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Japan and the Asian Region: Competition or Cooperation with China?

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There is a fundamental tension in Japan's relations with the rest of Asia -- particularly in economic relations--both in terms of the past and the present and simultaneously, between the potential and the reality.

Even after the bursting of the Japanese economic bubble, Japan still remains the Gulliver in a land of economic Lilliputians. With only 10% of the region's population and an even smaller proportion of its total landmass, Japan accounts for about two-thirds of Asia's total gross national product. Japan's economy is about ten times greater than that of the second largest economy in Asia namely, that of China, 20 times as large as in Taiwan, 15 times as large as in Korea, 30 times larger than Indonesia, etc.

Alternatively stated, Japan's GNP is about 6 times greater than the combined GNPs of Taiwan, South Korea, Singapore and Hong Kong. And, of course, Japan's per capita GNP shows similar gaps. The point is that when you add into this such things as technology differentials, strength of corporate organization, military and police power and environmental control capabilities -- Japan comes across clearly as the major potential engine for growth and the largest economic player across the Asian region.

However, in many respects, Japan is not living up to the potential it holds as the region's economic powerhouse. Instead, what we are seeing is something like a 6-cylinder Toyota that is working on only three cylinders.

Japan has had a long and somewhat tortured history economically with the rest of Asia that traces back to the complications of the Greater East Asia Co-prosperity Sphere and the difficulties that arose as a consequence of Japan's efforts to dominate developments in East Asia. Japan's tortured history with the rest of the region continued into the early post-war period. Japan's economy in the

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post-World War II period was initially focused on maintaining much closer links to the United States than to the rest of Asia. That was an unavoidable outgrowth of U.S. security concerns and the emerging Cold War.

Japan was prevented from developing closer relations with China and its economic relations with Southeast Asia were rather one-sided. Japan imported primary materials from that region and sold its own manufactured goods to the rest of the world. But this relationship has since clearly changed rather fundamentally with regard to Southeast Asia. The change began with the Fukuda Doctrine—focused on Southeast Asia--as well as with alterations in the character of China's own economic strategies.

Japan moved beyond its early reliance on Southeast Asia for raw materials starting with its early ODA policies. With these, Japan took on a rather large role in capacity-building across much of the rest of Asia -- starting initially with the North East Asian economies, Taiwan, South Korea and then later with Singapore and Hong Kong and increasingly moving to the rest of Southeast Asia. In many respects, Japan's official aid policy and then more importantly the private investment policies of Japan's corporate engines, began to play a increasingly substantial role in bolstering the economic capabilities across the rest of Asia. Japan's economic relations with China began a course of rapid improvement in the late 1970s and there too the Japanese emphasis was on overall capacity building and long term development.

Particularly critical was the rising role of Japanese global production networks across Asia. Particularly after the Plaza Accord of 1985, which resulted in a rapid rise in the value of the Japanese yen, multinational corporations that were originally headquartered in Japan began massive investments throughout the rest of Asia, outsourcing much of the production that had once taken place exclusively in Japan. As they moved abroad, Japanese corporations contributed significantly to foreign direct investment in South Korea, Taiwan, and subsequently in Malaysia, Thailand and Indonesia, and other countries.

On the one hand, this outgoing investment represented a great step forward for the globalisation of Japanese companies, most of which had been very much locked into production within Japan. These companies had long been export-oriented to be sure. Most were well integrated at the top-end with many of the world's global markets particularly the United States. Yet, until 1985, production by Japanese companies nevertheless took place primarily within the four main islands of Japan. Suddenly after the Plaza Accord, many of Japan's largest corporations, particularly those in the automobile and electronics sectors, became truly global producers with networks set up both for production and distribution across the globe. A high concentration of these production networks was created in Asia.

