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The Sky Isn't Falling

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With the exchange rate of the Japanese Yen once again breaching the psychologically important support level of 145 Yen per US dollar, there is renewed panic in the East Asian currencies and stock markets. The fear is that the devaluation of the Japanese Yen will drag down with it the other East Asian currencies, thus aborting once more the very tentative recoveries of the East Asian economies (with the exception of Indonesia) from their currency crises.

CONTENTS

There is fundamentally, however, no need to fear a decline in the US$ value of the Japanese Yen. The primary reason is that the decline in the exchange rate of the Japanese Yen is not caused by a decline in the competitiveness of Japanese exports. In fact, quite on the contrary, the Japanese current account surplus is at an all-time high. The decline in the Japanese Yen has been caused, instead, by actual and expected capital outflows from Japan due to the extremely low rates of return on its bank deposits and bonds (0.5% per annum), further fueled by the trading activities of the currency speculators.

In the past five years, the hedge

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funds, currently estimated to total several hundred billion U.S. dollars globally, have emerged to become the most important players in currency markets. With leverage, the hedge funds can, in principle, take positions collectively as large as ten trillions of U.S. dollars on one side or the other of a currency, dwarfing the effects of current account transactions on the supply and demand of the currency. This is actually what has happened. It will be argued below that this type of devaluation, caused mainly by short-term capital flows, and not by a decline in fundamental competitiveness, should exert very little downward pressure on other currencies.

Yen Devaluation Does not Necessarily Lead to Lower US$ Export Prices

First of all, it should be noted that just because the exchange rate of the Japanese Yen is lower does not necessarily mean that the export prices of Japanese goods will be lower in US$ terms. The easiest way to see this is to look at the situation from the point of view of a Japanese exporter. An exporter of, say, the Lexus, a car made by Toyota and sold in the United States, realizes that he is already competitive in the United States at the existing US$ price. There is therefore no particular reason for him to lower his US$ price pari passu with the decline in the Japanese Yen. Instead he should take advantage of the situation to increase his profit margin in Yen terms by maintaining his US$ price at the existing level. This is especially true in the automobile case because of the existence of the so-called voluntary export restraints (In fact, Japanese automobile manufacturers have already announced that they will hold their US$ prices) but is not limited to it. Under this scenario, the US$ prices of Japanese exports will not be significantly changed regardless of the decline in the exchange rate of the Japanese Yen. Consequently, there will be little or no competitive price pressure on the exports of other economies, such as South Korea and Taiwan. Thus, it should not lead to another round of competitive devaluations. Crucial to this analysis is the recognition that the exports of Japan are not mere "commodities" that are easily available and substitutable elsewhere; instead, many Japanese manufacturers and exporters, such as Sony, already have significant market shares and with it market power and the ability to set US$ prices. Empirically, the US$ prices of Japanese exports have been much more stable than the US$ value of the Japanese Yen. Thus, the US$ price of Japanese exports did not increase much as the Japanese Yen appreciated to 80 Yen per US$ in 1995 and also did not decrease much as the Yen depreciated first to the 120 Yen range and more recently to 145 Yen per US$. Moreover, it is also the case that most Japanese international trade is still denominated in U.S. dollars.

