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The Political Economy of the Dollar and the Yen in East Asia

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[**Abstract:** From the early 1980s until 1997 large amounts of Japan's current account dollar surplus were invested in U.S. Treasury securities. This economic relationship developed into an "alliance" sustained by the economic policies of U.S. and Japanese authorities. The U.S.–Japanese alliance indirectly promoted East Asian export-led growth during 1985-95. However, policies associated with the U.S.–Japanese alliance also contributed significantly to the 1997 Asian financial crisis. During the past years Japan has launched a number of initiatives for aid and regional monetary co-operation with the aim of internationalising the yen and redirecting regional current account surplus flows to go within the region, rather than being invested in the United States. The article assesses the viability of this regional challenge to U.S. monetary hegemony.]

In May 2000 a meeting of Asian finance ministers in Chiang Mai in Thailand agreed on a regional monetary co-operation arrangement which would include the so-called ASEAN+3, i.e. the ASEAN countries together with Japan, South Korea and China. The agreement would comprise a network of bilateral currency swap arrangements to defend regional exchange rates. Observers compared the proposal to the stillborn Asian Monetary Fund (AMF) initiative of Japan's Ministry of Finance in autumn 1997. The Ministry of Finance is probably also playing a leading role in the new currency swap initiative.

In this article, I relate this initiative to a broader Japanese effort to enhance the regional role of the yen. It is argued that this attempt is a departure from previous practices of monetary co-operation with the United States. Part I, I discuss U.S. monetary *seigniorage* from the Reagan period onward. The discussion focuses on the *strategic* role of Japan in this monetary order, particularly as large amounts of Japan's current account dollar surplus were used to purchase U.S. government securities. The effects of these U.S.–Japanese relations on East Asia economic development prior to the 1997 crisis are discussed in Part II. Part III discusses the impact of the U.S.–Japanese relationship on the crisis management regime imposed on East Asia by the IMF and the U.S. Treasury Department and the changes within this regime which allowed for a partial East Asian recovery in 1999. Part IV addresses the new initiatives taken by Japan during 1998-2000, aimed at promoting the regional role of the yen and redirecting regional investment flows so that they go within East Asia, rather than to the United States. Part 5 concludes the discussion with an assessment of the viability of this effort

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at regional monetary and financial integration.

U.S. *Seigniorage* and U.S.–Japanese Relations

Seigniorage refers to the advantages of controlling the world economy's currency reserve, a role which currently accrues to the United States. In the post-Bretton Woods setting of the 1980s the Reagan administration learned that the United States did not face the same constraint as other countries in efforts to earn foreign exchange in order to pay for its import bills and foreign investment since most of its foreign trade was conducted in dollar. It could therefore endure huge current account deficits. This advantage could be combined with large federal deficits, since private and public investors in other countries preferred to keep a major share of their foreign currency reserves in dollars and liquid dollar-denominated government securities. The U.S. Treasury Department (hereafter referred to as the Treasury) could then finance the federal debt through the sale of Treasury securities (bills, notes and bonds, hereafter referred to as "Treasuries") to foreigners and bring much of the current account deficit back home to the United States. Transactions in Treasuries also allowed the U.S. financial community to borrow investment funds cheaply from the rest of the world, and large-scale foreign purchases of long-term Treasury Bonds helped to hold down the long-term U.S. interest rate.

Under the Bretton Woods system (which lasted till August, 1971) one surplus country's gain of foreign currency reserves was balanced by another country's loss. This imposed strict limits on the world central bank holding of foreign currency reserves. These constraints disappeared with the end of the gold–dollar link. Persistent U.S. foreign balance deficits expanded foreign central banks' holding of dollar reserves, but this foreign exchange expansion was *not* balanced by declining U.S. foreign reserves. The resulting increase of world central bank reserves permitted a multiplied credit creation through domestic lending in the surplus countries. Huge U.S. current account deficits went along with U.S. political pressure and cajoling for international liberalisation of capital accounts and financial markets as its economy came to rely on inflow of offshore dollar investment as well as on world-wide investment by major U.S. investors. The combined impact of U.S. foreign balance deficits (the U.S. structural role) and political pressure for financial liberalisation (its instrumental role) led to increased financialisation of the world economy (Wade 2001: 201).

The role of Wall Street as the world's financial centre was strengthened in this process, while U.S. hegemony was transformed from being based on manufacturing strength to reliance on a new financial power base. Deficit spending allowed the federal government to finance an arms race that broke the spine of the Soviet Union. Eventually, the U.S. corporate sector regained much of its previous industrial strength in the 1990s after a tough restructuring process in the 1980s, while the Clinton administration succeeded in balancing the budget. The initial realisation of the potentials of U.S. *seigniorage* relied on a symbiotic relationship with Japan.

The U.S.--Japanese Alliance: In summer 1979 the U.S. Federal Reserve raised U.S. interest rates to unprecedented levels in order to bring inflation under control and restore

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confidence in the dollar. This policy of high interest rates continued during the early 1980s and attracted huge offshore dollar funds to the United States. As a result the dollar exchange rate started to climb. During the first Reagan administration (1981-85) growing military spending and tax cuts pushed the budget deficit to record heights. This went along with enormous trade and current account deficits. U.S. export competitiveness declined and generous tax reductions for the well-to-do fuelled a consumption spree which inflated the import bill. Maintaining a strong dollar and a low level of inflation under conditions of soaring budget and trade deficits would apparently require very high interest rates, which would, however, strangle investment and lead to increased unemployment. Yet, the administration could escape from this predicament if it managed to attract sufficient foreign dollar funds to pay for the U.S. budget deficit.

In the 1980s Japan became a major capital surplus country. Japanese banks were full of saving deposits and Japan's current account surplus was growing. A large proportion of this surplus was invested in U.S. securities. U.S. Treasuries Papers were popular, especially long-term Treasury bonds (Murphy 1996: 129-134, 144-145). Japanese investors, mainly insurance companies, accounted for about one quarter of foreign net purchases of Treasuries during 1981-9. Japanese investors were also investing in private U.S. securities, and large amounts of direct investment were pouring into the United States from Japan. Thus, large proportions of Japan's dollar trade surplus, most of which came from its trade with the United States, helped to finance the double deficits of Reaganomics and to maintain the U.S. investment level.

