

Chapter 5 Asian monetary integration

One of the questions for the twenty-first century is whether monetary integration analogous to the European Monetary Union (EMU) will happen in East Asia. With the dollar, the yen, and the single European currency floating against one another, other small open economies, like Malaysia, will be tempted to link up with one of the three. However, the linkage will only be possible if accompanied by radical changes in their institutional arrangements similar to those contemplated by the European Union (EU). The spread of capital mobility and political democratization will make it prohibitively difficult to peg exchange rates unilaterally. Pegging will require international cooperation, and effective cooperation will require measures akin to monetary integration.

5.1 Economic developments in Asia since 1980s

5.1.1 The Japanese economy

5.1.1.1 External credit flows

Let us begin our analysis by examining the external credit flows of Japan. Table 5.Appendix 1 shows the balance of payments of Japan between 1990 and 1996. The current account (line 1), which has recorded steady surpluses throughout the period, moved in parallel with the trade balance (line 3, balance on goods). The constant deficit in the balance on services (line 6) was offset by the steadily growing surplus in investment income (line 9).

Before looking at the financial account (line 18, [ΔFA position - ΔFD position]), we have to observe the changes in its components, i.e., the changes in foreign assets (line 40, increments to both short- and long-term FA position [ΔFA

position]) and in foreign debts (line 41, increments to both short- and long-term FD position [Δ FD position]). There seems to be no relationship between the changes in foreign assets and debts (line 40, 41). However, it should be noted that the current account surplus (line 1, the acquisition of short-term FA) could not fully finance the gross accumulation of FA position (line 40, the increment to foreign assets) except for the years of 1992 and 1993. Among the items in the financial account, the portfolio investment assets (line 23), particularly the debt securities (line 25), accounted for the major part of foreign investments. Although there are no statistics showing currency breakdown, it might be safely said that most of the portfolio investments have been denominated in dollars. That is, Japan, the largest creditor in the world, has accumulated her FA position mainly in the form of debt securities that were denominated in a foreign currency (i.e., dollar). It has been well known since the 1980s that Japanese banks and firms purchased huge amounts of US Treasury securities, and that they greatly contributed to the financing of the US budget deficit. Moreover, it should be noted that the current account surplus (line 1, the acquisition of short-term FA) was not enough to finance the gross accumulation of FA position (line 40, the increment to foreign assets), and that the gap was financed from abroad (line 41, the increment to foreign debts). There is no currency breakdown of foreign debts, but most of them are considered to be in US dollar denomination.

Table 5.Appendix 2 gives the changes to the international investment position of Japan between 1990 and 1996. In the portfolio structure of foreign assets (FA position, lines 2-12), the share of direct investment abroad (line 3) has been relatively low, and even falling (from 10.8% in 1990 to 9.7% in 1996). In contrast, the amount and share of the portfolio investment have been steadily growing throughout the period. In the same way, we can recognize foreign debts (FD position, lines 13-22) as

the liability profile (external financing resources) of Japan. Among the items of foreign debts, a relatively shorter-term FD position, mainly in the form of bank borrowing (line 21), has accounted for the majority of them. Although there is no currency breakdown, most of these foreign debts are considered to be denominated in US dollars as described earlier.

Japan is the largest net creditor country in the world. Japan is financing its economic development by a combination of the long-term FA position as shown in the matrix equation (3.10) of the foreign asset accumulation model, and the short-term FD position through short-term capital inflows as shown in the matrix equation (3.15):

$$X_{(FA)} = B \cdot FA_{(long-term)} \quad (3.10)$$

$$X_{(FD)} = B' \cdot FD_{(short-term)} \quad (3.15)$$

However, the financial structure of Japan is much more vulnerable than it appears, because both the long-term FA position in the matrix equation (3.10) and the short-term FD position in the matrix equation (3.15) are denominated mostly in US dollars. If American banks reduce their credit to Japanese banks and firms (i.e., a decrease in the short-term FD position for Japan), the Japanese economy would run short of US dollars to pay off debts. Even now, Japanese banks are suffering from the so-called “Japan premium,” meaning higher financing cost of funds in international interbank markets.

Moreover, within this financial structure, it is not possible for Japan to accumulate so great a short-term FD position in the form of trade deficits (or short-term capital inflows) as international liquidity supply to the rest of the world. With

regard only to the Japanese yen, the Bank of Japan can function as the lender of last resort. If the Japanese government really wants to make the yen a fully-fledged international currency, and to supply sufficient yen as international liquidity, we have to reform the current financial structure that is still dominated by the US dollar. In the Asian financial crisis, many Asian countries, including Malaysia, expressed the hope that Japan would contribute by absorbing exports from those countries suffering from economic downturn. However, if Asian countries want to earn US dollars, it is obvious that there is a limit to how much Japan can supply them.

5.1.1.2 Burst of the bubble economy

In addition to the vulnerable structure of external credit flows, Japan has been suffering for almost a decade from deflationary pressures caused by the reverse swing of the bubble economy. Table 5.Appendix 3 shows the changes in Japan's stock and land prices, by which we can observe the clear shape of the boom and bust of bubbles in asset prices. The peak in the stock market (lines 1-3) was recorded at the end of 1989, being followed by a peak in the property market (lines 4-6) in 1990.

In order to measure the magnitude of the reflexive effects of asset price changes on the whole economy, it might be appropriate to employ the domestic borrowing (asset inflation and deflation) model. We should once again recall the matrix equation (3.8), which stands for how much credit supply, i.e., the total value of both financial and real asset holdings $X_{(R)}$, by sector would be influenced by changes in property prices (R), and the matrix equation (3.14), which represents how much the total value of both financial and real asset holdings $X_{(S)}$, would be influenced by changes in mark-to-market values of corporate shares (S):

$$X_{(R)} = B \cdot R. (3.8)$$

$$X_{(S)} = B' \cdot S. (3.14)$$

Crashes in stock and property markets (R_{J} , S_{J}) not only destroy people's hopes for the future but also diminish wealth (i.e., the total value of both financial and real asset holdings X_{J}). Deflationary pressures caused by the reverse swing of asset prices seriously damaged the Japanese economy in the 1990s.

Unfortunately, in the same period, another source of deflation arose in the foreign exchange market. Table 5. Appendix 4 gives the changes in the net international investment position of Japan that are denominated in Japanese yen. We can observe the constant appreciation of the yen against the dollar (line 2), which diminishes the yen value growth of net foreign assets (line 1) despite the huge current account surplus in dollar denomination. Furthermore, since the majority are denominated in dollars, the yen value of net foreign assets (line 1, FA position) even recorded a slight decrease in 1994.

It might be appropriate to explain this type of deflationary process by recalling the matrix equation (3.10) of the foreign asset accumulation model:

$$X_{(FA)} = B \cdot FA. (3.10)$$

Under the circumstances that most of a FA position is denominated in US dollars, the appreciation of the yen automatically entails a depreciation in the value of a FA position denominated in yen (FA_{J}). It will lead to deflationary pressure on the wealth accumulation process (i.e., the total value of both financial and real asset holdings X_{J}). This is therefore yet another vulnerability in the Japanese economy.

5.1.2 Asian financial crisis

The Imperial Circle itself is not a problem for other countries. However, it will give rise to serious frictions because a benign circle for the United States, which remains at the center of the present international financial system, has its negative side—the vicious circle for other countries at the periphery. The Asian financial crisis that erupted in mid-1997 is one of the most typical cases of the vicious circle. In a sense, we could see the Asian financial crisis as the boom and bust of a bubble economy, which had proliferated through the Imperial Circle of the United States. That is, the huge scale of external debts of the United States were held by the rest of the world in the form of US treasury bills and more or less liquid financial assets. In Asian countries in particular, which sought economic development by way of the mixed financing models of domestic saving and foreign asset accumulation, we can see that the accumulated foreign assets in US dollar denomination in those countries functioned as the monetization of the foreign debts of the United States.

