

***Minutes of Japan-US Forum  
Second Study Group Meeting in Tokyo***

**“Bi-national Study on the Impact of the rise of China and India, and  
the U.S. - Japan Economic Relationship”**

*Saturday, July 8, 2006*

Venue: ANA Hotel Tokyo, Japan

09:00-12:30      Morning Session - Session 3 (in Banquet room AURORA on B1F)

**Key topic 3:      Meeting the energy challenges faced by the four countries**

The rise of China and India is dramatically increasing the demand for energy in the world and profoundly changing global energy markets. These developments will make it much harder for the United States and Japan to manage energy price shocks. They will also heighten competition for preferential access to oil and natural gas suppliers, potentially destabilizing security relations around the world. Finally, increased energy usage in China and India will adversely affect the ecology and environment not only of Asia but of the whole world as well.

The United States and Japan share a common interest in working together to advance world energy security interests by helping China and India develop more diversified energy resources and thereby reduce their future demand for oil and gas and promote the deployment of renewable energy and energy efficiency measures that mitigate environmental damage associated with rapid growth in energy demand. All four countries may also share a common interest in building larger petroleum reserves, resolving territorial disputes regarding petroleum resources in contested waters.

What are the United States and Japanese governments doing at the present time to cooperate in these areas? What measures can the United States and Japan take to support diversification of energy resources and greater energy conservation in India and China? Are there concrete cooperative measures all four nations can undertake to decrease the potential for tension or conflict over energy issues?

Co-Chairs:

Noboru Hatakeyama, Chairman and CEO, Japan Economic Foundation  
Kenneth Dam, Max Pam Professor Emeritus of American and Foreign Law,  
University of Chicago Law School

Speaker (10 minutes):

Kunihiko Matsuo, Chairman, INPEX CORPORATION

Participants:

Japanese study group members

## US study group members

### Discussants:

Tsutomu Toichi, Senior Managing Director & COO, The Institute of Energy Economics, Japan

Shigeru Sudo, Director, Energy and Environment Program, International Development Center of Japan

### Hatakeyama

Opened the meeting, and thanked members for coming on Saturday. Introduced Kunio Matsuo as guest speaker, Chairman, INPEX CORPORATION, biggest energy exploration company of Japan. Joined MITI in 1958, and climbed to the top. Became a representative member of Economic Planning Agency for Bank of Japan. Used to be a center banker, then became Director General of Small Enterprise Agency. After retiring from MITI, entered Inpex, became president in 1996. Became chairman in 2005. Also introduced two discussants, Tsutomu Toichi, Senior Managing Director & COO, The Institute of Energy Economics, Japan, and Shigeru Sudo, Director, Energy and Environment Program, International Development Center of Japan. Mr. Sudo has experience with JETRO.

### Matsuo

Expressed appreciation for opportunity to speak. Commented from viewpoint of Inpex, as an oil developer. Speech consists of:

Observation of current oil market

Impact from emergence of China and India as vast oil consumers

Establishment of cooperative energy interdependence

### Observation of current oil market

Oil prices likely to remain high for short and middle term, will take at least several years for situation to ease. Increasing consumption of light crude oil in China, India and US is placing high demand on crude oil. Saudi Arabia making efforts to expand capacity, but still can expect tight supply. Large oil companies making prudent investments.

Not easy to meet in a timely manner demand for light products, such as gasoline. Refining capacity is restrained by shortage and delay of investment. Specifications for oil products in each state is restricting investment in refining capacity. Hurricanes have also intensified this situation.

Geopolitical risk is spreading, and there are the threats of terrorism and nationalism. All these represent major affect on the oil market, and will continue to do so.

The international speculative fund is amplifying market volatility. Difficult to anticipate how monetary tightening policy affects its behavior.

### Impact from emergence of China and India as vast oil consumers

China and India may assume the same track for the immediate future. Chinese policy of continuous economic growth is inevitable to rectify income gaps between urban and agricultural regions.

China will intensively look for resources in various countries, and this may be a destabilizing factor. It is attempting to develop oil and LNG in disputed territories.

The enormous emission of warming gases and pollutants is a serious problem, and is exacerbating pollution.

### Establishment of cooperative energy interdependence

Promotion of oil & gas exploration, and positively applying EOR technology.

Creation of regional energy safety network, Asian version of IEA.

- Building up stockpiling scheme
- Expanding oil & gas pipeline, and use of super-conducting technology
- These efforts will soften geopolitical risks and their impact.

Diversification of energy consumption sources by promoting conservation and highly efficient utilization, aimed at environmental protection.

- Application of new technology for coal liquefaction
- Development of bio-fuel
- Safety and massive disposal of CO<sub>2</sub> underground. Japanese firms have already started first commercial project in Australia. Impex group company technical research center has developed technology to produce methane using CO<sub>2</sub>.
- Peaceful use of nuclear power, harmonizing with NPT. Certain concerns on how to harmonize proliferation under US - India agreement.

Need appropriate government assistance to achieve these goals, based on market mechanism, such as government to government talks, modification of CDM, or financial support to expansion projects for cross-border transportation/transmission grids.

Hatakeyama

Thanked Mr. Matsuo for presentation.

Overholt

What are differences between China's and Japan's energy security strategies, and resulting conflicts?

Matsuo

Possible cooperation and conflict with China and India.

Cooperation: May be able to jointly develop resources in third countries.

Conflict: Territorial dispute, and conflict in third countries on getting promised reserves. State-run Indian and Chinese companies are fully supported by government, therefore they are quite aggressive. Experience on working with state-run Indian and Chinese companies indicates they do not perform well. Excessive presence of Indian and Chinese companies is a sensitive issue. Kazakhstan restricted presence of Chinese company. Japan has a moderate position, and no ambition to exert political presence or acquire territories.

Gottlieb

Of available oil, how much is controlled by governments or industry?

