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# PACIFIC ENGAGEMENT
## JAPAN AND THE ASIAN ECONOMY

A Discussion Paper

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**SUMMARY**

- Japan has become more involved with Asia in recent years. Although unlikely over the medium term to displace Tokyo's current mainstream directions, this thrust will become increasingly important in Japanese policy and debate.

- Japan's economic exchanges with Asia have surged: 1995 saw increases over 1994 in Asia-related Japanese trade (exports up 20% and imports up 24%) while 1994 (latest numbers) saw strong growth in FDI (46%) and bank loans (20%). Some of this increase represented a cyclical rebound, but it also reflected a structural shift of production by Japanese firms offshore, both to traditional partners (eg the NIEs and ASEAN) and to newer ones (eg China, Vietnam, Burma and India).

- The Japanese Government's response has been positive, but the debate is intertwined with broader questions of foreign policy and domestic concerns on industrial "hollowing out".

- Japanese ODA and EximBank financing have long supported the activity of Japanese firms in Asia, and are beginning to respond to the recent surge in corporate activity there.

- A formal yen bloc is unlikely to emerge soon, but incrementa l increases in the regional use of the yen for trade pricing, capital movements and foreign reserves are probable.

- APEC, as a trans-Pacific entity, will continue to be Japan's favoured regional economic forum, but closer informal links with more "Asian" groups are also likely.

- While Asia is becoming the most important region economically for Japan, the reverse is not necessarily true. East Asia in particular has other economic options and drivers, especially intra-regional trade and investment. The EU will be an increasingly important outside player as well.

- Japan's strengthened Asia focus will not seriously affect Canadian trade flows or inward FDI from Japan, but will strengthen opportunities for third-country corporate synergy and for governmental cooperation in regional fora.

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(I) INTRODUCTION

Datsu-a nyu-o was a rallying cry for Meiji reformers such as Fukuzawa Yukichi: shedding Asia, entering the West. Recently, this slogan has been reversed by those in Japan seeking more distance from the West and closer ties with the countries of East Asia. More than just a political epiphenomenon, it has a basis in reality: academic analysis, media reporting, government and public debate increasingly focus on Asia. Over 120,000 Japanese citizens now live in East Asia (more than in any other region outside Japan except North America), and 5000 Japanese firms employ over a million people there.

This thrust into Asia has become a fundamental question in Japanese foreign policy and as such has many aspects, including recent events in USA/Japan trade and economic relations, re-evaluation of Japan's position in the post Cold War Asian security scene, and shifts in the political equation between Japan and its neighbours in the half century since World War II ended. This paper focuses specifically on one aspect of the question, that of recent developments in the economic relations between Japan and the countries of East Asia. As such, it discusses only a part of the broader puzzle, but one that has been the focus of increasing public attention and considerable misinterpretation.

For the purposes of this paper, "East Asia" is defined as China, Korea, Taiwan, Hong Kong, the seven ASEAN states, Laos, Cambodia and Myanmar. "Asia" adds the rest of the continent, as far west as the Central Asian Republics but excluding the eastern parts of Russia. "Asia-Pacific" includes East Asia plus Australia, New Zealand, Papua New Guinea and the four American members of APEC.

Major sources are detailed in the Appendix.

## (II) PRIVATE SECTOR TRENDS: TRADE AND INVESTMENT

The Japanese and international economic media, fuelled by statements from politicians, senior officials and businessmen, have over the past few years drawn a strong picture of Japanese companies throwing increasing resources into expansion of foreign commerce. This is depicted by some as an inevitable result of the rising yen (endaka) and increasing globalization of industry, by some as positive factor in generating and strengthening trade and investment for Japan, and by others as a negative factor in damaging domestic economic growth and employment prospects through the process of kudoka (hollowing out). Particular focus is placed in this debate on burgeoning trade and investment relations with Asian countries. A few examples:

-- Akai Electric announces the transfer of its VCR production from Japan to Malaysia and China. All of Akai's audio-visual manufacturing will now be offshore.

-- Shipbuilding giant IHI announces that it will subcontract the construction of two Czech freighters to Chinese yards, where they will cost 20% less to build than in Japan.

-- Honda announces that it intends to double auto sales in Asia outside Japan by the year 2000, to about 250,000 units. Mitsubishi Motors meanwhile plans to produce pick-up trucks in Vietnam for export to Japan.

-- Mitsubishi also announces that it is closing its last zinc smelter in Japan but will invest 48 billion yen in copper smelting joint ventures in India and Indonesia.

-- As part of a deliberate strategy to diversify production and marketing in Asia, Nippon Steel leads a joint venture building a million-ton cold-rolled steel plant in Thailand.

-- Hitachi announces a major agreement with Tata Engineering under which the Indian firm will develop software for the Japanese electronics giant. Competitor Fujitsu meanwhile buys 10% of International Computers Indian Manufacture Ltd.

-- Yaohan is a key player in the Japanese-Chinese consortium that opens the world's largest department in Shanghai.

-- Japanese leasing giant Orix announces a three-year plan to increase offshore assets in Asia by 30% to 520 billion yen.

-- Japanese advertising giant Hakuhodo announces the opening of an office in Hanoi, its 11th offshore site in Asia.

-- The Overseas Construction Association of Japan reports that 77% of its members' foreign work in FY94-95 was in Asia, as compared to 46% in FY90-91.

-- A Nomura Research report indicates that more Japanese subsidiaries were set up in Asia in the period 1987-93 (2544) than in the whole period 1951-86 (2045).

-- MITI reports that sales by Japanese subsidiaries in East Asia in FY93-94 came to 9.6 trillion yen, about double the figure for 1988.

-- A study by the Australian foreign ministry predicts that Japan-China trade will surpass Japan-USA trade (currently second in size only to Canada-USA trade) by the year 2015.

The evidence for stronger trade and investment flows is more than just anecdotal, but may at the same time be less revolutionary than it sounds.

Table I for example provides absolute numbers, growth patterns and regional shares for Japanese exports and imports over the period 1980-95. It shows that Asia is in fact the most important destination for Japanese exports (overtaking North America in 1991 and reaching US$201 billion last year) and the most important source for imports (US$155 billion last year). Asia has also shown the fastest growth of any major region in both categories over the past five years (105% and 57% respectively). And in 1995, Japan began for the first time to export more machinery to Asia than it did to the United States.

At the same time, it can also be seen that imports from Asia represented a higher share of Japan's total before 1986 than they do now (as high as 57.1% in 1980 for example), and recent highs in the Asian share of Japanese exports actually represent recovery from a down-turn (the 1979 figure of 38.6% was not reached again until 1992).

**TABLE I:**
**JAPANESE TRADE WITH OTHER MAJOR REGIONS (1979-94)**

(a) Magnitude of Japanese export/imports, by region (US$ Billions)

| YEAR | TO/FROM ASIA | | TO/FROM EUROPE | | TO/FROM N. AMERICA | | TOTAL (W/OTHERS) | |
|---|---|---|---|---|---|---|---|---|
| 1995 | 201 | 155 | 77 | 60 | 140 | 89 | 443 | 336 |
| 1994 | 168 | 125 | 68 | 47 | 136 | 74 | 396 | 275 |
| 1993 | 148 | 110 | 67 | 40 | 123 | 65 | 361 | 240 |
| 1992 | 131 | 105 | 74 | 41 | 114 | 62 | 340 | 233 |
| 1991 | 116 | 103 | 72 | 43 | 108 | 64 | 315 | 237 |
| 1990 | 98 | 99 | 67 | 47 | 104 | 64 | 287 | 235 |
| 1989 | 90 | 88 | 61 | 39 | 106 | 60 | 275 | 211 |
| 1988 | 85 | 77 | 60 | 34 | 102 | 53 | 265 | 187 |
| 1987 | 70 | 66 | 49 | 26 | 95 | 40 | 229 | 150 |
| 1986 | 61 | 53 | 41 | 20 | 92 | 36 | 209 | 126 |
| 1985 | 57 | 66 | 29 | 14 | 76 | 33 | 175 | 130 |
| 1984 | 57 | 71 | 27 | 15 | 70 | 35 | 170 | 137 |
| 1983 | 56 | 67 | 27 | 13 | 50 | 32 | 147 | 126 |
| 1982 | 51 | 73 | 26 | 12 | 44 | 31 | 139 | 132 |
| 1981 | 55 | 79 | 28 | 14 | 47 | 32 | 152 | 143 |
| 1980 | 49 | 80 | 25 | 13 | 38 | 31 | 130 | 141 |

(b) Growth by region and period (growth factor: ratio of later over earlier trade levels)

| PERIOD | TO/FROM ASIA | | TO/FROM EUROPE | | TO/FROM N. AMERICA | | TOTAL (W/OTHERS) | |
|---|---|---|---|---|---|---|---|---|
| 1980-95 | 4.10 | 1.94 | 3.08 | 4.62 | 3.68 | 2.87 | 3.41 | 2.45 |
| 1980-85 | 1.16 | 0.83 | 1.16 | 1.08 | 2.00 | 1.06 | 1.35 | 0.92 |
| 1985-90 | 1.72 | 1.50 | 2.31 | 3.38 | 1.37 | 1.94 | 1.64 | 1.81 |
| 1985-95 | 3.68 | 2.35 | 2.66 | 4.29 | 1.84 | 2.70 | 2.53 | 2.58 |
| 1990-95 | 2.05 | 1.57 | 1.15 | 1.28 | 1.35 | 1.39 | 1.54 | 1.43 |

(c) Proportional share of Japanese exports/imports, by region (%)

| YEAR | TO/FROM ASIA | | TO/FROM EUROPE | | TO/FROM N. AMERICA | | TOTAL (W/OTHERS) | |
|---|---|---|---|---|---|---|---|---|
| 1995 | 45.4% | 46.1% | 17.4% | 17.9% | 31.6% | 26.5% | 100% | 100% |
| 1994 | 42.4 | 45.5 | 17.1 | 17.2 | 34.4 | 26.9 | " | |
| 1993 | 40.9 | 45.6 | 18.7 | 16.7 | 34.1 | 27.2 | " | |
| 1992 | 38.6 | 45.0 | 21.8 | 17.6 | 33.4 | 26.7 | " | |
| 1991 | 37.0 | 43.8 | 22.9 | 18.2 | 34.2 | 27.0 | " | |
| 1990 | 34.1 | 42.0 | 23.4 | 19.9 | 36.3 | 27.1 | " | |
| 1989 | 32.7 | 41.5 | 22.0 | 18.4 | 38.6 | 28.3 | " | |
| 1988 | 32.1 | 41.3 | 22.7 | 18.2 | 38.6 | 28.3 | " | |
| 1987 | 30.6 | 44.4 | 21.4 | 17.1 | 41.3 | 26.8 | " | |
| 1986 | 29.0 | 42.3 | 19.8 | 16.2 | 44.1 | 28.6 | " | |
| 1985 | 32.5 | 51.1 | 16.3 | 10.9 | 43.3 | 25.5 | " | |
| 1984 | 33.4 | 51.8 | 16.0 | 10.9 | 41.3 | 25.5 | " | |
| 1983 | 37.8 | 52.8 | 18.3 | 10.2 | 34.4 | 24.9 | " | |
| 1982 | 37.1 | 55.3 | 18.9 | 9.1 | 31.9 | 23.3 | " | |
| 1981 | 36.5 | 55.4 | 18.3 | 9.6 | 31.1 | 22.2 | " | |
| 1980 | 38.0 | 57.1 | 19.4 | 8.9 | 29.3 | 21.8 | " | |