5.1.2.1 Case 1: Thailand and Indonesia

Even today, we cannot see signs of recovery from the crisis. It was distinctive in the sense of its suddenness and contagion effects throughout the region. Although there are some differences in the levels of economic stagnation and damage, we can attribute characteristics common to all such countries as the bust of bubble phenomena and the failure of external debt management. First, let us start with the cases of Thailand and Indonesia.

During the early 1990s, although Thailand and Indonesia maintained high rates of gross national savings, a large part of their funds were wasted on investments in low productive sectors and conspicuous consumption. The deterioration of current account deficits reflects the misallocation of resources in macroeconomic

management. The vigorous demands for credit to maintain high growth were financed through foreign borrowing, almost all of which was short-term financial assets in US dollar denomination. Rapid, and the huge scale of, capital inflows enabled high economic growth to be sustained, but before long, it turned out to be only an example of the bubble phenomenon. The foreign borrowing (capital import) model of economic development is suitable for application to the situations of these two countries. We can recall the matrix equation (3.15) in order to follow the processes of the boom and bust of the bubble economy in Thailand and Indonesia:

$$X_{(FD)} = B' \cdot FD. (3.15)$$

The crash came on July 2, 1997. When accumulated economic imbalances reached a fatal level, confidence in both the Thai baht and the government was lost, and turmoil swiftly spread to the region. The rapid and huge outflows of short-term capital caused the reverse spiral of economic contraction, as the matrix equation (3.15) has shown. The Thai and Indonesian governments immediately fell short of international liquidity, and there was no alternative other than assistance from the IMF and international financial community.

5.1.2.2 Case 2: Malaysia

For the second case, we will look at Malaysia, because it went through a somewhat different course of financial crisis. In the early 1990s, as in Thailand and Indonesia, Malaysia enjoyed a high gross national saving rate due to ingenious financial schemes such as the Employees' Provident Fund (EPF), Permodalan Nasional Berhad (PNB), and other public institutions for saving promotion. In spite of this, many more funds

were expended on investments such as property projects and securities markets, and conspicuous consumption.

Even under the pressure of strong demand for credit to sustain the extremely high pace of economic growth, the Malaysian authorities were adept enough to maintain economic soundness and prudence by limiting the rapid and large-scale inflows of short-term capital. Instead, they resorted to domestic borrowing. We should recall the matrix equations (3.8) and (3.14), which represent the domestic borrowing (asset inflation) model of economic development as follows:

$$X_{(R)} = B \cdot R.(3.8)$$

$$X_{(S)} = B' \cdot S.(3.14)$$

A high level of domestic borrowing gave rise to asset inflation in Malaysia. From the standpoint of spiral reflexivity, it is clear that the high growth of credit supply logically and inevitably leads to the high growth of property prices and corporate shares, i.e., the bubble phenomenon in asset markets, which cannot last forever. Malaysia is now suffering from the burst of its asset bubble, which will subsequently lead to huge non-performing loans and the vulnerability of the banking system as a whole.

5.2 Technical background to monetary integration in Asia

5.2.1 Future options for regional integration

In order to escape this vulnerable financial structure, there is no choice but to reduce the degree of dependence on the United States. However, in Asia, regional integration has been proceeding more slowly than in other parts of the world, reflecting both historical tensions which exist between Japan and the other countries, and the absence of an institutional initiative, such as the European Union (EU), to ease them. If we look at the challenges of European Monetary Union (EMU), it is natural, and even necessary, for us to consider the future possibilities for the monetary integration of Asia. In particular, the experience of the Asian financial crisis reminded us of the risks of excessive dependence on the US dollar and current monetary system that could not be controlled by ourselves.

We can classify the various levels of regional integration roughly into three categories: (a) commercial and/or economic integration,¹ (b) monetary integration, and (c) political integration. The interrelationships between the three levels of integration are less clear, but we may safely say that “monetary integration is not essential to realize the efficiency gains from economic integration, and political integration is not essential to derive efficiency gains from monetary integration” (Eichengreen, 1996b, p. 21). Asian countries have neither created a single market as part of commercial integration, nor prepared for exchange rate target zones like the European Monetary System (EMS). However, from the three possible levels of

¹ We use the term ‘commercial integration’ to refer to movement towards the establishment of free-trade areas and customs unions, and ‘economic integration’ to denote more far-reaching initiatives, such as the European Union’s effort to establish an integrated internal market both in goods and services and in factors of production. See Eichengreen, 1996b, p. 1.

regional integration, Asian countries are now facing the pressing and inevitable question whether there should be the monetary integration in the region.

Although we can discuss monetary integration independently from the other two, we should know that monetary integration itself requires a number of developmental stages to achieve a perfect style of monetary union, which banishes exchange rate volatility by abolishing the exchange rate itself. We understand that it would not be possible to establish a perfect style of monetary union in Asia right at this time, but we can explore here the various options for the international monetary arrangements required to achieve the same goal of escaping from the vicious circle of dependency on the US dollar.

5.2.2 Variations of exchange rate systems

We should first review the *pros* and *cons* of both the floating and pegged exchange rate systems,² before discussing optimum currency areas.

5.2.2.1 Floating exchange rates

The simplest option for exchange rate policy is 'freely floating' rates. This arrangement is an artificially limited case, and therefore a benchmark against which other options can be gauged. In contrast, under the 'managed floating system,' exchange rates are allowed to fluctuate but subject to intervention. Monetary authorities are expected to employ effective monetary policies not only by changing money supply and interest rates but also by intervening in exchange rates to attain both domestic stability (in prices, production, employment, etc.) and sustainable

² For a more theoretical explanation, see Kawai, 1994, pp. 313-325; Eichengreen, 1994, pp. 9-28.

external balances (in both current and capital accounts).³ The point is whether it is possible for monetary authorities to alter the exchange rate without changing the money supply. If domestic and foreign interest-bearing assets are perfect substitutes, capital is mobile, and sterilized intervention (equivalent to a swap of domestic and foreign bonds) conveys no information about future policies, then the only way in which the authorities can affect the exchange rate is by altering the money supply. It does not mean that exchange rate management is impossible, but other objectives of monetary policy have to be sacrificed in order to attain an exchange rate target. In contrast, if domestic and foreign assets are imperfect substitutes, then an open market operation (e.g., a sale of foreign bonds for domestic currency) that is sterilized (through a purchase of domestic bonds for domestic currency) can alter the exchange rate (one of the relative prices in financial markets that equates asset supplies with stock demands) without requiring a change in the money supply.

5.2.2.2 Pegged exchange rates

Pegged exchange rates typically entail a margin within which the rate is allowed to fluctuate and circumstances under which the peg may be altered or abandoned. Under the 'pegged-but-adjustable exchange rate system,' countries have little autonomy in their monetary policy to change their own money supplies or domestic interest rates without influencing the fixed exchange rates. The same point applies to 'crawling pegs,' under which monetary authorities announce in advance not a level for the exchange rate but a path along which the rate can move.

³ On the other hand, under the floating exchange rate system, fiscal policy is supposed to lose effectiveness to some extent, because of the crowding-out effect through the changes in interest rates. See Kawai, 1994, pp. 174-185, 222-234.

An 'exchange rate band' or 'target zone' attempts to restrict the rate within a particular spread. The attraction of target zones is that they promise to reconcile exchange rate stability with domestic policy autonomy. The rate is allowed to fluctuate only within the band, limiting volatility. However, even this limited flexibility provides some autonomy for monetary policy. A narrow target zone with periodic realignments bears a strong resemblance to a pegged-but-adjustable exchange rate system. A target zone thus combines elements of pegged and floating exchange rates.

