

The 19th Policy Recommendations of the Policy Council

Economic Globalization and Options for Asia

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Introduction

As countries around the world pursue greater liberalization of trade and investment, economic globalization has been making rapid progress. Goods, capital, technology, and management resources are all moving briskly across national borders, domestic markets of individual nations are increasingly integrating with the world market, and there is a flourishing international flow of manpower. These trends are especially notable in the Asian region, and appear likely to continue for some time to come.

While this globalization does enhance the efficient utilization of factors of production, it also destabilizes national economies and, indeed, the world economy. Globalization is forecast to move even further ahead in the coming years, but there are numerous factors that will complicate these trends and increase uncertainty and instability within the world economy. One example is the antagonism between the U.S., which is dedicated to a free market philosophy and is vigorously promoting globalization, and the countries of East Asia, which stress the darker aspects of globalism from a nationalistic and regionalistic perspective.

Attention has also focused on how the international currency system and the world economy will change with the advent of the euro, giving rise to a mixture of hopeful expectations and worries about uncertainty.

In the midst of these trends, what options should Asia select for the sake of stable and sustained economic development? Our fundamental view is that Asia should effectively utilize the trend towards globalization, which at the same time endeavoring to prevent or overcome any instability that might result. In actively preparing to usher in this age of globalization, the efforts and the policies of individual Asian countries, the cooperative systems encompassing the region, and the role of Japan therein will undoubtedly prove significant.

In considering these points, we must thoroughly investigate the true nature of the recent Asian currency crisis and re-examine what in fact the region's economic fundamentals are and how they can be strengthened. We must also look back at regional cooperation and Japan's policies towards Asia during the efforts to address this crisis and draw lessons for the future from both of them.

Starting from this viewpoint, we would like to propose 14 concrete policies and strategies. The 14 policy recommendations presented here can be broadly divided by content into the four topic areas given below. For our purposes here, the term "Asia" refers to East Asia, comprising Northeast Asia (Japan, South Korea, China, and Taiwan) and Southeast Asia (the 10 countries of ASEAN). The countries of the region can also be classified by their stage of development into Japan (an advanced country), the more developed countries (the Newly Industrializing Economies group, China, and some of the ASEAN countries), and the less developed countries (especially the newer members of ASEAN). In these policy recommendations, these will be respectively termed "Japan," "the more developed Asian countries," and "the less developed Asian countries." In the absence of any such specific reference, the recommendation will concern East Asia as a whole; the term "the countries of Asia" will be used in these policy recommendations to indicate all countries in the region other than Japan.

[Strengthening Fundamentals] 1, 2, 3

[Utilizing Global Resources Effectively] 4, 5, 6, 7

[Addressing the North-South Issue and Regional Cooperation in an Age of Globalization] 8, 9, 10

[Creating a Currency Stabilization Mechanism for the Asian Region] 11, 12, 13, 14

Let us add also that this English version of the 19th Policy Recommendations of the Policy Council is a reproduction in English of the

“Summary” part only of the same Policy Recommendations in Japanese. The full text of the Policy Recommendations in Japanese, which include not only the Introduction and the Summary but the Body as well, is printed and published separately, and can be viewed on the web site of The Japan Forum on International Relations at <http://www.jfir.or.jp/>.

The Policy Council of The Japan Forum on International Relations first met to consider these proposals on 21 January 1999, and adopted them in final form at its fourth meeting on the topic on 27 January 2000. During this time the Task Force headed by **Prof. Tran Van Tho**, Professor of Waseda University, and staffed by **Dr. Kwan Chi-Hung**, Senior Economist of Nomura Research Institute, and **Mr. Kawai Atsushi**, Editor of The Yomiuri Shimbun, assisted the Policy Council in preparing the final draft of the recommendations. Mr. Harada Yasushi, Vice President of the Institute of Fiscal and Monetary Policy, Ministry of Finance, had provided instructive suggestions to the Task Force.

Once this final draft was completed, it was sent to all members of the Policy Council, and the following 78 members of the Council indicated their approval of its contents. Their names appear below as signers of these recommendations.

