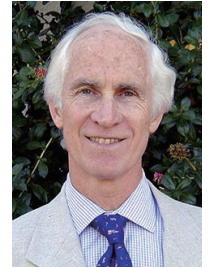


# Japan & Asian Region after Fukushima

By T. J. PEMPEL



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I spent a week in Japan during the middle of July, 2011. In that short period four seemingly unconnected events occurred. First, on July 17 in Frankfurt, Germany, Japanese women won soccer's World Cup. The smaller and less athletic Japanese team, playing with tight discipline and coordinated teamwork, twice rallied from behind to tie the score, ultimately beating the world's number-one-ranked American team in a penalty shoot-out. Second, in Tokyo, former Prime Minister Kan, embroiled in a two-front battle with the Liberal Democratic Party (LDP)-led opposition and dissidents in his own Democratic Party of Japan (DPJ), struggled to stay in office long enough to pass a second 2 trillion yen (\$25 billion) emergency budget to provide relief in the aftermath of the 3.11 triple disaster in Fukushima. Third, on July 19 I found myself trapped on the lovely island of Miyajima after officials cancelled all ferry services to the mainland in response to warnings about the possible arrival of typhoon Ma-on. Fourth and finally, South Korea's Free Trade Agreement (FTA) with the EU came into effect promising to eliminate tariffs on all manufactured trade items within seven years.

Though discrete events, these four episodes offer insightful windows into the strengths, weaknesses and challenges that Japan will confront in the Asian region in the aftermath of the triple tragedy. The victory by the Nadeshiko women galvanized the public and stood as a testimonial to the team's gritty and collective resourcefulness. The same resolve was demonstrated following 3.11 when the world watched in astonishment at the effectiveness of pre-disaster preparations, and the subsequent lack of looting, and the orderliness and the 'can-do' spirit demonstrated by disaster victims, rescue workers, vast numbers of citizen volunteers, and even retired nuclear engineers who volunteered to enter the meltdown areas despite substantial risk to their own long term health. Many local mayors, governors and citizen activists demonstrated similar energy and creativity in coping with the multitude of problems linked to the disasters.

This picture of collective cooperation in the face of adversity contrasted starkly with the political *kabuki* in Nagatacho, where parliamentarians behaved as if the 3.11 tragedy had taken place on Jupiter rather than an hour-and-a-half by train to the northeast. Ignoring information and pleas from the affected areas, the prime minister and other cabinet officials proved themselves almost totally in the dark as the tragedy unfolded, while the Diet was consumed, not by speedy and comprehensive planning for reconstruction, nor by a stoicism and resolve to match that of the women's soccer team or so many in the disaster area; instead, we heard only histrionic personal attacks aimed more at maintaining or toppling the prime minister than at coping with the disaster. Meanwhile officials from Tokyo Power and Electric (TEPCO) dissembled, bullied and bluffed in their efforts to minimize citizen blowback against a decades-long culture of bureaucratic-corporate-political regulatory malfeasance.

Without question the official response was vastly less inept than that following the 1995 Kobe earthquake or the 2005 Katrina disaster in New Orleans. Nonetheless a web of labyrinthine bureaucratic regulations

strangled relief efforts by impeding the release of emergency fuel supplies, delaying the delivery of needed blankets and food, preventing air drops of medical relief equipment and impeding foreign doctors from providing medical relief due to their lack of Japanese licenses.

This is where the suspension of ferry services from Miyajima fits in. Official discretion in the face of Mother Nature is to be applauded and the disaster of 3.11 had undoubtedly stiffened the normal work-to-rule cautiousness of nervous officials. So services were halted for 24 hours, despite the ride to the mainland being of only 10 minutes duration, despite the fact that the waters and winds remained exceedingly calm, and despite the fact that typhoon Ma-on was still hundreds of miles away (and never did reach the area).

Finally, on the Korea-EU FTA: despite the enormity of the Fukushima crisis and its dominance of the headlines within Japan, the FTA between South Korea and the EU dramatized how little the rest of the region's agenda would be upended by Japan's woes. Foreign governments and corporations continued their ongoing efforts to enhance trade, foster deeper economic interdependence, build financial ties, and cope with perceived security challenges. The Korea-EU FTA was but one dramatic manifestation of how East Asia is transforming itself - with or without Japan.