5.2.3 Optimum currency areas

5.2.3.1 A currency area and its optimum conditions

An optimum currency area refers to "the 'optimum' geographical domain having as a general means of payments either a single common currency or several currencies whose exchange values are immutably pegged to one another with unlimited convertibility for both current and capital transactions, but whose exchange rates fluctuate in unison against the rest of the world. 'Optimum' is defined in terms of the macroeconomic goal of maintaining internal and external balance. Internal balance is achieved at the optimal trade off point between inflation and unemployment (if such a tradeoff really exists), and external balance involves both intra-area and inter-area balance of payments equilibrium" (Kawai, 1987, p. 740; 1994, p. 334). Accordingly, the benefit from establishing a currency area is the improved usefulness of currency with no exchange rate volatility, while the significant cost is that the authorities, who participate in the currency area, are obliged to give up the means of managing their own monetary policies.

In theories of optimum currency areas, the central question has been how is it possible to attain both internal stability (in prices, production, employment, etc.) and external sustainability (in both current and capital accounts) simultaneously but without monetary policies. The crucial factor is the flexibility of wages and prices to adjust the fundamental disequilibrium in both internal and external balances. If wages and prices in some countries can change flexibly enough, they can make adjustments (in redistribution of both productive factors and final goods) without influencing employment, even in the case of asymmetric shocks. These countries should form a currency area and adopt a system of pegged rates or single currency to enhance the usefulness of the common currency.

Moreover, theories on optimum currency areas have suggested a variety of optimum conditions even without flexibility in wages and prices. They emphasize or combine some conditions of flexibility in productive factors (for instance, capital movement, labor mobility), financial development and integration, fiscal flexibility, symmetry of shocks, macroeconomic policy preference and coordination, openness and specialization of the economy, regional economic interdependence, and the like (Kawai, 1994, pp. 226-239; Eichengreen, 1994, pp. 79-87). In short, if it could fully substitute other conditions for the flexibility in wages and prices to make adjustments, the participating countries in the currency area could absorb asymmetric shocks inside the region. Considering the wide and rapid progress of financial deepening in the world of international finance, we could utilize free and smooth capital flows (as factor mobility) to make adjustments in both domestic and external balances. That is, if there are no capital controls within the currency area, and accordingly free and smooth capital flows are guaranteed, it would be the best alternative to wage and price

flexibility. In contrast, capital controls against those outside the currency area may be justified in order to exclude unwelcome attacks on regional currencies.

From the standpoint of the 3-dimensional T-account matrices model, an optimum currency area means the convergence of the stack of plural matrices into the one integrated matrix. For adjustments of disequilibrium inside the currency area, free and smooth capital flows (as factor mobility) will contribute towards reducing wage and labor market inflexibility. On the other hand, capital controls against those outside the currency area will stabilize the mark-to-market value of foreign assets and debts that are determined through foreign exchange cross-rates.

5.2.3.2 Application to Asia

Economic integration in Asia has been accelerating in trade and investment since the 1980s. As a proportion of total East Asian trade (exports plus imports) with the world, intra-East Asian trade has risen from 33% in 1980 to 39.7% in 1990, and to 49.5% in 1994. With regard to foreign direct investment (FDI), the degree of East Asian interdependence is also remarkable. In 1989, the combined total outward FDI of Taiwan, South Korea, Hong Kong, Singapore and Japan represented 60% of the investment received by Indonesia, the Philippines, Thailand and Malaysia (Noordin, 1996, p. 8).

We should note that it would be possible to establish systems of pegged-but-adjustable rates or target zones as a first step towards future monetary integration in Asia. Autonomy of action in monetary policy will be restricted but at least left to its member countries. Systems of exchange rate target zones with a reference range or bandwidth such as the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) will be worthy as a point of reference. In addition, the establishment of

a multilateral financial institution such as an “Asian Monetary Fund” (AMF),⁴ which will be expected to work as the lender of last resort for regional financial stability, will also be needed. The AMF should be in charge of exchange control with those outside the region and the provision of international liquidity on the lines of Keynes plan for an international clearing union. Japan could contribute to the establishment of an AMF by changing her FA position from portfolio investment in US dollars to the investment of creditor balance with the AMF, which will reduce the degree of dependence on the US dollar. The functions of the AMF should also include mutual surveillance of member countries and macroeconomic policy recommendations.

In order to examine the possibility of Asian monetary integration into reality, we should here again utilize the analytical tools of four financing models of economic development: (a) the domestic asset accumulation (domestic savings) model, (b) the domestic borrowing (asset inflation) model, (c) the foreign asset accumulation (import driven) model, and (d) the foreign borrowing (capital import) model. First, the domestic asset accumulation (domestic savings) model (a), i.e., the matrix equation $\mathbf{X}_{(w)} = \mathbf{B}' \cdot \mathbf{W}$ (3.13), appropriately shows the processes of economic development financed by the high domestic saving rates that are generally observed in Asian countries. Second, previously shown in this chapter, we explored the processes of the boom and bust of bubble economy in Japan and Malaysia from the perspective of the domestic borrowing (asset inflation) model (b), i.e., the matrix equations $\mathbf{X}_{(R)} = \mathbf{B} \cdot \mathbf{R}$ (3.8) and $\mathbf{X}_{(S)} = \mathbf{B}' \cdot \mathbf{S}$ (3.14). In order to control money and credit flows prudently, the AMF will serve for regional surveillance and enhanced cooperation in strengthening domestic financial systems and regulatory capacities. The AMF member countries will be expected to exert peer pressure on each other, to promote policy dialogue and

⁴ For reference, see Tanioka, 1992b.

mutual understanding. Third, based on the combined models of foreign asset and/or debt financing, i.e., (c) the foreign asset accumulation (import driven) model: $X_{(FA)} = B \cdot FA$ (3.10) and (d) the foreign borrowing (capital import) model: $X_{(FD)} = B' \cdot FD$ (3.15), we can recognize that Japan and the other Asian countries are complementary to each other for their stable economic development. That is, on one hand, Japan is financing its economic development by a combination of the long-term FA position as shown in the matrix equation $X_{(FA)} = B \cdot FA_{(long-term)}$ (3.10), and the short-term FD position through short-term capital inflows as shown in the matrix equation $X_{(FD)} = B' \cdot FD_{(short-term)}$ (3.15). If the long-term FA position of Japan is denominated in Asian common currency, the supply of international liquidity (i.e., short-term FD, which is also denominated in Asian common currency) to her debtor countries through the current account deficit (especially in the trade balance) will be facilitated. On the other hand, the economic development of the other Asian countries will be financed by a complementary combination of the short-term FA position through a trade surplus with Japan as shown in the matrix equation $X_{(FA)} = B \cdot FA_{(short-term)}$ (3.10), and the long-term FD position in the form of capital imports from Japan as shown in the matrix equation $X_{(FD)} = B' \cdot FD_{(long-term)}$ (3.15).

As a final point, it should be noted that it would be possible to form an optimum currency area in Asia on condition that controls on capital movements were removed inside the currency area. The price flexibility and/or geographical mobility of productive factors are essential for the adjustment of fundamental disequilibrium in a currency area. In particular, with regard to productive factors, if only capital can freely move irrespective of borders within the currency area, a smooth adjustment can be made. In contrast, capital controls against those outside the currency area may be justified to exclude unwelcome attacks on regional currencies.

As for the establishment of the AMF, Shinohara Hajime, Managing Director of the Institute for International Monetary Affairs, propounded an institutional setting in his studies as follows (1999a; 1999b):

a. Organization

I believe the Asian Monetary Fund should be established as an independently institutionalized body with its own full time staff, which should come from the nationalities of member countries. Participation is a political issue and member countries will be decided by the countries involved. However, reflecting the type of responsibilities the organization will be entrusted with, the members will be Asian economies that possess relatively well developed monetary markets, such as the ASEAN countries, the Asian NIEs, Oceanic countries, China, and Japan.

b. Functions . . .

First is to enhance policy dialogue among the participating countries. The Manila Framework can be followed in its present form. The AMF should provide a venue for exchanges of opinion on macroeconomic situations and foreign exchange and monetary market trends, and for enhancing dialogue on respective policies and trends in the funds and foreign exchange markets of those countries. Exchanges of opinion and deeper understanding among member countries will enable them to mutually apply peer pressure when necessary. . . .