Source: Japanese Ministry of Finance and Embassy calculations

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On the investment side, Table II indicates a similar picture. Fiscal year 1994-95 was unquestionably a good year for Japanese investment in Asia: at US$9.7 billion, flows grew by 46% over the previous year and surpassed Japan's investment in Europe for the first time since 1983. Deutsche Bank reported that, as a result, the total stock of Japanese investment in Asia at the end of 1994 (US$64 billion) was 2.5 times that of the USA. The growth in Japanese investment in Asia was also the highest for any region for FY84-94 (almost five-fold) and its share has grown every year since FY88-89. For the first time, Japan's investment last year in Asian manufacturing facilities exceeded its investment in US production sites (North America takes the overall lead based on real estate and other non-manufacturing investment). Numbers for the first half of FY95-96 suggest a continued positive trend for Japanese FDI in Asia, although rates of growth are unlikely to equal FY94-95.

**TABLE II:**
**JAPANESE FDI TO OTHER REGIONS (FY 1981-94)**

(a) Magnitude of outward FDI flows, notification basis, fiscal year basis, by region (US$ billion)

| FISCAL YEAR | TO ASIA | TO EUROPE | TO NORTH AMERICA | TO LATIN AMERICA | TOTAL W/OTHERS |
|---|---|---|---|---|---|
| 1995 Apr-Sep | 5.0 | 2.6 | 10.2 | 2.0 | 21.7 |
| 1994 | 9.7 | 6.2 | 17.8 | 5.2 | 41.1 |
| 1993 | 6.6 | 7.9 | 15.3 | 3.4 | 36.0 |
| 1992 | 6.4 | 7.1 | 14.6 | 2.7 | 34.1 |
| 1991 | 5.9 | 9.3 | 18.8 | 3.3 | 41.6 |
| 1990 | 7.0 | 14.2 | 27.2 | 3.6 | 56.9 |
| 1989 | 8.2 | 14.8 | 33.9 | 5.2 | 67.5 |
| 1988 | 5.6 | 9.1 | 22.3 | 6.4 | 46.6 |
| 1987 | 4.9 | 6.6 | 15.4 | 4.8 | 33.4 |
| 1986 | 2.3 | 3.5 | 10.4 | 4.7 | 22.3 |
| 1985 | 1.4 | 1.9 | 5.5 | 2.6 | 12.2 |
| 1984 | 1.6 | 1.9 | 3.5 | 2.3 | 10.2 |
| 1983 | 1.8 | 1.0 | 2.7 | 1.9 | 8.1 |
| 1982 | 1.4 | 0.9 | 2.9 | 1.5 | 7.7 |
| 1981 | 3.3 | 0.8 | 2.5 | 1.2 | 8.9 |

((b) Growth by region and period (growth factor: ratio of later over earlier investment levels)

| PERIOD | TO ASIA | TO EUROPE | TO NORTH AMERICA | TO LATIN AMERICA | TOTAL W/OTHERS |
|---|---|---|---|---|---|
| 1984-89 | 5.06 | 7.64 | 9.57 | 2.29 | 6.65 |
| 1989-94 | 1.18 | .421 | .526 | 0 | .608 |
| 1984-94 | 5.96 | 3.22 | 5.03 | 2.28 | 4.04 |
| 1993-94 | 1.46 | .785 | 1.17 | 1.55 | 1.14 |

(c) Proportional share of Japanese outward FDI, by region (%)

| FISCAL YEAR | TO ASIA | TO EUROPE | TO NORTH AMERICA | TO LATIN AMERICA | TOTAL W/OTHERS |
|---|---|---|---|---|---|
| 1995 Apr-Sep | 23.0% | 12.1% | 46.7% | 9.1% | 100% |
| 1994 | 23.6 | 15.2 | 43.4 | 12.7 | " |
| 1993 | 18.4 | 22.0 | 42.4 | 9.4 | " |
| 1992 | 18.8 | 20.7 | 42.7 | 8.0 | " |
| 1991 | 14.3 | 22.5 | 45.3 | 8.0 | " |
| 1990 | 12.4 | 25.1 | 47.8 | 6.4 | " |
| 1989 | 12.2 | 21.9 | 50.2 | 7.8 | " |
| 1988 | 11.9 | 19.6 | 47.9 | 13.8 | " |
| 1987 | 14.6 | 19.7 | 46.0 | 14.4 | " |
| 1986 | 10.4 | 15.5 | 46.8 | 21.2 | " |
| 1985 | 11.7 | 15.8 | 45.0 | 21.4 | " |
| 1984 | 16.0 | 19.1 | 34.9 | 22.6 | " |
| 1983 | 22.7 | 12.2 | 33.2 | 23.1 | " |
| 1982 | 18.0 | 11.4 | 37.7 | 19.5 | " |
| 1981 | 37.4 | 8.9 | 28.2 | 13.2 | " |
| AVERAGE 1981-94 | 15.6 | 20.0 | 45.2 | 11.5 | " |

Source: Japanese Ministry of Finance and Embassy calculations

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Moreover, as the Japan Center for International Finance (JCIF) pointed out in its May 1995 analysis of Japanese investment, official figures underestimate the total impact of Japanese investment in Asia, which tends to include a large element of reinvestment and other local financing by Japanese subsidiaries not captured in the numbers on FDI flow. The JETRO White Paper on FDI of March 1995 points out that in FY92-93, the ratio of local re-investment by Japanese firms to Japanese FDI in the NIEs (Korea/Taiwan/HongKong/Singapore) and ASEAN (Thailand/Indonesia/Malaysia/Singapore/Brunei/Philippines) was 80% and 60% respectively. A recent Japanese EximBank survey suggests that FDI made up only 40% of total financing of Japanese subsidiaries in Asia in FY94-95.

Mergers and acquisitions activity by Japanese firms in Asia was also up (to 58 cases) in 1994 after several years of decline, according to the JETRO paper; the Asian proportion of M&A cases has in fact increased sharply in the past few years, rising from 18% in 1990 to 33% in 1994 to 42% in January-September 1995. The bottom line of all this investment activity is the very strong presence of Japanese firms in some Asian countries; Taylor for example points out that Japanese manufacturers employ 7% of Thailand's entire workforce and that one company (Matsushita) alone produces about 4% of Malaysia's GDP.

Such numbers do not necessarily translate into a long-term growth trend in absolute terms, however. Japanese investment in Asia (as in other regions) actually dropped strongly with the collapse of the real estate bubble at the end of last decade; Asia's numbers only surpassed FY89-90 levels again in FY94-95. The region with the highest annual growth rate of Japanese investment in FY94-95 was in fact Latin America. And even now, Japanese FDI levels for Asia remain well below those for North America (US$9.7 billion versus US$17.8 billion in FY94-95 and a higher proportional disparity in the first half of FY95-96).

The cautions expressed so far should not be taken to imply that nothing is happening vis-a-vis Japanese trade and investment in Asia. They simply suggest that at least some of the recent statistical increases may be longer-term and cyclical in nature. It will take more time before a real medium-term trend favouring Asia can be confidently derived from the statistics alone.

An examination of some of the underlying factors, however, suggests that the Asia thrust may have some medium-term staying power. First of all, broadly speaking, Japan firms are aware of the almost unanimous analytical conclusion that East Asia will remain a centre of comparatively strong economic growth and demand over the next decade or longer. Secondly, East Asia is seen as an area where liberalization of external trade and investment regimes is gaining pace (as compared for example to the EU and NAFTA). Thirdly, endaka is seen as likely to continue, at least as a threat, with attendant pressures on domestic production costs and the return on exports. Finally, Asia has a recent history of high profitability for Japanese firms: MITI surveys indicate that among Japanese manufacturers, Asian subsidiaries have been more profitable than either North American or European ones over the past decade, and more profitable than domestic manufacturing since 1991; the most recent (FY93-94) composite numbers show a 4% profit for Asia, 2% for domestic production, zero for North America and a loss of 1% for Europe. Continued investment in Asia thus makes sense for Japanese firms.

Some argue that despite growth and liberalization prospects, the natural limits of absorptive capacity (for capital and imports) and supply of labour/resources (for export generation) in recipient Asian countries will limit Japanese commercial penetration in the medium term. Arguing against this view is the "flying geese" model (named from the look of its charts), which holds that successive waves of investment with differing targets will keep up the momentum; although productive Japanese investment in a given sector in a specific Asian country may fall after an initial surge, a high overall level of investment can be profitably sustained.

One way to apply the model is to look at Japanese investment in different countries. The original thrust of Japanese manufacturing investment in Asian countries was to seek low-wage conditions for simple assembly. At the time, that meant largely what are now the NIEs. As economic growth raised labour and other operating costs in these countries, and as other countries in the region developed more favourable attitudes toward foreign commerce (eg by opening up investment regimes and moving from import substitution to export promotion), there was a shift to other ASEAN states, especially Thailand, Indonesia and Malaysia, while investment in the NIEs dropped off. More recently, the same process has led Japanese investment to favour China and more recently still Vietnam and Myanmar. "Graduation" of production is ongoing: recent trends in the Japanese electronics industry, for example, include an increasing shift in production of high-tech computer peripherals from Japanese plants to those in the NIEs; of TV sets from Japan to the more advanced ASEAN states; and of cassette players from the less advanced ASEAN states to China.

Future "geese" appear to include South Asia -- currently almost unploughed ground: the entire subcontinent takes less than 1% of Japanese FDI, although investment in India has recently risen sharply (cf the Hitachi/Tata software project). Thus some individual country figures from Japan's 1994 FDI results: Hong Kong and Taiwan down 9% and 5%; the Philippines and Indonesia up 223% and 116%; China and Vietnam up 52% and 283%; India up 170%.

The "flying geese" model also applies to investment for different purposes, often within the same countries. Here five "flights" of geese can be identified, with linked trade/investment effects:

(a) Until comparatively recently, Japan imported raw materials and food (80% of total imports as late as the early 1980s) and exported consumer goods; FDI was sparse and directed in large part to securing sources of supply.

