Synchronized Business Cycles in East Asia and Fluctuations in the Yen/Dollar Exchange Rate

January 2003

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Summary

Because many authors have proposed stimulating the ailing Japanese economy by monetary expansion and yen depreciation, we explore the repercussions of depreciating the yen against the dollar on the other East Asian economies—which largely peg to the dollar. Since 1980, economic integration among Japan's neighbors—China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, and Thailand—has intensified and (except for China) their business cycles have been highly synchronized. These cycles have been closely linked to fluctuations in the yen/dollar exchange rate, through changes in their export competitiveness and inflows of foreign direct investment, as first shown by C.H. Kwan.

When the yen is high against the dollar, economic growth in the other East Asian economies speeds up as their exports become more competitive and as they attract foreign direct investment from Japan. Similarly, when the yen is low against the dollar, growth slows down as their exports become less competitive and inward flows of foreign direct investment decline. Thus we can show that a major devaluation of the yen would have a devastating impact on the other East Asian economies. Indeed, the sharp depreciation of the yen during the great Asian Crisis of 1997-98 made the downturns in the crisis economies much worse. Because of the obvious negative repercussions on Japan if its East Asian trading partners slump collectively, we conclude that a major devaluation of the yen—even it was feasible (which it may not be)— is not a sensible policy option for Japan.