The result was that by 1995, Japanese-owned companies were manufacturing more overseas than they exported from the home islands. This development, which began in 1985 was something of a watershed in the transformation of Japanese corporate behaviour. And, of course, for the rest of Asia, Japan's shift proved to be quite important in terms of expanded amounts of capital flowing into Asia. Thus in 1980, Japan had 99 banking offices in Asia. By 1990, these shot up to 313 and further to 363 in 1994. In 1991, 19% of all Japanese overseas bank lending went to Asia. Three years later it increased to 26 percent. By the middle of the 1990s, Japan held 37 percent of Asia's private liabilities, 80 percent the short-term loans to Thailand, and was essentially a dominant overall supplier of capital to many parts of the region.

At least as importantly for the rest of Asia, Japanese outflow in terms of capital investment and in terms of foreign direct investment by corporations had a profound effect, particularly on the smaller economies in Southeast Asia. In 1989, Japanese firms were investing four times as much in Taiwan as they had in 1985. They invested five times as much in Malaysia, five times as much in South Korea, six times as much in Singapore, fifteen times as much in Hong Kong, twenty-five times as much in Thailand. And this new money had a profound impact on development, growth and intra-Asian trade making all of them much more multinational and multi-dimensional and creating a number of trade and economic linkages across Asia and enhancing overall economic linkages across the region.

The result that is all too frequently missed in discussions about regional development and globalisation is that by the early 1990s to the mid-1990s, Asia had exploded upwards economically and had undergone the only profound shift in the share of world GNP of any of the non-developed or undeveloped parts of the world. In essence, Asia at the end of the War World II accounted for something like 4-5% of world GDP. Today, it represents much closer to 35 percent. Asia's rapid economic transformation represented a direct and profound shift in world wealth that other previously less developed regions such as Latin America, Africa or the Middle East, obviously did not enjoy.

The early 1990s were the golden years of Asia's economic development, and naturally enough, everybody in Asia was delighted with the rapid rise in GNP and rises in per capita income. Equally happy were those in the US and elsewhere who were investing their pension funds in Asia. And despite the short term downturns and economic problems that have been faced across Asia, it is very important to recognize this profound shift from which Asia now connects to the world.

Two very broad trends dominated Japan's interaction with Asia that began somewhere in the early '70s and then accelerated tremendously from 1985 and continued on to the early mid-90s.

The first of these trends reflected in many respects the familiar so-called flying geese model of economic development--the notion that, similar to the 'V' formation used by flying geese, Japan would take the lead by developing certain areas of economic activities. Then, as Japanese companies reached their capacity to produce effectively they would reduce their involvement in such economic activities and would pass them on to the others following in the formation. Little by little through this process all of Asia would develop economically, though of course, in Japanese eyes, Japan would continue to hold the lead.

In many respects this flying geese pattern reflected Asian realities during the '70s and most of the '80s. There was a very clear economic hierarchy across Asia with Japan at the lead. This sequenced down through the newly industrial economies of Northeast Asia and further down to the Southeast Asia economies. Within this pattern Japan not only led in most types of sophisticated production but it was also the key provider of capital and technology for others.

Ideologically, the Japanese model of development was also something that was largely perceived across Asia as worthy of emulation. Mahathir opted to look to Japan as the lead-goose while Singapore with its links to Japan and efforts to emulate Japan could most explicitly relate to the flying geese pattern of development. But such a model also had a profound effect on Korea, Taiwan and most of the rest of Asia. Importantly, the flying geese pattern of economic development prevailed into the late 1980s or early 1990s in much of the thinking among Asian elites.

The second trend was the very conscious move towards open regionalism. This move was hardly without debate, particularly in Southeast Asia, as those who followed the debate between the East Asian Economic Caucus and the formation of APEC will remember. But there was nevertheless a very clear move on the part of Japan and the Southeast Asian countries to embrace open regionalism in an effort to take advantage of cross-Pacific trade links and to integrate more closely, not just with one another, but across the Pacific as well. With the formation of APEC, there was at least some formal institutionalisation of the loose and fluid regional ties that had already been developing. There was also a recognition that the regional bloc or the regional ties that were emerging should become building blocks toward a larger global integration, rather than stumbling blocks impeding international economic integration.