This arrangement was convenient for Japan as well. Japanese dollar demand helped to hold down the exchange rate of the yen, which otherwise was pushed up by Japan's huge current account surpluses. Furthermore, the reinvestment of large proportions of Japan's dollar trade surplus in the United States helped to dampen U.S. trade policy pressure. Trade disputes with the United States did not end, but during periods of large Japanese investment in the United States, U.S. trade policy pressure was diverted to a greater extent than in periods of low or declining Japanese investment. The new economic relationship was favourable to both parties. Eventually the economic relationship based on the reinvestment of Japanese trade surpluses in the United States was turned into an economic alliance with mutual assistance between the governments of the two countries to maintain the relationship.

Plaza, Black Monday and the Japanese Bubble: Japanese investments in U.S. Treasuries during the first half of the 1980s appeared to be safe since the dollar was strong. However, the resulting large U.S. deficits on trade and current account caused political concern. In September 1985 a meeting of finance ministers and central bank directors of the G-5 (United States, Japan, West Germany, France and United Kingdom) at the Plaza Hotel in New York agreed on concerted central bank intervention to bring down the dollar to a more competitive level. A steep decline of the dollar followed, especially in relation to the yen, which soared from 260 to one dollar in March 1985 to 120 in 1988 (Funabashi 1989: 261-266).

Still the U.S. trade deficit with Japan and other East Asian countries (as well as the

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total U.S. trade deficit) continued to rise during 1985-7, and poor U.S. trade figures pushed the dollar further down. In October 1987 Japanese investors, seeing no end to the decline of the dollar, dumped large amounts of Treasuries and other dollar-denominated assets. On "Black Monday," 19 October 1987, the New York stock exchange collapsed. The stock exchange of Tokyo almost followed suit. Japan's Ministry of Finance responded by organising a buying campaign of U.S. securities by the four greatest Japanese institutional investors, rescuing the tottering stock exchanges in New York, Tokyo and the rest of the world (Murphy 1996: 194, 226-227). This was a first example of the operation of the U.S.–Japanese alliance to maintain the relation between the two parties.

Japanese current account surpluses did not spill over into growing central bank reserves in the early 1980s, as they were neutralised by capital exports to the United States and elsewhere. However during 1986-8, the growth of Japan's current account surpluses outpaced its capital export. There was a strong increase of central bank reserves, with a multiplier effect on domestic credit creation (Wade 2001: 198).

The Bank of Japan lowered its discount rate during 1986-87. This was a response to the problems caused by the strong yen after the Plaza Accord. Cheap credit should relieve immediate problems for Japanese exporters caused by a strong yen. It could also sustain purchases of Japanese stocks and assets in order to blow up their prices. That would expand the value of the collateral in stocks and real estate used by companies to obtain bank loans, so that they could finance the investments required for a major industrial restructuring. Japanese authorities also attempted to boost domestic consumption through the asset market boom in order to expand domestic markets for Japanese producers (Brenner 1998: 215-216; Murphy 1996: 199, 204, 217; Bevacqua 1998: 412). But this attempt to develop a new Japanese "model" was disturbed as the financial bubble went out of control.

Low Japanese interest rates boosted domestic asset speculation to much greater proportions than had originally been conceived by the Ministry of Finance. This went along with a shift of enterprise financing from indirect financing by banks to stock and bond market financing. A large proportion of the great corporations' new equity capital went into financial investment unrelated to their core activities. Meanwhile the banks, which had lost previous markets in financing the great corporations, turned to property financing (Whittaker & Kurosawa 1998: 763).

From December 1989 through August 1990 the Bank of Japan announced several discount rate increases in an attempt to cool down the Japanese economy. This coincided with reforms of Japanese banking. Japan had accepted to go along with the Bank of International Settlement (BIS) and the "Basle Accord" with a tightening of capital requirements in relation to the banks' assets (i.e. loans). In order to meet the new capital requirements, the banks would have to issue more shares and sell from their so-called "hidden assets" of property and assets, officially registered at prices far below current value. These sales along with interest rate increases triggered a price fall of the current value of assets and property, which served as the main collateral of bank loans. The banks were then forced to sell more assets, as the value of their collateral was depressed below BIS requirements. By September 1990 the Japanese financial system was caught

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in a vicious circle of falling asset prices and new selling of land, and issuing of new stocks by the banks that pushed asset values further down (Murphy 1996: 242-244; Whittaker & Kurosawa 1998: 763).

Liberal accounting standards allowed the banks to refinance *de facto* insolvent borrowers in the hope that property and asset prices would start to rise again. These measures prevented the latent crisis of bad debts from becoming manifest at the cost of enduring stagnation and growing levels of bad debt.

Japan's problems also influenced the U.S. economy as Japanese investors sold off their holdings in the United States to hurry the money back home to Japan. Declining Japanese purchases of long-term Treasury Bonds pushed up interest rates in the United States on new issues with an ensuing rise of long-term U.S. interest rates in the early 1990s (Murphy 1996: 272).

Declining Japanese investment in the United States led to a hardening of U.S. trade policy pressure. From 1993 the new Clinton administration pursued a 'result-oriented trade strategy' towards Japan directed by the U.S. Trade Representative Mickey Kantor, with specified targets for the reduction of Japan's trade surplus. A tough trade policy went along with efforts at 'talking down the dollar'. This reinforced the effect of Japanese sales of dollar-denominated assets and the exchange of the dollar proceeds for yen. In the result, the yen exchange rate once again increased from 125 to one dollar in January 1993 to 79/80 in March/April 1995 (Murphy 1996: 286-287).