On this occasion, we would like to thank Prof. Kent E. Calder, Special Advisor to the Ambassador of the United States to Japan, for his valuable opinions expressed at the second meeting of the Policy Council. We would also like to mention the helpful insights we have received from senior officials of our government, who willingly granted us their precious time to attend our meetings as individuals in their advisory capacity as Counselors of the Policy Council.

Let us also add that the views expressed in these recommendations do not represent those of Prof. Kent E. Calder or the ministries and agencies represented by the Counselors of the Policy Council and that sole responsibility for the contents of the recommendations lies with those members of the Policy Council who signed them.

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(In alphabetical order)

The Policy Recommendations

[Strengthening Fundamentals]

1. Stressing Stability and Seeking the Gradualistic Liberalization of Capital Markets

While globalization does promote market-based competition, division of labor, and more efficient use of factors of production, it also brings with it risk and instability. Given this, it is essential to merge with this trend in an effective manner. Globalization has made substantial progress in the areas of goods, services, and capital, but the special nature of short-term financial and capital markets (with a far faster speed of movement than goods or services and with a high price sensitivity to market expectations and remarks by government authorities) means that they cannot be approached using the same standards applied to goods as services. Sudden influxes of capital lead to wasteful investment and excess production, while rapid outflows, especially of short-term capital, destabilize the economies of the countries concerned. Hence, the globalization of financial assets can quickly upset the comparative advantage structure in individual countries, and can adversely impact long-term economic development policies. Aside from direct investment, then, the countries of Asia should proceed very carefully with the liberalization of their capital markets, implementing this in stages while training personnel and improving market infrastructure. In doing so, the concept of gradualism - the progressive transition from a planned economy to a market economy - will likely prove of great use. These countries should begin liberalization only after a certain degree of groundwork has been laid, proceeding from there step-by-step in a logical sequencing. To be more specific, Asia should adopt a gradualistic approach, moving ahead in stages from the liberalization of trade in goods and direct investment to the

liberalization of trade in services outside the financial and capital sectors, and finally pushing on to the liberalization of its financial and capital markets (from long-term capital and then short-term capital markets).

2. Preparing for an Age of Mega-Competition by Making Supply Side Improvements and by Working to Strengthen the Real Economy

Gradualism is needed in keeping up with globalization because effectively dealing with the mad rush of the international financial markets and the rapid changes in the world economy takes time. During that time, countries must reform their systems, train personnel, and improve their markets in order to enhance their economic condition. With the emergence of mega-competition worldwide spurred on by globalization and the rapid changes in the comparative advantage structures in individual countries, industrial structures must be augmented by training skilled labor resources, improving physical, legal, and system infrastructure, and raising technological standards. Domestic savings must also be bolstered to avoid an excessive dependence on foreign currencies. Only by continually making supply side improvements and strengthening the real economy will nations be able to thrive in an age of globalization. In many cases, systems and policies will need to be improved if the foundations of the real economy are to be reinforced. Fortunately, though, the countries of modern Asia do not have to start from scratch in developing system and policy know-how, but they can proceed with systemic reform by reforming to the cooperative framework of APEC (its plans for liberalizing and facilitating trade and investment as well as its economic and technical cooperation programs for developing countries) and the systematic framework of the WTO.

3. Attaching Greater Importance to Strengthening Social Capabilities and Establishing a Sound Financial System

The countries of Asia should pay particular attention to improving their financial systems and financial markets. Economic development of Asia thus far has

tended to focus on the real-economy, but efficiency must be enhanced in the financial sector at the same time. These countries must train financial specialists, maintain the independence of financial institutions from the government, stress economic principles, and increase transparency and openness. To cope effectively amidst an age of globalization, countries must also expand their social capabilities (the capabilities possessed by a society as a whole; the aggregate of governance capabilities, efficient administrative systems, human resources, entrepreneurship, etc.). These social capabilities will be furthered by ensuring social and political stability through the modernization of financial systems and the parallel pursuit of economic development and social justice. Establishing modern financial systems is especially important. Countries with fragile financial sectors should proceed carefully with the liberalization of capital transactions. Hasty liberalization of capital transactions in countries where banks have weak risk management and where insufficient currency controls are in place could create a bubble whose bursting could easily destabilize the financial system and the macroeconomy. Strengthening the financial sector, as well as government oversight of the same, and implementing effective financial policy measures are prerequisites for enjoying the merits of capital liberalization.