Japan's future in East Asia will be shaped by three powerful trends now well underway in the region: economic interdependence, regional multilateralism, and power transition. Will post-crisis Japan engage these powerful challenges positively and in a way that shapes their trajectories? Or will Japan become so mired in bureaucratic red-tape, political infighting and the demands of post-crisis reconstruction that it turns inward and ignores the dynamism in the rest of East Asia? The energy and diligence demonstrated by the women's soccer team as well as by the affected population, volunteers, and local officials in the Tohoku region suggest reasons for optimism. They show a Japan ready to confront and triumph over adversity and challenge. Yet, the solipsistic self-absorption and timidity of much of the country's political and administrative class raise worrisome red flags that Japan will soon find itself little more than a self-absorbed and marginal bystander in the face of dynamic regional developments.

## Regional Economic Interdependence

In the last two decades East Asia has become increasingly connected economically through trade, investments, and multinational production facilities. Japan was the initial engine behind this integration, with its combination of government policies and corporate decisions that spurred trade and foreign direct investment, making Japan a regional and global force. Similar moves from Taiwan, South Korea, Hong Kong and Singapore among others further obfuscated the region's previously unbridgeable national borders. China's flourishing economy also opened up trade and investment opportunities for firms from Japan, South

CHART 1

## East Asia's rising star: trade & investment over three decades

Korea, Hong Kong and Taiwan, and more recently China itself has become an important source of outgoing FDI.

Since the mid-1990s, intra-East Asian investment has taken a particularly sharp turn upward while US receipt of East Asian exports has dropped (*Chart 1*). Trade links have been especially vigorous among Japan, China and the ROK (*Chart 2*).

Compatible, if not always coordinated, policies are being pursued in finance through enhanced regional financial monitoring and efforts to expand Asia's collective weight in the IMF. Also, expanded foreign reserves provide a collective "regional insulation" against the forces of global capital and "hot money" so previously disruptive in 1997-1998. Japan's reserves are up fivefold in the last decade to over \$1 trillion, making it the world's second largest holder, but still only one-third of China's treasure chest.

Equally indicative of regional financial cooperation has been the multilateralization of currency swap arrangements in the Chiang Mai Initiative, along with the creation of two separate Asian bond market initiatives. These last moves weave into the second major trend in East Asia, namely the increased prominence of regional multilateral institutions.

### Increased Regional Multilateralism

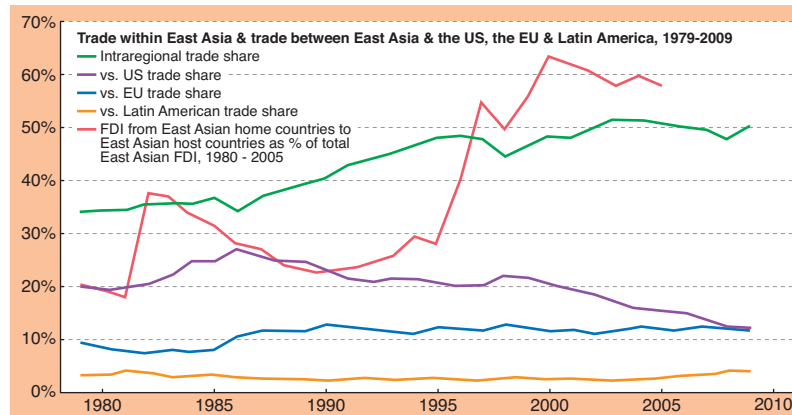
East Asia has seen a big jump in the number and significance of its regional institutions. The majority of bodies created in the last decade have been 'Asia-centric' rather than 'pan-Pacific' in contrast with earlier bodies which distinctly included the US. This was particularly true with the ASEAN Plus Three, the Chiang Mai Initiative Multilateralization (CMIM), the Asian Bond Market, and the East Asia Summit, along with the annual trilateral summits of the Plus Three leaders from Japan, Korea and China.

US foreign policy has long been wary that greater East Asian regional commitments might challenge American primacy in global bodies such as the IMF, the World Bank and the WTO or undercut its bilateral security relations with Asian allies. For Japan, the most demoralizing demonstration of this American predisposition came when the US squashed Japan's generous 1997 offer to create an Asian Monetary Fund. Later, the Bush administration reaffirmed America's foreign policy focus on bilateral alliances and military unilateralism, even at the expense of both APEC and ARF. Further the US moved to trilateralize its bilateral ties by boosting the Australia-US-Japan relationship and strengthening ties among Japan, Korea, and the US.