The second function is crisis management, which function must be backed by the capability to mobilize funds. There are two possible ways of fund raising. First is borrowing from member countries, a mechanism similar to GAB (NAB) of the IMF. However, the mechanism must operate much faster than GAB, for which some means should be devised. The other is fund mobilization on the markets in a broad sense. A mechanism must be devised to raise funds in the market backed by the foreign reserves of the member countries as collateral, or by guarantee contract or some form of callable subscriptions to its capital by member countries. Some means must be formulated to raise substantial funds quickly from the markets. . . .

The third function this organization must have is to become the core of various structures aimed at preventing the resurgence of a monetary crisis. One way is to provide a forum for the monetary authorities of member countries to coordinate their policies. An Asian BIS was discussed at one point, and I believe it quite possible for the Asian Monetary Fund to have the same principal functions. Information and the experiences of the monetary authorities of member countries will be shared in this organization, and there will be coordination in the supervision of financial institutions and the monetary system.

[c. Further steps]

The next step is to establish a settlement system for the currencies of member countries. Another lesson of the current crisis is to enhance the use of the currencies of the region. There are many benefits to this policy, and I believe it will be beneficial to have the netting system affiliated to or part of the Asian Monetary Fund, to carry out a smooth settlement among these currencies.

The third step is to establish an economic research institute. I spoke earlier about the re-building of the Asian model and applying Asian virtues. It is necessary to have a strong theoretical backbone to this thinking and that the new Asian Monetary Fund operate[s] on these new theories. (Shinohara, 1999a, chap. "Asian Monetary Fund")

5.2.4 Geographical sphere of regional integration

In East Asia, there are a number of regional organizations with different functions and geographical spheres, some of which overlap and others which do not. Here lies the challenge to promote regional integration in Asia. Around a decade ago in the late 1980s, not only the formation of European Union (EU)⁵ but also the imminent formation of the North American Free Trade Agreement (NAFTA)⁶ and Asia-Pacific Economic Cooperation (APEC)⁷ was clear from the initiatives of the United States and Australia. It was thus natural that in the minds of many Asian political leaders the question was whether these organizations were adequate for the needs of the dynamically developing East Asian economies. If North American countries can form their own free trade agreement, why can't East Asian economies form a corresponding free trade agreement, why can't East Asian countries promote freer trade and investment policies among themselves? This has led to two proposals.

⁵ The Single European Act was adopted in 1987, which declared their eventual intention to create a unified, free trade market in Western Europe. Measures implementing this declaration began in 1990 with the lifting of exchange controls and the elimination of barriers to Europe wide banking, insurance, securities, and other financial services. The Maastricht Treaty, which was approved in 1991, established a European Union (EU) and further advanced the economic processes of establishing the European Monetary Institute and of creating a vast free trade zone, i.e., the European Economic Area (EEA).

⁶ Trade pact signed in 1992 that would gradually eliminate most tariffs and other trade barriers on products and services passing between the United States, Canada, and Mexico. The pact would effectively create a free-trade bloc among the three largest countries of North America.

⁷ The forum formed in 1989 to advance Asia-Pacific economic dynamism and sense of community. Today, APEC consists of 18 major economies of the region.

namely, the ASEAN Free Trade Area (AFTA) and the East Asian Economic Caucus (EAEC). They offer a response similar to the EU and NAFTA, and show dissatisfaction with APEC as the lone countervailing force to the EU and NAFTA on behalf of East Asian countries.

5.2.4.1 ASEAN and its major initiatives

The Association of Southeast Asian Nations (ASEAN)* was established on August 8, 1967 in Bangkok, with the signing of the “Bangkok Declaration” by the five original Member Countries, namely Indonesia, Malaysia, the Philippines, Singapore and Thailand. The Bangkok Declaration united the ASEAN Member Countries in three main objectives: to promote the economic, social and cultural development of the region through cooperative programs; to safeguard the political and economic stability of the region against big power rivalry; and to serve as a forum for the resolution of intra-regional differences. Later on January 8, 1984, Brunei Darussalam joined the Association. Vietnam became the seventh member of ASEAN on July 28, 1995. Laos and Myanmar were admitted into ASEAN on July 23, 1997.

The ASEAN Regional Forum (ARF) was established in 1994 to serve as a multilateral consultative forum aimed at promoting preventive diplomacy and confidence building among the states in the Asia-Pacific region. The Forum consists of the nine ASEAN Member Countries, Cambodia as an Observer, ten Dialogue Partners, and Papua New Guinea as a Special Observer. The ARF agreed on a three-stage approach to cooperation, namely, (i) promotion of confidence building, (ii) development of preventive diplomacy and (iii) elaboration of approaches to conflicts.

* The following information on the ASEAN can be retrieved from the web site of the ASEAN Secretariat <<http://www.aseansec.org/>>.

The most significant step in enhancing trade in ASEAN was the decision of the Fourth ASEAN Summit in 1992 to establish the ASEAN Free Trade Area (AFTA) by the year 2008. In September 1994, ASEAN Member Countries agreed to accelerate the establishment of AFTA by reducing the initial time frame of 15 years to 10 years. The primary objective of AFTA was to enhance ASEAN's position as a competitive production base geared towards servicing the global market. This was to be achieved through the expansion of intra-ASEAN trade, making possible both greater specialization and economies of scale. It was also to be achieved through the inflow of more foreign direct investment who would be attracted by the emergence of a single ASEAN market. The 'Common Effective Preferential Tariff (CEPT)' Scheme, which is the main mechanism for realizing AFTA, was launched on January 1, 1993. The CEPT Scheme covers both manufactured and agricultural products. The product coverage in the CEPT Scheme is the most comprehensive ever in any ASEAN trading arrangement.

Between 1993-1995, intra-ASEAN exports grew from \$42.77 billion to \$68.83 billion. This represents an average growth rate of 30.46% per annum, significantly higher than the average 20% growth of total ASEAN exports. The share of intra-ASEAN exports to total exports inched up to 22% in 1995. In 1995, nearly 59% of intra-ASEAN exports was made up of exports of machinery and electrical appliances reflecting the extent of intra-industry trade. Other major sectors traded within the region are mineral products (petroleum), base metals, chemicals and plastics.

5.2.4.2 EAEC

Just after the breakdown of the Uruguay Round negotiations in Brussels in December 1990, the Prime Minister of Malaysia, Dr. Mahathir bin Mohamad, suggested the formation of what he called the "East Asian Economic Group" (EAEG). ASEAN

countries subsequently set up a working group to study the concept, and in October 1991, Indonesia put forward a proposal for an "East Asian Economic Caucus" (EAEC) at the ASEAN Economic Ministers' Meeting held in Kuala Lumpur (Noordin, 1994, pp. 1-21).

The EAEC proposal calls for "consultations" between East Asian countries (ASEAN member countries, China, Japan, and South Korea), but these consultations and the future affairs of the EAEC will eventually depend on the EAEC participants. As for the purpose of these consultations, it is clear that the proponents of the EAEC see it as having both an internal dimension and an external dimension. Internally, it is envisaged that these consultations would contribute to expanding economic cooperation among the region's economies. The external dimension is very much focussed on the promotion of "an open and free global trading system." Mahathir repeatedly stated publicly that East Asia should not become a trading bloc but should be coalition for the success of the Uruguay Round.

At the ASEAN Ministerial Meeting held in Singapore in July 1993, the Foreign Ministers agreed that "the ASEAN Economic Ministers Meeting would be the appropriate body to provide support and direction for the EAEC, taking into account that the prospective members of EAEC are also members of APEC. . . . Pursuant to this, they agreed that the EAEC is a caucus within APEC." In 1994, while the Korean and Chinese governments expressed their firm support, the Japanese government gave support only to the placement of the EAEC within the framework of APEC. This support from Northeast Asian countries to the EAEC (even operating within APEC) seems to suggest two things. One is the natural extension of AFTA to include the members of EAEC and to try to build a new AFTA: Asian Free Trade

Agreement. Another is the enlargement of the functions of the EAEC to include international monetary affairs.