[Using Global Resources Effectively]

4. Aiming for Sustained Economic Development through an Efficient International Allocation of Resources by Promoting Trade Liberalization

Economic development in the Asian region over the past several decades has been marked by the extension of industrialization from the more developed countries to the less developed countries. Industrialization spread from Japan to South Korea and Taiwan, and the wave continued on from there to China and the countries of ASEAN. This expanding wave of international industrial development is characteristic not only in the sense that the industrialization has spread throughout the entire region, but also in the sense that it has enhanced the

sophistication of the industrial structures in individual countries. The broadening and deepening of this wave of industrialization has accounted for the dynamism apparent in Asia. Setting aside for the moment the policies that encouraged direct investment and the activities of multinational corporations which will be discussed later, what made this dynamism possible was the adoption in individual countries of an outwardly-oriented industrialization strategy, behind which lay efforts directed at the liberalization of trade. Through this process, each country underwent a cycle featuring the emergence of new industries with comparative advantage and adjustments of industries placed at a comparative disadvantage, thus promoting a division of labor throughout Asia. The 1997 currency crisis has made the countries of Asia somewhat negative towards the idea of trade liberalization, but each country should promote trade liberalization, as far as their respective levels of industrial development will allow, within the frameworks of AFTA, APEC, and the WTO. These nations must not forget that furthering an international division of labor improves the efficient use of production factors within their own borders and helps them to achieve sustained economic development. A breakdown in WTO talks since the end of 1999 has brought to the forefront strong differences of opinion between the advanced countries and the developing countries. Japan should endeavor to persuade the US and the EU to reach a consensus with the developing countries on environmental and labor issues. The example offered by the WTO once again shows how difficult it is for a large number of countries to formulate and implement comprehensive rules on trade liberalization. Given this, geographically or culturally close countries have actively sought to conclude bilateral free trade agreements - such as those between Japan and South Korea and between Japan and Singapore - and such moves should be welcomed.

5. Striving for the Liberalization of Direct Investment and Making the Maximum Use of the Management Resources of Multinational Corporations

Multinational corporations are organizations that move about internationally with a package of capital, technology, and management know-how. The countries of

Asia should consider effectively utilizing these multinational corporations as part of their strategy to reinforce the supply side of their individual economies. As multinational corporations not only have excellent management resources but can also read the changes in the worldwide comparative advantage structure, they can contribute to the international competitiveness of industries in the countries in which they invest. In light of this, it might be wise for the region's nations to strive for the liberalization of direct investment, to create an environment in which it is easier for foreign companies to operate, and to make the maximum use of the management resources of these multinational corporations. Transitional economies such as China and Vietnam, which have in place a variety of restrictions on the activities of foreign corporations, should be especially encouraged to improve their investment environments. For countries still in a low stage of development, long-term foreign capital is more important than short-term capital, and direct investment is particularly significant. The countries of Asia should establish a legal environment encompassing investment by foreign corporations, streamline administrative procedures for authorization, and strive for the liberalization and facilitation of direct investment.

6. Improving the Ability to Absorb Foreign Management Resources by Developing Human Resources and Acquiring Greater Policy Formulation and Organizational Skills

Notwithstanding the preceding Recommendation 5, an excessive dependence on multinational corporations often comes into conflict with nationalistic sentiment, and the international movement (including withdrawal) of management resources in an age of mega-competition not uncommonly introduces greater risk. Therefore, recipient countries of global resources must endeavor to catch up with foreign companies. More specifically, they must promote the development of human resources, the cultivation of native capital, and the diffusion of technology and know-how introduced from outside. There are a variety of approaches available to these countries in their efforts to catch up with foreign corporations. These include, for example, technology transfer and study/absorption of management know-how

within foreign corporations, and policies promoting inter-firm and inter-industry propagation of such technology and management know-how between companies and industries. To improve their ability to absorb foreign management resources, countries will need to develop their human resources, to heighten awareness of this “catch-up” drive among their citizens, and to acquire greater policy formulation and organizational skills. If “catch-up” can be achieved in various industries through these efforts, countries as a whole will likely be able to avoid over-dependence on multinational corporations.