Yen Devaluation Does not Necessarily Lead to Less Japanese Imports

What about the effect of a decline in the exchange rate of the Japanese Yen on Japanese imports? With a devaluation, Japanese imports will become more expensive in Yen terms. In principle, this should result in a decline in the quantity of Japanese imports. Will this in turn hurt the exports of China, South Korea, Taiwan and other East Asian economies to Japan? The answer is, to a first approximation, no. The reason is the well-known fact that Japanese imports are not very sensitive to changes in relative prices, but are very sensitive to changes in Japanese real income. In general, the gap between the prices of domestically produced products and imported substitutes in Japan is very large. Japan is thus unlikely to import much more in the absence of a massive decline in the price of imports; by the same token, Japan is also not going to import much less even as the imports become somewhat more expensive. Within the range of potential variations of the exchange rate, the price effect is therefore not likely to be significant. The current slump in Japanese imports from other, including East Asian, economies is caused not so much by a weak Yen but by the anemic growth, in fact, decline, of Japanese real GDP. Devaluations by other East Asian economies since July 1997 have had only very marginal effects on the quantities of their exports to Japan to date and further competitive devaluations in response to the Yen devaluation are unlikely to help. One useful way to think about it is to consider that the Thai Baht has since July 1997 devalued approximately 30 percent with respect to the Japanese Yen, but there has been no surge of imports by Japan from Thailand. Why should another ten percent (competitive) devaluation of the Thai Baht be expected to make much of a difference now? For this reason, it is neither necessary nor effective for the East Asian economies to devalue competitively in response to a weakened Yen.

Yen Devaluation May Slow Foreign Direct Investment and Loans from Japan

The only possible genuinely significant effect of a weak Yen on other East Asian economies is the slowdown of Japanese outward foreign direct investment to these as the Yen depreciated first to the 120 Yen range and more recently to 145 Yen per US$. Moreover, it is also the case that most Japanese international trade is still denominated in U.S. dollars.

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Yen Devaluation May Slow Foreign Direct Investment and Loans from Japan

The only possible genuinely significant effect of a weak Yen on other East Asian economies is the slowdown of Japanese outward foreign direct investment to these economies. However, the current macroeconomic conditions in these economies are probably not propitious for Japanese foreign direct investment in any case, no matter what the exchange rate is, especially given the Japanese reputation as very conservative and deliberate foreign direct investors. "Plunging right in" is simply not the Japanese way.

There has also been a very significant reduction in the credit extended by Japanese banks to the East Asian economies. As most of this credit is denominated in US$, a weak Yen will accelerate the withdrawal of Japanese banks from these markets. However, this process of withdrawal began quite some time ago, for reasons mostly related to the financial conditions of the Japanese banks, and would have continued whether the Yen further devalues or not.

Even if there is a real effect on foreign direct investment from Japan, it is not clear that any economy should resort to a devaluation of its currency solely for the purpose of attracting foreign direct investment, or that such a devaluation would in fact be effective. Such a devaluation may actually have an adverse long-term effect as potential foreign investors factor in the risks of exchange rate losses in the future. It may also have negative consequences on the rate of inflation. Moreover, for those economies with net outstanding debt to Japan denominated in Yen terms, there may actually be a windfall, a benefit, resulting from a devaluation of the Japanese Yen, if they do not attempt to match the Japanese devaluation.

Other East Asian Currencies Need not Follow the Japanese Yen

We have already made a general case why other East Asian currencies need not follow the recent Japanese devaluation. We shall now examine specific currencies.

The Renminbi

First, it will be argued that the Renminbi, the Chinese currency, does not need to follow the devaluation of the Japanese Yen. There has been continuing speculation since July 1997 that the Renminbi may devalue, long before the latest decline in the Japanese Yen. The Chinese Yuan and the Hong Kong Dollar are the only two East Asian currencies that have not devalued since July 1, 1997. Will the Renminbi devalue?

It should be realized that the Renminbi is not a freely convertible currency and is therefore difficult for international speculators to attack. Any devaluation will have to be an intentional policy decision on the part of the Chinese economic decision makers. However, all the senior

Chinese leaders — President Jiang Ze-Min, former Premier Li Peng, current Premier Zhu Rong-Ji and Governor Dai Xiang-Long of the Chinese central bank — have said that the Renminbi will not be devalued. There are diplomatic and political benefits from maintaining the value of the Renminbi on the part of China, providing a pillar of stability in East Asia — a concrete gesture of cooperation with and support for the other East Asian economies.