Recently, Mahathir restated his belief in the EAEC as a regional forum as follows:

I believe that all conflicts should be resolved around the table. That is why we should support the East Asia Economic Caucus (EAEC). Through the caucus we can resolve problems between us and discuss common problems facing the region. Europe has the European Union and North America has the North American Free Trade Agreement. We accept them. Why cannot they accept the East Asia Economic Caucus. Japan should rethink the EAEC. It should not be led into believing that it is going to be a threat to countries outside the region. (Mahathir, 1999, par. 27)

5.2.4.3 The missing link: Asian monetary integration

As shown above, multi-layered regional regimes have been constituted in various policy areas and they are strengthening integrated policy coordination in the region. However, the Asian financial crisis since the second half of 1997 revealed that we have very few measures to tackle such serious problems that are common to the region as a whole.

Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, delivered a speech titled "Causes of and solutions to the recent financial turmoil in the Asian region" (1999), in which he put forward a concept of Asian common currency for the regional monetary system in the future decades:

The recent introduction of the Euro will, in my view, radically change the way in which the global currency system works and has important implications for our own region. Until now, the U.S. dollar has played a dominant role in world trade quite out of proportion to the size of U.S. trade flows. This is particularly the case in Asia, where, despite Japan's strong commercial and financial influence, the yen has failed to play a major role as an anchor. While the Hong Kong dollar has been well served by its solid link to the U.S. dollar, less solid commitments to the dollar in other economies have proved to be expensive and disruptive. Thus, despite the pre-eminence of the U.S. dollar, the Asian region as a whole lacks a viable exchange rate anchor. This is a problem that has to be addressed, and we would do well to look into it, especially once the current crisis has subsided. We have benefited from our own peg to the U.S.

dollar, and other countries could similarly benefit from links to key currencies when they are in a strong enough position to make such links fully credible.

The introduction of the euro will challenge the supremacy of the dollar elsewhere in other hemispheres by introducing a second currency pole in the global currency system. It will also offer another solid investment option to Asian central banks. The time may come when we might want to consider the possibility of our own Asian currency - perhaps something along the lines of an Asian Currency Unit - that would form an anchor currency for our region. This is a long-term possibility, but it would have the advantage of reflecting the strong trade linkages in the region. It would also create bigger and more liquid markets that are less susceptible to manipulation. It would also help address problems of intermediating financial resources within Asia. At present, Asia's central banks invest massive amounts in foreign securities, particularly U.S. dollar assets, only to see volatile funds flow back to the region from overseas markets. By investing reserves directly in Asian financial assets, this type of costly and unstable recycling through developed markets could be reduced.

There are, of course, many obstacles in the way of creating an Asian Currency Unit. The various economies of the region operate under widely differing economic regimes, and are at different stages of development. An institution would be necessary to administer the system, and the politics involved would doubtless be very complex. But I believe that now is a useful time to raise this topic for discussion, at least at an intellectual level: successful implementation in the longer term would go a long way towards addressing the currency instability we have seen in the region over the last year and a half. After all, it has taken the more homogeneous Europe fifty years to bring the euro into existence. (Yam, 1999, chap. "Solutions")

A regional regime for international finance has been the missing link in the move towards a more integrated community in Asia. We need to explore further the feasibility of, and rationale for, monetary integration in the region, studying not only the purely economic factors but also the political implications. This will be the greatest challenge for future generations across Asia.

5.3 Japanese dilemma over Asian integration

5.3.1 Subordination to the United States

5.3.1.1 Rent-seeking behavior of a rule-making state

The point here is that inter-state behavior is subject to the same strategic considerations as interaction among firms or individuals. The theories on rent-seeking are analogously applicable to the current international monetary regime, under which the United States has sought special status and privileges for its own national currency, the US dollar. It might be called a *de facto* “US dollar standard” (see Iwai, 1995, pp. 66-83; Seki, 1995, pp. 84-98). We can recognize the seigniorage of the US dollar through the monetization of huge amounts of US Treasury securities as monopoly rent. Despite the world’s largest external debts of consecutive years over decades, the United States has been able to enjoy strong economic growth and a dominant dollar in global markets.

The United States has been in the position of a rule-making state in international finance by using effectively multilateral financial institutions such as the IMF/World Bank and through leadership of the Group of Seven (G-7) countries. However, a problem has arisen from the fact that the goal of the United States as the rule-making state was not necessarily to benefit the rest of the world by maintaining the stability of the international monetary regime but only to satisfy its own national interests at the cost of the rest of the world. We can see clearly from experience the preference and behavior of the United States in protecting its own national interests (Nye, 1997, p. 205). If Japan (or any other country) targets a strategic sector for the United States (e.g., aerospace, defense, etc.) for commercial penetration, it always pressures or even threatens Japan to withdraw. If Japan tries to protect her own

strategic sector (e.g., information technology, petrochemicals, etc.) by restriction of market access, and if it also overlaps a strategic sector for the United States, the latter always intervenes to press for the liberalization of the Japanese market. In just the same way, the financial sector is one of the most important strategic industries for the United States.” When Japan proposed the AMF and offered \$100 billion for its establishment in 1997, the United States pressured Japan to withdraw the proposal, because it undermined the power that the IMF (and possibly the United States) had over the financial policies of other countries (Ishihara, 1998, pp. 165-169; Mahathir, 1998a). In effect, the existence of the IMF/World Bank under the post-Bretton Woods non-system functions as a rent-protecting instrument for the United States under the guise of structural reform through IMF-supported programs.

5.3.1.2 IMF-supported programs in the Asian financial crisis

The financial crisis unfolded against a backdrop of several decades of outstanding economic performance in Asia, and the difficulties that the East Asian countries face are not primarily the result of macroeconomic imbalances. Rather, they stem from weaknesses in financial systems. A combination of inadequate financial sector supervision, poor assessment and management of financial risk, and the maintenance of relatively fixed exchange rates led banks and corporations to borrow large amounts of international capital, much of it short-term, denominated in foreign currency, and unhedged. As time went on, this inflow of foreign capital tended to be used to finance poorer-quality investments.

” Jagdish Bhagwati used the term “Wall Street-Treasury Complex” to refer to the common interest in collusion by financiers in Wall Street and the US Department of Treasury (see Bhagwati, 1998).

These circumstances posed considerable challenges to the design of 'conditionality,' i.e., policies that a country agrees to follow as a condition for borrowing from the IMF. In the analysis of the origins of the crisis, the IMF emphasized governance issues in the affected countries, and accused Japan of being the ringleader of the crisis itself. The official viewpoint of the IMF on the Asian financial crisis was published on the web site, and justified itself as follows:

Although private sector expenditure and financing decisions led to the crisis, it was exacerbated by governance issues, notably government involvement in the private sector and lack of transparency in corporate and fiscal accounting and the provision of financial and economic data. Developments in the advanced economies, such as weak growth in Europe and Japan that left a shortage of attractive investment opportunities and kept interest rates low in those economies, also contributed to the buildup of the crisis. . . .

Forceful, far-reaching structural reforms are at the heart of all the IMF-supported programs, marking an evolution in emphasis from many of the programs that the IMF has supported in the past, where the underlying country problem was imbalances reflecting inappropriate macroeconomic policies.

Because financial sector problems were a major cause of the crisis, the centerpiece of the Asian programs has been the comprehensive reform of financial systems. While tailored to the needs of individual countries, in all cases the IMF-supported programs have arranged for: a) the closure of unviable financial institutions, with the associated write down of shareholders' capital; b) the recapitalization of undercapitalized institutions; c) close supervision of weak institutions; and d) increased potential for foreign participation in domestic financial systems.