Matsuo

In principle, companies take all geopolitical and commercial risks. However, differing from major oil companies in US, Japanese developers have a limited amount of risk capital. Japanese companies have unique risk of fluctuation in Yen value against the dollar. Most participants from Western Europe and US satisfy their projects, but Japanese companies suffer from exchange rate volatility. Government institutions better positioned to acquire dollar-based loans.

Herberg

75 to 80 percent of global proven reserves are controlled by national state-owned oil companies.

Matsuo

Super major oil companies told me they were not satisfied with their huge reserves, because they were small compared to state-owned oil companies. But Japanese firms are way behind the super major oil companies.

Garrett

Markets vs. government control. Lot of media coverage that China is trying to cut very long-term deals to secure energy supplies. This is a large impediment to operation of market forces to determine prices. Also has large geopolitical consequences, e.g. If China has a deal with Iran. Do you believe that this has a large effect? Is China changing nature of markets? Is this reality, differing from the past?

Matsuo

Yes, we find this to be the case. China is very aggressive in major oil producing countries. Lost out to China in Saudi Arabia and Indonesia, with its companies being supported by the government. Market mechanism should be applied. Not easy for Western companies to justify this type of aggressive proposal.

Hatakeyama

Asked Mr. Toichi to express views, and expand horizons, including other energy sources.

Toichi

Policy issues for China and India, and impact on US and Japan.

China and India face energy shortages, and therefore they pursue active policy in Sudan, Angola and other countries. Nigeria recently agreed to give China offshore oil rights. Government and oil companies are very closely connected in China, and it is offering comprehensive contracts to secure oil. Aggressive stance is bidding up cost of oil, and increasing nationalism. This also discourages new investment.

Energy and environmental issues.

China and India depend on coal for 65% of energy in China and 50% in India. Plants not equipped with desulfurization equipment, resulting in pollutants being observed in Japan as well as West Coast of US. CO2 emissions in China and India will increase dramatically. Even if Japan decreased to 0, increase by China and India will dramatically increase greenhouse gases.

China has 8 to 9 nuclear reactors, and plans to expand to 40 Gigawatts by 2020. India also intends to increase to 20 Gigawatts by 2020. Major concerns are how to operate nuclear power plants safely and not to weaken NPT. Support US – Indian agreement.

- Encourage opening of domestic energy markets of China and India. Opening markets is complementary to deregulate them. This will force these companies to become more market oriented.
- Create strategic oil stockpile to deal with future disruptions.
- Export Japanese energy-efficiency know-how. Should assist China and India. To encourage technology transfer, government should provide assistance.
- Invest in renewable energy abroad, such as GTL, CTL, photovoltaic.
- Harmonization of environmental (oil) standards, avoid unusual specifications. This creates shortages and bottlenecks.

Sudo

Observations on India, which is growing rapidly over the last few years. Government is concerned about satisfying energy demand.

- China and India are cooperating with each other and forming partnerships, as well as competing with each other.
- Both China and India share national agenda of coping with rapidly expanding demand.
- Stockpiling issue: Asian version of IEA. China and India have already started to build stockpiling facilities. Welcome this, but they are still inadequate.
- Security issues (pipeline): Any pipeline project places a large load on energy security. India constructing gas pipeline to Iran. Controversial in international community.
- Efficiency know-how, technology transfer. Koizumi visited India in April. Many agreements were made. ODA is very important for relationship between Japan and India. Yen loans have been made for many sectors, such as transportation (metro project). Includes Japanese efficiency know-how, and are welcome by India.
- Asian region is confronted by very different situation from EU. Regional cooperation is vital and should be enhanced.

Hatakeyama

Thanked Dr. Toichi and Mr. Sudo. Invited comments and questions, including opening of Chinese

domestic market, Iran-India pipeline, nuclear deal between India and US, and Asia version of IEA, CO2 emissions issue, Asian energy community.

Tanino

Secretariat has distributed two papers: Asahi Shimbun article and translated article. Also statement by chairman of IAEA, in support of agreement between India and US.

Japanese government appreciates huge energy demand in India. And, nuclear energy is a plus factor in terms of clean energy.

But are concerned that this deal may weaken NPT. Therefore, Japanese government will continue to monitor this process. Will be actively involved in discussion of nuclear supplier's group.

It is in interest of the region to help assist development of India. One way is to help India is to achieve good civil use of energy. Had big annual meeting of shareholders last month. One group strongly criticized Toshiba's deal to purchase Westinghouse, said deal should be scrapped.

Interested in advancing into Vietnam. On the losing side already. Making use of ODA in India, but not in the area of nuclear power plant. Should make use of soft loans. No consensus in parliament on nuclear power plants. France has promised to bring in soft financing.

In paper, do we take sides?

Hatakeyama

Any response from American side?

Bouton

Field of expertise is India, and relationship with the region. Convinced from the beginning India would develop nuclear weapons capability. Critique of agreement centers on concerns about NPT. Nations pursue nuclear weapons based on threat assessment, and will do so regardless of NPT. Do not believe in theological approach to nuclear weapons proliferation. NPT does help at the margins with incentives and disincentives. US spent 25 years after Indian nuclear explosion in 1974, but was never able to provide incentives.

If Indian program never existed, would it have made any difference to North Korean and Iranian decisions about what they do today? Do not think so. Indians were outside NPT. No cause and effect of what India was doing and what North Korean and Iran were doing. North Korean got enrichment technology from Pakistanis in exchange for missile technology. But fundamental motivations were not influenced by India and Pakistan in my opinion.

Therefore, positives of India – US deal outweigh the negatives. We create for the first time in 35 years a space with the Indians where we can have a conversation about nuclear proliferation. Indian program will also be much more transparent. Will have more influence over whether or not the Indians test again. 1998 tests did not provide sufficient information.