The Obama administration has endeavored to reverse direction with numerous top-level visits by American officials, the signing of the Treaty of Amity and Cooperation, the appointment of an American ambassador to ASEAN, efforts to join the East Asian Summit, and promises to resuscitate APEC in its next meeting in Honolulu. But such American efforts are being layered on top of the already well-established institutional arrangements created by Asians themselves.

### Regional Power Transition

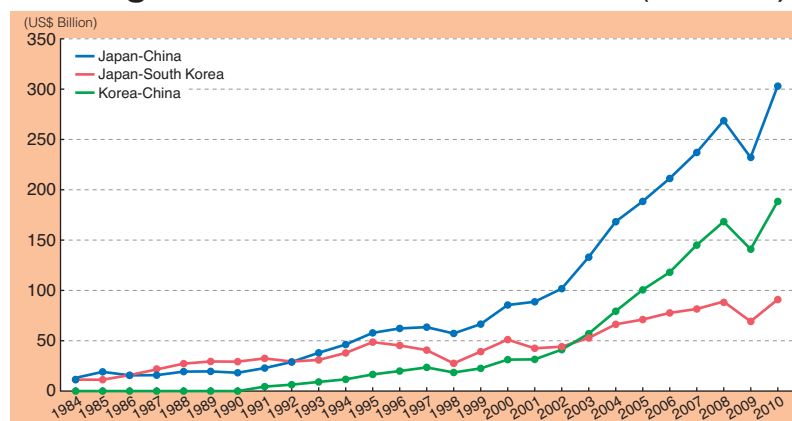
East Asia is currently in the midst of a power transition, the third major regional trend. The biggest turbine driving this transition is the



Source: IMF, Direction of Trade Statistics; UN Conference on Trade & Development; OECD (compiled by Witold Henry at the Wharton School of the University of Pennsylvania)

CHART 2

## Intraregional trade in northeast Asia (1984 - 2010)



Source: IMF, Direction of Trade Statistics

rising economic strength of China. Since throwing off the ideological shackles of Maoist economics in 1978, China's growth rate has consistently hovered near 10% per year and total GDP has risen fourfold. China's nominal share of world economic output is now more than 13%, compared to less than 4% two decades earlier. It has also become the number-one trading partner for Japan, Taiwan and the ROK, displacing the US in all cases. China is also a major recipient of FDI from these countries.

With the world's second-largest GDP, China is closing in quickly on the world's leader, the US. Japan, in contrast, has had the single lowest rate of growth in East Asia and has seen its share of global GDP fall from the 18% share it enjoyed in the early 1990s back to only 8%, the same as its level in 1970. For the US, two draining wars, fiscally irresponsible tax cuts by the Bush administration, the self-inflicted wounds of the Lehman crisis, and the recent political theater surrounding the so-called debt crisis have diminished America's economic muscle and its credibility while catalyzing a scarcely hidden sense of schadenfreude among Chinese leaders. Touting China's simultaneous role as the largest foreign holder of the ever-mounting US debt and as America's largest supplier of imported goods, Chinese leaders can make the facile but nonetheless compelling claim that America's economy is now based on borrowing from China to buy goods made in China. Although neighboring countries may have a more nuanced view, the basic image is clear - Japanese and American economic muscle is shrinking while that of China is rising.

Without question, the ability of Chinese leaders to continue this economic blitzkrieg is problematic but, regardless, future Chinese leaders

will oversee a far more robust and influential economy than their predecessors enjoyed as little as 20 years earlier.

China's economic strength has been paralleled by substantial increases in its military modernization expenditures, spurring worries in much of the region. Chinese defense spending constitutes 1.4% - 2.4% of the nation's GDP, depending on whose estimates are used. Chinese budgeters clearly give greater priority to military expenditures than do budget-makers in Japan (1% of GDP) though they are on a par with, or below, those for Taiwan (2.2-2.4%) and the ROK (2.9%). Yet the US figure remains strikingly larger at 4.7% of GDP and roughly six times China's military budget. Such comparisons help to keep the Chinese spending in regional perspective. Still, it is undeniable that China is slowly shifting the regional military balance, catalyzing considerable speculation about future implications.

