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THE PROSPECTS OF INTERNATIONAL ECONOMIC ORDER IN ASIA PACIFIC: JAPAN’S PERSPECTIVE

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The world economy's center of gravity is shifting towards Asia, and China has been the main driver of this development. In fact, China has become the largest economy in the world measured in terms of purchasing power parity but not in terms of US dollar. China has also become, replacing the United States, the largest trading partner for almost all Asian countries, and there is no doubt that a major power balance shift is taking place in the region.

So are we witnessing a power transition between the two biggest economies? If so, the world has been remarkably calm. My view is that the tipping point is still somewhat far ahead. Simply put, the US will continue to be the dominant economy at least for some time because of the strength and stability of the US dollar. Here also lies the structural challenges of Asia that has grown so rapidly thanks to its export-oriented growth strategy. As the US continues to provide "safe" assets, the origin of its safety can be traced back to the establishment of the Bretton Woods system that still governs the global financial order today. The lack of a "safe" investment vehicle in Asia has caused capital outflows into the US and Europe. The missing channel between savings and investments in the region is a major bottleneck for sustainable growth in the region, and has contributed to the global imbalances where the US and many other advanced economies have run long-term current account deficits while the opposite is the case in emerging economies in particular in Asia.

Asia can only realize its full growth potential when it develops regional markets and institutions that can channel savings effectively into long-term investments. Merely deregulating and liberalizing the capital markets is not enough. Capacity and institution building must be accompanied by the necessary structural reforms. The similarity in the macroeconomic environment between China today and Japan in 1980's is striking. One of the lessons from Japan's experience is that opening the real economy must be followed by opening up of the capital market. Given its size, the full opening of China's capital market would inevitably reshape the US-led global financial order.

The US, China and Japan are fundamental stakeholders in regional economic integration, the process of which are currently contested in two mega Free Trade Agreements: The Transpacific Partnership (TPP), an agreement on which was reached in early October 2015, and the Regional Comprehensive Economic Partnership (RCEP). The TPP is instrumental in harmonizing rules and regulations for trade and investment while the RCEP includes countries with the biggest economies in the region. The TPP poses a challenge for each government to implement the necessary structural reforms and strengthen the capacity to benefit from a level playing field. The reform process in China will be the key for promoting a rule-based system in Asia Pacific. Japan's largest markets are in RCEP. Therefore, it is in Japan's interests to play a leading role in laying the path for a merger between the TPP and RCEP.

Japan's experience

It is very clear that Japan's relative economic influence in the region has weakened since its peak in early 1990's. China has replaced Japan as the most important powerhouse in the region. However, the relative weakening of Japan's position cannot be understood by the rise of its giant neighbor alone. There are domestic factors that have played an equally important role. Firstly, the demographic trend does not favor economic expansion. Japan is the first Asian country that became an aged society. The low birth rate combined with the one of the longest life expectancy in the world places increasing financial burdens on the young generations, which largely explains the weak domestic demand today. Secondly, the financial sector spent two decades clearing the non-performing loans after the burst of the bubble economy in the early 1990s. While financial institutions have recovered their strength, the government has accumulated debt of more than 250% of the GDP, the highest by far in the developed world. Now Japan has a deflationary economy with an excess supply of money and weak domestic demand with more than half of the government's budget financed by debt. The Bank of Japan has absorbed most of the government's deficits indirectly in the secondary market, and the stock of government bonds is largely held by domestic financial institutions. On the other hand, with USD 3.2 trillion Japan has been the biggest creditor nation over the last 23 years. Piling up of both the debt and asset in Japan reflects a financial sector that has remained relatively closed to the rest of the world.

The efforts by the Bank of Japan to combat the deflationary economy have created excess liquidity, but where is this money flowing? Over the last five years, Japanese banks have emerged as the biggest lenders in Asia, and Japanese companies are investing ever more in the region. This trend has been accelerated by the Japanese public financial institutions including the pension fund and other private financial institutions, which are shifting their asset portfolios away from government bonds into buying more foreign bonds and shares. Through obtaining a major share of foreign companies and Mergers and Acquisitions (M&As), Japanese businesses are taking a larger presence in local economies in order to tap into growing markets beyond the traditional export businesses.

Since the Plaza Accord in 1985, (when the five states - Great Britain, West Germany, USA, France and Japan - agreed to stabilize their exchange rates) to fight the continuous appreciation of Japanese Yen, the Bank of Japan has been lowering interest rates over time. We know today that this was one of the main causes of the bubble economy with the well-known consequences of the following lost two decades. During that period Japan had failed to internationalize the Yen as a global currency for asset holdings. As a result, the percentage of foreign ownership of domestic assets has remained very low. Meanwhile, Japan's saving rate has dropped from over 20% to below 5%, and the drop has not been compensated by FDI. The lack of inward FDI into Japan has slowed down the structural reform processes in Japan.