Hatakeyama

Dr. Toichi, Amb. Tanino and Mr. Bouton support India – US deal.

M. Kojima

Indian government is quite happy that congress endorsed deal. Nuclear power plants in India only account for 3 percent of power generation. Doubtful of whether India will abandon plan to import liquid gas from Iran through Pakistan. Nuclear deal does not have any meaningful effect on energy situation in India.

Madsen

If India deal with US does not have effect on overall energy policy, does interrupting cooperation do damage to the relationship? If NPT is dead, must start to form more practical relations with countries. Not question of national security. Iranian popular opinion has turned in favor of their government because of nuclear program. North Korea traded nuclear program for aid, but when aid dried up, leader decided he needed a bomb. There are a range of reasons why countries develop nuclear weapons. Respected security analyst said we must get used to a nuclear bomb going off somewhere

around the world every few years.

Garrett

Alternative position. Remember when Pacific Council report came out. What happens if Pakistan demands the same treatment as India?

Bouton

Pakistanis already have. They did when president showed up in Islamabad. He said No. Pakistan's conditions are different. Way to address this issue is to find ways of building security cooperation. Costs of developing a nuclear weapon are very high. States make this decision when they feel it is vital for their security. On energy side, only 7 to 10 percent will come from nuclear power, up from 3 percent. But this is the way we are going to close the gap.

Current Indian motivation to get this deal done is not to get nuclear fuel supply. It is to get rid of the US restrictions on technology transfer. US has been very restrictive on technology of all kinds to India because of nuclear India. That will go away. That is what is driving the Indians.

Herberg

Thought we were trying to avoid getting into politics. Deal is not about energy. China and India need nuclear power generation, but it is trivial as far as power generation.

Madsen

Not just about security. France built nuclear weapons for prestige and influence, not because of security.

Dam

Wish those who know more about agreement would explain what advantages are from standpoint of IAEA. Secondly, attended meeting where Mr. Talbot was, and he did not say anything.

Overholt

Bilateral US – India sense, it makes sense. Does not have anything to do with security. India had dominance before, but it has now been equalized. It was about getting prestige. Due to attitude that only country with nuclear weapons could it get treated as a first class nation. Message to Iran and others is clear. Brazil has wanted to be treated as a great nation by getting nuclear weapons. Deal may be a good deal, but it is not about security. India's behavior is about the most aggressive of any country on earth. We obscure that. It does not get along with Pakistan, Sri Lanka and other nations. Deal cannot be justified on grounds of security or responsible democracy arguments. Some people in the US have the illusion that it is going to provide a balance with China.

Hatakeyama

Coffee break for ten minutes.

Resumed meeting, and invited questions and comments on what was said in first part of session, as well as energy section in final paper draft. Cannot have a working lunch, therefore must concentrate on discussion.

Schoppa

Focus on question of alternative strategies to stockpile oil, encourage Japan and US to allow India and China into IEA. Also there is a proposal for a regional Asia IEA.

Herberg

IEA does not make sense if the world's largest importer (China) is not in it. India is not as big, but it should be involved also. IEA should be prepared, and get China interested. That is effective way to talk about global emergency stocks. Need for Asian forum to talk about efficiency, demand management, efficient coal technology, etc. Idea of broad Asian group, 18 members. Have APEC, which is larger, but it has been ineffective.

Hatakeyama

IEA belongs to OECD. In order to enter IEA, must be a member of OECD. OECD is a club of developed countries. China claims it is a developing country.

Toichi

All IEA member countries are required to have 90 days. China has just started to build a stockpile, and India has none. ASEAN is gradually beginning to cooperate in this area. Important that companies in private sector participate.

Herberg

Critical element is political will. Not convinced US has political will to follow through.

Garrett

Why is it not a win-win on the market side that can provide efficient technology?

Herberg

Because all of these technologies are really expensive. Need government support and involvement. Does it not make sense to amortize the cost by selling them to developing countries.

Gottlieb

Added expense. If government makes regulations, technology would be exportable.

A. Kojima

After Asian monetary crisis, Japan proposed Asian version of IMF, but this was crushed by Washington. Consumption is exploding in Asia. US is depending on middle-east oil less and less. Japan has stockpile of 160 days. China only a few days. Korea has a stockpile of 99 days. Region needs stable supply sources when an emergency happens, like currency arrangements. As far as environmental issues or technological cooperation, there needs to be a regional approach.

There was mention about government vs. market mechanism. China has been increasing the price of oil, and resulting in energy nationalism. Latin American countries say China is giving them a better price than the US. In the long term, energy should be sold via the market mechanism. Many non market factors are coming from China.

Sudo

Function approach at ASEAN. ASEAN ministers in charge of energy are having meetings with other under ASEAN plus three.

Hatakeyama

Does institutionalization include ASEAN plus three?

A. Kojima

It is issue specific, so it easy to determine merits of joining. Have a functional idea.

Toichi

One comment with regard to Russia. What is happening in Europe is very interesting. European countries want access to gas in Russia. Russia is a very important player to energy security. How to access oil and gas in Russia is a key issue.

Matsuo

Agree with Mr. Toichi. The Asian region should diversify the supply source. Useful to build an East Siberian pipeline. Lack of service and infrastructure, and unstable business environment makes it difficult to go forward actively at present. But there is geographical merit to Japan and other countries.

Regarding market mechanism and relation to government control. Energy issue is linked to sovereignty in resource-rich countries. Must always be aware of government to government approach.

Asian version of IEA: Diversification issue. Asian countries mostly depending on middle east. If something happens, crisis will occur simultaneously. Way to solve issue is through diversification.

Whitman

Comment on points by Mr. Kojima and Mr. Matsuo concerning market mechanism vs. government intervention. China has introduced new factor. Only case with state-owned companies in a country which is a net consumer.