In arguing that power transition is underway in Northeast Asia, it is vital to recognize that this transition is moving forward on two rather separate tracks and on two rather separate timetables. China's enhanced economic strength - along with the increased economic muscle of Korea, Singapore, Taiwan and Indonesia, for example - mean a real shift in the economic power balance within the region. But the US remains by far the most powerful military presence in the region, a position it is unlikely to see remotely challenged for at least another decade or two, and its security alliances with Japan, Korea and Australia make a direct military challenge to its primacy highly improbable.

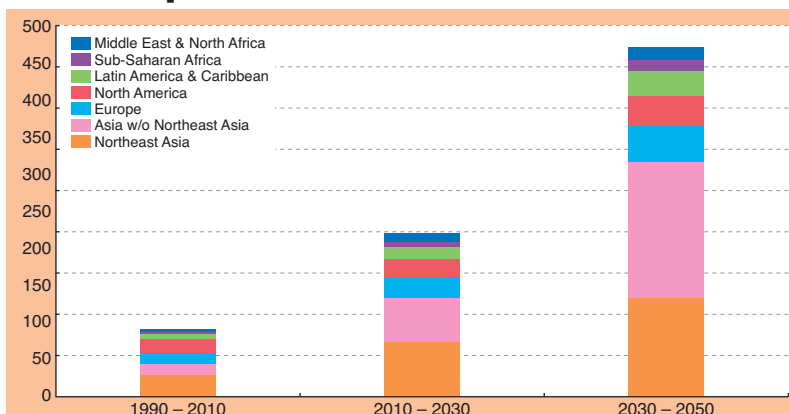
It is a mistake to over-inflate Chinese power. But clearly in economic, financial, and regional multilateral areas, Chinese strength is dramatically on the rise and automatically challenges the previously comfortable status quo. How to deal with this stronger China - as well as an economically stronger East Asia generally - will pose one of the central challenges for Japan's future foreign policy.

### Engaging Asian Region

In dealing with these regional trends, Japan faces at least three big hurdles. First and most critical is its declining productivity and slow economic growth. Despite its many globally competitive companies, Japan's economy remains straitjacketed by large numbers of globally uncompetitive companies and excessively cozy relations between regulated and regulator. No contemporary example is more persuasive

CHART 3

### Asia will account for 70% of the world's added capital stock between 2030 and 2050.



Source: Centennial Group projections, 2011

than TEPCO, a politically powerful company that reaped huge profits with its regional monopoly over both the production and sale of power. High prices for end-users, resistance to the development of a nationally integrated power grid, and lax oversight of TEPCO's safety procedures were among the logical consequences.

A recent study by the Asian Development Bank suggests that as much as 52% of global GDP could be produced by Asia in 2050, up from the current 27%. A big portion of this will be in capital stock (*Chart 3*).

For Japan to benefit from this expansion and to play a major role in shaping its trajectory, large swaths of Japan's own economy will have to be restructured in ways that enhance productivity and recapture some of its prior dynamism. Without such changes, even if Japan's economy is the most sophisticated in East Asia, it will be very tough for the country to claim any mantle of regional economic leadership. Yet Japan now appears to be moving in precisely the opposite direction. Thus, a recent survey by METI shows that just between 2007 and 2009, Japan has lost a considerable portion of its appeal as the headquarters for foreign investment in East Asia or as the most appealing center for regional research and development (*Table*).

Twenty years of slow to no growth in Japan, along with corporate dinosaurs such as TEPCO, underscore the widespread Asian perception that China is far more promising as Asia's future economic leader.

Second, Japan is impeded from deeper engagement with East Asia because of a foreign policy that remains excessively focused on ties to the US. The cold war and its rigid Manichean bifurcation of friends and enemies along with its prioritization of military power are vestiges of the past, and US-Japan relations must adapt to current conditions. Not least of these is the fact that most business and political elites in East Asia (with the conspicuous exceptions of North Korea and Burma) give far more policy priority to the development of their domestic economies and less to the exercise of military muscle flexing. Security threats have by no means vanished from East Asia, as many recent events have shown. East Asia remains a long way from having forged itself into a 'security community' in which military conflicts are 'unimaginable,' as is generally true for Western Europe or North America. Hence the US-Japan alliance must remain the cornerstone of Japanese foreign policy, and military cooperation between the two countries remains a logical outgrowth of their overlapping global and regional interests and a powerful hedge against future security challenges. That said, the DPJ manifesto calling for a greater Japanese engagement with Asia is also a logical necessity for Japan's future foreign relations. The bulk of that engagement should be economic and institutional.

