

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

The Japan–US–China Economic Relationship: Status and Political Relevance

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Peace and prosperity in the East Asian region will hinge on the nature of plans by three major powers which exercise great influence over the region's economy and security—Japan, the United States, and China.

But various problems are present in the diplomatic relations between Japan and China, as well as between the United States and China, and relationships of trust have not fully formed.

Interdependence is growing deeper among the three countries' economies, bringing benefits to each. But improved diplomatic relations would go far to improve their mutual advantage; economic ties between Japan, the United States, and China will undoubtedly influence diplomacy and security in the years to come.

Producing half of the world's GDP

At present the three countries together have a 43.8 percent share of

the world's gross domestic product, and China has grown into the world's sixth largest economy. By 2015, when China's economy is expected to be as large as Japan's, the three will have a 47.3 percent share of global GDP, close to half (figure 1). It is easy to appreciate the huge impact of the three countries will have on the world's economy and politics, and the heavy responsibility they must bear.

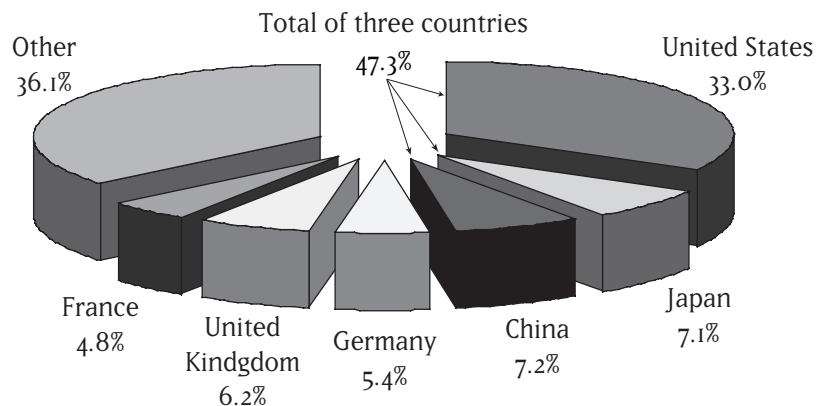
The rise of China will continue to be dramatic. After overtaking Japan's economy in 2015, the Chinese economy is projected to grow to the scale of the US economy by about 2040 (figure 2). This expansion of national power

will naturally influence the quality of that power. After all, China will be able to devote at least as many resources as other countries of a comparable economic size are devoting to infrastructure improvement and technological development, which are key factors determining a country's industrial competitiveness.

Naturally, China's rise is already having a profound impact on international relations. China's swelling strength has allowed its national defense spending to increase sharply. This spending has been making a two-digit expansion for many years in a row, and it is expected to surpass Japan's spending in a few

Figure 1

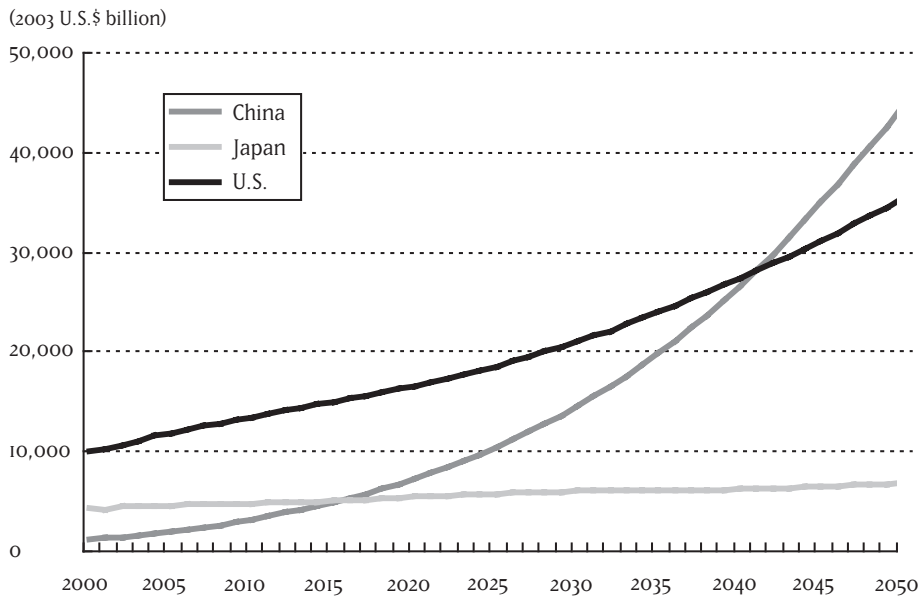
Shares of World Nominal GDP, 2015



Source: World Bank

Figure 2

Real GDP Forecast



Source: Goldman Sachs "Dreaming With BRICs: The Path to 2050"