To address the governance issues that also contributed to the crisis, the reform of the financial systems is being buttressed by measures designed to improve the efficiency of markets, break the close links between business and governments, and ensure that the integration of the national economy with international financial markets is properly segmented. Transparency is being increased, both as regards economic data (on external reserves and liabilities in particular) and in the fiscal and corporate sectors, as well as in the banking sector.

The reform efforts have been invaluablely aided by the World Bank, with its focus on the structural and sectoral issues that underpin the macroeconomy, and the Asian Development Bank (ADB), with its regional specialization. (IMF, 1998, chap. "The IMF's Immediate Response to the Crisis")

On the occasion of the IMF/World Bank annual meeting held in Washington D.C. in October 1998, the Japanese government forthrightly criticized the conditionalities of

IMF-supported programs enforced in Asian economies affected by the crisis. Their points were the following:

Together with the [World] Bank, the [International Monetary] Fund has continued to play a significant role at the core of the postwar international monetary system. Over the years, however, the environment in which the [International Monetary] Fund operates has changed dramatically. While limited capital movements and fixed exchange rate regimes were the norm when the institution was conceived, they are now giving way to free, large-scale capital movements and diverse exchange rate regimes, including floating exchange rate regimes. For the [International Monetary] Fund to better adapt to this new environment, we need to make a fundamental review of the international monetary system itself. (Tanigaki, 1998, chap. "Introduction") . . .

The most significant aspect of the Asian crisis is that the currency crisis and balance of payments difficulties did not stem from current account deficits but rather from a loss of confidence and resulting rapid deterioration in capital accounts. What one can draw from this experience is that the [International Monetary] Fund's traditional prescription which combines fiscal balance improvement with tightening of monetary policy is no longer appropriate in every instance. So, asking a country with a fiscal surplus to tighten further or asking a country to adopt a high interest rate policy for the sake of exchange rate protection could end up with more negatives than positives, inviting a downturn in the economy and further erosion of confidence.

With regard to exchange rate regime, we need to pay much greater attention to the possibility that the maintenance of a fixed exchange rate regime can be taken as a government guarantee against exchange rate risk, thus leading to excessive inflows of short-term capital. That being said, what also must be avoided is a hasty shift to floating exchange rate regimes following the eruption of a crisis as this may only invite a free-fall of exchange rates. With all this in mind, a further effort must be made to identify the appropriate exchange rate policy to be incorporated in IMF-supported programs, and also to identify the appropriate exit policy for making an exit from fixed exchange rate regimes.

Moreover, structural reform deserves further consideration. Take banking reform. When, for example, a country is not equipped with preconditions for reform, such as a deposit insurance scheme, the Fund should perhaps be more considerate of the timing of implementation and its social impact. Likewise, the [International Monetary] Fund should recognize that the modality of the market economy can be diverse, reflecting the history and culture of each country as well as its stage of economic development.

In this context, the [International Monetary] Fund should perhaps reflect on what it has done: whether or not it has demanded a little too hastily a conditionality either inappropriate or not really needed; and whether or not that has undermined the credibility of IMF-supported programs themselves. (Tanigaki, chap. "Global Response to Risk: Policy Responses to Recent Crises")

At that time, Stanley Fischer¹⁰ put forward a counterargument to the criticism of IMF-supported programs as follows:

The inclusion of structural measures in these programmes has been criticised. But financial and corporate inefficiencies were at the epicentre of the economic crisis, and have to be dealt with to restore durable growth. Indeed, the priority now should be to accelerate restructuring. Some argue that because this will take a long time to have its effects, it was a mistake to try to move so rapidly. But delay does not make banking problems go away: as seen in Japan, it makes them worse.

If their design was right, why have the IMF programmes worked less well than hoped? There are two answers. First, governments were initially reluctant to implement them. In each of the three countries [Thailand, Indonesia and South Korea] the programme began to take hold and the currency to stabilise only after a new government took office. And second, the external economic environment has worsened, due especially to the Japanese recession.

The consequences have been most visible in the three countries' exports. Rapid export growth to the United States helped bring Mexico out of its 1994-95 crisis. This time, the value of exports from Thailand, Indonesia and South Korea to both Europe and America did indeed rise in the year to the second quarter, but the value of their exports to Japan has declined sharply, by about 25%. So exports have not, so far, served as a source of growth. (Fischer, 1998, par. 5-7)

Although he emphasized the role of exports in any recovery from the crisis, such, in a sense, old-fashioned textbook response might not be wholly persuasive. The Asian financial crisis did not stem from current account deficits (and, in particular, never from trade deficits) but rather from a loss of confidence and resulting rapid deterioration in capital accounts. Furthermore, his opinion might seem unfairly biased towards the United States with no mention of US-originated hedge funds, while penalizing Japan so harshly in a public statement. This may be a simple example to demonstrate that the IMF serves as a rent-protecting instrument of the United States.

¹⁰ Stanley Fischer is first deputy managing director at the International Monetary Fund. It should be noted that the views expressed in this article are those of the author, and that they are not necessarily shared by the International Monetary Fund's executive board.

5.3.1.3 Structural changes to international credit flows

In the United States, a number of authors have argued that we have entered a new era, the so-called “New Economy,” where a “New Paradigm” of sustained productivity growth and low inflation holds (Shepard, 1997). The New Economy enthusiasts believe that the old speed limits on growth have been repealed, even that the whole idea of speed limits is obsolete. The essence of the new paradigm is the claim that the changes everyone can see in our economy, i.e., the rise of digital technology, the growing volume of international trade and investment, have qualitatively altered the rules of the game. Rapid technological change, the new paradigm adherents claim, means that the economy can grow much faster than it used to, and global competition means that we need no longer fear that an overheating economy will experience inflation.

Conversely, Paul Krugman pointed out that the New Economy coterie seemed to have failed to grasp the seemingly technical but actually crucial point that official measures of productivity, GDP growth, and inflation are not independent of one another (1997a; 1997b). If productivity is understated by the official data, so is growth by exactly the same amount. Even if there was unmeasured productivity growth, there is no reason to think that the economy could grow faster than it was already growing. In short, the New Economy doctrine made no sense at all, and without that intellectual justification, there was no way to regard the great stock market boom as anything other than a bubble. Yet, as long as inflation stayed low and the market continued to rise, skeptical voices were ignored.

Whether they are the New Economy enthusiasts or not, either side overlooked underlying structural changes to international credit flows around the United States. At this time, the United States is the largest net debtor country in the world, and even

the New Economy itself has been financed by enormous accumulation of short-term capital inflows from the rest of the world. We must recognize the fragility of the international financial regime, in which the only anchor state with a key currency pursues its own national interest through a vulnerable financing structure.

At the same time, the Japanese government has initiated comprehensive measures for the internationalization of yen (MOF, Japan, 1999), which called for the prompt reform of financial infrastructure in money and capital markets, further improvements of settlement systems, and so on. These efforts to be independent of the *de facto* US dollar standard are strategically consistent with the national interest of Japan.

5.3.2 Historical trauma

5.3.2.1 Greater East Asia Co-prosperity Sphere

When addressing the question of Asian integration, everyone remembers the miscarriage of the “Greater East Asia Co-prosperity Sphere.” Japan’s new order during World War II, which amounted to a self-contained empire from Manchuria to the Dutch East Indies (now Indonesia), including China, French Indochina, Thailand, and British-held Malaya (now Malaysia and Singapore) as satellite states. Japan intended to exclude both European imperialist and Communist influences from the entire Far East, while ensuring Japanese political and industrial hegemony.

Japan conquered its Greater East Asia Co-prosperity Sphere and arrived at the gates of India, displacing British, Dutch, and French colonial rulers as well as the Americans in Guam and the Philippines. The Japanese had to allow some margin of freedom to their satellite regimes in Burma and Indonesia in both of which preexisting local parties proved capable of creating sovereign states after the war. However,

despite the “Asia for the Asians” propaganda, the new and old colonial rulers had more in common with each other than either had with the indigenous peoples.