However, we should not place all of our hope on what government officials say they will or will not do. We should also examine the Chinese economic fundamentals and Chinese economic self-interest. The economic fundamentals are strong. The domestic savings rate has remained high (between 35 and 40 percent of GDP), perfectly adequate for Chinese investment needs — there is no savings-investment gap. There is a trade surplus of at least US$40 billion in 1997 and a large current account surplus of US$22.6 billion even in the first half of 1998, almost a full year after the beginning of the East Asian currency crisis. The foreign capital utilized by China is mostly in the form of foreign direct investment (FDI), which cannot be easily withdrawn at short notice. The external debt of approximately US$ 130 billion has staggered, longer maturities, unlike those of the other East Asian economies such as South Korea and Thailand. The rate of inflation cannot be much lower — it has been slightly negative for 9 consecutive months. The official foreign exchange reserves of US$140 billion are the second highest in the world (after Japan) and perfectly adequate if ever a defense of the Chinese Yuan becomes necessary.

The East Asian currency crisis will have a negative impact on the growth of Chinese exports. Chinese exports grew 7.6% to US$87 billion in the first half 1998 (compared to the same period of 1997), a significant slowdown compared to the full-year growth of 26.2% in 1997. However, this slowdown is almost entirely due to the decline in Chinese exports to the affected Southeast Asian economies. Chinese exports has continued its strong growth in other markets (Europe (25.5%), U.S. (18.1%), Africa (44.7%), Latin America (38.1%), and Oceania (15.2 %)). In other words, it has not lost market share to the Southeast Asian economies and in fact has gained market share. As the Southeast Asian economies recover, with more stable exchange and interest rates, they will pose some competition to China. However, it will not be a huge impact and can be managed. Exports constitutes only 20% of Chinese GDP and the Chinese economy, with its own huge domestic market, is nowhere nearly as dependent on exports as some other East Asian economies. The competition faced by Chinese exports from Southeast Asian economies is mostly in such goods as apparel, electrical appliances, footwear, and toys. The cost structure of such light industrial manufactured exports is approximately distributed as 20% local costs (including labor), 60% imported raw material and intermediate inputs, and 20% financing costs. The competitive advantage of the devaluations in the Southeast Asian economies is therefore substantially offset by the increase in the costs of the imported inputs as well as by the increase in financing costs (with nominal rates of interest of up to 30% per annum). That is why exports of Southeast Asian economies have not surged particularly even with devaluations in excess of 40% and are not expected to do so in the near future. Moreover, some categories of exports, e.g., apparel, are quota-constrained, and hence are even less sensitive to competitive pressure.

Chinese export competitiveness can in fact be significantly enhanced without a devaluation. Chinese prices have already been falling for nine months in a row. Through a variety of measures such as tariff reductions on imports of equipment and intermediate inputs, value-added tax (VAT) rebates, discounting of export letters of credit, reduction of port fees, and the devolution of direct trading privileges to the individual enterprises, the costs of exports can be lowered. Moreover, relocation of factories from the high-cost coastal areas into the interior of China, as some firms have already done, can also result in substantial cost savings. Chinese labor costs are currently still lower than many of the Southeast Asian economies even after their recent devaluations. With regard to South Korea, Japan and Taiwan, the Chinese exports by and large do not compete directly in the same markets. In fact, China runs a significant trade deficit vis-a-vis both Japan and Taiwan, mostly due to the imports of intermediate inputs, and therefore benefits, on balance, more from devaluations of the Japanese Yen and the New Taiwan Dollar, than it is harmed.

One other short-term problem faced by Chinese enterprises is the possibility of dumping by South Korea and Southeast Asian economies in China and in other competing markets. However, while a firm can sell from its pre-existing inventory at lower than the true cost to raise cash, no firm can afford to dump indefinitely — it must break even on its costs, which typically include a significant direct and indirect import component, priced in US$, as well as financing costs. Once the pre-existing inventory is exhausted, it will face the same costs as firms in other countries, e.g. East Asian petrochemical firms face the same prices for feedstock and energy (oil or gas), which are denominated in US$ terms; East Asian steel firms face the same prices for iron ore and energy, which are also denominated in US$ terms. The sensible way for China to discourage dumping is not a devaluation but the imposition of anti-dumping duties, which have been applied very successfully by the United States.