years. Indeed, the US Department of Defense's annual report "Military Power of the People's Republic of China" estimates that actual spending on national defense is two to three times the announced budget, and some people argue that the military balance in East Asia is already in danger. In this context, just how China uses its economic power is being closely watched.

Beijing's economic influence vis-à-vis Tokyo and Washington

Trade between Japan and China and also trade between the United States and China is now about as large as the total Japan-US trade (figure 3). Viewed simply, this implies that each of the

three countries is about equal to the others as a trade partner. That said, this general parity is not static: whereas growth in trade between Japan and the United States has slowed, China's trade with both Japan and the United States is continuing to expand. The influence Beijing can bring to bear in trade affairs is clearly on the increase.

China is also expanding its trade quickly with other parts of the world, notably Europe, Southeast Asia, and India. Judged in terms of total trade, China's ties with the European Union are even stronger than those with either Japan or the United States. For countries everywhere, China presents an extremely attractive market. Given

economic globalization, it would be unrealistic to adopt policies designed to contain China or to protect domestic industries from Chinese exports.

A key base for Japanese companies

An analysis of the Sino-Japanese trade relationship reveals that while Japan ran a deficit of \$4.4 billion in terms of country-to-country trade in fiscal 2002 (April 2002 to March 2003), there was actually a trade surplus when the activities of private sector companies are calculated (i.e. by adding indirect exports from overseas production bases to direct exports).

In the case of Japan-China trade, sales within China and exports to third countries of products originating from the plants of Japanese companies that manufacture in China are counted as Japanese exports. When these indirect exports included, Japanese companies had a surplus of \$17.8 billion. Clearly, China has become a crucial base for Japanese efforts to maintain an edge in international competition.

Business surveys invariably find that Japanese firms rank the Chinese market as the single most important overseas market and that they intend to expand their operations in China over the years to come. During the 10-year fiscal 1993-2003 period, sales of Japanese-affiliated manufacturing

companies in China grew 11 times, expanding explosively at an annual average 28.3 percent pace. No other market in the world has been as robust for Japanese firms.

America and China draw closer

Turning to Sino-American ties, the United States is growing increasingly reliant on China, now its fourth-largest trading partner. The gigantic trade deficit on the American side of this bilateral relationship often causes deep concern that the red ink is damaging American industry, depriving Americans of jobs, and in other ways harming the US economy.

Is this really true? The Office of the United States Trade Representative (USTR) has expressed dissatisfaction with the huge scale of the deficit, but it also acknowledges that imports from China provide American consumers with inexpensive products and American businesses with inexpensive parts, thereby helping the US economy to grow without inflation. Moreover, American exports to China are expanding faster than exports to other countries. Indeed, they have registered fivefold growth since 2001; China is now America's fourth-largest export market. On the Chinese side, meanwhile, the share of imports from the United States in total imports has

risen over the past 11 years from 5.8 percent to 14.6 percent.

Furthermore, even as the United States ran up a trade deficit with China in excess of \$200 billion in 2005, it received a flow of funds amounting to \$130 billion as a result of Chinese investments in US securities, and these funds are propping up the US economy's prosperity. If the Chinese currency, the yuan, were sharply revaluated, as Washington has repeatedly demanded, China's exports to the US market would diminish, and so would China's foreign exchange reserves. As a result, interest rates on US securities would rise which would likely have an unfavorable impact on the US economy. Interdependence

in the Sino-American relationship is growing ever stronger.

