

Newsletter



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Japan's Strong Leadership Urged to Promote Regional Economic Cooperation in East Asia

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1. Introduction

In November last year, President Jiang Zemin agreed to begin negotiations between China and ASEAN (Association of Southeast Asia Nations) to create a free-trade area within a decade. This was followed in January of this year by Prime Minister Junichiro Koizumi's "Initiative for Japan-ASEAN Comprehensive Economic Partnership" proposed in Singapore, during his trip to five ASEAN countries. He suggested going beyond East Asia (ASEAN 10 countries, Japan, China and Korea) to include Australia and New Zealand. Then in March, during Prime Minister Koizumi's visit to Korea for a summit meeting with President Kim Dae Jung, the two leaders signed the Japan-Republic of Korea Investment Agreement and also agreed to create a study group to consider the establishment of a free trade agreement (FTA) between the two countries. Furthermore, in April, Asian leaders,

including Prime Minister Koizumi, Prime Minister Zhu Rongji, gathered at the first “Boao Forum For Asia” (an Asian version of the “World Economic Forum”), held in Hainan Province, China, and exchanged views on various issues including regional economic cooperation.

These moves by Asian leaders indicate that regional cooperation has entered a substantive stage. The East Asian region faces a number of serious political issues, such as the Taiwan strait, the Korean peninsula and nuclear armaments, that create serious political tensions. Policy dialogue between governments, promotion of intra-regional trade and investment, and strengthening relations through regional financial cooperation will be conducive to promoting understanding and cooperation among countries of the region, thus having the positive effect of easing such political tensions. Increased interaction between politicians and government officials, as well as frequent meetings of the various, sometimes overlapping, regional forums, indicate that intra-regional dialogue has intensified in recent years. Such developments are a reflection of the growing inter-dependence in regional economies.

Japan played a crucial role, together with the IMF, and other governments mostly regional, in resolving the Asian financial crisis of 1997-98 by arranging a financial package which led to the early recovery of these economies. Four years after the Asian crisis, as a result of the decade-long economic slump and unstable financial system, Japan is seen as an inward-looking country, unwilling to take the initiative in external affairs. Loss of self-confidence is at the root of the alarmist discussions that perceive China’s economic development as a threat. Japan remains as the major contributor of the capital and technology that East Asia needs, and promotion of regional integration will undoubtedly serve Japan’s interests, while helping to overcome its grave history.

This paper considers the need to strengthen Japan’s leadership by developing a long-term vision for regional cooperation in the areas of finance, trade and currency.

2. Regional Financial Cooperation

ASEAN, established in 1967 by five founding members, is the oldest among the regional forums in East Asiaⁱ. Since its birth, ASEAN has nurtured regional cooperation, while maintaining the principle of non-interference in national affairs. It took steps to admit the remaining five countries in East Asia, making a ten-member associationⁱⁱ. In 1992, the ASEAN Free Trade Area (AFTA) was established, and in 1998, ASEAN established a regional surveillance mechanism to promote collaboration in macro economic policy. It now constitutes a large group of economies, consisting of 525 million people and a total GDP of US\$580 billion.

With the onset of the Asian financial crisis of 1997-98, however, it became clear that ASEAN alone could not cope with such a large-scale economic problem. Total official funds provided by the IMF, other international institutions, regional governments and others to the two ASEAN countries, Thailand and Indonesia, amounted to US\$17.2 billion and US\$36.1 billion, representing 12% and 17% of GDP respectively, while Korea received US\$58.4 billion, 12% of GDP.

The East Asian crisis, which occurred in an environment where international capital, dominated by foreign direct investments (FDI), flowed across borders freely, acted as catalyst for the promotion of regional economic cooperation. ASEAN + 3 (Japan, China and Korea) was informally set up in November 1999. It meets regularly at the top level and also at the ministerial level, covering a wide-range of issues in the East Asian region including foreign affairs, finance, labor and agriculture.

One concrete achievement of the ASEAN + 3 activities is the Chiang Mai Initiative (CMI) reached in May 2000, an agreement to enter into bilateral swaps. In the past 2 years, ASEAN has increased the total amount of swaps to US\$1 billion, and Japan, China, Korea and several ASEAN countries entered into bilateral swap contracts totaling US\$19.5 billion. These swaps include a Yen-RMB swap arrangement equivalent to US\$3 billion between the Bank of Japan and the People's Bank of China that was signed in March of this year.

i Indonesia, Malaysia, the Philippines, Singapore and Thailand

ii Brunei joined in 1984, Vietnam in 1995, Laos and Myanmar in 1997 and Cambodia in 1999

Drawing under the Japan-China swap agreement is unlikely, but the agreement has a symbolic significance as the two countries hold the key to regional cooperation. It is expected that the total amount of bilateral swaps will eventually reach over US\$30 billion.