By expanding businesses overseas with local partners beyond the traditional export strategy, Japan should promote the usage of its currency not just for trade settlement but also for storing value. The increase in foreign ownership of Japanese assets would exert pressure for Japanese companies to be more efficient and transparent in their corporate governance and asset management. These strategies should help increase inward FDI into Japan. Supplementing these initiatives, a wider usage of Yen-denominated assets in the region will help Japanese businesses expand overseas, and help stabilize financial systems in Asia as regional economic integration advances.

Lessons for China

Without an open capital account, high domestic savings in China are invested at home. Decades-long financial repression in China has led to overinvestment and overcapacity of the economy. Regulating the interest rates and exchange rates has caused misallocation of capital, and the growth of the shadow banking sector to circumvent the regulatory system. This has fuelled bubbles in both the real estate and stock markets. China's economic and financial expansion overseas has been driven by these domestic factors.

The Chinese government has carefully studied Japan's experience after the Plaza Accord in 1985, when the Japanese Yen was appreciated against major world currencies. Taking lessons from Japan's economic slowdown, China aims for a gradual liberalization of interest rates, exchanges rates, and the capital account. Nevertheless, the situation in China today is reminiscent to the 1980's in Japan where financial repression led to the bubble economy. It is critical for China to succeed in its structural reforms as the state-led growth model has shown its limitations. Opening China's markets necessitates transparency in managing and operating the economy. Giving up financial repression will improve capital allocation in the economy.

Japan's experience has shown that export-led growth with a closed financial system misallocates and misprices capital, and is not sustainable, it also suggests that currency internationalization is critical in facilitating reforms in corporate governance and asset managements. Without such reforms the economy will not be able to take full advantage of regional economic integration. It remains to be seen whether the Renminbi (RMB) can become a global currency of trade and investment. China's gaining weight in global finance must be accompanied by institutional reform and development at the multilateral level.

Saving-Investment nexus in Asia

High saving rates in Asia have historically contributed to the current account surplus and high foreign reserves, in particular, of the US dollar resulting in China and Japan being by far the largest US dollar holders in the world followed by countries in the region such as Taiwan, South Korea, India, Hong Kong, and Singapore. Equally significant both countries are the largest holders of US treasuries in the world.

The global savings glut - the net asset position of Asian countries and the corresponding US deficits - has resulted in the global imbalances. The US dollar and treasures have been substitutes for local currencies and bonds in Asia, and have absorbed a significant portion of savings in Asia. Blaming the US for having the most reliable and liquid currency and government bonds is inane, but it presents challenges for financing long-term investments in Asia.

The lack of long-term investments, on the one hand, and increasing trade volumes on the other, suggests that potential benefits are huge if savings can be channeled more effectively to long-term investments in the region. The double mismatching of maturity and currency was exposed in the Asian Financial Crisis in 1997. Financing long-term investments through short-term international capital flows has made the regional economies vulnerable to external shocks. The region still borrows short-term in the US dollar to invest long-term in the domestic markets.

The Asian Development Bank (ADB) estimates that the infrastructure funding gap is roughly 8 trillion US dollars for the current decade of 2010-2020 in Asia. Financing this gap will be impossible without further development of the local currency bond and stock markets at the macro level. This development must be supplemented by setting up sovereign wealth funds, pension and insurance funds, which typically serve to finance long-term investments. Needless to say, massive capacity building in human resources in managerial, technical, legal and financial skills is not only necessary, but must be accompanied by corresponding institutional development. To start, local governments must take ownership of infrastructure projects. Structuring a finance scheme and transferring risks over time to an operator requires a long-term commitment and planning. The private sector must be involved to enhance the efficiency and co-finance the projects, and could be done through a Public-Private-Partnership (PPP) scheme.

China and Japan, the biggest trading partners and investors in the region, should align their interests in strengthening the saving-investment nexus in Asia. The two countries must support and guide regional multilateral institutions such as the ADB, the Asian Infrastructure Investment Bank (AIIB), and the ASEAN+3 Macroeconomic Research Office (AMRO). When Asia invests less of its savings in the US dollar and US treasures, Asian financial markets will be less affected by US monetary policy; such efforts will eventually weaken the global dominance of the US dollar. Moreover, strengthening regional institutions will decentralize the power of The World Bank and the International Monetary Fund (IMF) in global finance and development. These challenges must be overcome before we see the dawn of an Asian century.

TPP vs RCEP

On October 5, 2015 twelve countries (Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, U.S., Singapore and Vietnam) declared on conclusion of the agreement on the Tran-Pacific Partnership (TPP). By granting the same market access in goods and services for all companies regardless of nationality, the TPP aims to expand market activities, reduce trade barriers, and promote efficiency and economies of scale. This has been seen by some as a threat to rules and practices that protect national interests, but what is at stake here? Harmonizing rules and regulations is supposed to create a level playing field for both domestic businesses and foreign companies. Under this reciprocity structure, a company in Japan, for example, would be able to benefit from new business opportunities in the US, as a company in the US would be able to in Japan. In this regard, the TPP will provide new business opportunities to its member countries and businesses, which will benefit all in the process.