Sustaining the U.S.–Japanese Alliance: Within the U.S. administration, Larry Summers, Treasury Secretary for International Affairs and Robert Rubin, Chairman of the Natonal Economic Council were growing sceptical about the tough U.S. economic strategy towards Japan. They feared that the weakening of the dollar would lead to a rise of long-term interest rates and inflation and were supported by Federal Reserve Chairman, Alan Greenspan (Sakakibara 2000: 170). In January 1995 Rubin became Secretary of the Treasury with Summers as his deputy. As the "result-oriented strategy" failed in the negotiations with Japan over automobile parts during spring 1995, Rubin and Summers assumed control over US trade policies and economic relations with Japan (Judis 1996; Judis 1997). It was agreed to respect a broad truce on trade conflicts between Japan and the United States along with policies to strengthen the dollar relatively to the yen.[1] The Bank of Japan would lower its interest rate and inject huge amounts of money into the banking system to boost stock markets, weaken the yen and allow the banks to use cheap money to purchase safe government bonds, realising a practically risk-free profit.

In August 1995 restrictions on foreign investments by Japanese financial institutions were liberalised. The Bank of Japan purchased huge amounts of Treasuries, helping to bring down the yen in the process. The United States, Japan and Germany intervened jointly to lower the yen. Eventually private Japanese investors were convinced and began to invest in U.S. Treasuries. From April 1995 to May 1997 the yen declined nearly 40%, from 80 to 127 yen to one dollar (Engelen 1996; Judis 1996; Sakakibara 2000: 179-180).

By 1996 the Japanese economy appeared to recover from its troubles. In the United

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States the manufacturing sector had improved its competitiveness and profitability, U.S. equity markets were growing and continuous appreciation of the dollar made U.S. securities attractive to international investors. Huge foreign purchases of U.S. Treasuries lowered the long-term interest rate and reinforced the equity market boom (Brenner, 2000: 16-19).

The U.S.–Japanese Alliance and East Asia's Boom and Bust

Major Japanese companies responded to the appreciation of the yen during 1985-95 by relocating core manufacturing export production to East Asia. Japanese manufacturing FDI in South Korea, Taiwan, Singapore, Hong Kong, Indonesia, China, Thailand, Malaysia, Indonesia and the Philippines nearly quadrupled from a little above US$ 600 million per year during 1981-6 to US$ 2,370 million in 1987, and continued to expand at a slower pace thereafter (Pempel 1997: 60).[2] A new wave of Japanese FDI followed during the 1990s. Japan's manufacturing direct investment in Asia (mainly East Asia) nearly tripled from US$ 2.9 billion in 1991 to US$ 8.1 billion in 1995. A major redirection of Japanese exports took place. Its export share to the United States fell from 40.2% in 1985 to 28.9% in 1995, while the Asian share increased from 18.8% to 43.6% (OECD 1995: 154-table K; 1996: 19-table 3, 229-table I).

The United States and other Western OECD countries were the main targets of the export of finished goods resulting from this build-up of regional manufacturing capacity through Japanese FDI. Japanese investments also stimulated inter-regional trade in components and parts with local subcontractors (frequently Japanese companies that followed with their mother companies abroad). However, Japanese companies did normally not move the production for Japanese markets abroad, only their production for regional markets and for export to third countries. Export of finished manufactured goods from East Asia to Japan was depressed, while the region's imports of key inputs from the Japanese workshop increased. In the result, regional trade deficits with Japan tended to increase (Bernard & Ravenhill 1995; Hatch & Yamamura 1996: chs. 1-2). The East Asian countries then relied on growing export markets in finished goods outside the region, especially in the United States; to cover their trade deficits with Japan.

Fuelling East Asia's Bubbles: The strong regional position of Japanese-controlled producer networks was not matched by monetary strength. Much of Japan's trade with her East Asian neighbours was conducted in dollars. Most regional currencies were tied to the dollar, not the yen. A dollar revaluation would therefore reduce East Asian export competitiveness. Japan's loose post-bubble monetary policies created surplus liquidity which "leaked out" to East Asia. Japanese banks lent heavily to Japanese subsidiaries and locally owned firms in the region as well as to local capitalists. Japan dominated foreign direct investment and lending to East Asia, while most of the foreign portfolio investment to the region came from the United States and Europe. Yet much of the funding of these portfolio investments initially came from Japan. International investors engaged in the so-called "yen carry" trade through borrowing at low interest rates in Japan, exchanging yen into dollar and re-investing throughout the world, including

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East Asia (Bevacqua 1998: p. 414-415). Most East Asian countries (with exceptions such as China and Taiwan) liberalised their capital accounts to attract these funds from the early 1990s.

The 1997 Asian Financial Crisis and Crisis Management

Net private foreign investment in South Korea, Indonesia, Malaysia, Thailand and the Philippines increased from US$ 40.5 billion in 1994 to 93.0 billion in 1996 (Radelet & Sachs 1998: appendix, table 1). As these inflows of foreign capital were exchanged for domestic currencies, the resulting demand wielded an upward pressure on local currency exchange rates and created an inflationary pressure. Domestic monetary authorities attempted to "sterilize" the inflationary impact of the increased supply of local money generated by these capital inflows through high interest rates and tight fiscal policies. High interest rates did, however, increase the differential between domestic and international interest rates. This encouraged more foreign borrowing and portfolio investment with further inflationary impact. The growth of money supply exceeded GDP growth. This resulted in excess liquidity, which in these economies with a high propensity to save and invest fuelled an extremely high level of investment. In result there was a rise in the level of "bad investment": various kinds of asset speculation and investment in industrial over-capacity (Bevacqua 1998: 416; Krugman 1999: 86; Wade 2000: 102).

East Asian foreign debt soared as a result of the inflow of loans. Large proportions of these loans were short-term (one year maturity or less) which were used to finance long-term investment, and renewed on a regular base. Much of the lending was not hedged against exchange rate changes, and growing foreign debt complicated the option a "soft landing" by abandoning the monetary pegs.

The defence lines of foreign reserves were growing increasingly thin. In Indonesia, Thailand and South Korea – all of whom would receive "rescue packages" from the IMF – short-term debt exceeded foreign reserves, and grew at a faster pace than these reserves (Radelet & Sachs 1998: appendix, table 3). Economic stability relied on the willingness of foreign lenders to renew short-term loans. As domestic bank lending was expanding at a fast pace, in part with financing from offshore borrowing, a foreign debt crisis would have strong domestic repercussions (Radelet & Sachs 1998: 14-15).