The other concrete outcome of the ASEAN + 3 activities is several research projects on regional surveillance, which is essential to promote regional cooperationⁱⁱⁱ. First, the Manila Framework group, established in November 1997, consisting of East Asian countries, Oceania, the United States, Canada and international institutions such as the IMF, has been conducting studies on regional surveillance with the aim to complement the global surveillance carried out by the IMF. Second, ASEAN+3 conducted studies on monitoring capital flows and an early warning system to prevent future crises with the assistance of the ADB. Furthermore, in November 2001, a working level meeting was held within ASEAN + 3 to discuss mainly regional surveillance at the technical level. Third, studies have been undergoing involving the private sector, based upon an agreement reached at the ASEM (Asia-Europe Meeting) Finance Ministers' meeting which took place in Kobe in January 2001. The project has been carried out by academia and think-tanks of Europe and East Asia on the question of what Asia can learn from the EU's experience in regional surveillance.

The success of regional integration in Asia is dependent upon how effectively the regional surveillance mechanism can be implemented by the member countries that have generally maintained a principle of non-interference in national affairs, so the outcome of these studies is considered important.

3. Deeper Regional Financial Cooperation

The establishment of a network of bilateral swaps under the CMI is considered an important step forward towards regional co-operation in East Asia. However, once the network is completed, further efforts should be made to continue to expand and deepen the CMI arrangement. First, more emphasis should be placed on the regional arrangement. According to the swap agreement, up to 10% of the swap amount can be drawn on the basis

iii Refer to "IMF Surveillance, A Factsheet, August 2001"

of CMI surveillance, but drawing of the remaining 90% is subject to IMF conditionality. Since the regional financial arrangement is complementary to the global arrangement, it is necessary to create a linkage between the regional and global arrangements. However, there should also be a reasonable balance between them, provided the regional arrangement is supported by appropriate surveillance. Regional surveillance is thus crucial to secure regional autonomy. Second, the total amount of the financial arrangement needs to be increased, since large financial arrangements act as a deterrent to future financial crises. Third, to improve the efficiency and effectiveness of the financial arrangement, the network of bilateral swaps should be organized into a multilateral arrangement, which may eventually lead to the establishment of an institution.

Up to now, financial cooperation has preceded trade and currency cooperation. Japan should continue to take the lead in this area. It is anticipated that in the not too distant future, regional surveillance will gradually be implemented, and an institution to streamline it and solve related matters will need to be created.

4. Free Trade Agreement

Japan changed its trade policy in the late 90's, from exclusively supporting trade multilateralism to a more flexible approach that permits regional trade such as the EU and NAFTA as well as bilateral free trade agreements (FTA), while emphasizing the importance of the WTO multilateralism. China's proposal to establish a free trade area with ASEAN within ten years has made Japan reconsider its position on regional FTA.

Since Japan has a serious domestic agricultural issue, there is always the fear of politicizing the FTA negotiations. In fact, Prime Minister Koizumi's speech, delivered in Singapore in January, carefully avoided reference to FTA. However, as the EU and NAFTA further deepen regional arrangements, Japan needs to carefully study, and eventually present its own ideas on regional FTA, including a liberalization program for agriculture.

One of the most serious problems Japan faces in agriculture is the fact that its self-

sufficiency in crops, except for rice, is so low that it is generally thought that there is a limit on further reduction of tariffs on agricultural products. It is difficult to make a direct comparison of the situation in Japan and China. However, the fact that more than half the population in China live in agricultural areas with 150 million unemployed, as compared to Japan's agricultural population of 4%, tells us that China's agricultural issue constitutes a very serious socio-economic problem. Since China's agriculture is labor intensive compared to, for example, land intensive agriculture in the United States, it is uncompetitive. China's WTO accession is bound to have a negative economic and social impact on its agriculture. FTA with ASEAN will also expose China's agriculture to competition from ASEAN countries.

A Chinese expert indicated that Japan may not join the China-ASEAN FTA, because of the stumbling block presented by Japan's agricultural problems^{iv}. So long as Japan resists the liberalization of agriculture, his prediction will be right. Liberalization of the agricultural industry and its structural reform will not be possible in the absence of strong political leadership. The critical test is whether or not Japan is ready to share the pain with its free trade partners. Japan needs to prepare well in advance so that the agricultural issue will not become an impediment in exercising its leadership in promoting regional cooperation.

Japan, for the first time, signed a FTA agreement with Singapore in January this year. The reason why the FTA was carried out smoothly was that there was no significant agricultural trade between Japan and Singapore, thus by-passing the agricultural issue. In fact, there were no agricultural import items for Japan that were newly classified as tax free. Japan's agricultural issue is bound to be put on the table in future FTA negotiations.