7. Promoting an Orderly International Movement of Labor for Boosting the Vitality of the Asian Region as a Whole

Asia is observing widespread movements of labor, not only from developing countries to Japan but also among the countries of Asia. The movement among Asian countries consists of skilled and educated manpower as well as unskilled labor resources. Given the mismatch in the supply and demand for these various types of labor resources among these countries, the international movement of labor towards highly productive countries and regions will boost the total production of Asia as a whole. However, this movement does give rise to cultural frictions, and an inability to maintain a stable labor force over a period of time will hinder the steady development of national economies as well as the transfer and establishment of technology. This makes it essential to promote an orderly international movement of labor in boosting the vitality of the entire Asian region. Because cultural frictions and other problems accompany this phenomenon, though, a firm management system is needed. First, in industries that can engage in foreign trade, the outflow of labor resources abroad must be minimized by cultivating and developing those industries which are in line with the domestic comparative advantage structure and thus employment is created at home. On the other hand, in industries such as home care, nursing, and construction which cannot be moved to other countries, an international movement of labor readily occurs, and attention must be given to the question of how to manage this movement of labor in future. Japan must examine the issue of labor movement from the countries of Asia, in light of its aging,

diversifying, and internationalizing society. It should also call on the countries of Asia to establish cooperative ties in promoting an orderly international movement of labor.

[Addressing the North-South Issue and Regional Cooperation in an Age of Globalization]

8. Promoting Cooperation to Strengthen the Economic Fundamentals of Less Developed Countries

As discussed above, the countries of Asia must work to strengthen their economic fundamentals and improve their real economy and financial systems if they are to thrive in an age of globalization. Despite the extremely high speed of globalization, training personnel, establishing physical and non-physical infrastructure, and improving financial systems will take time. For that reason, countries still at a low level of economic development will be confronted with major challenges and difficult trials by an age of globalization. Although only just beginning the long process of economic development, less developed countries in Asia - such as Vietnam, Myanmar, Laos, and Cambodia - already find themselves in such a situation as they continue to grope their way ahead in this process. Self-help efforts by these countries are essential, but cooperation from advanced and more developed countries is also necessary to help them cope with globalization. Japan should take the initiative by actively promoting cooperation in training personnel, developing industries, and cultivating local companies, as well as by pushing ahead with technology transfer to these less developed countries. More developed countries/regions such as South Korea, Taiwan, and Singapore should put their own experiences to use in cooperating with the less developed countries. Since the joint effort in cooperation between Japan and the more developed countries to less developed countries is effective in many cases, Japan should not only cooperate on a bilateral basis with less developed countries but should also work in concert with the more developed countries in uncovering problems, establishing a cooperative framework, and drafting and implementing proposals for joint projects.

9. Actively Promoting Intellectual Cooperation from Japan

The economies of developing countries have thus far been characterized by the existence of two gaps -- a shortage of savings (a savings-investment gap) and a shortage of foreign currency (a foreign currency supply-demand gap). High expectations have been placed on the roles of ODA and direct investment from advanced countries in filling these gaps. In fact, however, developing countries are plagued not just by these two gaps, but also by a "skill gap," i.e., a shortage of experience in drafting development strategies and a shortage of personnel qualified to select and promote development projects. Although their "domestic integration" remains incomplete as a consequence of underdeveloped markets and delays in reforms to legal frameworks and other systems, the less developed countries of Asia are being pressed by advancing globalization to join in "international integration." The skill gap in this regard is extremely wide. Japan should make use of its experience in "domestic integration" through the process of modernization from the Meiji Era onward as well as its experience in "international integration" during the 1950s and 1960s, in light of the condition in Asia at present, and, Japan should also pursue a variety of intellectual cooperation efforts in addition to cooperation in training personnel. Specifically, it should support the dispatch of specialists and scholars from various fields, invite policy makers and researchers from the developing countries to Japan, cooperate in improving research institutes and facilities in Asian countries-particularly in the less developed nations-and pursue joint research with the developing countries on development programs. There is also a place for intellectual cooperation from private Japanese corporations; they might, for example, sponsor courses and seminars in universities in the developing countries or dispatch persons who have accumulated long years of experience with financial institutions and private corporations to Asian countries to cooperate in economic construction. The Japanese government should actively support these kinds of private sector exchanges.