The declining yen affected regional competitiveness within higher end East Asian manufacturing directly involved in competition with Japanese products, especially in South Korea. Regional exporters were possibly also affected by the devaluation of the Mexican peso in 1995 and by growing Chinese competition. Declining export growth and growing current account deficits probably weakened foreign investor confidence, and the countries were becoming increasingly vulnerable to sudden capital outflows (Radelet & Sachs 1998: 14, appendix, table 6; Wade 2000: 103).

In May 1997 Japanese officials hinted that they were considering raising Japan's discount rate. This "threat" never materialised, but global investors who had been capitalising on the yen carry trade began to sell away Southeast Asian currencies. During May and June a number of major Thai financial institutions failed. By 2 July the Bank

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of Thailand was forced to float the baht (Fuerbringer 1997; Roubini 1997: entries "Early May," May 14-15, May 23, June 27, July 2).

As the Thai crisis evolved, foreign investors took a closer look at the huge amounts of outstanding debt, modest currency reserves and high asset prices in the region. Lenders refused to renew loans falling due. Large-scale dumping of assets and currencies pushed down asset values. Eventually the central banks decided to let their currencies float. The Philippines, Malaysia and Indonesia were forced to abandon their currency pegs (or quasi pegs) in July and August. In the next round attention shifted to Taiwan and Hong Kong despite their huge foreign reserves. Taiwan floated the NT dollar in October 1997, leading to a moderate fall of its value, while speculators failed to break the peg of the Hong Kong dollar. This was followed by an attack on the Korean *won*, which was floated in late November (Haggard 2000: 3).

A 1996 *net inflow* of private capital to South Korea, Thailand, Malaysia, Indonesia and the Philippines of US$ 93.0 billion changed to a US$ 12.1 billion *net outflow* in 1997 (Radelet & Sachs 1998: appendix, table 1). The countries were now caught in vicious circles of currency depreciation, increased foreign debt and collapse of domestic financial institutions. They then had to go to the IMF to ask for emergency credits. Stand-by agreements were signed by Thailand (5 August), Indonesia (31 October) and South Korea (4 December), while the Philippines extended a previous IMF agreement.

Wrong Medicine: The IMF insisted on closing financial institutions and enforcing strict regulatory standards. These policies enhanced the investor panic. The most serious case was the abrupt closing of sixteen commercial banks in Indonesia during autumn 1997, which caused a run, including the healthy banks. The IMF was also demanding policies of fiscal contraction and discount rate increase in a failed attempt to stabilise East Asian currencies. These pro-cyclical policies had a serious effect on regional markets and starved local business of credits. Zealous demands for budget surpluses, which the countries failed to meet and high interest rates that expanded the domestic debt weakened the foreign investors' confidence. The IMF attempted to act as an international lender of last resort, rather than mediating in the rescheduling of debt payment, as it had done in the Latin American crisis of the 1980s. Yet it failed to deliver on its promise. Emergency funds were sliced in tranches to be disbursed over the programme period, pending adjustment performance. These tranches were too small compared to the debt falling due to stem the panic, and disbursement was delayed by drawn-out, complicated negotiations (Radelet & Sachs 1998: 34-37).

The IMF was backed by the Clinton administration, which had developed a more pro-active, systematic and coherent foreign economic policy than its predecessors. The newly established "National Economic Council" co-ordinated U.S. government institutions involved in foreign economic policy-making. A number of "emerging markets," mainly in East Asia, were targeted for an offensive in foreign policy with increased emphasis on U.S. foreign investment interests. The administration actively supported multilateral agencies such as the IMF, OECD, WTO and APEC to promote international financial liberalisation. As these policy instruments, alliances and the strategy of targeting East Asia were in place, the administration was in a strong position

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to use the IMF to promote liberalisation of trade, finance and institutional reforms according to the standards of Anglo-Saxon capitalism. This would "open Asia" and allow for U.S. take-overs of credit-starved companies (Gowan 1999: ch. 5; Rothkopf: 1998).

AMF vs. IMF: Some East Asian countries, notably China, Taiwan, Hong Kong and Singapore had (after the mid-1980s) large balance of payment surpluses and foreign exchange reserves. Like Japan, they had invested much of this surplus in Treasuries, especially in the 1990s. Regional central banks were major purchasers of Treasuries. By the autumn of 1997 the Hong Kong central bank alone held about 60 billion of its foreign exchange reserves in U.S. securities, mainly in U.S. Treasuries, while the Bank of Japan held a 170 billion dollars worth of Treasuries (Engdahl 1997: 5; Gowan 1999: 52). During the September 1997 IMF/World Bank meeting in Hong Kong Chief Executive of the Hong Kong Monetary authority, Joseph Yam, publicly questioned this investment of the region's foreign reserves:

> Much of Asian savings, in particular official sector savings and private sector savings that have been institutionalised, are still invested in assets of OECD countries ... [M]ore than 80% of total Asian foreign exchange reserves amounting to US$ 600 billion are invested largely in North America and Europe ... It can be argued therefore that Asia is financing much of the budget deficit of developed economies, particularly the United States, but has to try hard to attract money back into the region through foreign investments. And the volatility of foreign portfolio investments has been a major cause of disruptions to the monetary and financial systems of the Asian economies. Some have even gone so far as to say that the Asian economies are providing the funding to hedge funds in non-Asian countries to play havoc with their currencies and financial markets (Yam 1997: 9-10).

But what would happen if East Asian central banks invested their reserves elsewhere? In August 1997 the ASEAN countries officially proposed a permanent regional Asian Monetary Fund (AMF) financed by the East Asian countries, but the real driving force was Japan's Ministry of Finance.[3] The AMF should operate at the regional level to maintain monetary stability. Its total funding would be about US$ 100 billion with Japan as the main contributor.

