

Japan and East Asia: Economic Prospects and Challenges¹

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The last decade of the twentieth century saw a marked shift in thinking about regional cooperation in East Asia and the Pacific. East Asia became the locus of interest in economic cooperation within the region. At the end of the decade, economic cooperation across the Pacific within the framework of APEC seemed on the wane. This was not simply a shift of direction in economic diplomacy. The wellsprings of the change were also deeply political in character. Its timing had as much to do with how East Asia came to perceive the need for a new framework for managing the growing dominance of America as it did with the steady rise of East Asian economic power. But both economic and political forces drove the change. The policy attention devoted to East Asian cooperation has not abated, but rather intensified in the past few years.

Japan was the leading edge of East Asian industrialisation in the postwar period and the growth and transformation of Japan into a modern industrial economy has had a profound effect on the East Asian and world economies. By one measure, Japan is the second largest economy in the world and it is the world's second largest trader. The geo-political impact of the rise of the East Asian economy led by Japan was less profound but nonetheless presaged the emergence of a third major East Asian centre of power in the world, alongside North America and Europe. The rise of Japan and East Asia had particular importance for Australia, both in international economic as well as political affairs.

The 'lost decade' in the 1990s put Japan's leadership in East Asia under question and encouraged perceptions of Japan as a spent force. This has affected thinking at the

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highest political level in Australia and to a lesser extent how Australia relates to Japan at all levels.

The last two decades saw the emergence of China and, what I call, 'the third wave of East Asian trade and industrial transformation', after the first led by Japan and the second led by the newly industrialising economies of Northeast and Southeast Asia. China is a huge new economic and political force, challenging Japan's leadership in East Asia. Measured in terms of purchasing power parity (PPP), China is already the largest economy in East Asia, larger than Japan and on the way to being larger than the United States in the next couple of decades. APEC encompassed the first and second waves of East Asian power within a framework that includes North America. After the East Asian financial crisis, the establishment of ASEAN plus 3 saw the tentative emergence of an East Asian community and nascent political and economic cooperation between Japan and China and the rest of East Asia. Neither Australia nor North America is part of this process.

How will this regional architecture evolve in the years ahead? Is Japan a spent force and what is its role in East Asia's and Australia's future? What is China's potential and what is its impact likely to be on East Asian and global affairs? What are the implications of these developments for Australia?

The new regionalism in East Asian had long-term structural as well as these more proximate origins. The long-term forces that led the East Asian economies to begin to think about the construction of a new regional framework for cooperation revolved around two factors. The first and most important was the growth of economic and political interaction among the East Asian economies themselves. The second was the emergence of the new international economic and political environment after the end of the Cold War, in which the resurgence of US hegemonic power challenged perceptions of the growth of independence and national power within East Asia.

The growth and deepening integration of the East Asian economy is the result of three huge waves of trade and industrial transformation. The first came with the rise of Japan

and its emergence as a major industrial power, especially in the first three decades after the Pacific War. The second was led by the newly industrialising economies (NIEs) of Northeast and Southeast Asia in the late 1970s and 1980s. Now a third great wave is sweeping the region, with the remarkable rise of China. These successive waves of trade and industrial transformation have created a new centre of East Asian economic power that has begun to rival North America and Europe in terms of its contribution to world output and world trade.

A central feature of deeper East Asian economic integration has been the remarkable growth of trade in intermediate goods and components, and China is now a major element in this process. The location of relatively labour-intensive component production and assembly within complex, integrated international production chains has been a growing feature of the international division of labour, especially in East Asia.

The most notable feature of international product fragmentation in recent years has been the rapid integration of China into regional production networks. This development is an important counterpoint to the popular belief that China's global integration would crowd out opportunities for export-led growth for other economies within the region.

In the manufacturing sector, FDI has been the driver of the substantial intra-industry and intra-regional trade growth, and the role of FDI is expected to rise, fostering deeper integration of the regional economy. The effort to cut production costs through improvement in productivity and more efficient procurement and outsourcing has led to the relocation of some segments of multinational firms' production processes within East Asia. The effect on trade and investment flows is significant. The increased fragmentation and specialisation in production and trade that has been promoted by the activities of multinational firms in the region presents enormous opportunities for East Asian economies to become integrated into international production chains and markets.

The trade and industrial transformation of the East Asian economy, in brief, is a continuing dynamic. The scale of the change in China and its impact upon East Asian

economic integration will work itself out, barring major reversals, over the next two to three decades, in the same way that the rise of Japan did in the last half of the twentieth century. The recovery of Japan's economic vigour (now in prospect but only assured if there is delivery of more and substantial economic and related reform) will greatly restore and enhance Japan's role and effectiveness in regional and international economic diplomacy. But China is already a major player regionally and globally and its potential for growth is huge alongside that of Japan, an economy that is already economically and demographically mature. Whatever Japan's strategies for, and role in, regional cooperation, they must accommodate that reality.