Returning to1985 and the Plaza Accord however, it is valuable to note that, although these provided very positive engines for much of Asia's subsequent economic development, hind-sight shows that Plaza provided a tremendous, but missed, opportunity for Japan to move away from its old pattern of economic development and to embrace a very new model of growth. Japan's economy at least until 1985 (and I would suggest continuing even to the present) could be characterized as what I have called "embedded mercantilism" Virtually all key economic actors within Japan were invested in, and deeply committed to, a mercantilist approach to the world economy: capital for development of plant and infrastructure was raised almost exclusively in Japan from domestic sources; products were built within Japan; these were exported abroad; and meanwhile, foreign direct investments as well as competing manufacturing products were largely prevented from coming into Japan. Numerous indicators show how "closed" the Japanese economy was for the bulk of the postwar period. And, with respect to Japan's incoming foreign direct investments, this remains largely the case.

In 1985 with the rapid escalation of the value of the Japanese yen, Japan had the potential to move away from this embedded mercantilism and to shift its economy toward a greater reliance on domestic consumer demand and on the import of competitive products from the rest of Asia and of course, from the United States. Japan rejected that more open model and moved towards a very loose monetary policy instead. Focusing on traditional exporters who benefited from a weaker yen, and largely ignoring domestic consumers, the government tried to prevent the value of the Yen from escalating too quickly, thereby creating the tremendous bubble that prevailed over the Japanese economy from 1985 to 1991. When that bubble burst, Japan began a real reversal in the trend that had taken place between the positive economic link between Japan and the rest of Asia ushering in the more negative consequences that have continued until the present time.

In the period since the bursting of Japan's economic bubble, Asia has seen three big changes that challenge the previously dominant patterns of flying geese and open regionalism.

The first, of course, is the domestic economic devastation within Japan that followed in the wake of the bursting of the Japanese bubble. The broad outlines of the statistical and human chaos that followed have been well-covered. The picture is one of mass destruction of wealth; huge drops in the prices for land, stock, and other fixed assets; the rise in bankruptcies and unemployment; sweeping levels of non-performing loans; massive government indebtedness; and perhaps most importantly, the tremendous decline in Japanese labour and capital productivity.

Basically the bubble's bursting showed the underlying duality in Japan's economy. It was an economy in which many of Japan's most successful companies had moved abroad taking some of Japan's best jobs with them and leaving behind the remaining second tier of the economy. Companies that stayed behind were for the most part very heavily dependent on the domestic economy and domestic sales for their overall success. And for these companies to stay in business, they thrived on protection from any form of price competition—foreign or domestic.

Obviously Japan's agricultural and construction sectors are among the country's least productive. But more importantly the financial sector, stock brokerages, much of the service industry and a whole host of other sectors within Japan's economy have also been exposed as terribly uncompetitive globally, and dependent on extensive domestic protection to retain any viability. In this way, Japan is increasingly showing itself to be a country housing some of the world's most competitive companies — Sony, Canon, Toyota — but also some of its least competitive namely those that rely heavily on the domestic economy and particularly those that are based in financial services. There is an increasing awareness politically in Japan that structural reforms to reduce this economic schizophrenia is economically critical but quite obviously we have also seen a political reluctance to make those "economically logical" moves.

The LDP that is now in power is unlike its predecessor formed in 1955. While Koizumi has shown signs of enthusiasm for more radical economic reforms different, the LDP as a whole, since 1994, has been heavily committed to protection of the domestic sector without much enthusiasm for injecting positive changes into the Japanese economy in ways that will allow Japan's least competitive firms to exit from inefficiency and become better competitors. So that is the first big trend, the bursting of Japan's economic bubble and the domestic slowdown that has ensued.

The second big trend is the economic crisis in 1997/98. Importantly, the failure of Japan's proposal for an Asian Monetary Fund and the imposition of IMF loan conditionality upon Indonesia, South Korea, Thailand, and implicitly on other parts of Southeast Asia, put firm brakes on the tremendous regionwide economic success that had been going forward until this time.