Failure of CNOOC to bid for UNOCAL. Is this a matter of a market determined transaction, or the government had an impact? Answer is yes. Congress got quite stirred up on the issue, partly promoted by Chevron lobbyists. Issue of whether oil was really available in Southeast Asia. Should private oil companies have to compete against state-owned companies? Believe that CNOOC pulled out because Congress had threatened to delay the deal. Had some impact on the perception of other countries.

Should this be discussed in the paper? Part of much larger issue. Paper should be focused on smaller range of recommendations. Nature of this transaction raised some broader issues globally about attitudes towards inward foreign investment. Economic nationalism carried much further in France and other countries.

Madsen

This deal was a question of oil resources in Southeast Asia? Are other Asians worried about that?

Whitman

Did not hear about those concerns. Did get that far, but if CNOOC had been winner, there would have had to be reassurances.

Herberg

In the study, have to talk about energy nationalism throughout Asia, as well as US nationalism. This report needs to argue about security of global energy market, and all countries have a stake in this. All have similar common interest.

Garrett

This issue is important because there are common interests.

Helping India and China good for global environment, security standpoint and economic standpoint. But how do you do that?

Whitman

One criteria for report content: Whether a particular issue either involves externalities (positive or negative), or public goods – things not taken care of in the private marketplace. Only issues which involves externalities or public goods should be addressed.

Dam

Issues seem to be increasing, and decision must be made by Monday morning. Will not take up national security issues, but energy involves security. Russian pipeline for Far East. Concerned that range with energy needs to be narrowed.

Hatakeyama

Do externalities and public goods include mentioning specific cases? Mr. Nishimuro referred to his company's case with India: To close a plant is very difficult. This is a convincing example.

Whitman

Do not mean that specific cases should be excluded. That is a challenge, and it has implications on



the decisions of whether or not to invest that are made by other countries.

Schoppa

Propose to articulate principles specified by US and Japan on how China and India should deal with energy issues. Goal should be to force the countries to see the geographically discrete problems as being connected.

Bouton

On question of examples, all agree that judicious use is powerful. Need to be rigorous that examples are highly salient and accurate to prevent them from undermining the overall report. In India, it is currently the transaction cost of getting in, and not of getting out for 99% of companies.

Have a formula to make broad observations that counter popular perception. Want to say that economic growth in China and India is not threatening to US and Japan. Innovation at this point does not represent a threat.

In case of energy, we are worried about an outbreak of energy nationalism in Asia.

Hatakeyama

Toshiba's case may be rare, but India was notorious for its bad exit policy, and that is one reason FDI has not increased in India as much as China. Remains to be seen whether closure is still difficult.

Tanino

Toshiba's mistake was they chose wrong, inefficient lawyers. It is still in the court. They should change the lawyers.

Dam

Second bullet – Kyoto regime, disagree with US government. Piece in Washington Post points out this is political correctness.

Moskow

Support your view on Kyoto agreement, it is beyond scope of this group. Carbon trading system is widely viewed as an efficient way to deal with pollution.

Hatakeyama

US is the only developed country not in the Kyoto protocol.

Garrett

Politics is quite clear. Want China and India to buy into some limits. Unless US gets into a system, it does not have the morale leverage to do this. Believe there is global interest, and would be in interest of China and India to be in such a system.

Madsen

US should have signed on and cheat like everyone else. Using term Kyoto is like using term democracy with China. If Kyoto is used, right wing in US will write off the report.

Yellen

Carbon trading is not the only approach. Could also adopt common carbon taxes or use other methods. Without thorough debate, cannot weigh in.

Dam

Kyoto limits being missed because nobody knows how to meet them. Signing on to Kyoto agreement does not solve a single thing, including Japan.

Schoppa

Limits and trading approach. Best way is to pay China and India as our way of meeting our targets.

Garrett

US has done pretty good job last 20 years with clean coal technology.

Yellen

All these technologies only become viable with cost imposed on carbon emission. No incentive without that, because people do not want to pay for it.

Herberg

Should be careful about the term clean coal. Have cleaner coal, but it is 30 to 40 percent more expensive. This is why government must be involved in promoting these technologies and subsidizing cost.

Dam

Market solution with lots of subsidies, or a tax.

Toichi

China uses a lot of inefficient old boilers. Huge potential to increase efficiency by simply replacing the boilers. Should use regulation and market forces.

Hatakeyama

Should first recommend that China install sulfur removal equipment on 90 percent of its power generation facilities.

Madsen

This kind of pollution control is only taken seriously once the country gets a middle class that gets mad about pollution.

Bouton

Agree with that. In Beijing twice in May, and on a national level, China is close to a tipping point. They realize they are on a path to environmental calamity unless they do something about the issue.

Herberg

Chinese leadership is beginning to get the message. Should support reformists by saying something in the report in this regard.

Hatakeyama

Cannot decide language about CO2 emission issue at moment, but would like to consider everything that has been said. Any other energy points to be discussed?

M. Kojima

Different opinion about Kyoto protocol. Loose persuasiveness unless some restrictions are provided. Fundamentally endorse Mr. Sudo's point. Railways is a preferable means of transportation in terms of efficiency and environment, and this can have some positive effects in India.

Sudo

Energy conservation issue: Not matter of China and India. US is biggest energy consumer, and there is a lot of room to conserve. Reported that Bush administration is reviewing CAFE standard. Also like to point out public transportation system from longer-term viewpoint.

Tanino

Have not addressed regional cooperation to ensure safe passage through sea lanes, such as Malacca Straits. This is important, and can be done by extending financial support and other means. It is vital for Japan and China. Pirates very active in this region.

Herberg

Recommendation should be that governments work together to improve security.

Garrett

One justification by China for naval build-up is to improve security of energy transportation at sea.

Herberg

Must be regional solution.