10. Promoting Cooperation towards the Construction of Social Safety Nets

It is quite possible in this age of globalization for economic crises to arise suddenly. Though crises can be prevented to a point by strengthening economic fundamentals and pursuing cautious liberalization policies, efforts must also be made to minimize the impact of any crisis that does in the end occur. The resultant disruption to the daily lives of the socially disadvantaged and, above all, the poor, who are hit especially hard at such times, must be alleviated as much as possible. Deterioration in the livelihood of the poor inevitably sparks social and political disorder, and proper consideration must also be given to assistance from the standpoint of social justice. In other words, the economic boom spurred on by progressing globalization may create disparities between social classes and regions, leaving few benefits to be enjoyed by poorly educated persons unable to participate in the market economy and by workers in the informal sector. At the same time, economic crises sparked by globalization will lead to greater inflation in the wake of cuts in public spending and to rising import prices as a result of plunging exchange rates; both of these will deal an especially hard blow to the livelihood of the poor. The governments of Asian countries need to advocate a fundamental policy of promoting wider education and vocational training to help enable the socially disadvantaged to participate in the market economy. They should also set up social safety nets, including unemployment insurance schemes, and establish effective relief measures for implementation should a crisis occur. Japan and the more developed countries of the region should support these efforts.

[Creating a Currency Stabilization Mechanism for the Asian Region]

11. Stabilizing Exchange Rates through an Effective Basket System

The countries of Asia adopted a dollar peg policy in the hopes that it would

ensure stable growth. The recent currency crisis has shown, however, that these were baseless hopes. Since the 1985 Plaza Accord, fluctuations in the yen-dollar rate have had major repercussions in Asian economies. A truly stable exchange rate policy must be constructed. The stability of Asian currencies against both the dollar and the yen must be maintained (through a stable monetary system). To this end, a method should be found to determine exchange rates through linkage to a basket of currencies. Although the basket method makes it more difficult to generate an economic boom than the dollar peg, it does on the other hand allow countries to avoid crises. An objective of rapid economic growth can still be achieved with supply side and structural policies rather than by exchange policies. Determining the respective weights of currencies in the basket should be done on a pattern taking into account the distance in economic development stage between Japan and an individual Asian country rather than by the weight of Japan in the trade of that country. This means that countries such as South Korea, which lags only a short way behind Japan in terms of economic development, will increase the weight of the yen in the basket. The opposite is also true. Being close behind Japan in economic development, such countries have similar export structures and are strong competitors with Japan in export markets; linkage with the yen rate would thus make it easier to maintain stability in export markets. This basket method, however, is in essence a fixed exchange rate system, and a fluctuation band should be established for flexible management of exchange rates.

12. The Asian Monetary Fund Should Be Set Up

Some form of regional cooperation framework is necessary in Asia to effectively prevent currency crises, maintain economic stability, deal with the consequences of crises that do occur, and promote recovery from economic downturns. The functions and roles of the IMF, in which such high hopes were placed, have proved subject to certain limitations. Such a framework cannot be established on a worldwide scale, though, as forming a consensus among a large number of countries is difficult and requires considerable time. In addition, the spread of crises is a matter of regional concern, and it is perhaps only natural that deeply interdependent countries help

