Asian-Led Global Growth and Japan's Economy

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Japan needs to readjust its position in Asia

Backed by growth in other parts of Asia, the Japanese economy has been recovering since the April-June quarter of 2009. But the economy may slow down in the fourth quarter of 2010 because the Bank of Japan's latest tankan quarterly survey of business sentiment shows that companies are less optimistic about the future. Diplomatic friction with China could also negatively affect the economy. The situation requires Japan to reconsider its position in the Asia-Pacific region.

In the September tankan, the diffusion index for large manufacturers stood at 8, up 7 points from the previous quarter. The number of firms that had positive views of the economy outnumbered those with negative views for June and September 2010, the diffusion index improved for the sixth straight quarter. But sentiment for the coming three months stood at –1, indicating that the index is likely to fall into negative territory in the fourth quarter.

The Bank of Japan attributes the pessimistic outlook to the expiration of a government subsidy program for eco-friendly cars and the yen's rapid appreciation. But a closer look gives a different picture. Six manufacturing sectors gave positive outlooks for the next quarter: chemicals (with an index at 2), nonferrous metals (14), general-purpose machinery (13), production machinery (4), business-oriented machinery (2) and electrical machinery (5). All these sectors export many of their products to Asia. That makes future economic trends in China, Korea and the Association of Southeast Asian Nations (ASEAN) a focus of attention.

Relations with China rapidly deteriorated after the collisions between a Chinese trawler and Japan Coast Guard ships near the Senkaku Islands in the East China Sea last month. Behind this trouble is China's naval expansion. The country also has territorial disputes with the Philippines and Indonesia over the Spratly Islands and with Vietnam over the Paracel Islands. At the ASEAN Regional Forum meeting in July, ASEAN members criticized China for trying to consolidate its de facto control in the South China Sea. U.S. secretary of state Hillary Clinton said ensuring safe navigation in the area is in her country's interest. Katsuya Okada, Japan's foreign minister at that time, made a remark in support. Chinese foreign minister Yang Jiechi took 40 long minutes to issue his counterargument.

Describing the South China Sea as one of its core interests along with Taiwan and Tibet, China is trying to ensure its control of the sea with military power. Some people are urging Japan to step up its military alliance with the United States and work with ASEAN in dealing with China.

ASEAN is becoming wary of China's military buildup. Up until the early 19th century, China's economy was estimated to have accounted for about 30 percent of the world's total. India was another economic powerhouse at that time, putting Southeast Asia into a peripheral position.

Despite a historical disadvantage, ASEAN countries got a chance in the 1970s when they adopted export-oriented economic systems and accepted foreign capital as rich nations began to globalize their economies. They did not follow Latin American states that protected their national capital with high tariffs. That is why ASEAN was able to achieve the "Miracle in East Asia" in the 1980s and the '90s. However, the collapse of the Soviet Union prompted China and India to open up their economies, and their rapid development has made it difficult for ASEAN to retain its lead. At the turn of the 21st century, the regional bloc adopted a policy of taking in the economic growth of its two giant neighbours. First, they invited China, Japan and Korea to create ASEAN+3. Then India was invited, followed by Australia and New Zealand for a wide Asia-Pacific framework.

How has Japan contributed to economic development in the ASEAN? One way is investment by Japanese firms in the region, which began to increase after the 1985 Plaza Accord caused the yen to surge. They also introduced supply chain management (SCM). Direct investment from Japan helped supply chain networks expand and become more efficient. The SCM process has taken root in multiple layers with various export destinations, parts and materials and managers of the networks.

The first phase of SCM consisted of exports to the U.S., investment from Japan and managers from the region. This pattern was established by 1990. In the second phase, export destinations diversified. Economic integration within ASEAN progressed with local procurement of parts and materials. After the collapse of U.S. investment bank Lehman Brothers, SCM in East Asia became less dependent on the U.S. and other markets in the industrialized world. This can be called the third phase, in which China plays a greater role.

Japan's machinery sector is included in the third phase. It is not uncommon for state-of-the-art Japanese industrial machinery to be installed in ASEAN countries, not in Japan. Many supply chains consider China as their export destination. So even if U.S. consumers and businesses keep adjusting their balance sheets for some time, Asia will not be affected much because it is creating a new framework independent of the U.S. market. Whether this framework will help solidify Japan's industrial structure remains to be seen.

Geopolitical changes in East Asia can be summarized in three points: 1) delinkage through flexible SCM from an economic structure that relies on industrialized nations; 2) expansion of China's hegemonic influence; 3) the World Trade Organization (WTO), U.S. involvement and other global risk-hedging frameworks. These changes will affect Japan's economy and its role in the region.

Japan returns to zero interest to stimulate economy

On October 5, 2010, the Bank of Japan decided to readopt its zero interest rate policy, which had previously lasted until July 2006.

When Prime Minister Junichiro Koizumi stepped down in September 2006, the yen-selling intervention in the currency market and the zero rate policy had already ended, leaving behind a medium- to long-term theme of how to reduce the dollar assets piled up in the Foreign Exchange Fund Special Account and massive government financing bills in the liability section of the central bank's balance sheet. Also, the full-scale exit strategy had yet to be addressed. Four years later, the Japanese economy sees both the foreign exchange and monetary policies entirely return to the state in those years, highlighting that it is a tough challenge to find "exits."