5. Currency System

The Japanese yen is the only international currency supported by a large economy in the East Asian region. However, the use of the Japanese yen in trade, capital transactions, etc. is limited in the East Asian region and there is virtually no prospect of forming a yen zone.

iv Nikkei February 5, 2002 "Agriculture, a stumbling block for FTA"

The de facto U.S. dollar-pegged system that was adopted by many of the East Asian countries was suspected to have triggered speculative movements resulting in the East Asian financial crisis of 1997-98. Reflecting on this experience, some East Asian countries loosened the linkage of their currencies to the U.S. dollar shortly after the crisis. However, this was a short-lived phenomenon and countries like Thailand, Indonesia, and Korea have returned to a de facto U.S. dollar pegged system, or a system close to it, although they have adopted a managed floating rate system. Malaysia maintains a fixed exchange rate system at US\$ = MR3.8 since September 1998. Hong Kong maintains a currency board system, a hard peg to the U.S. dollar. China has also adopted a de facto fixed exchange rate system at US\$=R8.3 since 1994. Although Singapore adopts a basket of currencies system including the Japanese yen, the share of the U.S. dollar is estimated to be overwhelmingly large^v. Therefore, many of the countries in the East Asian region maintain a de facto dollar-pegged system or a system close to it.

International currencies have a tendency to inertia, a tendency to return to a familiar currency, such as the U.S. dollar. There is also a tendency in the East Asian region to prefer a fixed exchange rate system to a floating exchange rate system, which creates a feeling of instability. The fact that many of the East Asian currencies returned to a de facto dollar-pegged system endorses these two tendencies. As a result, there is a fear that the region's currency system is vulnerable because many countries returned to a potentially dangerous de facto dollar-pegged system. Therefore, it is important to conduct an in-depth study on the most suitable currency for the East Asian region in order to attain a stable exchange rate system, which is necessary for the promotion of intra-regional trade and investment.

As seen in the history of EU, the ultimate goal of a regional currency system might be considered to be a single currency. However, in East Asia, there is no prospect of reaching a political consensus in the foreseeable future that warrants a single currency in the region. The region will continue to search for a common currency rather than a single currency to which each of the region's currencies will be anchored.

v Eiji Ogawa (2000)

Before introducing the single currency, the euro, the EU adopted a mechanism in which currencies in the region moved within a narrow band to stabilize their exchange rate fluctuations. Many of the regional currencies were de facto anchored to the German mark, the strongest currency in the region. East Asian currencies are pegged to an outside currency, the U.S. dollar, reflecting their close economic linkage to the United States. As an alternative to a de facto dollar-pegged system, academics, including many Japanese researchers, proposed a currency basket system linked to G3 currencies (U.S. dollar, euro and yen)^{vi}. A system linked to a basket of currencies would mitigate exchange rate fluctuations in these anchor currencies. More importantly, even if each country assigns a different weight to each of the three anchor currencies at the initial stage, if the countries wish to make the basket currency their common currency, they can do so by attaching the same weight to each of the three anchor currencies. In the absence of a suitable regional currency, a currency basket system could provide an interesting option, and an in-depth study, including the technical aspects, should be conducted further.

China's currency policy is important for the region's future currency regime. China moved to liberalize current account transactions in 1996, and after WTO accession, it has started to liberalize trade, banking, direct investment and currency transactions in accordance with the agreed time schedule. Foreign banks in China have been gradually allowed to deal in RMB and the process will be completed in five years. However, there is no time schedule for the liberalization of capital accounts. China's tight capital control is considered to have worked well, helping to protect China from the Asian crisis in 1997-98. It is unlikely, therefore, that China will liberalize capital accounts in the coming five years, a period during which it will work on reforms required by its entry to the WTO. Thereafter, China may relax capital controls gradually and by the time of the 2008 Olympics, use of RMB in international transaction may have made some progress, although it is not possible to estimate with a high degree of certainty. In the meantime, international use of the Korean won may make substantial progress.

vi Works by Japanese researchers include Kawai and Akiyama (1998), Ito, Ogawa and Sasaki (1998), Ogawa and Ito (2000), Yoshino, Kaji and Suzuki (2000), Ogawa and Sun (2001).

If RMB and the Korean won become a convertible currency, the region may have several currencies, such as the yen, won, RMB, H.K. dollar, New Taiwan dollar, and Singapore dollar that may be used in international transactions. Then, there will be more ideas and proposals for a common currency system, as the choices for an anchor currency will have widened.