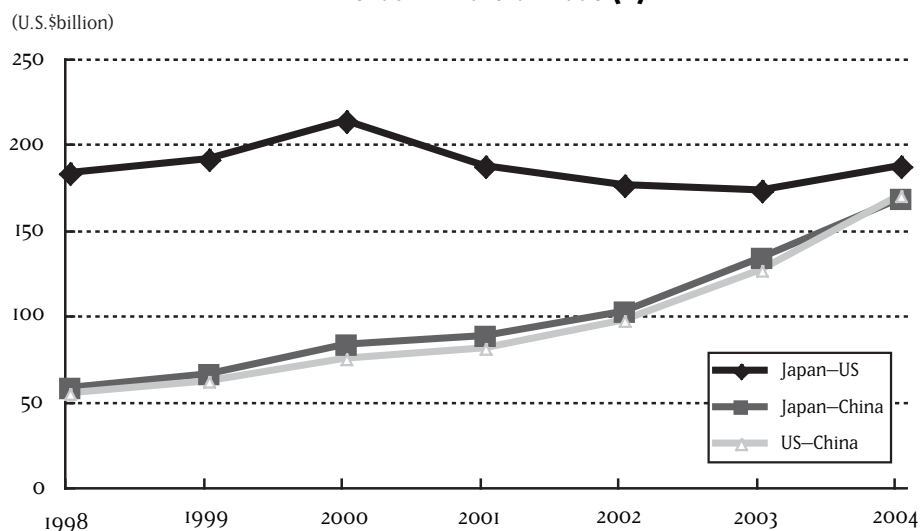
The Chinese market is just as attractive to US firms as it is to Japanese firms. A study by the American Chamber of Commerce in China found that some 80 percent of its member companies rank China among the top three countries to invest in and that almost all plan to expand their Chinese operations. In addition, 90 percent are optimistic about the prospects for their Chinese operations, and roughly 70 percent say their profit rates in China are as high or higher than the rates elsewhere.

Benefits accruing from foreign capital

There can be no doubt that China's economic development has relied heav-

Figure 3

Trends in Bilateral Trade (1)



Source: IMF

Washington should actively support any international organization in East Asia making a contribution to stability.

ily on investment from other countries. Just how important foreign-affiliated companies are as players in the Chinese economy can be appreciated from the fact that their exports account for some 60 percent of total Chinese exports. Of China's total social fixed assets investment, the nonpublic sector accounts for 47 percent. Of that, foreign-affiliated companies have a share as large as 19 percent (2003 data). The industrial added value of so-called foreign investment enterprises now amounts to 28 percent of China's total industrial added value. In this light, we may say that without the entry into the country of foreign-affiliated businesses, China's development would not have come to much.

The Japanese, US, and Chinese economies are becoming increasingly interdependent. As separate states, Japan, the United States, and China are the world's three foremost economic powers, and they are playing the role of the driving forces of the world economy's development. Accordingly,

the avoidance of political conflicts among them is vital to enhance global prosperity and bring mutual benefits.

Engaging the United States in an East Asian Community

Intraregional trade transactions have grown to 54 percent of the region's total trade transactions, larger than the intraregional trade share of the North American Free Trade Area (NAFTA). Since each East Asian country is forming a web of bilateral free trade agreements with other countries in the region and is thus in effect moving toward economic integration, it might be argued that an economic community is not really necessary. But it is also a fact that East Asia faces all sorts of problems involving resources, energy, the environment, poverty, and epidemics, which would suggest the need for a powerful international consultative mechanism to resolve these problems.

A possible worsening of the relations between Tokyo and

Beijing is a matter for particular concern. To improve this situation, it is vital that Japan and China work cooperatively toward common goals. By jointly demonstrating leadership in the construction of an East Asian Community, they should be able to contribute to the peace and stability of Asia and the world.

Washington is wary of the idea of an East Asian Community, fearing that such a grouping might adopt an exclusionary stance toward the United States. In fact, however, many Asian countries already have bilateral security arrangements with the United States, as well as strong economic ties, and their interests would only be harmed if they moved to shut the United States out of a geographical scheme. From the American perspective as well, stability in East Asia is in line with US interests.

For this reason, Washington should actively support any international organization in East Asia making a contribution to stability. We must find ways to encourage the United States to participate in a new East Asian international organization.

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Japan's Economic Policy after Koizumi

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Japan's economy is finally back on track. With companies posting higher profits and hiring more workers, banks resuming new lending, and concerns about deflation subsiding, optimism about the economy is rising. The current economic expansion is poised to become the longest expansion in the postwar period. Yet Koizumi's departure has left many wondering whether the era of structural reform and economic transformation is coming to a close.