Tokyo had a strong interest in stabilising the financial systems of the region. In 1996 Japanese banks had US$ 265 billion in outstanding loans to East Asian countries, and US$ 83.9 billion to the three countries that eventually would have to be bailed out, Thailand, Indonesia and South Korea (Altback 1997: 5). A regional financial collapse would enhance Japan's bad debt problem. Tokyo did apparently not trust the IMF to solve these problems.

Japan floated the AMF idea during a G-7 meeting in Hong Kong in September 1997. The EU countries and the IMF immediately objected to the proposal. During the annual meeting of the IMF and the World Bank in Hong Kong in September/October U.S. Vice Secretary of the Treasury, Larry Summers, also strongly resisted the initiative.[4] In addition, China was reportedly resisting the AMF initiative as it was considered by Chinese authorities to constitute an effort to impose "yen hegemony" on East Asia (Rowley 2000a: 23).

The Western critics argued that two rivalling monetary funds would create problems

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of "moral hazard" by allowing for access to emergency funds without reform. From the U.S. Treasury's viewpoint the AMF would reduce the U.S. influence on the adjustment processes and impede liberalisation of trade and finance. Concern about East Asian holdings of Treasuries may also have been important. If regional central banks led by the Bank of Japan had sold out from their holdings of Treasuries to finance this costly operation, U.S. long-term interest rates would probably have soared (Johnson 1998: 658).

The Treasury attempted to accommodate the East Asian countries by assuming a greater responsibility for the emergency funds in return for an abandonment of the AMF plans. Japan withdrew from the AMF proposal and the other East Asian countries gradually followed suit. The AMF initiative was abandoned in November 1997. APEC's meeting in Vancouver 23-24 November backed IMF's leadership in the financial rescue operation. Shortly afterwards Tokyo announced that its contribution to the regional emergency fund would be "only" about US$ 20 billion (Rowley 1997).

The "contagion" from the Thai crisis could have been much reduced if the AMF had been in place by September/October 1997. The foreign investors' knowledge of a US$ 100 billion defence line ready to be issued on short notice might had calmed down the market in a period when regional currencies, except the Thai baht, still were relatively stable (Felix 1998). Instead, the Asian financial crisis reinforced the Japanese crisis in late 1997.

Reverse course in South Korea: The U.S. Treasury had a strong influence on the 4 December IMF package to South Korea. Regional officials of the IMF were reportedly willing to accept more lenient fiscal policies and interest rate policies, but the Treasury objected and was supported by IMF's director Michel Camdessus (Gowan 1999: 109). South Korea was required to undertake tough austerity policies and to deregulate foreign investment and trade, undertake corporate reform, reform its financial institutions, end government intervention in credit institution decisions, end public work programmes and remove employment protection (IMF 1997a; Wade & Venoroso 1998: 11-12; Gowan 1999: 111).

The emergency loans were too small and were issued too slowly to stem the panic. Soon after the emergency package the Korean *won* and asset prices once again declined. On 12 December Seoul began to hint that it was considering its position, including suspending debt payment. The Treasury and the IMF insisted that South Korea would have to complete promised reforms before a new tranche would be released in January 1998, but then the Japanese bad debt problem once again emerged.

In April 1997 Japan's Ministry of Finance introduced a new tax on consumption in an attempt to balance the budget and hold down long-term interest rates. As it coincided with the regional crisis, this tax had a depressing impact on the economy. During autumn 1997 a major bank and security firm collapsed. These developments enhanced the propensity of the ageing Japanese population to save, rather than spend, while gloomy industrialists held back their investment (Wade 2001: 199).

The U.S. Treasury now feared that a South Korean collapse would trigger a financial meltdown in Japan, followed by a Japanese panic sale of Treasuries.[5] Yet it was uncertain whether the IMF would be able to stem the tide simply through fast disbursement of

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unconditional loans, making available the so-called second line of defence of US$ 10 billion from the United States and other countries. Eventually the Treasury decided to speed up emergency credit disbursement in combination with an initiative to cajole South Korea's major foreign creditors to re-negotiate outstanding debt. A new IMF agreement with South Korea was signed on 24 December with a faster pace of loan disbursement (IMF 1997b).

By then America's Treasury had started to pressure U.S. commercial banks to roll over Korean short-term debt. The major debtor banks of Europe and Japan were mobilised by U.S. banks through the effective networks of international *haute finance*. An agreement to extend the maturity of Korean short-term debt held by 13 major international banks, accounting for 30-40% of the Korean outstanding short-term debt, was reached on 23 January (Euromoney 1998). This agreement was later extended to include smaller foreign creditors. In 1998 the IMF changed its focus on policy adjustment increasingly to the conversion of short-term debt into long-term debt. It no longer demanded the closing of financial institutions and accepted more relaxed fiscal policies (Radelet & Sachs 1998: 32; Tripathi 1998).

Restructuring of external debt stabilised the situation in South Korea and Thailand during 1998-9. The governments of South Korea and Malaysia were also taking effective measures to re-capitalise their banking system from mid-1998. Things were moving much more slowly in Indonesia where debt restructuring was delayed by decentralised foreign debt and political instability, little bank re-capitalisation took place.

In 1998 the current account balances of Indonesia, South Korea, Thailand and Malaysia improved substantially due to a major cut in imports caused by the crisis and austerity policies. Yet export was also contracting, although not as strongly as import. The countries were able to service their external debt, but declining domestic and foreign sale, import shortages and high interest rates exacerbated domestic debt problems. Regional demand was undercut by the crisis, and East Asia's dependence on U.S. export markets increased.

The situation improved in 1999, although the extent of "recovery" varied widely. In South Korea a GDP contraction of 5.8% in 1998 was turned into 10.7% growth in 1999, Indonesia turned from a catastrophic 13.7% contraction in 1998 to a pithy 0.5% growth in 1999. Malaysia and Thailand were in between these two extremes. Exports were now improving due to the delayed effects of currency depreciation, growing markets in the United States, strengthening of the yen and renewed growth in world electronics markets. Export growth interacted with rising stock markets, which improved the financial position of East Asian companies (IMF 2000: 69-70). The boom that unfolded in the stock market and, later in the U.S. economy played an important role in this recovery.