The major pressure for a devaluation of the Renminbi actually comes from Chinese exporters, many of whom are state-owned trading corporations, even though they have not been significantly affected by the East Asian currency crisis, as the export data described above demonstrate. Like exporters in other countries, they always prefer a lower Renminbi to a higher one, no matter what the exchange rate is. This is because even if the actual quantity of exports does not increase as a result of a devaluation, their profits, in Renminbi terms, will always be higher. It is therefore in their self-interest to advocate a devaluation, regardless of the overall merit of the case for the economy as a whole. There is, in addition, a short-term profit motive. Many of the Chinese exporters have purposely been keeping all of their export proceeds abroad, in US$, rather than selling the bulk of it to the Chinese central bank for Renminbi, as required, hoping to make a quick "Yuan" in the event that they succeed in pressuring the Chinese government to devalue.

The impact of the East Asian currency crisis on foreign direct investment (FDI) into China is significant but not critical. First of all, FDI, including recycled Chinese investment (to be explained below), accounts for only 10% of total Chinese domestic gross fixed investment, so that even if FDI dries up altogether, the Chinese investment rate will only come down from close to 40% of GDP to the mid-30s, still a very impressive rate. Second, in terms of the impact, FDI originating from Southeast Asian economies such Indonesia as Malaysia, Singapore and Thailand, and from South Korea, will be most affected. FDI motivated by low labor costs may be affected because of potential competition from the Southeast Asian economies, even though, as noted above, Chinese labor costs are still lower than those of South Korea and Southeast Asian countries. However, FDI aimed at access to the Chinese market will be unaffected. Thus, General Motors and Motorola will continue to push ahead on their investment plans in China. Moreover, a significant proportion of FDI, estimated to be a third of the total, is actually recycled Chinese investment. This is investment made by Chinese enterprises in China itself, but masquerading as foreign direct investment, so that the investment projects can qualify for favorable tariff and tax treatments in China. This type of investment will, of course, be largely unaffected by the East Asian currency crisis. In the first half of 1998, actual FDI arrivals in China totaled US$20.5 billion, a slight decline of 1.3% from the same period of 1997, principally because of the withdrawal of investors from Southeast Asian countries. During the same period, FDI commitments totaled US$24.2 billion, an increase of 5.5% over the previous year, reversing two consecutive years of decline. Actual FDI arrivals in 1998 are projected to decline to US$40 billion from US$45.3 billion in 1997.

The Chinese economy has, however, shown signs of slowing down. Exports will not be growing as robustly in the new international exchange rate and growth environment. Domestic macroeconomic stimulus is needed to make up for the slowdown in the growth of exports and the expected, albeit relatively modest, decline in FDI. This will take the forms of increase and acceleration of infrastructural investment projects and the encouragement and promotion of the development of affordable owner-occupied residential housing in Chinese urban areas, among other measures. We shall begin to see the early effects of these stimulative measures in the third and fourth quarters of 1998. An effective macroeconomic stimulus package will also reduce the pressure for a devaluation.

Finally, the most convincing argument against a Renminbi devaluation is that it will, at best, have a very marginal effect on Chinese exports, but a high probability of actually doing great harm not only to other East Asian economies but also to the Chinese economy itself. Exports to all markets other than East Asia have continued their high rates of growth. Imports by Japan from China are not price-sensitive but are income-sensitive. Southeast Asian countries are not going to import more from China, no matter how inexpensive Chinese exports becomes, because of their crisis-induced recessions. Nor are they likely to invest more in China no matter how low the Renminbi exchange rate becomes. However, there is a definite probability that a devaluation of the Renminbi may well trigger another round of competitive devaluation among the East Asian economies, thus nullifying any competitive advantage that a Renminbi devaluation alone might have gained, and leaving everyone, including China itself, in a worse situation than before. In fact, it would increase the cost of imports of intermediate goods and capital equipment as well as the real burden of the external debt for China, without an increase in the quantity of exports (on account of the competitive devaluation of the other East Asian economies). It would rekindle domestic Chinese inflation, or worse, might even lead to stagflation. It might also undermine the confidence of the Chinese citizens in their Government and in its currency.