Hatakeyama

Asia Pacific Energy Cooperation Mechanism

Herberg

This is the US end run on Kyoto. It is potentially an important organization, 50% of energy consumption. It could be a base for voluntary cooperation. Partnership is aimed at carbon and climate change.

Hatakeyama

Meeting adjourned for lunch.

14:00-17:00 Afternoon Session - Session 4 (at Banquet room AURORA in B1F)

**Key topic 4: Trade relationship issues, including the WTO, protectionism, and examining ways to avoid politicization of trade and exchange rate disputes, and Evolution of East Asia as an economic region and how it relates to the United States and Japan**

Japan and the United States, as well as China and India, have all benefited from the current era of globalization and the opening of markets around the world. But there are clear strains to the liberal economic order. The Doha Round of WTO negotiations is stalled. Bilateral and regional agreements are proliferating to compensate for the lack of progress at the global level.

Japan and the US benefit from economic integration with China and India both in terms of access to burgeoning markets and increasing the efficiency of production. China and India benefit from investment from Japan and the US as well as from demand for their products. But there are real tensions in these relationships. Japan and the US are concerned about intellectual property protection, whereas for China and India rapid technological diffusion is critical to their future development. The US and Japan have domestic incentives to protect vulnerable sectors, for example agriculture, whereas these are sectors of strong comparative advantage for China and India.

How can the United States and Japan best work together to make sure the global liberal order does not unravel and moves forward to tackle unresolved issues? What are the implications of bilateral free trade agreements cut by the US and Japan with third countries for the broader liberal economic order? What are the future prospects for free trade agreements in Asia? Should and will the United States be involved in any potential pan-Asian FTA? What are the implications of the waning of Asian regional economic cooperation (notably the East Asia Summit of December 2005) and the

waning of Pacific Rim cooperation via APEC?

Co-Chairs:

Sakutarō Tanino, Former Ambassador Extraordinary and Plenipotentiary to India and People's Republic of China, Director of Toshiba Corporation  
Noboru Hatakeyama, Chairman and CEO, Japan Economic Foundation  
Kenneth Dam, Max Pam Professor Emeritus of American and Foreign Law, University of Chicago Law School

Speakers (10 minutes each):

Noboru Hatakeyama, Chairman and CEO, Japan Economic Foundation  
Zembei Mizoguchi, President, Japan Center for International Finance

Participants:

Japanese study group members  
US study group members

Discussants:

Sayuri Shirai, Professor of Economics, Keio University  
Shujiro Urata, Professor of Economics at Graduate School of Asia-Pacific Studies, Waseda University

Tanino

Opened afternoon session. This session will deal with trade, investment and regional financial cooperation. Have two speakers.

Introduced Noboru Hatakeyama, Chairman and CEO, Japan Economic Foundation. Found out he celebrated his 70<sup>th</sup> birthday.

Second speaker is Zembei Mizoguchi, President, Japan Center for International Finance. Joined Ministry of Finance in 1968, and held post of vice minister for international affairs. Will talk about regional financial cooperation.

Two discussants are Shujiro Urata, Professor of Economics at Graduate School of Asia-Pacific Studies, Waseda University, has a PhD from Stanford. Also known as senior adviser to government of Japan, government of Indonesia, and working at World Bank.

Other discussant is Sayuri Shirai, Professor of Economics, Keio University. Her specialty is international finance, Asian economy, macro economics and Japanese ODA policy. She has a lot of experience at Columbia University. Earlier, she worked at IMF, and was invited to work for United Nations. She is a well known scholar.

Hatakeyama

American start speeches with a joke. Japanese start with an apology. We are talking about trade imbalance between US and China and regional integration in Asia.

Will focus on regional integration in Asia.

This began in 1998, initiated by Japan, first solicited by Mexico. Japan wanted to create an FTA with Mexico. China was not interested, saying they were too busy with entrance into WTO. From 2000, China became interested, and asked ASEAN colleagues to start negotiations.

India also interested in FTA with ASEAN as a whole, although it is a latecomer. ASEAN colleagues asking if India is really interested in FTA. ASEAN was supposed to be finished by end of last year, but has been delayed, and is under negotiation.

This issue was supposed to be discussed in Kuala Lumpur. Decided this should be discussed by ASEAN Plus Three (Australia, New Zealand and India). In addition to this, Russian president attended first part of ASEAN summit meeting, and wishes to participate in next East Asian summit

meeting. Newspapers say there is possibility Russia will be admitted to this year's East Asian summit.

There is also concept of East Asian free trade area, which is quite different. First, a community mainly consists of three pillars: Economic, security and cultural. However, FTA only deals with economic issues. Community often requires concession of part of sovereignty. In EU, negotiation for trade or competition have been conceded to EU. No such concession of sovereignty with FTA. Third pillar is common values, such as democracy, rule of law. FTA only requires shared interests.

In conclusion, it would be very difficult to have a community in this area, because there are communist countries, and countries led by the military. Minister Nikai announced proposal in April regarding East Asian comprehensive FTA, which includes 16 countries except for Taiwan. These negotiations will start after 2008. Need to implement agricultural and immigration policy reform in Japan for this purpose. Poor Japanese consumers should be treated equally as consumers in exporting countries.

Immigration issue is included in FTA on trade in services. Japanese Ministry of Welfare requested Filipino nurses to pass Japanese examination to become a nurse, and the Philippine side accepted this. Japan placed a limit of 200, and this became point of contention with the Philippines. Cannot compensate all losses in population with foreign workers, but can compensate to some extent. There are only 15,000 Indians in Japan, but 1.9 million in the states. There are 450,000 Chinese in Japan, but 2.5 million in the US. Japan needs to increase the number of immigrants.

Japan needs to make Asia one integral market by creating an East Asian FTA, which becomes a domestic market. The lifting of import restrictions in ASEAN and China will make this possible. The US side has many opinions about this. There were three complaints: No advance consultation, Possibility for US to be admitted, and What would be relationship with APEC.