5.3.2.2 Coping with China

The most difficult international relationship for Japan is that with China. The government of Communist China (the People’s Republic of China) does not want Japan to extend her influence over East Asia through her economic, political, and particularly military resources. On this point, the national interest of China is naturally consistent with that of the United States.

When a new initiative for an AMF came out in September 1997, despite a strong persuasive effort by the Japanese government, China did not in the end change her negative attitude (Ishihara, pp. 165-172). The government of Communist China regarded the AMF as a tool for Japan to increase her influence in the region, which meant a relative reduction in the power of China. Together with the United States, which had similar misgivings that the AMF might undermine the *de facto* US dollar standard, China frustrated the proposal from Japan and ASEAN.

Nevertheless, the national interest of China is obviously different from that of the United States. China is China in all respects. China is absolutely independent of any political pressures from the rest of the world. There might be little possibility of China participating in macroeconomic policy coordination in the multilateral framework. The government of Communist China has already started efforts to diversify external asset and liability denomination, and to minimize the risks of excessive dependence on the US dollar (see Kynge, 1998). With respect to the monetary integration in Asia, we cannot expect China to participate in the process for some time yet. However, the Japanese government should keep the door open for China to join in the near future.

Gyoten Toyoo, the former Vice Minister of Finance for International Affairs, made proposals for coping with Japan-China relationship as follows:

The relationship between Japan and China stretches back some 2,000 years, an unprecedented length in world history. But the length of the relationship does not necessarily ensure its continuing stability.

After all, human beings are influenced by memories of the recent past and prospects for the near future. I, for one, consider that a necessary first step in securing future Japan-China relations is the creation of an environment that enables the two nations to start constructive dialogue.

Japan should apologize sincerely for the damage it inflicted on China during 15 years of war between the two countries. China, for its part, should put a stop to education aimed at cultivating animosity toward Japan using just a chapter of history. If the difference in historical assessment of incidents like the Nanking Massacre is still at issue, the two countries should launch a joint fact-finding investigation immediately. . . .

Various scenarios can be conceived as to how Japan-China relations will hold up in the context of East Asia. There is a possibility that Japan and China will compete against and antagonize each other in the struggle for leadership of the region. But the two countries could undoubtedly share the view that a hostile relationship between them would prove a major disadvantage for both countries and for East Asia as a whole. An essential task is for the two countries to foster next-generation leaders who can formulate policies based on that perspective. (Gyoten, 1999, par. 21-23, 25)

5.3.2.3 Recapitulation of the past and resolution for the future

The Japanese government should investigate what happened during World War II as openly as possible. It is important for the Japanese to reach a clear sense of what the Japanese armed forces did in each case at that time. Based on such an honest assessment, Japan can decide case by case whether or not, and to what extent, she is responsible for the past. It will not be until Japan reviews the war and her responsibility in the true sense that we can take a step forward. The words of apology made by the Japanese government so many times over the succeeding decades were too general and vague in addressing the issues of why the Japanese were apologizing to her neighbors or in what form they were taking responsibility. It raised, on one

hand, a feeling of dissatisfaction among those neighboring countries, and on the other hand, it also frustrated the Japanese people themselves.

Based on such a comprehensive review of past actions, the Japanese government should express her resolution never to resort to an act of aggression or become a military threat to the other countries for any reason. Under the strict allied regime of the Japan-US Mutual Security Treaty (1951), the Japanese government has not been used to deciding on its own foreign policy outside the US sphere of influence. However, it is dangerous in any circumstances to entrust the authority of foreign policy to another government. There are risks involved in unintended warfare. The Japanese government must not allow US armed forces to mobilize resources in Japan and attack Asian neighbors in pursuit of the US national interest. The Japan-US mutual security treaty should be interpreted in the restricted sense of self-defense only.

Malaysian Prime Minister, Mahathir, expressed his views on the historical trauma held by the Japanese as follows:

[O]ver the past five years or so, the Japanese seem to have lost some of their self-confidence and even national pride. It is right not to be militaristic, but it is not wrong to be nationalistic. Nationalism motivates and helps a country to overcome problems. Alliances with other countries should not result in total dependence. To be able to defend one's own country is not synonymous with aggressive militarism.

Japan has a good reason for rejecting militarism. It should be ready and willing to admit that it had done a lot of wrong in the past. But it should not be burdened by a permanent sense of guilt over actions committed more than half a century ago. I don't see Germany being reminded of its Nazi past. Nor is Germany required to go around apologizing for Nazi atrocities during the war. But it would seem that every Japanese Prime Minister must apologize for deeds committed by people of two generations ago. Apologies are not needed, but undertaking not to be an aggressive military power is necessary if Japan wants to allay the fears of its neighbors. . . .

Japan feels a need to be allied to the United States. This is understandable if it is not directed against other nations. Unfortunately, the United States shows open hostility to some countries in Asia and the U.S.-Japan alliance seems to be directed against these countries. This is not good because these countries would regard Japan as an enemy and there would always be tension in the region. . . .

Chapter 5 ASIAN MONETARY INTEGRATION

As much as Japan fears China, China must fear the U.S.-Japan alliance. However the world must accept that China, with 1.3 billion very hard-working, intelligent people cannot help but be a powerful country eventually. We have to live with this eventuality. If we can live with the United States as the sole superpower, there is no reason why we cannot live with China as a world power. China has practically no history of conquering and colonizing neighbors. European powers have. (Mahathir, 1999, par. 20-21, 23, 26)

The end of Cold War changed dramatically the structure of international relations, and inevitably affected the Japan-US relationship. One hypothesis is gaining ground among policy-makers and intellectuals in Japan (Saito, 1998, p. 52): If an American soldier became a casualty somewhere in Japan during the Cold War era, his parents could find some significance in his fate in the cause of freedom and democracy despite their heavy grief. But what if the same misfortune occurs now in the post-Cold War era? His parents, and other Americans, cannot accept it, believing that their son has been sacrificed for Japan, the country with the largest GDP per capita in the world. We are now feeling the structural impact of the post- Cold War era. It might be the right time for a revision of the Japan-US relationship in every aspect.

Table 5 Appendix 1
Balance of Payment Japan, 1990-96
(Billions of US dollars)