(b) The revaluation of the yen following the Plaza accord of 1985 led to a sharp increase in FDI to low-wage economies, many in East Asia, largely (as noted above) for assembly of consumer goods from parts exported by Japan, with the endproducts re-exported both to Japan and to third countries. The attraction of such a move is clear even from current wage differentials (Japan:Malaysia 20:1, Japan:Vietnam 50:1, Japan:Myanmar 200:1), and Japanese investment in Asia on this basis still exists, often moving from one country to the next as wages rise (the first "flying geese" application). Asian countries also take part in more sophisticated global assembly programs: Hitachi projection TVs, for example, incorporate parts from Malaysia (chassis and circuitry) as well as the USA and Japan itself, but are now assembled in low-wage Mexico.

(c) The second half of the 1980s also saw a sharp increase in Japanese FDI designed essentially to get around trade barriers by locating production of consumer durables within protected markets. This initially targeted North America and Europe, for example in the automotive and electronics sectors. Since about 1990, however, it has increasingly been used by Japanese firms in East Asia (especially in China and certain ASEAN states). This is fuelled in part by rising consumer demand in increasingly affluent Asian countries; by one estimate, for example, Asian demand for consumer electronics will pass that of Europe this year, and that of the USA in 1997. Japanese FDI flows for this purpose have been accelerated by further endaka, which makes investment cheaper for a firm and exports less price-competitive; see for example plans by many of the major auto-makers to start local production of "Asia cars" and "Asia trucks" in ASEAN by 1996/97. Such investment leads to export of capital equipment (especially initially) and components from Japan, but does not contribute strongly to Japanese import flows.

(d) Endaka in the 1990s has also led to further shifts, with whole production processes moved abroad, including significant transfers of technology and movement of Japanese parts suppliers abroad, with the primary goal of supplying domestic Japanese markets from offshore. Japanese exports under this scenario have become even more heavily concentrated on capital goods (the value of capital goods and related components as a proportion of total Japanese exports rose from 47% in 1985 to 60% in 1994), while imports of manufactured consumer goods have increased dramatically. This sort of investment is concentrated mainly in East Asia (for access to the Japanese market) and was largely responsible for the rapid increase in Asia-related Japanese trade and FDI in 1994 and 1995.

(e) Finally, recent months have seen the increasing displacement of non-production corporate activities offshore as well. This appears to involve largely (although not uniquely) East Asian sites. One reason is that with more and more production units already offshore, offices left in Japan increasingly represent a revenue drain unbalanced by any direct revenue generation. In the case of R+D facilities, there is increasing recognition that locally-trained scientists and engineers are often less expensive (and as Aiwa president Unoki points out, labour costs are 90% of R+D programs, compared to only 10% for assembly plants). Joint R+D ventures with the NIEs are also taking place (eg advanced chip cooperation with Korean and Taiwanese firms). Although FDI for the relocation of non-production units offshore is not as yet a major factor for Japan, it has growth potential. Toshiba announced earlier this year that its Singapore subsidiary would become the world headquarters for its videocassette business, for example, giving it authority inter alia over units in Japan itself; this appears to be the first instance of a major Japanese headquarters unit being moved overseas.

Given these various factors, Japanese investment in Asia will in fact probably continue to grow through the end of the decade in both absolute terms and regional share. A survey released in November by the Export-Import Bank of Japan (EximBank) on Japanese businesses with a major international presence suggests that 70% of their total new overseas investment in the next three years will be in Asia, with eight out of the ten "most promising" centres for investment falling in Asia (China, Thailand, Indonesia, Vietnam, Malaysia, India, the Philippines and Singapore), with the USA in 4th place and the UK in 10th. A recent Nikkei survey similarly indicated that 42.7% of major manufacturers intended to open one or more new factories abroad over the next few years, with a strong proportion in Southeast Asia (46.9%) and/or China (47.6%) compared to the USA (15.4%) or Europe (4.2%). Another indicator is the increased interest in Asia by the big Japanese trading houses (shosha), which tend to act as match-makers for major international trade and investment deals involving Japanese firms; in FY94-95, for example, six big shosha (Itochu, Mitsui, Nissho-Iwai, Marubeni, Mitsubishi and Sumitomo) brokered about US$20 billion worth of business in China alone.

On the question of motivation for such investment, a 1994 survey by the Japan Machinery Exporters' Association suggested that much of its growth would come from an increase in plants supplying either the local market (93% of firms intended to have plants in Asia dedicated to this purpose in 1998, as opposed to 80% with such plants in place in 1994) or the Japanese market (74% in 1998 as opposed to 46% in 1994, the largest increase for any purpose). The EximBank survey showed a varying pattern by sub-region: FDI in China is intended most strongly (ie over 40%) for low labour cost operations, locking in local markets and exploring new market opportunities; FDI in ASEAN for low labour cost operations, locking in local markets and exporting to third countries; FDI to the NIEs is very strongly for locking in local markets; and FDI to other Asian economies is for developing new markets.

Increased investment will in turn have trade effects. Although the exact nature of these effects will depend on the relative weight of the various types of investment outlined above, one would expect a continued rise in Japanese exports of high-tech capital goods to Asia, gradually tapering off, and a permanent reduction in exports of certain goods that will now be produced offshore instead of in Japan (Japanese exports of consumer durables for example fell from 30% of total exports in 1985 to 20% in 1994). There should also be a sustained rise in imports of finished goods (where Asia supplied 37% of Japan's import needs in 1994, up from 20% in the early 1980s). Nomura Research estimates that by the year 2000, Japanese subsidiaries in Asia alone should be exporting about 6 trillion yen worth of goods to Japan, almost 4 times as much as 1994.

(III) REGIONAL BANKING AND FINANCE

As one would expect, Japanese bank capital markets show a similar picture to trade and investment flows: a strong and increasing interest in Asia. Oba indicates that as of 1994, aggregate Japanese bank lending to Asia totalled US$81 billion, or 39% of the total supplied to Asia by all BIS banks (by contrast, the USA supplied 9%, France 10% and the UK 12%). Much of this Japanese funding went to Thailand, Indonesia, China and South Korea; it in fact represented respectively 57%, 55%, 40% and 31% of all foreign commercial bank lending to these countries.

Asia also accounts for a rising proportion of total Japanese bank lending. Against a background of weak domestic loan demand, Japanese banks have been increasing their offshore operations generally. Outstanding long- and medium-term loans to Asia at the end of 1994 totalled US$70 billion or almost 20% of Japanese overseas lending, up from about 15% only two years ago, and estimates for new overseas loans suggest that 30% went to Asia in 1995. Through the 1980s, Japanese banking focused mainly on developed Western markets. A shift to East Asia began around the end of the decade, based on solid economic growth and decreased political risk in the region, augmented by a strong demand for funds based on rapid infrastructure development, the increasing presence of Japanese firms, financial liberalization, the strengthening of local financial markets and an increasingly sophisticated local demand for financial services. As a result, loans by Japanese banks to Asia grew 20% in FY 94/95 over the previous year -- most for infrastructure-related projects in power, transportation and telecommunications -- as compared to about 4% growth in loans to North America and an average of 5% worldwide. In FY94-95, loans to Asia were expected to match this 20% growth in the first six months alone, compared to overall growth of 11%.

This attention to Asia is reflected in the presence of Japanese bank branches, subsidiaries and other offices in Asia. For the five-year period ending March 1995, according to a Nikkei survey, employees of the Japanese "city banks" (the top 11 in the country) in Asia outside Japan increased by 42% to over 9000, and the number of regional offices rose from 83 to 382. Asian operations typically account for 20-50% of total international earnings at the city banks, according to the survey, based on rates of return that generally trail earnings in North America but remain well ahead of flat or negative returns in Europe or Japan domestically. Looking at a broader list of Japanese banks, Asian branches/subsidiaries amount to 37% of the overseas total in 1995, virtually the same number of offices as in the Americas and up five-fold since 1980. According to the Ministry of Finance, all of the 20 Japanese overseas branch banks opened in the first ten months of FY95-96 were in Asia.

Nor is the expansion over. Following the lead of Japanese firms, many banks (including the Bank of Tokyo-Mitsubishi, Sakura, Sumitomo, Asahi and Fuji) are now expanding operations in the less-developed ASEAN states (such as the Philippines and Vietnam) and in the next "flying geese" states (eg China, Myanmar and India). The focus is on both corporate financing and participation in project financing syndicates organized by the World Bank, the Asian Development Bank, etc. Partnerships with non-Japanese Asian banks are also growing; Sanwa Bank for example recently signed an agreement with the Chinese Agricultural Development Bank under which it will train the CADB's employees in modern banking practice and become its trustee bank for foreign bond issues. Non-bank Japanese firms are also setting up in Asia. The Mitsubishi shosha has for example set up a merchant banking joint venture in Singapore to handle Asia-wide investment business, and is considering new investment funds in the Philippines and other Asian sites. Sumitomo and Mitsui are following suit.

Japanese securities firms are also moving increasingly into Asian markets. Nomura, Japan's largest securities house, has for example recently indicated that it is refocusing its foreign activities in favour of Asia. Already the lead foreign broker for Chinese debt, it is expanding its presence dramatically in Seoul, Hong Kong and other centres, after tripling its offshore Asian staff over the past half-decade. This shift, replicated on a smaller scale by other Japanese houses, has in turn led to a sharp increase in holdings of Asian stocks by Japanese investors (over 20% of all foreign stock holdings in 1994, up ten-fold from 1988, although there was a certain sell-off in 1995). Japanese banks and securities firms have increasingly become involved in lead- or sub-managing Eurobond and Dragon-bond issues, and take the lead in Asian issues of Samurai bonds (20% of which, or about 300 billion yen worth, were offered by Asian issuers in 1993). Japanese financial institutions also increasingly facilitate the access of Japanese Asian subsidiaries to local financial markets (through listing on stock exchanges and/or issuance of local bonds and other paper) as an alternative to bank borrowings, transfers from corporate parents or retained earnings as a source of capital. The cornerstone of Nomura's expansion strategy is in fact reported to be offering just this sort of assistance to Japanese subsidiaries hoping to expand their operations in Asia.

Japanese banks and other financial firms have played a key role in funnelling large amounts of Japanese investment dollars into Asia; access to such funds, traditional lending ties to the powerful Japanese corporations increasingly active in Asia, and close relationships with wealthy Japanese government financial bodies like the EximBank indeed provide much of these banks' comparative advantage. They are not however without competitors. Western bankers in particular have been more successful in a number of specialized markets, including lead-managing syndicated loans (a highly profitable area). The financial markets of Hong Kong and Singapore, which were fairly minor regional centres in the late 1980s, now outperform Tokyo in key respects, based on a more rapid financial liberalization, the growth in China and the ASEAN economies, the growing importance of NIE capital transactions and (compared to Tokyo) the advantage of dealing primarily in dollars. Hong Kong and Singapore were responsible respectively for 64% and 24% of syndicated loans arranged in Asia in 1993, for example, as compared to Tokyo's 12%; Hong Kong's balance on offshore bank loans at the end of April 1995 (US$770 billion) equalled that of Japan. At the same time, Oba notes that the flow of funds from Japanese banks to the Hong Kong and Singapore financial markets as of mid-1994 (outstanding balances of US$135 billion and $95 billion respectively) represented 61% and 55% respectively of all funds sent to these markets by BIS banks, so a good part of their turnover reflects Japanese capital movements.

