assistance by installing capital controls.<sup>27)</sup> Furthermore, it has been suggested that the consensus-building and non-confrontational "Asian approach" threatens to undermine real economic reforms and has already shown itself unable to stop the backsliding on tough policy actions, such as the pursuit of free trade and greater transparency in the AFTA and APEC frame-

26) Concerning the reaction of other Asian countries, there is an intriguing gap in perception between Japanese and Western sources. Japanese sources generally feel that they have the enthusiastic support of the Asian region, while other sources tend to emphasize the mistrust for Japanese leadership in any initiative leading to the development of a yen-based financial bloc. In other instances, such as in Korea, initial interest in the AMF seems to flag after the worst of the crisis is over. For instance, see Bergsten (1988).

27) See for example the critical discussion in Lewis (1999).



works.<sup>28)</sup>

The most difficult task in creating an Asian Monetary Fund probably lies in the sheer complexity of hammering together an agreement and creating a fully mandated multilateral organization with profound future implications. To do so under crisis conditions may be difficult enough, but the task can be even more daunting and time consuming under tranquil conditions. In recognition of this fact, Japan appears to have opted for an incremental approach and is forwarding various "watered down versions" of the AMF. Such is the current proposal for a coordinated network of currency swaps to be mobilized in defense of the region in future crises. Whether such initiatives ever get off the ground will depend in large part on the stance of other Asian countries with large foreign reserves, such as China. Another potential obstruction to the progress of the Japanese initiatives is the evident gap in post-crisis perceptions of necessary revisions in the international financial architecture. Compared to its Western counterparts, Japan has shown itself to be far more amenable to less market friendly revisions, including backtracking on capital liberalization to achieve proper sequencing, the imposition of capital controls and restriction of the activities of highly-leveraged institutions. Likewise, Japan has consistently prioritized exchange rate stability and appears to favor Asia's adoption of exchange rate targeting or even an outright return to pegged rates, albeit using a basket assigning a heavier weight to the yen. Moreover, in spite of its official professions, Japan's willingness to act in support of bailing-in the private sector remains in doubt given its penchant for the bail-out, nor has it developed a proven track-record of being prepared to apply unpopular conditionalities. In the final analysis, even if Japan's prescriptions for international financial reform play well to a captive Asian audience, the danger remains that they may be shrugged off in the United States and Europe as running counter to forces of globalization.<sup>29)</sup>

Finally, why is Japan taking this belated stab at regionalism against the prevailing tide of globalization? A key concern is the risk of the yen becoming a "dwarf between two giants," of not being able to hold its ground against the dollar and the euro, and being shunted into growing economic and financial isolation. The stalled "internationalization of the yen" which persisted throughout the 1990s and the growing risk of the erosion of its international status following the emergence of the euro have been presented as a critical long-term liability for the Japanese economy in terms of exposing both the trade sector and the country's vast stock of excess savings to higher than necessary levels of exchange rate risks. Particularly galling has been the underrepresentation of the yen in Japan's own international trade (accounting for 40 percent of exports and 20 percent of imports), the declining international share of yen-denominated bond issues (down to 4.5 percent in 1997 from more than 13 percent in 1994), the stalled

28) Within the context of the domestic U. S. debate condemning the IMF and the participation of the United States in its moral-hazard inducing bail-outs, it was suggested that an AMF would not be all bad because it "forces Asia to cleanup its own mess and excuses the U. S. from any action." (Global Intelligence Update, 1998.) However, the initiative was not without its legitimate, but somewhat qualified, supporters in the United States, such as Bergsten (1998) who has proposed the creation of an Asian Pacific Monetary Fund (APMF) encompassing both sides of the Pacific Basin and geared to developing reliable early-warning systems and prompt relief complementing IMF programs.

29) The Japanese contribution to the debate on international financial architecture is outlined in Sakakibara (1999), Ministry of Finance (1999), and 『アークテクチャーについての黒田財務官ステートメント』 (2000).

share of yen-denominated loans in the overseas lending of Japanese banks (approximately 20 percent), and the erosion of the status of the yen as an international reserve currency. In the past, the increased use of the yen in current-account settlements was hampered by various technical peculiarities of Japan's trade structure, such as Japan's high reliance on the importation of international commodities traditionally traded in dollars, the high ratio of intra-firm trade between Japanese parent companies and overseas subsidiaries in which the parent company assumes the exchange rate risks, and the dollar-preference and dollar-peg of Asian trading partners.<sup>30)</sup> On the capital-account side, the stalled internationalization of the yen owes much to the delay in the liberalization and invigoration of Japan's domestic capital and financial markets which the Big Bang program is designed to rectify. Given the time consuming and often painful nature of this exercise, Japan's sponsorship of the Asian Monetary Fund and related regional plays take on the appearance of a quick and relatively inexpensive fix to the problem of the erosion of the international status of the yen.

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## JAPAN IN THE ASIAN ECONOMIC CRISIS

Zafar MOGHBEL

The Asian economic crisis starting in the summer of 1997 has been widely referred to as a “21st century type crisis” in which countries with relatively sound macroeconomic fundamentals suffered sudden and very large outflows of short-term foreign funds leading to the collapse of de facto fixed exchange-rate regimes and widespread financial-sector turmoil throughout the region. Under normal circumstances, this capital-account based crisis would have provided Japan with an excellent opportunity to further the goals of its economic diplomacy in the Asian region, including the promotion of the internationalization of the yen to counter-balance the global presence of the dollar and the euro. In fact, however, Japan was forced to adopt a defensive stance countering persistent allegations that it was in some way responsible for triggering the Asian crisis.

This paper considers how developments in Japanese trade, foreign direct investments, and bank lending may have contributed to setting the stage for the crisis, and how domestic economic conditions in Japan may have opened up channels for the spread of the regional contagion once the crisis had started. It finds that the withdrawal of Japanese banks in the early stages of the crisis may have acted as a signaling mechanism for other investors in the region. In addition, the paper reviews Japanese responses to the crisis consisting of a “re-active program” geared to controlling the impact of the crisis on the Japanese economy, and a more ambitious “pro-active program” for pursuing regional goals under the aegis of the Asian Monetary Fund and related initiatives.