The U.S. Economy and East Asian Recovery: By the mid-1990s the U.S. manufacturing sector had improved its competitiveness and profitability substantially after a long period of stagnation and restructuring. This improvement stimulated growth in the U.S. equity market. The resulting surge of U.S. securities was further boosted by the Federal Reserve's lowering of the short-term interest rate, the Clinton administration's tight budget policy which held down inflation and the appreciation of the dollar from mid-

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1995. Huge foreign purchases of U.S. Treasuries lowered the interest rate of 30 year Treasury bonds. This cheapening of long-term borrowing enhanced the stock market boom. In 1998, the Asian financial crisis and its "contagion" led to a sharp contraction of U.S. exports to East Asia and Latin America along with intensified competition from East Asian imports cheapened by devaluation. Manufacturing exports and profits dipped. The U.S. economy now relied on expanding consumption boosted by asset market inflation (Brenner 2000: 16-20).

For some time international investors' "flight to quality" from East Asia and elsewhere sustained the U.S. asset market boom. However, by mid-1998 investors became wary about declining U.S. manufacturing profits. U.S. equity prices were depressed and some highly leveraged institutional investors, such as hedge fund Long Term Capital Management (LTCM), were caught in a liquidity squeeze. By late September 1998 the U.S. economy was close to the brink, and reduced U.S. demand threatened to reinforce the international crisis to the point of a full-scale world depression. The Federal Reserve responded with organising a bail-out of LTCM along with three successive reductions of the discount rate from late September through mid-November. These actions calmed uneasy investors by signalling support of the U.S. stock market and consumption boom (Brenner 2000: 20-23).

During 1999 U.S. stock markets resumed their strong growth. Rising share prices expanded household incomes and justified a borrowing spree based on the mortgage value of heavily inflated assets. GDP was growing 4.2%, and domestic consumption was growing even faster, expanding U.S. imports and promoting economic recovery throughout the world economy.

The U.S. interest rate reduction promoted a lowering of interest rates among G-7 countries. This allowed the East Asian countries to reduce their interest rates without triggering capital flight. Lowered interest rates dampened their domestic debt problems and sustained domestic demand (Jomo 2001: 287). Growing U.S. demand promoted the bounce-back of East Asian exports in 1999. Export to the United States from Malaysia, Thailand, the Philippines and South Korea expanded from US$ 63.0 billion in 1997 to 65.7 billion in 1998 and then leaped to 76.5 billion in 1999 (U.S. Census Bureau).

Challenging U.S. *Seigniorage* in East Asia

The surge of the U.S. economy in 1999 relied heavily on foreign inflows of capital, and, to a greater extent than previously, the capital inflow came from Europe, especially from the United Kingdom, while the Japanese share was modest. During 1997-2000 the net inflow of foreign capital into long-term U.S. securities was US$ 1,473 billion. Japan accounted for US$ 150 billion of this sum, or 10.2% of total foreign investment. In comparison, 607 billion (41.2%) came from the U.K. and 388 billion (26.4%) from all other European countries (Treasury Bulletin 2001: chart CM-C).[6]

The Japanese dollar demand has also been much reduced due to the weakness of Japanese banks. Previously the banks supplemented their dollar deposits from Japanese exporters with borrowing in offshore dollar markets. Their dollar demand helped to maintain a strong dollar. This arrangement was disturbed when international credit rating

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agencies lowered the ratings of Japanese banks so that they were prevented from raising dollar funds from non-Japanese sources. Reduced Japanese dollar demand pushed up the yen (Murphy 2000: 46-47). The economic foundation of the U.S.–Japanese alliance was thereby weakened. A weakening of economic ties has been accompanied by growing friction over trade policy issues.

During 1998 U.S. authorities criticised Japanese authorities' handling of the banking crisis as well as Japan's declining imports from the region. The United States enlisted support from the G-7 and East Asian countries for this critique. Japan came under strong pressure to expand spending and imports to promote regional recovery. At APEC's trade ministers' meeting in Kuala Lumpur in June 1998 an isolated Japan was pressured on "Early Voluntary Sector Liberalisation" within marine and forestry products. Eventually, the Japanese government responded by launching a massive economic stimulus and bank bailout package in October 1998 along with a regional aid initiative that diluted the pressure for trade liberalisation (Hughes 2000: 232-233).

The New Miyazawa Initiative: At a G-7 meeting in Washington in October 1998 Japan's Minister of Finance, Kiichi Miyazawa presented a US$ 30 billion aid plan in soft credits to Indonesia, Malaysia, the Philippines, Thailand and South Korea. Loans made under the plan would be denominated in yen and tied to projects involving Japanese companies. Tokyo managed to reduce resistance from Washington and the IMF by couching the idea in the context of a broader aid effort involving the G-7 countries, the IMF and the World Bank. Additional Japanese aid commitments followed in December 1998 and during spring 1999 (Vatikiotis with Hiebert 1998/99; Castellano 2000: 2). These Japanese funds provided an alternative source of emergency credits without the stringent conditions that accompanied IMF support.[7]

One indication of the success of the Miyazawa initiative was that East Asian countries in November 1998 declined to force the "Early Voluntary Sector Liberalisation" within marine and forestry products through APEC's agenda. The compromise solution was to defer a decision to the WTO (Hughes 2000: 246). But apart from trade policy, Tokyo's regional aid policy was also closely related to its efforts to internationalise the yen.

Regionalisation of the Yen: The yen has played a modest role in transactions outside the Japanese border as indicated by low and declining levels of international holdings of the yen, yen-denominated international bond issues and foreign exchange and trade transactions which involved the yen in the 1990s. Most of Japan's foreign trade is paid in dollar, rather than yen, not only in its trade with the United States, but also with third countries, and most of the foreign lending by Japanese financial institutions is dollar-denominated (Castellano 1999: 2-4; CFEOT 1999: appendices I.1-8). This has been a deliberate strategy from the side of the Ministry of Finance (MOF) to hold down the yen exchange rate. However, during the past years there have been worries about the weak position of the yen. Since mid-1998 the MOF has advocated the internationalisation of the yen. So far it has focused on promoting the yen in East Asia.