Another feature of the East Asian economy noted above is its extra-regional trade and economic reach. A high proportion of the region's trade in intermediate, but especially in final goods, is destined for the major industrial country markets of North America and Europe, outside the region. Large flows of FDI particularly into China, now the largest recipient of direct capital inflows, cement economic interaction with the global economy. And East Asia is a major interest in the international financial market as was discovered painfully in the East Asian financial crisis.

In these and other respects, the structure and dynamic of the regional economy is very different from that of Europe and North America, and it is likely to remain so for a very long time. India is also now on the rise and there are growing ties between the East and South Asian economies. It has become fashionable to seek to emulate the European model of economic integration in East Asia, but there is a question about whether imposing the European model or, even, the North American model upon East Asia would reinforce or derail integration East Asian-style.

The imperative of deeper financial and trade cooperation in East Asia became clear through the experience of the East Asian financial crisis. The crisis saw Japan's regional leadership on these issues in disarray. Japan's own financial market was in a mess. The call for the establishment of an Asian Monetary Fund (AMF) lacked credibility even within the region. Japan was a major factor, though not the only one, in failure to make

progress on trade liberalisation within APEC. And Japan exercised no sway or leadership towards averting the US retreat from a new WTO Round in Seattle. In this context, the emergence of ASEAN + 3 reflected the interest in re-grouping and building a framework for substantive economic cooperation within the region.

ASEAN + 3 is not a regional trading arrangement but rather seeks to provide a framework for demonstrating East Asian influence and leadership on regional and international affairs. The initial focus was very much on regional financial cooperation. That was the hook on which the political level dialogue began. In January 2002 in Singapore, Prime Minister Koizumi proposed an East Asian community encompassing cooperation beyond trade and financial issues (and including Australia and New Zealand) to promote regional integration. The agenda of ASEAN + 3 already extends far beyond the issue of financial cooperation and the ambition, stated more clearly at the recent meetings in Bali, is for the evolution of an East Asian Economic Community.

A parallel development was the rush towards bilateral or sub-regional FTAs. FTAs are preferential or discriminatory trade arrangements. Preferential trade arrangements within East Asia (including the participation of key regional economies such as Japan, China and Korea) had never before found favour.

At the centre of this shift in policy direction was Japan. For Japan to choose a strategy of bilateral (or sub-regional) discriminatory trade arrangements was bound to have considerable reverberations within East Asia and the Pacific and throughout the world trading system. One of the consequences of Japan's FTA initiatives was to encourage China to join the FTA game too. Most importantly China, in dealing with the sensitivities in Southeast Asia about its economic rise, was freed to propose an FTA with ASEAN. The Japanese policymakers who initiated these moves had no comprehension of what the reaction to them would be elsewhere in the region, especially in China.

Prospects for an East Asian Community

The trajectory of economic growth and the nature of trade and industrial transformation define both the special character of the East Asian economy and economic integration and the shape of regional cooperation arrangements that are feasible and will sustain it. East Asian growth and integration is now riding the third great wave of industrial transformation, at the base of which is China. A recent study for the Governor of Guangdong suggests that, between 2025 and 2030, Guangdong will attain per capita income levels equal to those in Japan today, and much higher in Guangzhou and Guangdong's other large cities.

There are risks in all such historic events. The most important risk to Chinese success relates to political system reform.

The core of Chinese trade and economic success is the growth of the private sector, both private foreign-invested enterprise and domestic private enterprise. But the opaque relationship between the private sector and the state in a one-party political system is the root cause of endemic corruption and, at some critical point, is doomed to derail such economic success.

The good news is that the Chinese leadership appears aware of the nature and the importance of this problem. President Hu Jintao's historic and carefully argued address to the joint sitting of the Australian Parliament on 24 October 2003 is encouraging in this respect. But the task is huge in a country of the size and complexity of China. And it is a task that will take some time to complete, when time is fast running out because of China's very success in reform, opening and growth.

At the heart of the process of future East Asian economic integration will be the deeper and deeper integration of the Japanese and Chinese economies. This is reflected in the projected trade shares mentioned above. But it is also and already reflected in the strategic re-positioning of almost every leading Japanese corporation in the Chinese market, and in the rapid growth in the importance of China-related business to Japan and Japan-related business to China.

All this might seem to suggest the development of a China-centred East Asian community. On current policy trends and strategies, one would have to conclude that this is the most likely outcome. The weight and growing power of China, both economically and politically, means that an architecture of regional economic and, therefore, political relations designed around a system of bilateral and preferential arrangements, rather than rooted in rules and institutions that are multilateral in their obligations, will increasingly deliver China the whip hand. In this architecture China will become the natural hub in the economic and political structure of the region over the next generation or two. This is the architecture that Japanese policymakers have put in place over the last half dozen years, and it is precisely the outcome that the region is stumbling towards should nothing be done to change it.