What are the major challenges? We must acknowledge that there are vast differences in the capacities of companies from different countries to operate and expand their business domestically and internationally. In this light, governments are discussing certain concessions and grace periods. The challenge for a country like Vietnam, a TPP negotiating partner, is to develop and strengthen institutions in this given time frame. In order to implement the agreement, the TPP members must tackle the required structural reforms, and open the respective markets for new business. Some governments may find the external pressure of the TPP useful in getting the political support for reforms that challenge the status quo, and ultimately, there will be winners and losers. The question is what the overall gain is. For example, can FDI promote technological transfers so that local companies can climb up the ladder of the global supply chain? FDI should help capital flow into productive ventures instead of speculative investments. In order for this arrangement to be beneficial, not only multinationals but small and medium size enterprises must benefit from being part of this global network.

Somewhat overshadowed by the TPP, RCEP is an alternative free trade agreement that may be concluded in the near future as well. The figure below compares the two.

TPP and RCEP (2012)

	Population (million)	GDP per capita	% share of world GDP	% share of global trade
TPP	795	35,000	38.4	26.0
RCEP	3,398	6,000	29.5	28.5

Sources: International Monetary Fund and World Trade Organization

One of the fundamental differences is that RCEP members combined have a four times larger population than TPP members, but the TPP members have a six times larger income on average. This is because RCEP includes both China and India excluded in the TPP. This implies that the RCEP has a much larger growth potential because of the inclusion of the two rising Asian economies. One may think that because of this RCEP has a larger potential in advancing regional economic integration as well, as it also includes all of the ASEAN members, who are currently embarking on establishing the ASEAN Economic Community (AEC) by the end of 2015, and other states that have FTAs with ASEAN, such as South Korea and Japan. Yet, it is hard to see a common market vision beyond ASEAN in the near future as they themselves struggle to harmonize national practices within the organization.

Alternatively, the TPP through harmonizing rules and regulations induces a new dynamic in regional economic integration. Through the TPP, the US aims to promote its rebalance to Asia and reassure its regional partners of its continued commitment to the region. To maximize the growth potential of Asia, however, the TPP must have a roadmap for including new members such as China, India, South Korea, the remaining ASEAN members, and Taiwan. Considering the trade and business relationships, the natural next negotiating partners would be South Korea and Taiwan. China's accession to the TPP at this point would be possible only with massive concessions and reforms, which would require liberalizing foundational elements of the country's financial system and economy. Ultimately, the success of China's reforms will determine whether or not they are able to join the TPP.

While China's involvement is essential for regional economic integration, China will not set guiding principles as it has little that other countries can follow. Setting market rules and regulations are necessary to support market activities, and the ASEAN members will eventually join the TPP when it meets their own national objectives. Meanwhile, the TPP and RCEP will coexist. Economic logic suggests that two initiatives will eventually merge, as they are complimentary; while the TPP sets the rules and regulations, the RCEP has the larger growth potential. Competition for best practices and the economies of scale will lay a pathway to form the Free Trade Area of the Asia-Pacific (FTAAP) for all APEC economies. The politics and vested interests in each country, however, may uphold this process.

Japan's perspective

Under the shrinking domestic demand and the ultra-loose monetary policy by the Bank of Japan, Japanese corporations have been going global. While Japan goes on a buying binge through M&As and other forms of cooperation, Japanese companies, however, face challenges as their corporate structures and practices are deeply rooted in Japanese culture. Here, the TPP can be beneficial. Under common set of rules and regulations, Japanese corporations must find their way to remain competitive and attractive to a larger pool of workers and capital in the region. This would require that Japanese corporate governance be revised in order to expand beyond Japanese society. Japan should also encourage foreign entities to hold more Japanese Yen. Whether in terms of currency, bonds, shares or other forms of assets, the Japanese economy has been largely insulated from the rest of the world. Japan will benefit from a more open type corporate governance and asset management that is compatible to the rest of the world. The TPP in this light is an instrument for not only opening up the Japanese economy, but also for Japanese corporations to become global enterprises and not just export champions.

Whether the TPP is ratified or not, Japan should continue to deepen its engagement with Asia. The obvious starting point is to conclude a trilateral FTA with China and South Korea. In doing so, the three countries should identify their mutual interests for regional economic integration. While Japanese businesses seek to establish a stronger footing in overseas markets through utilizing the assets they have accumulated over the past decades, Japan on the other hand needs inward FDI to revitalize the economy. In order to dually leverage its position and attract FDI, Japan should work towards bringing the TPP and RECP closer by expanding the rule-based system that is inclusive and transparent.

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