It is argued that an internationalisation of the yen will enhance the competitiveness of Japan's financial institutions. Japan's capital market will benefit from the yen

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investment by foreigners and the foreign exchange risks of trade and capital transactions will be reduced. These advantages are said to outweigh disadvantages, such as the appreciation of the yen that would result from its internationalisation (CFEOT 1998, 1999). The pressure to market Japan's government debt may have played an important role in these deliberations.

In Japan the MOF has managed the government debt through a controlled system of government bond purchases. The bonds have been sold to banks and security firms with no choice but to follow the MOF's request, and to the MOF's trust fund bureau, which is funded by the postal savings system. These measures have kept bond rates and long-term interest rates low. But the banking crisis has reduced the banks' capacity to purchase unprofitable bonds, and the postal saving system has become increasingly burdened. The government is then under pressure to turn to "real" bond markets at home and abroad. Bond rates and long-term interest rates must then be raised (Murphy 2000: 37-38, note 11, 50). Accordingly, the marketing of Japanese government securities internationally has become a main concern. By internationalising the yen Japan may be able to attract East Asian current account surpluses and seeing them invested in government bonds.

The euro was launched in 1999. The MOF predicted that it would become a strong competitor to the dollar with "Euroland" and Central and East Europe and Africa as its main area (CFEOT 1999: 4). A monetary triadisation of the world economy was imminent, but the yen was lagging behind in this process, because of its limited use in East Asia. The Asian crisis provided an opportunity for a change of the regional monetary regime as most East Asian countries unlinked their currencies from the dollar. MOF claimed that the pegging of regional currencies to the dollar had been a major cause of the 1997 crisis and recommended that East Asian currencies be tied to a basket consisting of the U.S. dollar, the euro, and the yen.

In a speech in April 1999 Miyazawa, repeated some of the issues raised by Hong Kong's Central Bank Director Yam one-and-a-half year earlier. East Asian savings were invested in the West, while the region relied on unstable capital flows from U.S. and European investors. These financial flows should be redirected to go within East Asia. Japan would play a key role at the centre of the regional financial flows, channelling aid and public investment to the region. Internationalisation of the yen, financial liberalisation, the creation of new financial instruments and tax rebates would attract regional yen holdings into private and public securities (Miyazawa 1999).

Regionalisation of the yen was also promoted through Japan's foreign aid. Loans made under the Miyazawa plan were denominated in yen. In addition, it has been discussed to use aid loans to promote yen-denominated exports from poor East Asian countries to Japan to shield these countries from uncertainties relating to the volatile yen/dollar exchange rate (Yahoo 2000).

Regional Currency Swaps: In May 2000 a new regional initiative for monetary co-operation was launched. A meeting of finance ministers in Chiang Mai agreed on a regional monetary co-operation arrangement which would include the ASEAN countries,

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Japan, South Korea and China. A network of bilateral currency swap arrangements should ensure that countries with significant currency reserves would lend foreign currency, mainly dollars, to defend the exchange rates of their neighbours. Japan was a driving force. The Miyazawa Plan of autumn 1998 had included bilateral currency swap agreements with South Korea with a loan quota of US$7.5 billion and with Malaysia with a loan quota of US$5 billion. These arrangements were to be extended under the Chiang Mai framework. According to one estimate at least US$ 20-40 billion would have to be committed by Japan and the other countries with large foreign reserves (Rowley 2000a: 23; Rowley 2000b: 11; Bello 2000; Foreign Press Center Japan, 2000).

In 1997 China had been unwilling to accept a Japanese-dominated AMF, yet the Chinese supported the Chiang Mai initiative. Apparently the two sides had sorted out their differences prior to the meeting and found a formula which smacked less of "yen hegemony." Japan also managed to get the question of greater regional use of the yen on the agenda of ASEAN+3. A meeting was scheduled in China in 2001 to discuss whether Asian exchange rates should be pegged to the dollar, to a "basket" of the dollar,

Conclusion

High U.S. consumption rates and ensuing low saving rates, reliance on foreign capital inflows to finance the investment-saving differential and trade and current account deficits have been mirrored by Japan's low consumption rate, high saving rate, large trade and current account surpluses and a growing saving-investment differential. In the early 1980s Japan became a main source of finance of the U.S. deficits, while Japanese exporters profited from access to U.S. markets.

During 1985-95 persistent trade deficits in the United States and trade surpluses in Japan created an upward pressure on the yen exchange rate relatively to the dollar. Japan's East Asian neighbours benefited as most of them tied their currencies to the dollar. East Asian export competitiveness was further strengthened by Japan's regionalisation of key manufacturing exports through foreign direct investments in response to the soaring yen. The result was a regional division of labour with Japan at its core, with increasingly dense intra-regional trade in manufacturing inputs. Still, the region relied heavily on outside markets in finished goods, especially in the United States.

From mid-1995 the situation became less favourable to East Asia as the United States and Japan agreed on co-operation to lower the yen exchange rate relatively to the dollar and Japan loosened its monetary policy. The export competitiveness of East Asian countries that tied their currencies to the dollar was weakened. Japan's loose monetary policy created huge amounts of liquidity in the international credit market, and much of this liquidity was exported to East Asia in the form of loans, portfolio investment and direct investment. This inflow fuelled over investment and made East Asia dependent on volatile financial flows. The ensuing 1997 East Asian crisis provided a golden opportunity for the Treasury to "open Asia" with the IMF as its battering ram.

Japan proposed to establish an "Asian Monetary Fund" (AMF) which should provide swift disbursement of emergency credits to countries with major foreign balance problems without strict conditionalities. This was a challenge to U.S. investment interests, but

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also to U.S. *seigniorage*. The initiative was blocked by the U.S. Treasury in November 1997. Japan has however forwarded new initiatives for regional co-operation since autumn 1998 aimed at regionalisation of the yen.