Think difficult for US to be admitted, since the name is East Asian FTA. To facilitate linkage, US should try to create APEC FTA, or an FTA with individual countries in this region, including Japan, China or India. Can negotiate at the same time with the US.

Tanino

Thanked Hatakeyama for presentation. Glad Taiwan was mentioned, which cannot be left out. Agricultural reform and immigration reform are important sensitive areas. Need to have active discussion.

Mizoguchi

Will focus on regional financial cooperation in East Asia. There are three initiatives: Chiang Mai Initiative, made in May 2000. Second: Economic Policy Dialogue 2002. Third: Asian Bond Market Initiative, 2003.

In July 1997, Thailand experienced huge capital outflow, and economic crisis. Meeting was held in Tokyo. 17.2 US\$ billion financial support provided.

IMF/World Bank Annual Meeting, idea of Asian Monetary Fund, but was not supported, because idea was floated abruptly, and there was fear by non-Asian countries that AMF lending would be made in a way not consistent with IMF operation. AMF should be complementary to IMF operation.

Nov. 1999, third summit meeting of ASEAN + 3 was held in Manila. Language of AMF was dropped in communiqué.

China and Korea worked together to work out practical alternative to AMF. Next initiative was started in 2002, for economic review and dialogue.

Third initiative started Aug. 2003.

Large capital outflow caused crisis in Thailand, Korea and Indonesia, and required rescue lending.

16 bilateral swap arrangements (BSA) were concluded. Japan concluded five BSA with ASEAN five, one with China and one with Korea, for a total of seven. Maximum amount of lending by Japan is now 35 billion US\$. 19\$ billion could be lent to ASEAN, 3\$ billion to China and 13\$ billion to Korea.

Chiang Mai Initiative has been improved since it was agreed upon in May 2000.

Future tasks are:

- One single agreement (multilateralisation or post CMI)
- Enhancing surveillance. Dialogue held once a year at ministerial level, and twice at deputy level in order to have better understanding. But this is just an exchange of views and information. Some say Secretariat should be set up, but this is not possible. Originally, only 10% of amount of swap was intended to be used without IMF participation. 10% was raised to 20%. Dialogue of ASEAN + 3 is helpful to know what is currently happening, and maintains spirit of cooperation.

#### Asian Bond Market Issues

Bond market has developed very rapidly. Achievement of three initiatives is a landmark.

Nature of cooperation is very loose, and has been carried out with existing international systems and standards. Due to nature of cooperation, strong political will has not been necessary. Stronger cooperation cannot be started without political will.

ACU (Asian Currency Unit), considered to be constructed as a weighted index of Asian currencies. Some member countries are very cautious on starting a study, worried it may become a regional currency. ASEAN + 3 agreed a study should be started.

US stance: Cooperation on a technical level will not affect political decisions. Not necessary for US to seek direct participation. Useful to have informal meetings at APEC or other informal bilateral meetings, like today's.

Thank you.

Tanino

One question for each speaker, then proceed to discussion.

Dam

Has India expressed any interest in participating in these initiatives? Asian Bond Market includes government and corporate. Is China developing a corporate bond market?

Mizoguchi

India has not shown serious interest, but it seems to have some interest in Asian Bond Market initiative. The work under this initiative is to exchange views or knowledge. If India is interested, it will be easy for it to be included.

China is developing very rapidly a domestic bond market for direct financing. The Chinese government is promoting development of a corporate bond market. But this depends on how China decides how to develop it market.

Dam

My impression is there is not a corporate bond market in China, but this is very important.

Mizoguchi

This is linked to liberalization of the financial market in China, but they are slow.

Dam

Is that related to concern to preserve state-owned enterprises?

Mizoguchi

In Japan, it took a long time to liberalize financial markets, so it is natural that it will take time in China. Have to monitor situation.

Madsen

Private sector is not involved in expansion in financial sector China. Most lending comes from second tier banks. Worrysome, because quality of lending appears dubious.

Tanino

Question for Hatakeyama san? No. Presentation by Prof. Shirai.

Shirai

My specialty is international finance, related to Mr. Mizoguchi's presentation. Like to ask some things. Seeing emergence of bilateral FTAs in Asia, but there is not region-wide FTA. There is progress in financial monetary cooperation, due to East Asian crisis in 97 and 98. Severity of crisis in Thailand, Indonesia and Korea led to realization there needed to be a mechanism to prevent or manage a crisis in the future. This is the idea behind East Asian monetary cooperation.

Progress in two areas:

- Chiang Mai Initiative, to borrow dollars or yen to stop a panic. The amounts are expanding, but it is still pegged back to IMF. More than 20%, must have IMF conditionality. Still not autonomous. Malaysia wants to have a more autonomous system. US has strong involvement in IMF. Developments. There is movement away from US.
- Economy was heavily dependent on banking sector in East Asia, when one bank went bankrupt, many went bankrupt. This caused such negative economic growth. People realized there needed to be a corporate bond market, like the US system. Impossible to develop a corporate bond market in each country. This resulted in idea of regional bond market. On supply side there was Asia Bond Market Initiative, and on demand side there are 11 central banks in Asia.

There is a lot of savings in East Asia. Many people used these to invest in US. These savings should be used within Asia. Mechanism is getting away from depending on US economy, and dominance of US dollar in security transactions. This involves many sensitive issues.

Tanino

Financial cooperation has advanced more than in the area of free trade.

Urata

Rationale for having FTA, EPA (Economic Partnership Agreement)

In East Asia, foreign investment and international trade have been very important in promoting development, resulting from GATT. There is room for further liberalization. WTO is functioning, but it is in trouble. FTA framework should be used when possible.

FTAs have promoted trade among member countries. Like to ask US participants about NAFTA. FTAs are justified, but there are some conditions. FTAs should be comprehensive, but also include other properties.