And the panoply of activity by Japanese financial firms in offshore Asian markets contrasts sharply with the notable lack of interest on the part of Asian investors and issuers in doing business on the Tokyo money and capital markets per se (samurai bonds being an exception). This is despite strong disparities in size; the market capitalization of the Tokyo Stock Exchange in 1994 (US$3.3 trillion) was for example 2.4 times the combined capitalization of all its main Asian competitors (Hong Kong, Malaysia, Taiwan, Korea, Singapore, India, Thailand, Indonesia and the Philippines) put together. An ongoing saga of what one observer calls "heavy taxation, residual regulation and unusual business practices" has led to a fall-off of foreign participation in Tokyo markets broadly, an ongoing slide that has many Japanese experts worried about a permanent kudoka in this field unless liberalizing reforms are implemented. This slide is mostly in European and American listings, and a number of Asian firms are expected to join the exchange this year; on the other hand, a survey last year by the JCIF of foreign banks and security dealers in Japan even suggested that Singapore could be a more important money centre than Tokyo in five years' time.

Overall, as in manufacturing, a combination of high domestic cost and close domestic regulation seems in many cases to have made it easier for Japanese financial firms to make money in offshore Asia, despite fierce competition there, than at home.

## (IV) GOVERNMENT RESPONSE

This paper began with a look at the economic realities because the recent surge in Japanese economic relations with Asia is driven primarily by commercial factors, not by political decisions or bureaucratic policy. This being said, the surge has certainly become the subject of government debate, decisions and policy, and is in turn affected by them.

The Japanese government is broadly favourable to the expansion of economic relations with Asia. The Government has a number of programs to encourage such development, including financing mechanisms, and has raised the profile of the issue by setting up special policy groups and studies. While there is on the other hand little public discussion by officials on potential down-sides, debate exists on two main fronts:

(a) First, as noted in the Introduction, the economic drive into Asia has become part of a larger debate between those who accord a strong priority to maintaining relations with the United States as the unchallenged keystone of Japanese foreign policy and those who favour a policy of balance that draws somewhat closer to Asian countries without abandoning existing ties with the West. Economic success in Asia thus becomes part of the arsenal of the "pro-Asia" faction, linked to a whole range of political debates (such as the role of the USA in Asia) and on the economic side to such sub-debates as the value for Asia of the Japanese model of economic development, the creation of a "yen bloc" and the respective merits of APEC and EAEC as vehicles for regional economic integration.

(b) Secondly, there is the debate between those who express concern about the economic impact (in terms of growth and employment) of the current wave of <u>kudoka</u> associated largely with Asian development by Japanese firms, and those who regard it as a necessary and temporary side-effect of modernizing the Japanese economy. Those who fear <u>kudoka</u> are often the same forces (eg among the protected non-export industries) who express concern about too rapid an opening of the Japanese economy to global competition and too rapid a pace in domestic deregulation and restructuring.

Aspects of the Government response to the economic surge into Asia are discussed in more detail below.

(1) Government approaches

At least certain sections of the Japanese government have clearly concluded that economic relations with Asia need more guidance and support. MITI created a new senior office, Counsellor for Asian Affairs, last summer and staffed it with an experienced trade official who is in charge of marshalling MITI research and support for the Asian thrust, including development cooperation (MITI has its own private ODA budget of about US$300 million for technical assistance programs). MITI also set up last year a special external advisory group under Professor Toshio Watanabe of the Tokyo Institute of Technology, mandated to study ways by which MITI can encourage Japanese trade and investment ties with the Asian region, including such measures as more efficient use of development assistance and other financing mechanisms, expansion of goods and services eligible for trade insurance, possible changes in import policy, and the creation of "foreign access zones" under the Import and Domestic Investment Law. Watanabe's group is reporting to MITI's Director-General for International Trade later this month. Separately, the Economic Cooperation Committee of MITI's Industrial Structure Council reported earlier this year with a recommendation that the government enhance assistance to private sector led infrastructure projects in developing countries, especially in Asia, using an integrated package of ODA loans and technical assistance, EximBank financing, trade insurance, and cooperation with the multilateral development banks. MITI has also announced a range of special projects involving Asia, including (for example) programs to promote transfer of energy-efficient technologies, to train nuclear-power engineers and (in cooperation with Toyota) to create an on-line automobile design and production management system spanning six Asian countries. All in all, MITI seems prepared to commit substantial resources to a forward Asia strategy.

The Finance Ministry is also moving. Another advisory panel, set up to advise the Finance Ministry and MITI jointly, recommended last June that the government encourage Japanese commercial banks to set up a fund to invest in infrastructure-development projects in Asia. (Such a venture was in fact announced in August by the Industrial Bank of Japan, which co-founded a consortium of major banks in Japan, Korea, China, Singapore, Thailand, Indonesia and Malaysia to finance industrial development in Asia. The Nippon Credit Bank was in turn involved with Mitsubishi, Fujitsu and other large Japanese firms in establishing with the Asian Development Bank a new funding mechanism, the Asia Infrastructure Development Company (AIDEC), to finance large-scale projects in Asia through syndicated loans and share purchase.) The August 1995 Government package of economic measures designed to combat endaka included Finance Ministry regulations that significantly liberalized the possibilities for investment abroad by insurance companies. Although not linked explicitly to the Asian economic thrust, this move is expected to have a major impact on investment in Asia. Finally, another panel, under former Vice Minister Tadao Chino, has been set up by the Ministry to offer technical assistance to other Asian countries on fiscal and monetary policy and strengthen Japanese ties with Asian financial markets broadly.

Other Ministries are also joining the fray. The Japanese media reported last fall, for example, that the Ministry of Labour had decided to extend its domestic job training assistance programs through Japanese firms to local citizens of certain Asian states, starting this year in Thailand and Malaysia. The Ministry of Post and Telecommunication has recently announced a project to provide interactive educational programming by satellite to China, Thailand and other Asian countries, starting this summer.

There is meanwhile no shortage of advice from the business community on what the Government should be doing. The Keidanren, which has made Asia the focus of its international activities (inter alia through stepped up research and high-level visits to Asian countries of interest to Japanese business), set out a policy last July for Japan's role in the Asia Pacific region. This report included extensive recommendations to the Government for action on domestic reform (to stimulate demand for Asian imports inter alia), further deregulation of Japanese financial markets (to allow easier access to Japanese capital), internationalization of the yen, facilitation and encouragement of technology transfer, cooperation on energy and environment questions, and active participation in APEC's work on both the liberalization and development fronts. (The Keidanren report also provided an extensive list of problems faced by Japanese business in other Asian countries -- including high taxation, investment restrictions, import licensing, intellectual property and standards questions plus weaknesses in infrastructure, capital markets, supporting industries and educational standards -- which it clearly wanted the Japanese government to alleviate.)

The November 1994 Keizai Doyukai report on Japan's role in the Asia-Pacific region took a similar stance, calling on the Government to promote integration of the Japanese and East Asian economies through bilateral and multilateral action. (The organization has also taken its own steps to this end, for example by recently establishing formal cooperation with its Indian counterpart.)

(2) ODA and other government financial support

The Japanese Government has a number of financial mechanisms that, as part of a global mandate, support the growth of economic relations with Asia. Important among these are official development assistance (ODA) extended by a wide range of agencies in the form of loans and grants, commercial and concessional loans extended by the EximBank, and trade insurance extended by MITI. As a general remark, while support for Asian commercial activity through these channels has long been significant, it is only beginning to reach the levels that one would expect from the attention paid to this region by Japanese business and media circles.

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**TABLE III:**
**JAPANESE OFFICIAL DEVELOPMENT ASSISTANCE DISBURSEMENT (1984-94)**

(a) Magnitude and proportional share of total bilateral ODA disbursements, by region (US$ millions and %)

| YEAR | TO ASIA | | TO AFRICA | | TO LATIN AMERICA | | TOTAL W/OTHERS | |
|---|---|---|---|---|---|---|---|---|
| 1994 | 5544 | 57.3 | 1144 | 11.8 | 832 | 8.6 | 9680 | 100 |
| 1993 | 4861 | 59.5 | 966 | 11.8 | 737 | 9.0 | 8164 | " |
| 1992 | 5524 | 65.1 | 859 | 10.1 | 772 | 9.1 | 8484 | " |
| 1991 | 4520 | 51.0 | 910 | 10.3 | 846 | 9.5 | 8870 | " |
| 1990 | 4117 | 59.3 | 792 | 11.4 | 561 | 8.1 | 6940 | " |
| 1989 | 4240 | 62.5 | 1040 | 15.3 | 563 | 8.3 | 6779 | " |
| 1988 | 4034 | 62.8 | 884 | 13.8 | 399 | 6.2 | 6422 | " |
| 1987 | 3416 | 65.1 | 516 | 9.8 | 418 | 8.0 | 5248 | " |
| 1986 | 2494 | 64.8 | 418 | 10.9 | 317 | 8.2 | 3846 | " |
| 1985 | 1732 | 67.7 | 252 | 9.9 | 225 | 8.8 | 2557 | " |
| 1984 | 1594 | 65.7 | 211 | 8.7 | 229 | 9.4 | 2427 | " |

(b) Growth by region and period (growth factor: ratio of later over earlier disbursement levels)

| PERIOD | TO ASIA | TO AFRICA | TO LATIN AMERICA | TOTAL W/OTHERS |
|---|---|---|---|---|
| 1984-89 | 2.66 | 4.93 | 2.46 | 2.79 |
| 1984-94 | 3.48 | 5.42 | 3.63 | 3.99 |
| 1989-94 | 1.31 | 1.10 | 1.48 | 1.43 |
| 1993-94 | 1.14 | 1.18 | 1.13 | 1.19 |

source: Japanese Ministry of Foreign Affairs, Embassy analysis

Japan has been the world's largest foreign aid donor for some years. In 1994, assistance to Asia made up over 58% of all bilateral Japanese ODA, or about US$5.6 billion (see Table III). This absolute number represented a 3.5-fold increase since 1984, and a 15% increase over 1993; almost half the increase in Japanese ODA since 1989 has in fact gone to Asian countries. Eight of the top ten recipients of Japanese ODA in 1994 were Asian (China, India, Indonesia, the Philippines, Thailand, Pakistan, Bangladesh and Sri Lanka, making up over 50% of total bilateral ODA, with Syria and Egypt the other two). Asia also accounted for 47% of all trainees accepted under ODA by Japan in FY94-95, 56% of all ODA experts dispatched by Japan, 50% of all ODA development studies and 89% of all ODA loan commitments. This does not count further Japanese assistance through Asian multilateral institution such as the ADB (US$1.6 billion for the FY92-95 replenishment) or APEC (at the Osaka Summit last November, Japan announced a special US$100 million fund for projects in APEC developing economies in the areas of trade and investment liberalization).