The Bank of Japan has lowered target rates of unsecured overnight call loans to zero–0.1 percent from 0.1 percent while making it clear that the bank will continue the zero rate policy until the consumer price index sustainably records an increase of around 1 percent. This is a complete revival of the zero interest rate policy introduced in 2001. This time, the bank also took a step, which will further bloat its balance sheet, of purchasing from financial institutions exchange-traded funds and real estate investment trusts in addition to government and corporate bonds and the like, seemingly the most unorthodox approach that a central bank can possibly employ. Why has the Bank of Japan been forced to go to this length?

Continued weakness in U.S. economic activity is behind the bank's move. All of the attempts by the Obama administration to increase employment have failed. Furthermore, the aggressive fiscal spending only boosted the country's budget deficit, and the U.S. government has yet to find a way to clean up the aftermath of bailing out government-sponsored enterprises like Fannie Mae and Freddie Mac by buying their mortgage-backed securities. As for the green job strategy intended to expand employment in areas related to preservation of the environment, activity appears to be far from vibrant because of uncertain returns on investments in such areas.

The prescription written by Larry Summers and some other economist aides to Barack Obama have proven barely effective, and they are leaving the government. Someone who cannot flee is Federal Reserve chair Ben Bernanke, as it becomes clear that because U.S. households and the federal government are compelled to adjust their balance sheets, the Fed needs to wait for economic fundamentals recovering while letting its own balance sheet bloat. Bernanke's standstill directly leads to affliction of the monetary authorities of Japan, which cannot help but play a role in activating the global economy, as it is impossible to keep the U.S. economic indicators from affecting the Japanese economy, through ordinary policy measures. The mechanism is as follows.

First, the outlook for returns from the U.S. financial assets will worsen. Only optimistic economists expect the U.S. economy to finish its balance sheet adjustment in two to three years. Under the circumstances, the yield on U.S. 10-year Treasury notes plunged 1.5 percentage points in only six months. Nonetheless, Americans' investment appetite remains dull.

As long as individuals' desire to buy houses continues to sag, investment trend among the U.S. businesses will unlikely pick up. Thus, falling interest rates have failed to spur investment. The development raises the prospect that the Fed will continue the ultra loose monetary stance. The descent of the dollar's value represents price adjustment against this backdrop. Japan cannot avert the influence of the price adjustment in the U.S. of financial assets in terms of yen or other foreign currencies.

Until this situation arose, investors worldwide had snapped up financial products structured in the U.S., such as securitized shopping malls. Now they are seeking other assets to avoid the risk of a fall in prices of the U.S. assets. Here the second stage has started. In this second phase, Japan has emerged as a place where a huge amount of financial assets are traded and free settlements of the deals are guaranteed.

Japan is second to the U.S. in the extensiveness of financial transactions. Given the outstanding balance of government and corporate bond issue, stocks in a wide variety of industrial sectors and the transparency of market making for real estate income trusts and other instruments in Japan, no one could deny that Japan is the second only to the U.S. in the depth of the financial market. No doubt international investors think of Japan's financial assets as the ones to buy when they dump U.S. financial assets.

Yet there should be the third stage. If long-term funds flowed into Japan in torrents, it would invigorate the country's stock market and possibly stimulate physical investment as well. Unfortunately, however, this is unlikely to happen.

Where there is continuous cash flow, securitization efforts are usually prompted. But Japan has lagged in the field. In sectors, such as city water, railways, electric power, pipelines and roads, where cash flow is produced in a stable manner, little progress has been made in creating investment certificates.

Rather, government intervention has been a prerequisite for constructing such infrastructure facilities, and the Japanese version of government-sponsored enterprises, were set up to handle these infrastructure projects. Government-affiliated banks and postal savings and insurance units, which managed a quarter of the Japanese public's financial assets, provided financing to the corporations.

The Koizumi administration tackled a reform of the special corporations and launched the privatization of the postal services. In the process, software ranging from the design and construction of infrastructure to the recoupment of investment should have been commercialized. If this had been realized, the influx of funds to Japan would undoubtedly have benefited the Japanese economy from the inside and businesses holding the software could have built a presence outside Japan too.

In reality, however, the initiative faced a backlash after Koizumi resigned as prime minister as the establishment and others already began tiring of the reform. It has been four years since Japan's media commenced habitually using the expression "unable to bear the pain" of reform.

The capital flow into Japan has turned into upward pressure on the yen in the currency market. But these funds are effectively put aside on a shelf in Japan's financial market borrowed by international investors for hedging purposes. They are not confident that Japan will regain fiscal health in the long run nor do they intend to hold Japanese stocks for a long time on expectations that the stocks' prices will rise in future. Increasingly, foreign investors pick undervalued Japanese shares only to sell them as soon as the prices edge up.

Such a state of the financial market restricts the movements of the Bank of Japan. Long-term interest rates fell in the end, making the yield curve nearly flat. Japan's financial market has again lost the function of distributing funds. This means that Japan's financial and capital markets were not mighty enough to block the spillover from the battered U.S. economy.

Bank of Japan governor Masaaki Shirakawa will unlikely be able to decouple his fate from Bernanke's for the time being. Shirakawa's personal competence should not be to blame for this. This is because Japan painfully lacked efforts or was regressive on designing the future of the Japanese economy and implementing policies for that before Koizumi, and it has been since his resignation. Amid these inactions and backlash, Japan is wasting time, which will run out before long.