It remains to be seen whether a new regional financial and monetary order under Japanese leadership is feasible. This will require greater amounts of Japanese aid and loans than those committed so far. It may be hard to muster that money as the pressure for fiscal retrenchment on the heavily indebted Japanese government is increasing. The stability of the yen needed to ensure confidence among the investors, and the range and sophistication of Japanese financial instruments may also be insufficient to attract regional yen funds (Castellano 1999: 9). Internationalisation will induce an upward pressure on the yen at the cost of Japanese exporters. This may be politically unfeasible. Influential groups within the many-headed Japanese political-administrative establishment are likely to resist a new foreign economic policy which challenges the United States. If the Ministry of Finance can handle these difficulties, it will still have to convince the countries of the region to go along with a change of monetary arrangements with considerable learning costs and to calm Chinese suspicions about "yen hegemony." The greatest obstacle to the effort may however be the region's reliance on the U.S. economy.

It is frequently argued that hegemony in the international system of states in addition to coercive power and bargaining leverage also requires "Gramscian" consensual power. As argued by Giovanni Arrighi and Beverly Silver, the hegemony should supply solutions to serious international problems and rise above "the tyranny of small decisions" (Arrighi & Silver 1999: 26-31). In their world systemic context this refers to the ability to forward solutions to major problems within the capitalist world system in the interest of the states or their (ruling class) citizens. They claim that this quality of U.S. dominance now is gone. The new power of the United States in the 1980s and 1990s rests on its capacity "... to outcompete most other states in global financial markets. A new tyranny of small decisions has been resurrected, in the context of even more pressing system-level problems" (Arrighi & Silver 1999: 274).

To some extent this argument is well taken. During the Asian crisis, the Treasury's use of the IMF to promote U.S. investor interests demonstrated the darker side of the new U.S. strength and U.S. promotion of investment interests. However, Arrighi and Silver fail to take into account that monetary hegemony also has strengthened the U.S. ability to deliver very useful services to the world economy and East Asia.

When the regional crisis threatened to evolve into a system-wide crisis the Treasury – co-operating closely with Wall Street – initiated the re-negotiation of short-term debt in South Korea. The Federal Reserve's lowering of interest rates during autumn 1998 sustained the U.S. stock-and-consumption boom that helped East Asian efforts to export its way out of the crisis in 1999. As has been noted by Lester Thurow (1999) the Fed's lowering of the interest rate demonstrated the ability of the United States to use the freedom of monetary policy resulting from its *seigniorage* to serve the world economy with counter-cyclic demand stabilisation. In a longer time perspective *seigniorage* has allowed for two decades of huge U.S. current account deficits to the benefit of East Asian exports.

The U.S. role as East Asia's "consumer of last resort" may be the strongest

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impediment to the internationalisation of the yen. Regional arrangements that restrict capital flows from East Asia to the United States, and make the region more resistant to U.S. investor interests are likely to trigger retaliatory U.S. trade sanctions. East Asian governments may be unwilling to risk this kind of showdown. Large-scale regionalisation of the yen may require increased intra-regional trade in finished goods driven by Japanese imports. Yet Tokyo appears to be unwilling to take on this burden. As was noted above, the 1998 Miyazawa aid initiative may in part have been undertaken to dispel pressure on Japan for import liberalisation. As Japan's economic stagnation continues, it is even more unlikely that the country will serve as East Asia's consumer of finished goods.

In the end the East Asian governments may finally face a tough choice which they have been postponing for decades, thanks to the U.S. role as the region's "consumer of last resort." If export markets are shrinking, a new home-market oriented development strategy may be needed. This will require a change of deeply rooted policies and power relations oriented to constraining domestic consumption in order to promote saving and investment. This would be an extremely difficult task, requiring greater autonomy of East Asian states towards their upper classes than seen so far based on new class alliances which included East Asian lower classes.

Notes

1. John Judis (1996, 1997) and Hans Engelen (1996) both argue that Rubin and Summers had become that Japan was on the verge of a major financial crisis that would trigger large-scale dumping of Treasuries, push up U.S. long-term interest rates and halt U.S. recovery. Engelen claims that the Federal Reserve guaranteed a US$ 500 billion dollar credit line so that the Bank of Japan could absorb Treasuries in the event of large-scale dumping by Japanese investors. Eisuke Sakakibara does not mention any imminent Japanese financial crisis or U.S. guarantee in his discussion of the U.S. policy change. He argues that it came in response to U.S. economic overheating and a weak dollar, which along with the repercussions of the 1994/95 Mexican pesos crisis created inflationary pressures and pushed up long-term interest rates. See Sakakibara 2000: 173-176.
2. These and the following FDI figures underestimate the real investment level, as they do not include reinvestment of the affiliates' profit locally.
3. Surprisingly, the idea for an AMF financed by Japan probably came from IMF's director Michel Camdessus, who feared a shortage of funding for the rescue operations as the United States declined to contribute during the early phase of the crisis. Japan's Vice Finance Minister of International Affairs, Eisuke Sakakibara, took up the idea and presented it as his own. Camdessus later changed his position as the U.S. Treasury, which had not been informed, began to resist the AMF and promised more generous U.S. emergency funds. I thank Robert Wade for this information.
4. During the conference Japan's Eisuke Sakakibara called a meeting of senior Asian officials to discuss the AMF proposal without informing the U.S. representatives. As Summers learned about this meeting he entered the room where the Asians were sitting, sat down at the table and said, "Now, where were we?" See Wade (1999: 147, note 46).
5. Peter Gowan (1999: 112-113) argues that Wall Street was the main agent in this policy shift as it was lobbying the U.S. Treasury to change its tough position. The account by Jacob Weisberg (1998) alleges that the policy change took place within the Treasury without outside interference.
6. The composition of long-term foreign investment in the United States was changing during this period in response to the stock and bond market boom. A 1997 net foreign purchase of US$ 184 billion of Treasuries had changed to a US$ 53 billion net foreign sale in 2000. Net foreign investment in U.S. government corporations and private corporate stocks and bonds increased from 204 billion to 510 billion over the same period. See Treasury Bulletin (2001: Table CM-V-1).

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7. Christopher Hughes (2000: 222) suggests that the competition from the Miyazawa plan pressured the IMF to take a milder stance towards the East Asian countries.

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