And this focus on Asia reflects strong support from the Japanese public -- the Government's 1995 foreign relations poll, for example, indicates that 57% of respondents see Asia as the #1 priority for economic cooperation/assistance.

This being said, it should also be noted that the <u>proportion</u> of Japanese bilateral ODA going to Asia has generally been declining over the past decade; the average for 1984-89, for example, was 64%. And there is some indication that this downward trend is likely to continue, based on shifting development demands and priorities; the four countries added last year to the list of ODA recipients with whom Japan holds formal annual meetings are all outside Asia (Turkey, Peru, South Africa and Brazil); of the existing 12, all but one (Egypt) were Asian.

Broken down by sub-region, ODA allocated to Northeast Asia (largely China) has increased over the past few years to about 30% of the Asian total (US$1.5 billion in 1994); the Southeast Asian share has fluctuated strongly around a median of about 50%, with the 1994 share coming to 40% (US$2.2 billion) and an increasing sub-proportion disbursed to non-ASEAN countries; Southwest Asia (largely the Indian sub-continent) was up strongly again in 1994 at 27% (US$1.8 billion) after generally lower numbers over the past few years; and there was the beginnings of a program for the Central Asian republics (about US$49 million in 1994).

It will be noted that these country trends do to an extent mirror the more recent developments in business interests in Asia, with a focus on places such as China, Vietnam, Myanmar and India. It is also worth examining the pattern of lending provided through the Overseas Economic Cooperation Fund (OECF), which amounts to about half of Japanese ODA, tends to fund projects of special interest to

Japanese business: 78% of its outstanding loans at the end of FY94-95 and 82% of its disbursements that fiscal year were to Asia. The top five countries in OECF lending were in fact all Asian -- Indonesia, China, the Philippines, India and Thailand -- representing 56% of total loans outstanding and 66% of disbursements. The OECF has funded significant amounts of Asian infrastructure, including 45% of all Indonesian hydro-electric capacity and 83% of all railway construction in China since 1970, and Japanese business has gained both directly (construction and other contracts) and indirectly (improved infrastructure for business).

This pattern reflects close ties between Japan's ODA and business communities. Japanese technical assistance (grant projects) must be contracted to Japanese firms (although sub-contractors can be foreign), and while Japanese firms officially receive only a comparatively small proportion of contracts based on OECF loans (27% in 1994), the much larger proportion disbursed to firms in developing countries (57% in 1994) is held to include payments to Japanese subsidiaries. Further, the government is setting up new business-oriented ODA mechanisms of the type advocated by the Industry Structure Council (see section IV.1 above).

Although published data on EximBank financing is less revealing than on development assistance, the broad picture is similar in many ways. Of loans outstanding as of the end of March 1995, which totalled about 8.8 trillion yen, 35% were extended to finance economic links with Asia. (By comparison, North America accounted for 21%, Latin America for 16% and Europe for 13%.) While this is a very substantial sum of money, and one that has increased in absolute terms every year since 1988, once again it represents a declining proportion of total funding: the Asian share in the period 1985-89 for example was in the range of 38-40%. The same trend was observable over the first nine months of FY95-96: loans for Japanese commercial operations in Asia (primarily in such areas as petrochemicals, automobiles and electronics) were up a healthy 59% year-over-year, but loans to the rest of the world expanded even faster. Rapidly expanding Japanese operations in Asia are by contrast likely to be favoured by a recent indication that EximBank financing would be extended directly to foreign subsidiaries of Japanese firms (formerly only domestic Japanese companies were eligible).

The Eximbank also provides some break-out on the types of loans offered by region. Four major types are offered: export financing, import financing and overseas investment loans (all mainly for Japanese firms but also available to foreign borrowers in some cases) and untied loans (for governments and other institutions in developing countries, sometimes with reduced interest rates). For FY94-95, financing for Asia was primarily investment loans and untied loans -- respectively 36% and 37% of the Asian total. (By comparison, Eximbank financing relating to Europe was over 60% linked to investment loans, while financing related to North America was almost entirely linked to investment loans and import financing-- 61% and 39% respectively.) To look at the same figures another way, investment loans and untied loans relating to Asia made up respectively 31% and 48% of Eximbank totals for those categories (trade lending made up about 27% of its category). This pattern is about what would be expected given the recent focus on investment, the development assistance linkages and the comparatively high proportion of intra-firm (and thus internally financed) import trade in Japanese economic relations with Asia.

Trade insurance figures show a slightly different picture. The total amount of Japanese trade underwritten in FY94-95 came to about 19.4 trillion yen (US$190 billion), of which about 36% (7 trillion yen) was for Asia. Both the proportion and (despite gradually declining overall levels of trade insurance) the absolute amount for Asia has increased steadily over the past five years, for example from levels of 26% and 5.8 trillion yen 1990. The fact that it is a short-term oriented and demand-driven mechanism probably reduces the "reaction time" of this channel in responding to increased business interest in Asia. Nevertheless, it is worth noting that trade insurance for North and Central America (country break-outs are not provided by MITI) remain about 10% higher than coverage for Asia, and that the growth in trade coverage for Asian business in 1994 was only 1.4% in yen terms, less than the increase for North/Central America, Africa or Oceania, although better than the declines registered for South America and Europe.

(3) The Japanese model of development

The Japanese foreign aid program transfers a great deal of economic know-how to recipient countries, including many in Asia. This flows through a number of channels, including provision of experts under ODA programs (Japan sends a total of 12,000 specialists yearly in various fields, and macro-economic policy-making has recently been identified as one priority), direct project assistance (the OECF for example developed a model last year for long-term comprehensive development planning, using Indonesia as a practical test case) and specialized training (eg seminars on policy-driven lending put on by the Japan Development Bank for its Asian counterparts). The Japanese private sector also carries out much of the same kind of work; for example, the Keidanren and the Keizai Doyukai sponsor programs that send Japanese executives to other Asian countries to lecture and provide advice on corporate management, and a consortium of Japanese high-tech firms and universities decided last summer to begin satellite broadcasts of S+T programming throughout Asia.

This sort of detailed economic-technology transfer segues into a broader ideological debate concerning the applicability of the Japanese economic development model holus-bolus to developing Asian societies. Some analysts suggest that the Japanese Government is seeking somehow to impose such a model on the rest of Asia, for both ideological and practical reasons. Johnstone for example suggests that the basic tenets of Japanese development assistance include the conviction that reliance on pure free-market approaches is inappropriate for the "immature" market economies of Asia, while Japanese industrial policies provide an easier route to modernization; he also notes that such an approach tends to "harmonize" the interests of the developing countries with those of Japanese industry. Within Japan itself, the debate is complex; the bottom line tends to include both support for the concept and denial that Japan has much role to play in fostering it.

The best-elaborated form of the model, as codified in the World Bank's report on "The East Asian Miracle", is actually an idealized version of the Japanese historical approach, as applied in the post-war era by economies such as Taiwan and Korea, which have achieved dramatic growth with a more interventionist approach than advocated by classic free-market development theorists. The broad model focuses on a high savings rate, investment incentives and restrictions, tight monetary policy, rapid centralized development of social and physical infrastructure, agricultural reform, encouragement and channelling of private sector industrial development, paternal management-labour links and an export-oriented growth strategy, all within an essentially stable ("Confucian") socio-political order and a conservative bureaucrat-dominated governing structure.

One of the major counter-arguments against the active promotion of a strictly Japanese model is that while historical Japanese economic development patterns have much in common with the broader East Asian model, the Japan of that era had unique political and economic characteristics that make simple replication impossible for other countries. Some analysts therefore see no special role for Japan in promoting the adoption by other states of its "non-market capitalist" development system. Aside from the problems of adapting Japanese particularlism, they note other useful models in play, from which Asian countries should choose in adapting a development approach that suits their needs and their own national traits. In addition to government-influenced market capitalism of the Western variety, they cite as a model of a private sector driven but still "Asian" development approach the highly successful overseas Chinese economies (both territorially based and otherwise), which they argue are a stronger influence on Asian economic relations than Japanese penetration.

Wada goes further in criticizing the Japanese model, arguing that it may no longer even be appropriate for Japan at its current developmental stage, when what the country needs most is to accept global liberalization and full market discipline. This line implicitly echoes Krugman's thesis that economic development on the East Asian model represents an intensification of resource use rather than a genuine paradigm shift, setting inherent limitations on the contribution it can make. Some analysts also argue that the reality of the Japanese model, as opposed to the idealized East Asian model of the World Bank, contains elements that few modern economic planners would favour, such as a highly protected and inefficient non-export sector, excessive government regulation (written and unwritten) and a petrified financial structure. All this being said, Wada suggests that many of the Southeast Asian states have in fact adapted the better aspects of the Japanese model to their own national characteristics, and can now join a reforming Japan in moving even closer to free-market capitalism. (The UNCTAD secretariat recently noted in this regard the growing view that the East Asian model should be divided into Northeast Asian and Southeast Asian variants.)

Attitudes toward Japan and its economic activities in any event vary from country to country in Asia. A Yomiuri survey last spring on reactions to Japanese business activity found comparatively positive feelings in China, Malaysia, Vietnam, Thailand and Indonesia, compared with more negative feelings in Korea. In a broader Asahi poll last summer on questions relating to friendship, trust and economic partnership, Japan scored highly with participants in Thailand, the Philippines, Singapore and Indonesia, but distinctly lower with participants in China and Korea.

At a Nikkei seminar last year on Japan in Asia, Hii suggested that Asians generally had a high regard for Japan's technology but not for its management and social structures -- a point echoed by Taiwanese private sector participants in an earlier Nikkei forum. Speaking of Southeast Asia in particular, Hii indirectly reinforced the idea of Japanese particularism by suggesting that ASEAN government and business leaders were already more western-oriented in economic terms than their Japanese counterparts, and in this might differ from their Northeast Asian counterparts. Hii also however agreed that PM Mahathir himself was drawn to Japanese as well as Western models, and Johnstone points out that many Southeast Asian leaders -- for example Singapore's Lee Kwan Yew -- view Japan as an Asian success story to emulate.

It seems most likely that Asian states will choose their own individual paths from a range of available models, including but not restricted to the Japanese one.