	line	1990	1991	1992	1993	1994	1995	1996
Current account	1	35 87	68 20	112 57	131 64	130 26	111 04	65 88
Balance on goods, services & income	2	41 39	80 24	116 41	136 74	136 36	118 72	74 88
Trade balance (Balance on goods)	3	63 58	96 08	124 76	139 42	144 19	131 79	83 56
Goods Exports f.o.b.	4	280 35	308 17	332 56	352 66	385 70	428 72	400 28
Goods Imports f.o.b.	5	-216 77	-212 08	-207 79	-213 24	-241 51	-296 93	-316 72
Balance on services	6	-44 69	-41 79	-43 96	-43 08	-48 06	-57 36	-62 24
Services Credit	7	43 34	44 84	49 07	53 22	58 30	65 27	67 72
Services Debit	8	-88 03	-86 63	-93 03	-96 30	-106 36	-122 63	-129 96
Balance on investment income	9	22 50	25 96	35 60	40 41	40 23	44 29	53 55
Income Credit	10	122 64	140 93	142 87	147 83	155 19	192 45	225 10
Income Debit	11	-100 14	-114 97	-107 27	-107 42	-114 96	-148 16	-171 55
Current transfers	12	-5 52	-12 04	-3 83	-5 10	-6 11	-7 68	-9 00
Current transfers Credit	13	1 00	1 42	1 67	1 58	1 83	1 98	6 04
Current transfers Debit	14	-6 52	-13 46	-5 50	-6 68	-7 94	-9 66	-15 04
Capital account	15	0 00	1 20	-1 30	-1 46	-1 85	-2 23	-3 29
Capital account Credit	16	--	--	--	--	--	0 01	1 22
Capital account Debit	17	--	-1 20	-1 30	-1 46	-1 85	-2 24	-4 51
Financial account	18	-21 54	-67 66	-100 28	-102 21	-85 11	-63 98	-28 10
Direct investment, net	19	-46 29	-30 33	-14 63	-13 71	-17 18	-22 47	-23 24
Direct investment abroad	20	-48 05	-31 62	-17 39	-13 83	-18 09	-22 51	-23 44
Direct investment inward	21	1 76	1 29	2 76	0 12	0 91	0 04	0 20
Portfolio investment, net	22	-4 81	44 40	-26 96	-70 87	-27 21	-36 57	-41 15
Portfolio investment assets	23	-40 20	-81 65	-34 57	-64 23	-91 54	-87 24	-114 59
Equity securities	24	-6 26	-3 63	2 98	-15 28	-14 00	0 07	-8 18
Debt securities	25	-33 94	-78 02	-37 55	-48 95	-77 54	-87 31	-106 41
Portfolio investment liabilities	26	35 39	126 05	7 61	-6 64	64 33	50 67	73 44
Equity securities	27	-13 26	46 62	8 88	19 86	48 95	50 60	49 46
Debt securities	28	48 65	79 43	-1 27	-26 50	15 38	0 07	23 98
Other investment, net	29	29 56	-81 73	-58 69	-17 62	-40 72	-4 93	36 28
Other investment assets	30	-89 14	26 46	46 55	15 08	-35 12	-102 24	5 21
Monetary authorities	31	--	--	--	--	--	--	--
General government	32	-10 12	-12 56	-9 51	-7 80	-8 76	-8 66	-5 28
Banks	33	-64 16	37 03	49 64	27 73	-10 67	-85 62	75 56
Other sectors	34	-14 86	1 99	6 42	-4 85	-15 69	-7 96	-65 07
Other investment liabilities	35	118 70	-108 19	-105 24	-32 70	-5 60	97 31	31 07
Monetary authorities	36	14 46	--	--	--	--	--	--
General government	37	-0 36	-2 16	1 28	0 10	-2 00	1 18	-2 13
Banks	38	44 46	-126 97	-119 86	-37 90	4 87	17 27	-9 06
Other sectors	39	60 14	20 94	13 34	5 30	-8 47	78 86	42 26
Memoranda								
Foreign assets (20+23+30 increase/capital outflow [40	-177 39	-86 81	-5 41	-62 98	-144 75	-211 99	-132 82
Foreign debts (21+26+35 increase/capital inflow [+])	41	155 85	19 15	-94 87	-39 22	59 64	148 02	104 71
Net Errors & omissions	42	-20 92	-7 73	-10 38	-0 50	-18 03	13 78	0 64
Overall Balance	43	-6 59	-8 39	0 62	27 47	25 27	58 61	35 14
Reserves & related items	44	6 59	8 39	-0 62	-27 47	-25 27	-58 61	-35 14

Note: Negative sign indicates debit

Source: International Monetary Fund (IMF), *International Financial Statistics Yearbook* (1997), p. 499

Table 5.Appendix 2
International Investment Position: Japan, 1990-96
(Billions of US dollars)

	line	1990	1991	1992	1993	1994	1995	1996
Net International Investment Position	1	329.36	384.34	514.85	612.04	690.32	817.60	891.02
Assets (Foreign Assets)	2	1,857.88	2,006.51	2,035.24	2,180.88	2,424.24	2,632.86	2,652.61
Direct Investment Abroad	3	201.44	231.79	248.06	259.80	275.57	238.45	258.61
Portfolio Investment	4	595.84	679.18	715.45	771.11	858.69	858.28	937.16
Equity Securities	5	--	--	--	--	--	146.26	154.90
Debt Securities	6	--	--	--	--	--	712.02	782.27
Other Investment	7	980.89	1,022.27	998.94	1,050.29	1,162.87	1,351.30	1,239.23
Monetary Authorities	8	--	--	--	--	--	--	--
General Government	9	90.44	110.73	123.40	142.22	165.01	184.05	170.47
Banks	10	725.40	729.67	690.32	701.47	752.12	911.23	773.14
Other Sectors	11	165.05	181.87	185.22	206.60	245.74	256.02	295.63
Reserve Assets	12	79.71	73.27	72.79	99.68	127.10	184.82	217.61
Liabilities (Foreign Debts)	13	1,528.52	1,622.17	1,520.39	1,568.84	1,733.92	1,815.26	1,761.59
Direct Investment Inward	14	9.85	12.29	15.51	16.89	19.17	33.51	29.94
Portfolio Investment	15	395.97	527.69	513.10	545.32	630.67	548.27	558.97
Equity Securities	16	90.38	141.78	124.59	171.17	250.88	306.28	315.65
Debt Securities	17	305.59	385.91	388.51	374.15	379.79	241.99	243.32
Other Investment	18	1,122.70	1,082.19	991.78	1,006.63	1,084.08	1,233.48	1,172.69
Monetary Authorities	19	35.74	50.11	54.72	65.52	99.85	--	--
General Government	20	--	--	--	--	--	14.96	11.35
Banks	21	904.41	812.82	696.71	673.58	694.94	745.42	701.56
Other Sectors	22	182.55	219.26	240.35	267.53	289.29	473.10	459.78

Source: International Monetary Fund (IMF), *International Financial Statistics Yearbook* (1997), p. 501 ;
International Financial Statistics (December 1997), p. 388.

Table 5. Appendix 3

Stock and Land Prices: Japan, 1985-97

line	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Stock prices													
The Nikkei Stock Average (JPY)	1	n.a.	n.a.	n.a.	38,915	n.a.	n.a.	16,925	17,417	19,723	19,868	19,361	17,888
(TSE 225 issues)													(Sept.)
Total Market Value (JPY tril.)	2	196	293	488	630	394	392	289	324	358	366	348	330
(Sum of 1st and 2nd Sections of TSE)													
Total Market Value/Nominal GNP	3	0.6	0.9	1.3	1.6	0.9	0.9	0.6	0.7	0.7	0.8	0.7	n.a.
Land prices													
Officially Published Land Prices (%)	4	n.a.	n.a.	25.0%	7.9%	17.0%	10.7%	-5.6%	-8.7%	-4.7%	-1.6%	-2.6%	-1.6%
(Residential Land, All Japan)													
Total Market Value (JPY tril.)	5	1,004	1,257	1,673	2,153	2,365	2,173	1,944	1,865	1,824	1,775	1,740	n.a.
(System of National Accounts)													
Total Market Value/Nominal GNP	6	3.1	3.7	4.8	4.9	5.4	4.7	4.1	3.9	3.8	3.6	3.4	n.a.

Source: Bank of Japan (BOJ), *Economic Statistics Monthly* 608 (November 1997), pp. 10, 157.Economic Planning Agency (EPA), *Annual Report on National Accounts* (1998), pp. 66-67, 334-37.

Note: All lines except line 4 are the figures at the end of period. Line 4 is the data for 1st half year (Jan. 1) that are based on the National Land Agency Survey.

TSE (line 1, 2) is the abbreviation of 'Tokyo Stock Exchange.'

Table 5. Appendix 4

Net International Investment Position: Japan, 1986-97 line

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Net Assets (Billions of Japanese yen)	1	n.a.	28,865	30,199	36,745	42,453	47,498	64,153	68,823	66,813	84,072	103,359	124,587
Memorandum item: exchange rates of JPY/USD	2	238.6	168.5	144.6	128.1	144.8	134.5	126.7	111.2	102.2	94.1	108.8	125.5
(Average of daily rates)													(Estimates)

Source: Ministry of Finance (MOF), *Monthly Finance Review* 300 (July 1998), No. 300, pp. 12-13.OECD *Economic Outlook* 61 (June 1997), p. A40.