Koizumi's successor, Prime Minister Shinzo Abe, is better known for his foreign policy views than for his stance on economic policy, and some question his resolve to tackle the tough issues facing Japan's economic future. Moreover, the political challenge of retaining the ruling coalition's majority in the Upper House in the election next July looms large over Abe's policy agenda.

Koizumi brought about major changes in the political and economic status quo through his structural reform agenda and his creative political strategies. However he left the details of implementing his key reforms, including postal privatization, to his successor. Moreover, Koizumi's telegenic charm and political savvy will be hard to replicate. And Abe is coming to power at a time when many

in the public are expressing a sense of "reform fatigue" and concern about rising inequality.

The biggest economic challenge facing Japan is massive government debt. Japan's debt now exceeds 170% of GDP, four times larger than the OECD average, and will pose an increasingly difficult burden in the midst of a rapidly aging and shrinking population. Debate has centered on whether growth strategies should take priority over tax increases and spending cuts. Koizumi sought to slash government spending on public works projects and other areas, but he left the question of tax hikes to his successor.

Financial circles, led by former Finance Minister Sadakazu Tanigaki, have advocated an increase in the consumption tax as a necessary step towards fiscal consolidation. Abe instead has put forth a "rising tide" policy that emphasizes growth as the means to boost tax revenue rather than tax cuts. He has pledged to refrain from increasing taxes until after next year's election. Tanigaki and other fiscal hawks are noticeably absent from Abe's new economic team, while Hidenao Nakagawa, the architect of the pro-growth economic policy, has been promoted to LDP Secretary General and will likely exert strong influence over economic policy.

Abe's economic team also represents a stronger business perspective, compared to Koizumi's emphasis on financial policy reforms. Two key members of Abe's Cabinet are closely tied to business and industrial circles. The new Finance Minister, Koji Omi, is a former trade official, a MITI "old boy" who is also considered "old school" in his industrial policy views. Omi has already suggested cutting corporate taxes as a way to stimulate growth by promoting innovation and corporate competitiveness. To head the Ministry of Economy, Trade and Industry (METI) Abe chose Akira Amari, a relatively young politician best known for his very close ties to METI and business circles. As a leading member of the LDP's commerce and industry caucus (*shoko zoku*) Amari has worked closely with METI policy initiatives in areas ranging from energy, intellectual property rights, and small and medium industries. METI officials and business and industrial circles are pleased with these appointments, viewing them as signals of a pro-business stance. Business groups were further delighted with Abe's early diplomatic overture to China, and remain hopeful that Abe can warm relations between the two increasingly interlinked economies. They are also optimistic that Abe may provide a fresh start to resume trade talks with South Korea.

METI would certainly welcome a chance to become a more central player in economic policy, and the theme of "innovation" provides an opening.

Another big question is whether economic policy-making will continue to be centralized under the Prime Minister's Office, or whether it will revert to more "normal" channels of bureaucratic control. Koizumi asserted more political control over the economic policy process by creating the Council on Economic and Fiscal Policy (CEFP) to centralize and coordinate economic policy in the Cabinet. Koizumi's economic policy chief, Heizo Takenaka, skillfully utilized the CEFP to galvanize public support for Koizumi's reform proposals, and to undercut opposition from within the LDP.

Abe's new Economy Minister, Hiroko Ota, is a former university economics professor who served as Takenaka's deputy in the CEFP. Although she will likely stay loyal to the course set by her mentor, she may not have the same flair as Takenaka, nor enjoy the political backing that he had from Koizumi.

Abe has made clear his intention to take a top-down decision-making approach to assert political control

over the bureaucracy and any resistant LDP lawmakers. To this end he has appointed a team of advisors within the Prime Minister's Office to handle key issues, a framework motivated by the example of the National Security Council in the U.S. White House. Abe named his ally Takumi Nemoto, a young LDP Lower House member, as advisor on economic and financial policy. How this framework will work in practice, however, is an open question. Will it further centralize economic policy-making in the hands of the Prime Minister, or create some degree of confusion or perhaps tension among competing centers of influence in the Prime Minister's Office, the Economic Council in the Cabinet, and senior officials in the bureaucracy?

Innovation and Industrial Policy: Back to the Future?