6. Changing Environment

The following three points are relevant when considering the future of the East Asian region:

(1) Growth of China's economy

The growth of China's economy and its impact upon regional economies will be the most dynamic change in the region. China has achieved an annual growth rate of 9% annually since the economy was liberalized in 1978. With its accession to the WTO, it is generally expected that China will achieve an annual growth rate of around 7%. The strength in China's economy comes from the manufacturing industries that have been making great strides with the help of low cost labor as well as foreign direct investment of around US\$40 billion annually. Although China may face some difficulties like a sharp rise in imports and a higher rate of unemployment for some time, as a result of its accession to the WTO, its domestic market will expand and the quality of exports will rise with a higher level of technology. The East Asian region, in return, will greatly benefit from the expansion of China's domestic market.

(2) Changes in the Japan-U.S. relationship.

For the United States, Japan's economic strength is no longer a threat. Trade friction between the two countries has diminished and so-called Japan-bashing through Gaiatsu (foreign pressure) is no longer necessary. The Japan-U.S. relationship is now entering a phase of normalization. These changes reflect a

weakening in Japan's economic position. Although the strong Japan-U.S. alliance remains intact, U.S.-China relations, at least economically, will be strengthened. As a result, it will become strategically more important for Japan to build a closer relationship with China, Korea and the ASEAN countries.

(3) Improvement in Korea, NIES and ASEAN economies.

As Korea and many ASEAN economies undertook structural reforms as a result of the East Asian economic crisis, their financial systems and corporate governance improved considerably. Due to the reforms, these economies may enter a new phase of economic expansion that is different from the "East Asian miracle" perceived by the world in the early 90's. The rivalry between these countries and a rising China will stimulate competition on the one hand and mutual cooperation on the other.

These three changes will enhance competition and provide incentives towards closer regional cooperation. Intra-regional trade and investment will increase steadily. Japan's manufacturing industries will continue to move into the East Asian region and Japan will become more dependent upon external supplies of agricultural produce. Likewise, direct investment from China, Korea and other NIEs will gradually increase. Mutual interdependence of the region's economies as a whole will grow even more and, as a result, the need to create a suitable trade arrangement and a stable currency system in the region will increase.

ASEAN+3 is considered a stable forum for regional financial cooperation, due to the proximity and shared cultural and historical background of the members. Although ASEAN +3 shares common interests, it should neither be exclusive, nor should it be automatically expanded to become a trade, monetary or currency forum as well. Since several FTAs may be created within the region or involving a country in the region with a country outside the region in several years' time, the membership profile for regional FTAs may be quite different from ASEAN+3. Participation of countries like Australia and New Zealand will certainly become an important option for regional forums.

In East Asia, it is often said that there is no leading country, like the United States in the Western Hemisphere, that is essential to promote regional integration. No doubt, Japan - China relations will be the key to regional integration. If the two countries are successful in overcoming their differences and cooperate in regional integration, they will be in a position to play an important role in the region just as Germany and France were in promoting European integration. Now that political leaders have started focusing on regional cooperation, Japan should seriously consider the importance of its leadership.

7. Japan's Leadership

As a response to the deepening regional integration of the EU and NAFTA, Japan should continue its endeavors to deepen financial arrangements in the region, and formulate a long-term vision in the areas of trade and currencies, in order to establish its policy and strategy on these matters.

In this context, two points should be highlighted. First, the question of how Japan can formulate its policy and strategy on important international issues to exercise its leadership. FTA negotiations with Korea, Mexico and several other countries are expected to start in the near future. The basic issues in these negotiations will be how to consider bilateral or regional FTAs in the context of WTO multilateralism, how to deal with individual countries, and how to tackle the difficult agricultural issues. It goes without saying that it is of vital importance for Japan to build a firm stance in its policy and strategy on these basic issues, before entering into negotiations with other governments.

In trade negotiations, there have been cases where some ministry officials have tried to defend a specific sector's interest rather than Japan's interest as a whole. As a result, Japan's divided position resulted in a weak negotiating position. To avoid the recurrence of such problems, a firm rule should be established so that the Prime Minister's office can decide Japan's basic policy and strategy on important external issues, instead of leaving the matter in the hands of the concerned ministries.

Second, the government should utilize private sector think-tanks and academia more effectively. Think-tanks and academics will contribute by providing basic studies needed for the formation of policy and strategy. Furthermore, disclosure by the government of the policy formation processes is critical to make government operations transparent and to deepen public understanding on the issues involved. By doing so, over-dependence on the bureaucracy in policy formation will be balanced by the private sector's perspective.

Globalization, helped by information technology, has created increasingly integrated and inter-dependent economies worldwide. As demonstrated by the initiatives taken by the region's leaders, the East Asian countries have recognized the need to strengthen regional cooperation to cope with the highly volatile economic environment. More messages originating in Japan should be sent out to partners in the region to promote dialogue. It is Japan's responsibility as well as in its interest to exercise strong leadership to deepen regional cooperation so as to achieve the common objectives of financial cooperation, trade and investment promotion and a stable currency system in the region.

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