It is also important to remember that the economic crisis of 1997/98, at least implicitly, telegraphed the message that many of the countries in Southeast Asia were very successful in embracing Japanese foreign direct investments as a way to build infrastructure, build capacity, generate a jumping-off platform for economic growth. Bur they were also finding it difficult in 1997/98 to make a transition from that early reliance on external support to self-generating mechanisms for economic development and domestic economic control.

The message that much of Asia took away during this time was not just the difficulties of coping with the IMF and with the so-called Washington Consensus, but also the inadequacy of the regional institutions, particularly ASEAN and APEC, to overcome those economic challenges. Simultaneously Japan (through the failure of the AMF proposal) proved itself unable, despite its enormous economic resources, to provide serious financial support for the rest of Asia.

The third big trend that has really shifted things across the region can be summarized as the rise of China. This is certainly seen with China which has begun to take the diplomatic, if not the economic, lead in many areas: agreement to negotiate a bilateral free trade pact between China and ASEAN; the key source of influence on matters of non-state terror which has helped China to improve its ties with the U.S. and particularly the Bush administration; or as a major source of U.S. imports from Asia.

Even more particularly important has been that country's increased openness to multilateral and regional approaches to economic development. China, of course, previously shared with the ASEAN countries a great deal of scepticism about supporting any formal organizations that might challenge national sovereignty and political control. However particularly since the economic crisis and then China's entry into the WTO, China has begun to recognize the possible benefits of co-operating with ASEAN and expanding its commitment to multilateral diplomacy. Consequently, China's leadership has become increasingly open to co-operation with regional organizations.

People talk about the rise of China but it is important to note that in many respects, the rise of China is just part of a much more complicated phenomenon which has undercut the flying geese model of development across Asia. What really is happening is that there are now multiple sources of capital development and economic energy contributing to growth across Asia; Japan is no longer the sole source of capital, technology or global corporate dynamism. Shanghai, Hong Kong and Singapore have all gained serious edges over Tokyo as financial hubs and service sectors. Similarly, deregulation in South Korea has made the country the world's leader in broadband hookups to the internet, with roughly three times the per capita rate of penetration as Japan. Taiwan, Singapore and Hong Kong also lead Japan in broadband access.

Korean and Japanese companies investing in China, money from Taiwan moving into China, Hong Kong and Singaporean money, as well as investments from ethnic Chinese businesses in parts of Southeast Asia all combine to create a much more complicated and much less clear hierarchy and pecking order among the companies, production networks and economies of Asia. The result is a much more complex pattern of economic linkages across the region. No longer do we have a clear-cut Japan-dominated hierarchy. Instead, we have multiple overlapping networks.

Japan remains by far the most economically powerful country in Asia, but it is no longer the universally acknowledged lead goose in a flying geese pattern. Many other sources of economic dynamism have sprung up in Asia to challenge Japan's leadership in critical economic sectors and the longer it takes for Japan's economy to recover, the more difficult it will be for the country to catch up.

Certainly, China has been a major contributor to, and a beneficiary of, this change. As one very simple statistic, the production and trade network that has been built between China, Taiwan and Hong Kong has really gained massive regional weight. The total external trade of these three have now amounted to US$810 million, which is greater than Japan's total productivity of US$731 million.

Obviously the greater China production network poses serious competition to Japan in technology, including in the electronics sector. Simultaneously of course Chinese economic developments have also posed challenges to the economic development in the rest of Southeast Asia.

China's economic development underscores the need in both Japan and the rest of Asia for rapid and serious structural and economic reforms. As China moves ahead, the pace of economic change across the Asian region has speeded up, putting even more importance on the part of both Japan and Southeast Asia to move rapidly away from economically detrimental domestic patterns of development.

Clearly we are no longer in a pattern of flying geese. The hierarchy has changed and using the phrase that Yoichi Funabashi has offered and probably others have used as well - we are in a situation in which Asia is really facing a leapfrog economy i.e. the capacity of different national economies to rapidly vault ahead of the others.