Japan initiated FTAs in Asia. Is it true Japan was approached by Mexico? Understand Japan was a passive partner until 2002 when it approached ASEAN. Japan decided to negotiate with Singapore first. Reasons for why Mexico approached Japan: Because it was burned with NAFTA.

In favor of promoting FTAs, and feel that agriculture and immigration policy are two serious obstacles. Japanese not interested in liberalizing agricultural market or having foreign workers in Japan. General public does not seem to be behind FTA policy in Japan. What can be done to change the views of people?

US – Japan relationship: China and India are increasing economic influence, should consider this to be an opportunity. Maybe should have US – Japan FTA. Can make rules which are transparent, reliable and efficient. Can use WTO for trade issues, investment, competition policy, etc.

Hatakeyama

Clarify relationship between FTA and EPA. Disturbed by use of EPA, because NAFTA includes everything in EPA. Economic cooperation can be done without such an agreement. In US, understand EPA is considered as something not fully including liberalization of agriculture imports. That is called EPA in Japan according to their interpretation. Regarding Mexico, it took the initiative. What I said is movement in Asia started from Japan, due to Mexico's action. Japan was passive in the past. Second initiative came from Korea. Then Singapore.

You asked why Japanese are not sympathetic towards FTA, agricultural liberalization or immigration policy. Japanese female consumers are very conscious about safety of agricultural products. They doubt quality of imported foods or materials. It is difficult to persuade females. Japan's isolation makes it difficult to implement change in immigration policy. In a viscous circle in Japan. Due to restrictive immigration policy, only people willing to violate immigration law come to Japan. Since they are ready to do this, it is easy for them to steal something, violating criminal law, and Japanese people which are already suspicious, conclude that foreigners are not good, and lobby for stricture regulations.

Agree regarding FTA between Japan and USA. This might undermine WTO value, but need to explore the possibility. One technical problem: Both Japan and USA are passive regarding any FTA in the past. US has been passive except for some places where there is political motivation. Ambassador talked about Australian – US FTA, but think that both US and Japan would be passive about this.

Tanino

Ten minute coffee break.

Would like to finish dialogue in thirty minutes.

Dam

Prof. Shirai wanted to say from use side, e.g. Asian Bond Market Initiative. India is a very unusual situation. They do not have a good infrastructure. Corporate bond market provides a way of financing infrastructure. Think there may be other opportunities to use to the benefit of Asian countries. Do not view this interest as being anti-US. Development of financial sector is of benefit to the US. Would like to ask if Japan would like to be begged by the US to create a FTA. US is proposing an FTA with Korea. Success in the Doha would be best, but we cannot count on that. Think NAFTA has been a success. NAFTA started with agreement with Canada, and was later expanded. Whatever is required from standpoint of etiquette can be handled.

Shirai

Agree with you. Ministry of Technology compares US and Japan. US is largest debtor in the world, and Japan is largest creditor in the world. Paradox is that US is a debt nation, but its income is larger than Japan. Answer is that investment portfolio is completely different. US diversifies, but in Japan, big portion is accumulation of reserves, US bonds. Japan is strongly going to shift and possibly invest more in Asia. Some say "Why don't we invest more in Asia because of more lucrative returns."

Mizoguchi

Income surplus in Japan may be smaller than the US. Japan recorded more than 115 billion \$ surplus in current account last year. Foreign reserves of government in Japan is larger than other countries. This is not a policy, but reflection of reality. Private sector does not have much appetite to buy foreign bonds or equities. Private institutions do not have the ability to take risk to invest in foreign assets to prevent excessive exchange rate fluctuation.

Shirai

Agree with this. Composition of foreign reserves in Japan and China. Japan has 80 to 90% invested in treasury bonds, while China only invests about 20%. China is investing in US stocks and others, so they are more diversified.

Madsen

Volume of foreign reserves accumulated is so huge, no other market beside T Bond market is large enough to absorb this amount. Developing bond market makes sense, but it would be better to convince these countries to invest in their future. Conclusion of more agreements between Japan and US would be good if there were agreements concluded between Japan and China.



Hatakeyama

Agree about FTA with US, but concerned about who will take initiative. Understand negotiations with Canada for FTA were very difficult, and NAFTA negotiations were also very difficult. If Japan takes initiative for FTA with US, it would be the same. Interesting that US is interested in starting negotiations with Korea. The Bush administration has a policy to approach good boys and punish bad boys. For example, New Zealand was excluded from the US – Australian FTA, and Singapore and Chile made FTAs, but a ceremony was only held for Singapore due to the displeasure of US with Chile. Whether or not Korea has been good or bad is obvious, and is not viewed as good by US. Why has this happened, and US officials replied this was tricky. This should be a comprehensive FTA, including agriculture. The US side explained chapter by chapter the content of NAFTA. Korea said yes. The US proposed four conditions: Ignoring BSE import restrictions, pharmaceutical liberalization, inspection (auditing) of people who buy imported cars by tax authorities, abolishment of screen quota.

Garrett

This conversation is important for report. Most difficult is “What is the role of the US?” Clinton thought APEC was a nice idea. Nice meetings until Asian financial crisis, and Asian countries not happy with response of IMF. IMF gave less than half as much to Thailand as ASEAN + 3. Developing Asian economies not happy about this. Asian finance ministers created scheme to cushion financial shocks. But undermining IMF conditionality was a no-go area. On trade side, there was APEC, but it became stillborn, and with efforts at trade integration, US is now a long way from being a central player.

Was Japan lending or was China involved? In our report, it would be a good idea if there was a robust US – Japan FTA. Your presentation went in opposite area, Asia should come first, and then a FTA should be from bilateral negotiations.