(4) The yen bloc

Another significant part of the debate over Japan's role in Asia has been a discussion of what is termed the "internationalization of the yen" by its proponents and the "creation of a yen bloc" by those who oppose it. There are various aspects to this debate, including:

(a) the degree to which the yen should be used as a settlement currency for trade between Japan and the rest of Asia. The current level of yen-denomination already reflects strong growth; as recently as 1970, less than 1% of Japanese exports and almost no imports were so denominated, while by 1995 the numbers had reached 38% for exports and 24% for imports. The 1995 numbers for Japanese trade with Asia further suggest a regional influence: 48% of Japanese exports and 34% of imports are yen-denominated. Oba suggests that rapidly increasing intra-Asian trade relative to trade with the USA should increase pressures for yen-denomination further, adding that 80% of German export trade, for example, is DM-denominated. As a straw in the wind, the Ministry of Finance has decided, starting with the January 1996 numbers, to publish trade and current account numbers only in yen (dropping parallel dollar numbers).

(b) the degree to which the yen should be used as the currency for inter-Asian capital transactions. This aspect has been highlighted for Japanese lenders in particular by the losses they suffered last year on returns from dollar-denominated investments, and the consequent increase in yen-denominated lending in Asia as elsewhere. (According to the Economist, 30% of non-Japanese Asian governments' long-term debt is already in yen, compared to 12% for all developing countries.) Yen-denominated investments by Asian countries also form a useful hedge against currency losses resulting from fluctuating yen/dollar rates. (A recent Financial Times survey estimated that in the period 1985-95, Japanese financial institutions alone suffered 37 trillion yen in exchange losses on holdings of foreign-currency investments.)

(c) the weight of the yen in Asian foreign reserve holdings and as a transaction currency between central bankers. The Keidanren report points out that an increase in non-dollar (primarily yen) foreign exchange holdings by Asian states outside Japan would be an appropriate response to the trend toward dollar depreciation. IBJ President Kurosawa indicated last year to an American bankers' meeting that Asian central bankers currently held about 60% of their reserves in dollars, down from 70% ten years ago, with the difference going mainly into yen and marks. He also predicted a certain and possibly sudden slide in dollar holdings to below 50%. A Reserve Bank of Australia official recently stated that 30-40% of the RBA's foreign currency reserves are now in yen-denominated assets. To set this in context, Asian countries (including Japan) currently occupy six of the top ten spots in the world ranking of foreign exchange reserves, accounting for more than a third of the global reserve total.

(d) a shift toward a greater weight for the yen in Asian exchange rate calculations. Some analysts argue for a phased decoupling of Asian currencies from dollar-based exchange rates in favour of the yen, based initially on changes in foreign reserve holdings (as above) and revision of the basket of currencies against which a given Asian currency is tracked. Kwan points out by way of example that in Taiwan, yen weighting has risen from 6% in the early 1990s to about 30% now. Such moves in the direction of yen-pegged currencies, analysts point out, should reduce exchange-rate risks for Japan's Asian partners engaging in yen-denominated transactions, and thus encourage both trade and capital transactions with Japan.

Some Japan analysts argue that a combination of such factors makes greater use of the yen in Asia a matter of urgency, suggesting for example that increasing Asian trade with Japan, reinforced by increased intra-regional yen-denominated investment, will result in more yen liabilities to be settled and thus a greater need for yen-based foreign reserves and a short-term T-bill yen market. This in turn, they argue, means that Japan needs to consider a broader regional monetary policy, in consultation with major Asian partners. Regional cooperation is in fact beginning to emerge. The APEC Finance Ministers' meeting in Kyoto in March endorsed "ongoing initiatives among monetary authorities in the APEC region". Such initiatives have included a currency-defence agreement among Australian and Southeast Asian central bankers and increased cooperation in currency-market intervention by Japan, Hong Kong and Singapore. Some have suggested that the process might in time go further, including the possibility of an Asian version of the Bank for International Settlements.

The problems inherent in the current mixed yen- and dollar-denominated financial system were certainly illustrated by the effect of the mid-1995 burst of endaka on China and many Southeast Asian economies: their large yen-denominated loans from the Japanese government and private sectors suddenly represented a much larger burden relative to export earnings mainly denominated in dollars (the numbers for Indonesia, for example, are 40% of its foreign debt in yen and 80% of its export earnings in dollars). Other negative impacts on Asian states from this bout of endaka, as identified by Kwan, included inflationary pressure from the higher cost of imports from Japan, overheating from the surge of Japanese investment and excess liquidity based on a surge of speculation in Asian currencies.

In economic terms, a gradual increase in the use of the yen in Asian economic transactions is probably both inevitable and anodyne. Certainly the issue is under study in Japan. The April 1995 package of emergency measures for dealing with endaka stated for the first time that the Government favoured greater use of the yen in trade and closer relations with the central bankers of other Asian countries. MITI's Watanabe group, among others, has worked on the implications of yen internationalization on trade and investment flows. Ministry of Finance officials (cited by Kwan) have pointed out that the increasing use of the yen as an international currency would reduce currency risks for Japanese firms that now trade heavily in dollar terms, while also promoting expansion of Tokyo financial markets.

There are also however arguments against increasing use of the yen. These include the liquidity of US dollar, its easy convertibility, the practice of pricing major global commodities in dollar terms, the importance of financial markets that already deal in dollar-denominated financial instruments, the comparative rigidity of Japanese markets, the continuing importance of the US import market for Asian exports and the close exchange rate links to the dollar of many Asian currencies (whether formally pegged or not). Even much of the yen-denominated investment in Asia and elsewhere is quickly hedged by swaps against more liquid currencies, and there is little in the way of a secondary market for yen-denominated instruments. This will not change unless restrictions on the use of the yen are significantly loosened; last year's deregulation of interest rates and liberalization of overseas investment by insurance companies, for example, represent the sort of market opening actions that are needed if the yen is to become a major currency for trade and capital transfers.

The issue is at least as much political and emotive as economic. The idea of an East Asian currency bloc excites those who are promoting greater Asian integration, and correspondingly concerns those who fear replacement of a single dollar-oriented global financial system with a tri-regional structure based on the dollar (for the Americas), the DM (for Europe) and the yen (for Asia). In an era of free markets, there is in any event no way of creating a currency bloc unless these markets determine that it is in their interest to do business in that currency -- ie unless there are liberal enough market mechanisms and adequate enough instruments denominated in that currency to allow users to profit from using/holding them. Under the present circumstances, the issue of a bloc seems more likely to be resolved by evolution than by revolution, and the realities of the Asian economy seem likely to dictate continued reliance on a mix of yen and dollars.

(5) Japanese participation in regional economic fora

The debate over Japan's role in the Asian economy also covers the question of participation in regional economic organizations. APEC remains the mainstream choice, but other groupings with a less Asia-Pacific and more specifically all-Asian or East Asian focus also have support in some circles.

APEC enjoys broad support in Japan in part because it embodies the sort of globalization and liberalization dynamics that are promoted by the export-oriented sectors of Japanese business and its political allies. The Keidanren July 1995 report for example strongly supported APEC, while minimizing the role of governments in its achievements, calling for a fairly cautious approach on the liberalization agenda (but with MFN treatment of any results) and concentration on trade facilitation efforts (but without forcing the private sector to implement any resulting cooperation agreements). The Keizai Doyukai report supported APEC as well, arguing inter alia that it should be expanded in time to include Vietnam, Myanmar and other non-member Asian states. Japanese business also supports the various specifically APEC-related business fora. On the government side, both then Foreign Minister Kono and then MITI Minister Hashimoto expressed strong support for APEC's work and toured its East Asian capitals last year to encourage support for a strong outcome at the Osaka Leaders' Meeting in November. The meeting, chaired by Japan, adopted an Action Agenda to guide implementation of the Bogor declaration on liberalization of regional trade and investment.

This is not to say that APEC is without its detractors. A number of critics have argued that it is in fact a stalking horse for Western attempts to influence the region economically. These critics see the increasing systemization of APEC, the growth of its Secretariat, and the sort of ambitious liberalization agenda set out at Bogor and Osaka as destructive of the kind of looser and more convivial APEC they prefer ("northern logic" versus "southern emotion" as Goto puts it). Some also see APEC as too disparate in political/economic and cultural terms to form a successful free trade area or economic policy coordination mechanism. In reply, some have argued that APEC allows the smaller Asian members to engage the United States on trade and investment issues in a collective manner, giving them much greater strength than they would enjoy in a series of bilateral negotiations with Washington.

Some analysts also stress that the very great differences in economic development among APEC's members mean that the organization must be prepared to address equalization issues if it is to prosper, an analysis that others question. The Keidanren for one agrees on the need to support liberalization in APEC through development assistance and technical cooperation, both to encourage less developed economies to take part in the process (which will mean a significant opening-up of their economies to global competition) and to facilitate their ability to do so.

The key alternative to the APEC approach has been the East Asia Economic Caucus (EAEC), proposed by Malaysian PM Mahathir in 1990, which would include most of the East Asian members of APEC but exclude those from the Americas and Oceania. The organization is intended to be economically less ambitious and culturally more coherent than APEC. This proposal has raised concerns among some non-Asian APEC members, who see it as an attempt to reduce their influence in the region. EAEC proponents point out in reply that they have raised no objection to NAFTA, a similar sub-regional grouping within APEC; one commentator has suggested that the success or failure of NAFTA should in fact be used as a test for the EAEC's potential, since both involved close economic cooperation among countries at very different levels of development.

Mahathir has stressed that he wants Japanese participation in the Caucus, but Tokyo has adopted a cautious approach. Japanese trade officials have in any event long expressed reservations on regional economic/trading blocs generally (chiefly the EU and NAFTA); Watanabe criticizes such groupings as "revelations of weakness", arguing that strong economies do not need formal integration of this nature. Japan is in fact one of only six APEC members who do not belong to a sub-regional trading bloc and one of only two within the OECD. Tokyo would clearly have points of principle as well as practicality to overcome before it could join an EAEC as originally proposed. On the other hand, there are a number of commentators who argue that a window should at least be left open to the possibility of Japan encouraging Asian regional groupings and informal "networking".

Japanese business circles have seemed cautiously attracted to the EAEC idea, if generally as a complement rather than an alternative to APEC. Keidanren President Miyoshi, for example, wrote in a Nikkei op-ed piece last year that Japanese business was "more flexible than the Japanese Government" in approaching the EAEC, and that the organization could be "useful for promoting regional dialogue and economic cooperation". On the other hand, the July 1995 Keidanren report limited itself to a single short paragraph on the EAEC, which urged study and attention to ensure that it not become a closed group, but did not discuss the issue of Japanese participation.