Actually, the devaluation of the Japanese Yen, from 80 Yen per US$ to 145 Yen per US$ while the Japanese economy remains mired in recession, itself is living proof that devaluation is not a cure-all by any means. In this regard, we may add that the recent Japanese Yen devaluation, if unmatched by China, will actually result in a windfall gain for China. China is a significant debtor to Japan (estimated to be approximately US$40 billion) and the loans are denominated in Yen — a Japanese Yen devaluation lowers the cost of repayment of both the principal and the interest to China. The current weakness in the Japanese Yen presents a good opportunity for China to purchase Japanese Yen for the purpose of prepaying its Yen-denominated debt.

All of these considerations suggest that a devaluation of the Renminbi is neither necessary nor in China's best self-interest.

The Hong Kong Dollar

Another frequent question is: Will Hong Kong maintain its US$ peg? The peg was adopted in response to a crisis of confidence in October, 1983 and has remained ever since. It has provided an anchor of confidence through various crises and periods of stress faced by Hong Kong, such as the stock market crash in 1987, the Tiananmen incident in 1989, the reversion to Chinese sovereignty in 1997 and now the East Asian currency crisis. Will a devaluation do Hong Kong any good? We shall show that there is nothing that a devaluation of the HK$ can achieve that cannot be achieved through other means that are more desirable on economic grounds.

As a free port and with little natural resources, the prices of tradable goods in Hong Kong follow world price levels. For example, an orange, being a tradable good, will always cost US$1 in Hong Kong (as in California, ignoring transportation cost), regardless of the exchange rate. International competitiveness of Hong Kong depends only on the prices of the two non-tradable goods (labor and land), both of which are flexible downward, in US$ terms. The wage rate depends on the cost-of-living, which in turn depends on the prices of tradables and land. So that the one price that is critical for the international competitiveness of Hong Kong, and that can also be influenced by Hong Kong, is the price of land.

The international competitiveness of Hong Kong can be enhanced without the necessity of a devaluation. Compare two alternative scenarios. In the first scenario, there is a devaluation of the HK$. Such a devaluation leaves the prices of tradable goods the same in US$ terms, but non-tradable goods, principally land, lower in US$ terms (but not necessarily lower in HK$ terms). In the second scenario, the peg is maintained at its current level, but the price of land is allowed to decline. In this second case, the prices of tradable goods remain the same in US$ terms, and the price of land is lower in US$ terms. Thus, to an international investor or a multinational corporation, the two scenarios have identical implications. However, from the point of view of the citizens of Hong Kong, the impact is vastly different between the two scenarios. A devaluation of the HK$ will lead to an immediate jump in the HK$ prices of all tradable goods and with a time lag higher prices of labor and land, and hence higher domestic inflation as well as a higher nominal rate of interest, with significant adverse distributional consequences. By maintaining the peg and letting the price of land come down, there is not only no inflation in HK$ terms, but the cost-of-living should decline, led by housing costs, and eventually so would the nominal wage rate. There is therefore no good justification for a devaluation of the HK$. Instead, the price of land, which has been driven to astronomical levels by mid-1997 by a real estate bubble, has been adjusting downward, which is the way it should be.