Abe has made innovation a key theme of his economic policy, and has pledged efforts to promote fields such as engineering, medicine, and

information technology. Finance Minister Omi and other members of his economic team have suggested corporate tax cuts and perhaps other financial incentives to promote innovation in the corporate sector. Meanwhile, METI in recent years has struggled to retain its relevance and prestige in Japan's transforming economy. METI lacked a strong voice in the Koizumi Administration, and Koizumi's central policy reforms—such as postal privatization and reform of public sector corporations—had only marginal connection to METI policies. METI would certainly welcome a chance to become a more central player in economic policy, and the theme of "innovation" provides an opening. Does this mean Japan is headed back to the old days of industrial policy?

A return to old-style industrial policy is unlikely if not impossible. METI itself is quite different from the MITI of old. A younger generation of METI officials is skeptical about heavy-handed market intervention to target specific sectors or companies. METI's business clients are even more skeptical about sector-specific industrial policy. Instead, both METI and business officials tend to emphasize more indirect policies designed to promote a competitive business environment, such as promoting university-industry

research collaboration, protecting intellectual property rights, promoting more venture capital investment, and deregulating labor markets and the broader economy. Any new policies to promote innovation, including any financial incentives to stimulate R&D or other innovation activities, are expected to be aimed across-the-board, rather than targeted at specific sectors or firms.

Openness and Trade Policy: the WTO and EPAs

Openness is the second key theme sounded by Abe in his economic policy. In his policy speech to the Diet, Abe declared that "the power of innovation and openness" would be used to "channel in new vitality to the Japanese economy." To this end he has promised stronger efforts to conclude Economic Partnership Agreements (EPAs) and to resume the Doha Round negotiations in the WTO. He also pledged to increase foreign investment in Japan.

Koizumi made similar pledges to advance Japan's EPA agenda, although in practice he left the details of trade negotiations to the bureaucrats, who were sharply divided over giving concessions in sensitive areas such as agriculture and visas for skilled workers. This internal resistance has complicated

the process of negotiating EPAs with key trade partners. Yet, despite these limitations, Japan's EPA strategy has been advancing comparatively well, placing Japan in the front of the pack in the regional FTA game. Japan's recent proposal for an East Asian Free Trade Area, encompassing the 16 countries represented at the East Asian Summit, is the next stage of Japan's FTA strategy. Japan hopes to lock in its version of FTAs, which include rules on intellectual property, investment, and other areas, as the regional standard. This is motivated in large part by concerns that China has an edge in proposing and negotiating "softer" FTAs with ASEAN and other regional players.

Implications for U.S.–Japan Relations

What do these new directions mean for U.S.–Japan economic relations? The days of trade wars between the two countries are clearly over. Issues like beef or steel may arise from time to time, but Japan is unlikely to

again become a major target of U.S. economic frustration, even if the U.S. economy slumps. Abe's emphasis on openness and the growing foreign presence in corporate Japan should contribute to the ongoing progress in the deregulation and liberalization of Japanese economy.

Some Japanese observers worry about Democrats gaining control of Congress in the upcoming midterm election, a prospect that looks increasingly likely as the election approaches. However a shift to Democratic Congress would not alter the positive course of bilateral trade relations. Support for free trade is declining in Congress, but it is important to note that it is declining in both parties, making party control less important. Protectionist sentiment that may emerge from Congress over the next few years is much more likely to be targeted against China and other emerging market economies, which

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pose much greater trade problems for American businesses and workers.

The next several years may in fact present an opportunity to further strengthen bilateral economic ties. Both countries have strong incentives to revitalize the economic agenda of APEC, especially if the Doha Round continues to falter. A more robust APEC could provide a valuable framework to coordinate the emerging patchwork of FTAs in the region. A trilateral free trade agreement in services between the U.S., Japan, and the EU has been proposed by Senator Max Baucus (D-Montana), and is an idea that could gain traction in U.S. policy circles.

And perhaps the time will soon arrive when serious consideration will be given to a US–Japan FTA. One stimulus would be a successful conclusion of a U.S.–South Korea FTA, currently scheduled for completion next year. On the U.S. side, a U.S.–Korea deal would provide a model for similar sectoral issues that would be sure to arise in a U.S.–Japan FTA. For Japan, the prospect of two of its three largest trade partners entering into a bilateral FTA would make it very hard to resist forging its own agreements with these partners. Moreover, the decline of the importance of the rural vote for the LDP may open the

way for more generous agricultural concessions in the future.

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