each other out. An Asian Monetary Fund (AMF) was in fact proposed in September 1997 as an institution that would supplement the IMF and other international institutions, but this effort was blocked by criticism from the IMF and the US. Japan subsequently announced bilateral assistance plans such as the New Miyazawa Plan and special yen loans, and has continued to implement these. Japan should not, however, assume this as a permanent framework and, indeed, it will no doubt one day reach the limits of its ability to perform this role. We would like to recommend that a new look be taken at the concept of an AMF centered on Japan in the meantime and featuring the participation of China, Taiwan, South Korea, and the ASEAN countries among others. There have been growing calls from many Asian countries for the establishment of such an institution under the leadership of Japan. If Japan again offers such a proposal and encourages the participation of countries outside the region, on the condition that they contribute funds to this institution, then the US and other countries will likely endorse this plan.

13. Stabilizing Economic Transactions between Japan and Asia by Actively Promoting the Internationalization of the Yen

With the advent of the euro, the international monetary system continues to make the transition from a unipolar system revolving around the dollar to a bipolar system. In Asia, dependence on the dollar has come to be viewed as problematic, a position only reinforced by the currency crisis, and expectations are rising of the role of the yen in complementing the dollar. It is entirely feasible that the yen will become the key currency in Asia in the intermediate to long term, and that the world as a whole will see the formation of a tripolar currency system. Despite the overwhelming economic power of Japan in Asia and the deepening interdependence between the countries of the region, however, the status of the yen in Asia remains weak. The yen also plays only a small role as a currency for trade settlements between Japan and Asia. Nevertheless, internationalization of the yen and the establishment of a “yen sphere” (which should be understood in a restricted sense) in Asia would be beneficial for both Japan and Asia. Such a yen sphere can be defined in the sense that the countries of the region would adopt a policy of stable exchange

rates versus the yen (as discussed above), and there would be greater use of the yen in international transactions - including intra-regional trade and capital transactions - as well as in the foreign currency reserves of the central banks of these countries. Strengthening the linkage between Asian currencies and the yen would lessen foreign exchange risk and thus encourage the use of the yen. Japan should actively promote the internationalization of the yen and endeavor to establish the conditions needed for the yen to serve as an international currency. While a yen sphere is the immediate objective, Japan and the countries of Asia should seek over the long term to establish an ACU (Asian Currency Unit) sphere. At some point in the future, when the discrepancies among the Asian countries in stages of development and economic structure have diminished further, an ACU sphere can be formed resembling that of the euro in the EU.

14. Constructing a Package Framework Combining Yen Loans and Yen-Denominated Import

Japan should take the initiative in promoting the use of the yen in Asia, making full use of every possibility presented to it. One possibility, for example, would be the use of Official Development Assistance (ODA). Japan is the world's top donor of ODA, and the principal recipients of this ODA are in Asia. Yen loans will no doubt continue to have a major presence in Asia, particularly in assisting the development of the Indochinese peninsula. Given the high likelihood of fluctuations in the yen rate over the long term, the countries of Asia assume risk in repaying these yen loans. In fact, some countries are reluctant to accept yen loans for fear that the yen may continue to rise. To lessen this problem and to promote the internationalization of the yen, we would like to recommend that a package framework be constructed combining yen loans with yen-denominated imports from Asia. Such a framework might involve Japan importing duty-free from a less developed Asian country, on a yen-denominated basis, industrial products in an amount corresponding to a set percentage of the yen loans accumulated by that country. In the process of doing so, relevant organizations in Japan would cooperate in the production of competitive industrial products through market research, technology transfers, and quality

improvement efforts. This approach would not only avert or reduce the aforementioned foreign exchange risk but also would promote the export of industrial products from Asia and contribute to the internationalization of the yen-killing three birds with one stone. Japan should promote yen-denominated imports by various measures, not limited on yen loans, but the increase in yen-dominated imports tied to yen loans will prime the pump and help generate an overall increase in yen-dominated imports. There remain, of course, several problem areas in this recommendation, not the least that it contradicts the WTO rules, based as they are on the principle of free and non-discriminatory trade, but this is not to say that such difficulties cannot be overcome.