An additional argument against changing the peg is that its whole value for maintaining confidence in Hong Kong lies in its absolute stability. Once a precedent is set that the peg can be changed, the expectation is that it can be changed again, no matter at what level the new peg is set. This will lead to increased volatility in the expectation of the HK$ exchange rate and defeat the whole purpose of a peg. Increased volatility will also increase, rather than decrease, the interest rate risk premium. There are of course economists and others who advocate doing away with the peg altogether and simply floating the HK$. Given the huge global pools of footloose hot money and the relatively small size of the HK$ market, it is inevitable that any monetary authority/central bank of Hong Kong will have to wind up being a market maker to prevent the currency being in an extended overbought or oversold condition, which will tend to obstruct, rather than facilitate, international commerce and investment. It is not clear that such a "managed float" is easier to maintain than a peg; but it is clear that with a floating rate regime, the interest rate risk premium will definitely be higher than that of a credible "peg" regime.

With a low aggregate external debt of only approximately US$20 billion and the third highest official foreign exchange reserves (US$96 billion) in the world, equal to more than seven times the currency in circulation (which the Monetary Authority is committed to redeem in terms of U.S. dollars on demand), the peg can be and has been successfully defended. The devaluation of the Japanese Yen will have only very marginal impact on the Hong Kong economy. Japanese tourists have not been traveling not so much because of prices in Hong Kong, which have been coming down in any case, but because of the uncertainty in their incomes and more recently the security of their employment. A lower HK$ is unlikely to lure too many of them to come at this time.

The South Korean Won and the New Taiwan Dollar

Both the South Korean Won and the New Taiwan Dollar do not need to follow the Japanese Yen. A devaluation of the Japanese Yen is actually potentially more beneficial than harmful. Japan has a huge trade surplus vis-a-vis South Korea and Taiwan. Many South Korean and Taiwanese firms rely on imported Japanese intermediate inputs and capital goods. A decline in the value of the Japanese Yen, to the extent that it implies lower Japanese export prices in US$ terms, benefits such firms. Of course, this is potentially offset by possible lower exports to Japan as exports from South Korea and Taiwan appear more expensive in Yen terms. However, as already argued above, the quantity of imports into Japan is not very price-sensitive. But even if the quantity of exports from South Korea and Taiwan to Japan are price-sensitive, a Yen devaluation, on balance, will result in a net benefit to South Korea and Taiwan because they both import so much more from Japan than Japan from them. There is therefore no compelling reason for South Korea and Taiwan to try to offset such a Yen devaluation. In fact, the experience of the past six weeks indicates that the Korean Won has appreciated and the New Taiwan Dollar has stabilized. It should be remarked that a further devaluation is not helpful to either South Korea or Taiwan in the upgrading of its industrial level. The costs of inputs to high-technology industries — equipment, engineers and scientists, and components and parts — are at world prices.

A devaluation will raise not only revenues but also costs in terms of domestic prices, resulting in little or no net advantage. Finally, with large trade surpluses vis-a-vis China (especially on the part of Taiwan), it is definitely in the interest of South Korea and Taiwan to see a stable Renminbi.

Southeast Asian Economies

The Southeast Asian economies do not need to react to the recent devaluation of the Japanese Yen because on the one hand, they do not compete with Japan in their export markets, and on the other hand, their exports to Japan are on the whole not price-sensitive (but income-sensitive). In any case, given the market power that Japanese importers have, they can extract concessions from Southeast Asian exporters even in the absence of an explicit devaluation of the Southeast Asian currencies.

There is a short-term speculative fervor in the currency markets in East Asia. However, if one examines the economic fundamentals, the capital-outflow induced weakness in the Japanese Yen does not require any adjustment in the exchange rates of most currencies vis-a-vis the US$. This list includes the Renminbi, the Hong Kong Dollar, the South Korean Won, the New Taiwan Dollar and the other Southeast Asian currencies. This is not to say that the Japanese economy is irrelevant — a higher rate of growth of real GDP on the part of Japan will definitely be helpful. However, the Japanese devaluation per se should not lead to another round of competitive devaluation in East Asia. The sky isn't falling.