The debate has also been joined by other business groups. The Keizai Doyukai report argues that regional cooperation proposals such as the EAEC should be supported, assuming they comply with GATT/WTO restrictions; the paper also suggests that Japanese participation should hinge on "relations with countries in and outside the region." The study issued last fall by the business-funded Japanese Economic Research Institute also straddled the question by calling for a "soft landing" on the EAEC concept through the active mediation of Japan. This approach would include guarantees to the USA that the EAEC would not take up security questions, EAEC (and NAFTA) positioning within the APEC structure and participation in the EAEC by Australia and New Zealand. A similar proposal was advanced by Nagatomi, who added that concerns related to the EAEC's potential impact on regional security could be assuaged by strengthening the ASEAN Regional Forum process. On the other hand, a group of pro-EAEC Japanese business leaders, including several prominent names, held its first meeting last spring and announced plans to lobby the Government and link up with similarly-minded business leaders in other East Asian countries.

Japan's formal position has remained careful over the last year. Then Foreign Minister Kono attended an informal meeting with counterparts from ASEAN, Korea and China (Mahathir's envisaged core group) in July 1994 to discuss the EAEC concept. On the other hand, then MITI Minister Hashimoto declined to attend a planned informal meeting of trade ministers from the same group in April 1995 (widely touted as the meeting that would set up the Caucus), unless Australia and New Zealand were invited as well; as a result, the meeting was cancelled. An official at the ASEAN Regional Forum meeting in August 1995, speaking on behalf of Kono, told reporters that Japan would not join the EAEC unless this had the approval of all 18 APEC members. Hashimoto meanwhile had successful bilateral meetings with ASEAN economic ministers in Brunei last fall on the margins of their Ministerial, without EAEC being prominent.

The EAEC forum may have had a partial resurrection, however, in the context of the Asia-Europe Meeting (ASEM) process, which brought together the leaders of the EU, ASEAN, Japan, China and Korea in March 1996. The Asian preparatory meetings for this Summit (eg in Osaka on the margins of the November APEC meetings and in Thailand in February) had the same participants as the proposed EAEC, but a clear ASEM focus. PM Hashimoto played a strong role in the Summit, arguing inter alia for an ASEM business conference and an economic ministers' meeting next year, for Asian contributions to Bosnian reconstruction and European contributions to funding the North Korean nuclear agreement, and for attention to UN reform. In his statements, he was also careful to stress that ASEM was not an anti-American forum, and he argued for the admission of Australia and New Zealand to future Summits.

Other forums involving Japanese contact with Asia are also either in the air or underway. A number of analysts (including Dobbs-Higginson and Mano) have for example suggested a new organization that would include all Asian countries, from Japan to Afghanistan or even Turkey, but excluding Oceania. Japanese regional governments and private sector representatives are also active participants in sub-national bodies such as the Northeast Asia Economic Forum (NEAEF), which groups counterparts from North and South Korea, northeast China, the Russian Far Eastern Provinces and Mongolia. This forum, founded in 1990, met last year in Niigata and is focusing with the UNDP on joint economic development of the Tumen River delta in the China-Russia-Korea border area. On another front, Japan hosted in February 1996 a meeting of senior trade officials from East Asian and Latin American economies, described as an attempt to strengthen cross-Pacific economic and environmental links, providing a new regional focus.

Unless the political situation in Japan changes radically, APEC seems likely to remain the key to Japanese regional involvement, as it has the support of the both the USA and most of Japan's Asian partners. At the same time, Japan seems likely to move gradually toward participation in new regional groupings provided they are either sufficiently restricted in scope (like the NEAEF) so as not to be seen as threatening to major non-Asian partners, or else sufficiently open in structure to include them. Japan seems likely to seek an indirect association with useful organizations, especially those with an ASEAN focus like AFTA. In doing so, and in participating in groups like ASEM, Japan will seek to gain from occupying the middle ground between pro-Asian and pro-Western forces within East Asia generally.

(6) The <u>kudoka</u> debate

Returning for a moment to the domestic scene, recent moves by Japanese firms to offshore production in Asia tend to be linked in public debate to the threat of <u>kudoka</u>. This makes government policy on economic relations with Asia at least partially hostage to the state of the economy. It is worth stressing, however, that this is primarily a political rather than an economic problem.

While globalization and liberalization remain major trends in international trade and investment, and with <u>endaka</u> or its threat a constant presence, the basic pressures on corporate Japan will remain the same, and the response of those firms that can do so will be to relocate offshore. This is a normal effect of economic growth: domestic resources need to be shifted to higher value-added production. At the same time, as commentators such as Abegglen, Ohta and Wada point out, Japan has a long way to go before it can really be seen as over-dependent on offshore production. Accepting MITI's estimate for the overseas production ratio for all Japanese firms (7.4%), Japan still comes in well below Germany (20%) or the USA (30%). Based on recent developments, Sanwa estimates that the Japanese number may reach 13% by the end of the century and other analysts estimate that 20% may be reached 10 years later: still not alarming figures by international standards. The November 1995 ExImBank survey, which covers only firms with an already-established international presence, indicated that FY95-96 represented a watershed year for such firms, in that their overseas production ratio was expected to exceed their export ratio (ratio of company exports to total production), a gap that is expected to widen to 5% by FY98-99. The fastest shift in this regard will be among assembly industries such as machinery, autos and electrical goods, which are expected to see a growth in overseas production ratio from 20% in FY94-95 to 29% in FY98-99, while their export ratio remains about constant at 26%.

At worst, if the pressures on unemployment prove irresistible and economic reform is delayed, support may increase for policies of managed trade and economically-distorting incentives favouring domestic investment and maintenance of a traditional production base. At best, kudoka will prove a major incentive to deregulation and restructuring of the Japanese economy, with employment gains in high-tech, knowledge-intensive and modern service sectors. Some analysts have argued that kudoka has potential benefits in terms of expanding Japanese economic relations with the "Pacific Asia" region and encouraging liberalization of the domestic economy, suggesting that the Government should take as a medium-term priority the goal of making the Asian offshore thrust compatible with stable employment at home. This approach is implicit in the May 1995 MITI White Paper, which talks about Japan "speeding up the process of building a division of labour network that covers all of East Asia" while simultaneously addressing the crucial issues of domestic structural reform. A similar position is taken in the Keizai Doyukai's November 1994 report.

The Japanese Development Bank argued earlier this year that kudoka was likely to slow down, given the rebound of the yen/dollar rate from mid-1995 levels. In any event, strong pressure from Japanese business and from both pro-globalization and the pro-Asia spheres, suggest that fears of kudoka are unlikely to have a strongly negative effect on economic relations with the region.

## V REACTIONS OF OTHER PLAYERS

The analysis in this paper has been written from the standpoint of Japan and its internal debate on economic relations with Asia. To provide perspective, however, the reactions of other players in the region should at least be summarized, further to the aspects already mentioned earlier in this paper. The most important of these players are the East Asian states. And the bottom line here is that while East Asia may now be seen as the most important region for Japan in economic terms, the reverse is not necessarily true.

In trade terms, for example, Japan is not East Asia's most important market. Watanabe points out that the most important export market for the core East Asian group (ie the NIEs, ASEAN states and China) is in fact each other, followed by the United States and then at a distance by Japan; the numbers for 1993, when total exports by this group were US$442 billion, were 50% internal (US$221 billion), 31% to the USA (US$135 billion) and 17% to Japan (US$75 billion). WTO 1994 numbers for a broader definition of Asia (the whole continent less Japan, Australia and New Zealand) show 35% of all export markets and 33% of import sources as internal, well ahead of other partners (the USA is the next biggest export market at 24%, with Western Europe at 17% and Japan at 14%; Japan is the next largest import source at 23%, followed by Western Europe at 17% and the USA at 14%).

The US market has probably been the most important external "locomotive" for the East Asian economy over past two decades. By contrast, Japan has had a strong trade surplus with the region for most of the last decade -- one that exceeded its surplus with the other OECD countries for the first time in 1994 and grew to US$71 billion in 1995. This has fuelled complaints about Japanese trade barriers from certain Asian countries (including China, Taiwan and Korea). This Japanese surplus is likely to decline in the medium term, since exports of capital goods for establishment of new plant by Japanese subsidiaries will peak earlier than the return flows of consumer durables to Japan, especially if <u>endaka</u> renews itself, and in fact February 1996 saw the first monthly drop in Japanese exports to the region in almost six years. The situation still however compares unfavourably for Asians with the heavy surplus they enjoy with the United States. And as Wada and others further note, competition for world markets between Japan and dynamic Asian producers is likely to grow as the NIEs in particular continue to catch up in economic terms.

On the investment side, while Japan remains the most important external investor for the East Asian region, its dominance is shrinking. For many Asian countries, Japanese FDI actually dropped between 1993 and 1994 both in absolute terms and as a proportion of their total inward FDI (in the case of Indonesia, for example, from roughly 10% to 7%, in the Philippines from 21% to 4%, in Malaysia from 26% to 16%, and in Thailand from 58% to 38%). By way of comparison, the JETRO White Paper on FDI of March 1995 points out that while annual average Japanese investment in the region declined from US$6.9 billion in the period 1988-90 to US$6.2 billion in 1991-93, the comparable figures for the USA went from US$1.8 billion to US$4.4 billion, and figures for the three biggest EU investors (UK/France/Germany) rose from US$1.2 billion to US$1.9 billion.

The <u>Economist</u> estimates that Japanese, US and European shares of total FDI to the major East Asian states over the period 1988-94 is respectively 18%, 11% and 10% -- ie no clear dominance. Part of the reason is that the importance of East Asia as a <u>source</u> of investment has been growing. Taiwan has been a net exporter of investment capital since 1988 and Korea since 1990. The importance of Hong Kong and Singapore as capital markets was noted earlier. Even China, although still a net importer, made external investment approaching US$4 billion annually in 1992 and 1993. As a result, the JETRO report indicates, 59% of the FDI flows within the region in 1993 were sourced from other East Asian countries. (The Economist estimate for 1988-94 is 51%.) Especially strong flows were notable from the NIEs to ASEAN countries, China and Vietnam, where the NIEs have generally been following the same "flying geese" pattern as Japan, using FDI to shift production overseas to lower-wage economies. Asian companies even bought nine Japanese firms with a total value of about US$700 million in 1995, mainly in high-tech sectors.

This theme of increasing East Asian self-development is becoming common. Ogura for example recently estimated that two-thirds of recent growth in the region has been internally-generated, and other analysts have argued that domestic savings rates have been a more important force for regional growth than FDI (part of the East Asian development theory).