Overall Asia's exports to the rest of the world have grown strongly despite the economic downturn of Japan and the crisis of 1997/98. But importantly, there has been a huge drop in Japan's share of

Asia's collective exports. Generally speaking, Japan's share of Asia's exports to the rest of the world has dropped from 45% ten years ago to 30% today. At the same time, China's share has increased from roughly 6% to roughly 21% today. Thus, there has been roughly a 15% shift in the share of world trade from Japan to China.

Now Japan is still very heavily dependent on the rest of the Asian market. And its power within that market has begun to grow rather dramatically. Roughly 40% of Japan's exports and 40% of Japan's imports are to or from Asia compared to only 20% of Japan's imports coming from the U.S. and 30% of Japan's exports going to the U.S.

But as Japan's economy has slowed and as Japan has failed to provide the continual engine of growth for Asia, there has been a widening and deepening perception that the future of Asia's economy rests heavily with the decisions and actions of China and that much of the economic leadership in Asia has fallen to China by default. And this of course was played out in that bifurcated situation in which China and former Premier Zhu Rongji proposed to ASEAN the creation of a free trade pact while Koizumi showed up in the region a couple of weeks later with a proposal that was nothing near as serious.

Even more problematic is the fact that the longer Japan delays in coming to grips with its current domestic economic restructuring problems, the more the difficulties and costs of solving them will be passed on to Japan's next generation. As the country's national debt mounts, paying it off consumes an ever larger share of the national budget. Today some 20 percent of Japan's national budget goes simply to service the nation's mounting debt. As the country's population ages the taxpaying workforce shrinks. And the longer current policies of public borrowing continue the more difficult it will be for the subsequent generations of Japanese citizens to escape the mounting debt. Such high stakes make it even more vital that Japan's problems be dealt with sooner rather than later. The longer it takes the country to come to grips with its economic troubles, the further behind its neighbors Japan will fall and the more difficult it will become for subsequent generations to catch up.

The data on Japan's reluctant move to Free Trade Agreements (FTAs) is equally problematic. The only FTAs that Japan has entered into so far are those with Singapore and Mexico. Japanese's domestic agricultural interests remained sufficiently strong to force Singapore to exclude the export of gold fish to Japan which to the best of my knowledge is not anything that approaches 5 or 10% of Japan's imports or even 0.5% and 0.2%. I imagine under truly free trade perhaps ten or twelve Singaporean gold fish might have made it to Japan. But even they were seen as a threat. The negotiations between Japan and Mexico were also delayed due to Japanese agricultural opposition.

However, the end result is one that seems at first glance to signal a serious increase in Mexican exports to Japan and a reversal (albeit limited) of the power of agricultural groups to resist greater opening of the domestic Japanese market.

On the other hand, there is something very positive in the general move towards Free Trade Agreements in Asia. And the Chiangmai initiatives and the ways in which greater financial integration is taking place in the region are also positive for regional interconnectedness. But the central concern we have here is the fact that Japan, while still a technological and capital powerhouse across Asia, has nevertheless not been taking the economic leadership to boost the region's economies. As a consequence not only has Japan's economy been stagnating but so have the economies across much of the rest of Asia, particularly those in Southeast Asia.

Critics of Japan have frequently targeted the construction industry and agricultural sectors, which of course have tremendous built-in political networks to protect them and they have been a very serious part of Japan's problems. But as someone who is well over the age of feeling completely comfortable with video games and for whom the original introduction of the email was a little bit painful and less than easy, I must say that when I go to Japan even I find the lack of technological competence overpowering. It amazes me that most Japanese executives haven't a clue as to how to deal with email. Most of them are still functioning in a fax society despite the fact that the world long ago entered the Internet age. South Korea has made tremendous progress in embracing e-commerce and the Internet; however, Japan was slow to move in this direction. Only recently has Japan begun to catchup in broadband penetration. This suggests to me that the problem in Japan is more than simply agriculture, construction and a couple of retrograde industries. Japanese finance and brokerages are probably 10-15 years behind their British and American counterparts. Internet usage is behind as well. Except for a few industries, Japan has simply not been competitive at the front end of the rapidly changing technology curve.