Mizoguchi

China cannot be a lender. Chiang Mai Initiative was just complementary to the global institution, IMF lending. 10% lending without IMB problem, means lending should be subject to IMF conditionality. This was raised to 20%, but this is still very small. Nature of initiative has not been changed at all. It is only a complementary measure.

A. Kojima

What are conditions to have a better functioning exchange rate system?

Hatakeyama

Order of Japan – US FTA and East Asia FTA. Was proposed in 2001. Started working on this issue then. Therefore natural that I started talking about this first, and does not represent importance. China may be disturbed by hearing about promotion of US – Japan FTA, but blessing to East Asian FTA that includes China should alleviate the problem. They could proceed simultaneously.

Bouton

Considering trade between Japan and US, do not understand notion that because US is far away, US cannot be part of trade agreement.

Hatakeyama

If this has something to do with the security issue, of course US should be included. I don't think the US is located in East Asia, so joining would result in US becoming more unpopular. These negotiations can be done simultaneously. So if Japan and US are enthusiastic enough, they should just expedite the process so it can be concluded earlier.

Dam

Would US – Japan FTA be as comprehensive as East Asia FTA? People in US recognize soybean

problem in 73 was a big mistake. Could you get similar commitments not to cut off food supplies to Japan?

Hatakeyama

The government of Japan is more restrictive. Therefore, they have never proposed this idea in the GATT round, because of fear once it is accepted, Japan must logically liberalize importation. Regarding other issues, I doubt the coverage can be the same. East Asia FTA will have a more narrow coverage. But that would not be a big problem.

Dam

Now talking about last portion of report. Any other comments?

Moskow

Difference in coverage is an important issue. It could be done simultaneously. Would government of Japan really want to have an FTA with the US at this time? It would be quite a change.

Hatakeyama

Cannot say that majority of politicians or people are in favor of this, so we would have to enlighten them.

Moskow

People of US and Japan do not want FTA because of political considerations. Adversely affected people are more outspoken. Requires very strong leadership to get this done.

Dam

For NAFTA, agricultural part will not be phased in until 2008, if then. Being discussed now. Agricultural sector would not be open immediately, but it would be a commitment.

Tanino

Lack of interest in FTA. Immediate concern or problem is not cheap vegetables, but concern about future of health system, employment rate. These are the immediate issues. You have to enlighten the public. Need good strong political leadership. Energy reform requires strength of political leadership. Opening up agriculture requires strong political leadership. This is what is missing in Japan, South Korea and China.

Dam

What is most pressing issue in US: Medical care, pensions and budget deficit. Number one issue is always jobs. No public demand for progress in free trade.

Bouton

Gotten into discussion of Japan – US FTA. How can US and Japan provide leadership globally? If there were a US – Japan FTA, would it be seen as a standard setter, demonstrating willingness to take the lead, or as a US – Japan condominium? Asking this as a factual question.

Garrett

Talk about concrete timeline for East Asia FTA. Maybe it is better that it go first.

Hatakeyama

US already has an FTA with Singapore, and has started negotiations with Thailand and Korea. So Japan would be number four at best. Therefore, even if FTA between Japan and US was created, the rest of Asian countries would not feel that they were excluded. Or hope so.

Madsen

Why not a Japan – China FTA?

Hatakeyama

China is included in East Asian FTA. There was an opinion that China – Japan should be first, but this was the minority opinion.

Madsen

Seems China is making more progress than Japan, would like to see more progress by Japan in this area.

Hatakeyama

Leaders cannot meet other, so these negotiations cannot start.

Overholt

US awards FTAs depending on how much a country supports our Iraq policy. Japan is maneuvering in Asia. But in the process, both Japan and US have lost. China just joins. While Japan and US are playing politics, Chinese are winning. That should cause leadership to reconsider and play different game. Suggest broad US – Asia FT negotiation that includes everybody. Ultimately, US and Japan could join ASEAN. Worst possible outcome is current course by Washington and Tokyo.

Mentioned that small countries get larger benefits. But opposite argument can be made that agreements are discriminative against small countries. Many Australian and Singaporean companies have a hard time proving origin, so decide to pay tariffs. This results in loss in ground politically.

Dam

Nothing can happen in the US immediately. US – Korea FTA will not happen until next presidential term. Here, must paint a vision, and not worry about who goes first. Could say in report, there are issues about what goes first, but do not need to deal with that. Final vision more important.

Madsen

Issue of bilateral FTA or broader agreement.

Dam

From US side, want to have series of agreements. Difficult with China right now.

Moskow

Agree that support of bilateral agreement should be in context of multilateral agreement. Regional agreement. Rather have Doha round, but assuming that it fails or stalls.

Bouton

Surprised how quickly APEC lost favor. Do not understand why it lost so much force, although I understand basic politics. If broadest observation is a win-win for the world, then US should be associated in long-term with an approach that is as broad as possible.

Hatakeyama

APEC lost momentum because of two reasons: Failure of EVSL, and Proliferation of FTAs. However, the US should support idea of APEC FTA, which was proposed by Chile. India is not included in APEC, therefore India must be included. Maybe too many countries are included. Reshuffling of members may be needed.

Schoppa

Proposal could avoid irritating other Asian countries by helping to achieve market opening with US – Japan FTA that would be available to other Asian countries if they joined.

Madsen

Think pushing forward with regional approach would be helpful.

Urata

Everybody knows their position in ASEAN. There are many ASEAN + 1s. Why doesn't the US work on agreement with ASEAN. As long as there is ASEAN + US and the other agreements are honored, US can take part. Many channels can be pursued. Naturally, US would be invited to East Asian summit.

Hatakeyama

ASEAN is not ready to have comprehensive FTAs yet. Russia and China have an FTA. Regarding goods, there are many highly sensitive items. Only 10% can remain as sensitive items.

There is a guest speaker at dinner, Mr. Toyoda, not related to the auto company. Then we can discuss his speech.

Dinner will start at 7:30.