Further to the polling results mentioned above on Asian attitudes to Japanese economic penetration, there is also an undercurrent of concern in some Asian countries on the approach of Japanese businesses. Hii points out criticisms of such firms for retaining a strongly Japanese management cadre, compared to overseas subsidiaries from many other countries, which tend to adopt local managers at a much higher rate. Parallel concerns have been expressed that Japanese firms in Asia will establish links primarily with other Japanese companies to the detriment of local firms, creating the sort of vertically- and horizontally-integrated structure that characterizes industrial organization in Japan itself. These concerns are perhaps exaggerated; Johnstone for example points out that adoption of the Japanese approach has resulted in a serious loss of East Asian market share for the Japanese electronics industry, faced with competition from decentralized and therefore more adaptable American firms -- suggesting that Japanese subsidiaries in Asia will in turn have to become more open to survive. Experience also suggests that such concerns are not totally groundless, however -- even Johnstone cites the counter-example of the Japanese auto industry's dominance in East Asia. And Taylor goes even farther, arguing that such practices are actually a source of Japanese success in Asian markets, one that should be emulated by the USA. Such factors in any event inject a note of balance in the reaction of Asian states to the Japanese economic drive in the region.

For the USA, the issue of Japan drawing closer to the rest of Asia in economic terms links up closely with the general debate over the role of the USA in Asia. For those who advocate the status quo, recent Japanese moves are disquieting on a number of fronts. Then

Commerce Under-secretary Garten for example expressed concern both that the spread of a "Japanese model" could duplicate restrictive practices across Asia, and that the Japanese were seeking to make Asia "a platform for their commercial policy around the world" in a direct "competitive race" with the United States. And a Business Week editorial argued last year that "Japan's Asia tilt means the end of meaningful negotiations to open Japan's economy" and warns of a return by Tokyo to pre-war economic nationalism.

US concern over the Japanese economic surge in Asia is not likely to be resolved separately from the broader issues that give it its intensity -- including the future of the USA-Japan security relationship and developments in bilateral trade and economic relations generally. But as pointed out by a number of commentators -- including Nye, Chalmers Johnson and Henry Kissinger -- one logical response to a perceived Japanese swing away from North America and toward Asia in economic terms would be for a corresponding US swing away from Japan and toward closer ties with the same East Asian states. Certainly, as noted above, East Asian countries have a significant economic and technological relationship with the USA on which such an enhanced relationship could be built. US officials were quoted in the Japanese press last summer as suggesting that "for the US economy...the time to dwell on Japan has passed", and suggesting that the Clinton administration would instead shift its focus to Asia as a whole, including such growth centres as India and Indonesia, while stepping up its activities in APEC. This shift is further evinced by the decision of the US Commerce Department to add the ASEAN nations to its list of priority export markets (six out of the original twelve of which were already East Asian economies).

Other outside actors are also of course active in the Asian economy. As noted above, the EU has a significant presence in investment terms, and served as a market for about US$85 billion in East Asian exports in 1993 -- about 10% more than Japan according to the MITI White Paper. The EU also exported more to the region than did the USA in 1994 (by about US$7 billion), and the growth rate of two-way trade with Asia excluding Japan more than doubled in the period 1985-94, significantly faster growth than for Japan/Asia or USA/Asia trade. East Asia has in turn become the most important non-EU market for European exports -- overtaking the USA in that role last year for the first time. In order to enhance its regional influence, the EU has been looking for a more formal role to play in Asian and Asia-Pacific economic organizations. East Asian states seem interested in encouraging greater European engagement in the region, and the ASEAN states were particularly active in mediating the Asia-Europe Summit.

In summary, Japan will continue to find the Asian playing field a complex and demanding one, one that will not necessarily provide unchallenged running-room for deepening its ties with the region.

## VI IMPLICATIONS FOR CANADA

Canada is a medium-ranked player in the Asian game, and Japanese regional moves will affect its economic interests.

The new patterns of trade between Japan and Asia do not seem likely to affect Canadian exports and imports strongly in the near future.

(a) Certain of the basic industrial materials that Canada exports to Japan, such as metals and chemicals, could be affected to the extent that they serve as inputs to the production either of such machinery and components (in which case Canadian sales could rise slightly over the short term) or of the consumer durables made by such machinery (in which case Canada could see some reduction in sales to Japan as production here declines, but should be in a position to recoup sales to the newly-relocated plants, especially if efforts are made to maintain traditional supplier contacts with the Japanese firms in question). In neither case does the net effect seem likely to be large.

(b) The major growth areas in recent Canadian exports to Japan, and the areas of focus in the Action Plan for Japan, are specialized high-tech niche sectors and "lifestyle" sectors such as food and housing, rather than the traditional consumer durables that form the focus of increasing Asian sales to Japan.

(c) Increased Japanese exports to East Asia are mainly in the category of industrial machinery and component parts, a sector in which Canada is not a major supplier in any case.

In terms of FDI and other capital flows, East Asia provides general competition for investment that might otherwise flow to Canada, although such competition is not present in all specific sectors. It can be noted in this regard that Japanese FDI in Asia has increased every year since 1991, a period over which Japan's FDI to Canada has steadily dropped (most recently to a 1-2% share of total Japanese FDI). Without belittling the impact of enhanced Japan/Asia capital flows, however, there must be more to Canada's weakened position than increased competition from Asia. When FDI from Japan to Canada in fact started dropping in 1989, Japanese investment in Asia was dropping as well; Asia has recovered its growth trend while Canada has not. And Japanese FDI flows to the USA increased in both 1993 and 1994 over the year before (by 6.6% and 17.7% respectively), while flows to Canada fell (by 25.4% and 12.5% respectively). There are however signs that FY95-96 may be a better year for Canada (half-year numbers were up significantly) and it seems probable that Canada can regain a higher share of Japanese FDI despite the Asian challenge, if the Japanese perception of Canadian fundamentals continues to improve.

The thrust of Japanese firms into Asia meanwhile suggests increased possibilities for third-county cooperation with Canadian firms in these markets. The key here will be to find matches where Canadian firms can supply specialized skills and experience (eg in environmental technologies) that supplement Japanese corporate strengths and goals. If Japanese ODA and EximBank financing for Asian projects are increased, this will of course give a boost to such possibilities, and the Canadian Government can facilitate the process to a certain extent through suggesting corporate match-ups, promoting greater bilateral cooperation on development assistance programs and ensuring that Canadian firms are aware of Japanese financing opportunities. (Canada/Japan joint seminars for business on such issues were held across Canada in December.) Given the Japanese Government's approach on the Asian economic thrust, however, and the fact that most Japanese financing (whether private sector or governmental) for major overseas projects is company-initiated, Canadian firms themselves will have to take the lead in approaching and establishing relationships with potential Japanese corporate partners; a strategy emphasizing primarily government contact will be a non-starter.

Should the trend toward greater use of the yen continue (whether or not a formal yen bloc coalesces), this will also have implications for Canada. Already, for example, there has been a clear shift toward the yen-denomination of Canadian borrowings in the Tokyo capital market; an Embassy survey of Canadian securities and loans held by Japanese creditors as of 31 March 1995, for example, indicted that 35.2% were yen-denominated, as opposed to 22.7% a year before. This will naturally shift currency risk to Canadian borrowers. A Japanese decision to denominate more of its exports in yen would have a similar impact on Canadian importers.

In terms of regional economic organizations, there appears to be considerable scope for Canada to cooperate with Japan in promoting trans-Pacific cooperation through an active APEC program of trade and investment liberalization based on the Osaka Action Agenda. In this respect, however, Canada should remain outside the ideological debates on "Asia versus the West", instead seeking to position itself as Japan's partner in a joint bridging of the East/West divide, on the sound (metaphorical) basis that a bridge needs to be anchored at both ends.

CONCLUDING THOUGHTS

The evidence presented in this paper suggests a clear thrust by Japanese business in Asia, combined with domestic uncertainty as to the nation's role vis-a-vis its neighbours. This is hardly a new debate; nor is it likely to be decided soon.

While some Japanese analysts for example suggest that Japan is "not quite Asian" given a lengthy period of isolation followed by 100 years of rapid industrialization and intensive contact with the West, it is also true that the degree of Japanese academic and governmental interest in Asia has probably not been higher since the end of World War II. Abegglen cites Huntingdon's "Clash of Civilizations" article on the uniqueness of Japanese civilization and the constraints this places on Japan's participation in regional integration. He adds that "Japan is in but not of Asia" -- the closest parallel being perhaps that of England to Europe. Just as the UK has drawn closer to the EU economically while asserting an independent political stance, it is argued that Japan will draw economically closer to Asia, based on the practical realities of day-to-day commerce, while continuing to maintain its own <u>sui generis</u> political and diplomatic identity.

In terms of public opinion, the Government's April 1995 foreign policy survey reveals that a high and growing percentage of Japanese support a <u>global</u> economic orientation for the country, either directly or "as a member of the Asia-Pacific region" (a total of 68.5% in 1994, up from 63.0% in 1993), while the proportion of those favouring an explicitly <u>Asian</u> economic approach is smaller and falling (down from 15.4% in 1993 to 10.9% in 1994).

In sum, the current surge of Japan's involvement in Asia should probably be seen more as a rebalancing (following comparative post-war isolation from the continent) than as a seismic shift. Japan is geographically Asian, but politically and economically it is an independent power committed to global engagement. While Japan may therefore emphasize Asian values and connections more as the 21st century dawns, and while it will certainly take advantage of opportunities to make economic gains in Asian commerce, in broad terms it seems likely to remain committed to a modern Western-oriented approach, as a <u>sui generis</u> but successful practitioner of a modified market capitalism. <u>Datsu-o nyu-a</u> (shedding the West, entering Asia) may enjoy cyclical favour as a slogan to rally nationalists, but (in the economy at least) the Meiji acceptance of <u>Datsu-a nyu-o</u> seems unlikely soon to be reversed.

While some Japanese analyses for example suggest that Japan is "be[illegible]" [illegible] Asian [illegible] given a lengthy period of isolation followed by [illegible] years of rapid industrialization and intensive contact with the West, it is also true that the degree of Japanese academic and governmental interest in Asia has probably not been higher since the end of World War II. One example cites Huntington's "clash of civilizations" thesis on the uniqueness of Japanese civilization and the constraints this places on Japan's participation in regional integration, and adds that Japan is in fact of Asia, the closest parallel being perhaps that of England to Europe. Just as the UK has drawn closer to the EU economically while asserting an independent political stance, so it is argued that Japan will draw economically closer to Asia, based on the practical realities of [illegible] commerce, while continuing to maintain its general political and diplomatic identity [illegible].

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[illegible] current [illegible] of Japan's involvement in Asia [illegible] by [illegible] balancing [illegible] comparative [illegible] Japan [illegible] economically [illegible] independent power [illegible] While Japan may [illegible] century [illegible] certainly take advantage of opportunities to make economic gains in Asian commerce, in broad terms it seems unlikely to [illegible] the modern Western [illegible] as a [illegible] successful [illegible] [illegible] [illegible] [illegible]

**APPENDIX: SOURCES**

The first iteration of this report was completed in September 1995, based on material gathered over the preceding twelve months. The second iteration was prepared in April 1996, based on additional material available to the end of March (at which time some of the 1995 and much of the FY95-96 statistics had yet to be released). The main sources mentioned or used in the text are detailed below.

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