For Japan and secondarily for the ASEAN countries, the biggest economic challenges that are now being faced are those of restructuring the domestic economies--to begin to take better advantage of the opportunities that are presented in the global commercial arenas.

Prime Minister Koizumi had advanced a potent reform agenda but his pro-reform critics are quick to point out how much more has been promised than has been delivered. Whether we are going to see radical changes now that his position within the LDP has been bolstered and whether he would be able to overcome some of the deep political resistance to reform is not clear to me. But until Japan begins to make those structural changes we are going to see very slow growth in Japan. And this is not just a Japan problem. It has major repercussions for the rest of the region.

In addition to the need for domestic changes there is the alleged trade-off between free trade arrangements and regional institutions. I think it is a false dichotomy to see this as “either or”.

One of the major benefits of free trade agreements, particularly as they affect much of Asia including Japan, is that many FTAs can break down or challenge the politically entrenched powers that have held back their domestic economies in the past. They can do this on an ad hoc basis, with each successively negotiated agreement creating an additional pinhole in the enclosures of protectionism. Certainly this is a direction that holds a lot of potential for Japan. It is not simply that a series of separate FTAs may impede long-term institutionalisation that would create a harmonious ASEAN or that would create a more harmonious Asian region.

Both of these can go forward simultaneously--with FTAs on the one hand and AFTA on the other. Japan can pursue integration within a broader region and simultaneously FTAs with other countries. Ultimately whatever happens regionally has to be embedded in a broader global economy and whatever happens in Asia is going to be meaningless if it is contradictory to broader global trends. Just to pick up one simple thread, consider the importance of recycling Japan’s savings for investment in the rest of Asia. This is certainly true but such a move would also mean a substantial redirection of Japanese savings from the American bond market and the American investment market to the rest of Asia. And it is hard for me to imagine that George Bush with a massive (at least US$87 billion) outlay for the war in Iraq and a massive and rapidly escalating budget deficit is going to sit back quietly as Japan moves its money into the rest of Asia while the American bond market collapses. It is imperative that we keep this very much in mind. Ultimately as FTAs and Asian regional ties move forward, these could also lead to the creation of an institution that would provide a container within which ensuing global changes can be held.

The last point to address is that of closer economic compatibilities. In trying to close on a note of optimism, I would simply say that there is great potential within Asia for a win-win scenario. There are tremendous economic compatibilities among China, ASEAN, Korea and Japan. There are obviously going to be tremendous competitions amongst individual companies over specific products within different sectors. But ultimately these could generate great regionwide growth and considerable national level prosperity. It is becoming increasingly clear that Japan’s recent economic improvements have been the result heavily of growth in China which has benefited many Japanese-owned firms located there or exporting to that country. China’s growth and Japan’s growth are far more likely to be complementary than competitive—at least at the macro-level. There is little reason to assess the Asian economic future from a zero sum perspective. Gains in various parts of Asia can, and most probably will, stimulate gains (not losses) in other parts of the region. Critical to a country's or a company's being on the winning side is a commitment to flexibility and global competitiveness, rather than attempts to insulate and protect existing markets.

To go back to an earlier point, the Asian region is the only one that has generated a substantial positive reallocation of world GNP. It is crucial for the people of Japan and the rest of Asia as well as the political and business leadership in the region to recognize the positive power inherent in closer regional economic ties and to try to cope with the problems that may now slow down the movement in that direction rather than to set up national or corporate barriers that would impede that broader set of movements.

A rising regional tide may in fact be uplifting and may create a more positive climate in many areas. But in order to achieve that a number of changes have to be made. For Japan, the critical question is whether these can in fact be made in a timely fashion. Failure to do so will almost certainly ensure that other countries gain both long and short-term competitive advantages that will further handicap Japan and limit its regional leadership capabilities.

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