Economics has proven its ability to soften geopolitical tensions. Witness the continuation of bilateral Chinese-Japanese discussions during dust-ups over history texts, Yasukuni visits and territorial disagreements. See also the successful arrangements over contributions to the multilateralized Chiang Mai Initiative concluded by Japan, Korea, and the PRC. Both Japan and China sought to be the largest single contributor. Eventually each won national bragging rights by a compromise under which Japan contributed 32% - the largest single percentage - but a figure that was equaled by the PRC + Hong Kong contribution. Japan can thus claim it gives "more" than China, which in turn can retort that "the Chinese" contribute as much as Japan. The ROK, meanwhile,

TABLE

## Most attractive country/region in various aspects (Data only for top six countries; those ranked Nos. 1 & 2 highlighted)

| FY 2007 Survey     |                  |                  |                  |           |             |                  |
|--------------------|------------------|------------------|------------------|-----------|-------------|------------------|
|                    | Japan            | China            | India            | Singapore | South Korea | Hong Kong        |
| Asian headquarters | <sup>1</sup> 23% | 18%              | 8%               | 16%       | 4%          | <sup>2</sup> 20% |
| Production center  | 3%               | <sup>1</sup> 62% | <sup>2</sup> 12% | 2%        | 5%          | 5%               |
| R&D center         | <sup>1</sup> 30% | <sup>2</sup> 25% | 16%              | 9%        | 4%          | 6%               |
| Back office        | <sup>2</sup> 15% | <sup>1</sup> 24% | <sup>2</sup> 15% | 12%       | 5%          | <sup>2</sup> 15% |
| Logistics center   | 11%              | <sup>1</sup> 41% | 8%               | 9%        | 7%          | <sup>2</sup> 13% |
| Finance center     | —                | —                | —                | —         | —           | —                |
| Marketing center   | —                | —                | —                | —         | —           | —                |

\* Respondents chose one country/region for each aspect.

\* Percentages are calculated based on 209 respondents (including 51 companies already operating in Japan), excluding those who did not reply. (78 firms in Europe, 74 in North America, 57 in Asia)

Source: METI, "Survey on Western and Asian Companies toward Investment in Japan" (FY 2009, FY 2007)

| FY 2009 Survey     |                  |                  |                  |                  |             |                  |
|--------------------|------------------|------------------|------------------|------------------|-------------|------------------|
|                    | Japan            | China            | India            | Singapore        | South Korea | Hong Kong        |
| Asian headquarters | 10%              | <sup>1</sup> 42% | 10%              | <sup>2</sup> 16% | 2%          | 13%              |
| Production center  | 1%               | <sup>1</sup> 64% | <sup>2</sup> 14% | 2%               | 2%          | 2%               |
| R&D center         | <sup>2</sup> 21% | <sup>1</sup> 33% | 20%              | 8%               | 4%          | 2%               |
| Back office        | 8%               | <sup>1</sup> 39% | <sup>2</sup> 19% | 15%              | 2%          | 9%               |
| Logistics center   | 3%               | <sup>1</sup> 63% | 8%               | <sup>2</sup> 11% | 2%          | 6%               |
| Finance center     | 10%              | <sup>1</sup> 30% | 9%               | 21%              | 4%          | <sup>2</sup> 23% |
| Marketing center   | 7%               | <sup>1</sup> 50% | 7%               | 11%              | 4%          | <sup>2</sup> 13% |

\* Respondents chose one country/region for each aspect.

\* Percentages are calculated based on 180 respondents (including 30 companies already operating in Japan), excluding those who did not reply and those who chose no country/region. (60 firms in Europe, 60 in North America, 60 in Asia)

succeeded in securing the right to contribute one-half of the 32% maximum contribution with its 16%.

Finally, Japan, unlike China and increasingly unlike South Korea, has been reluctant to open its domestic market to imports of agricultural, food and other low-end goods that are vital exports from Southeast Asia, thereby impeding Japan's ability to utilize economic openness simultaneously as a way to enhance its regional role and to spur creativity and development at home.

### Fukushima: Rebuild or Recreate?

These regional obstacles and the approaches to overcoming them face tangible challenges in considering how to deal with Fukushima. Rebuilding after the 3.11 disaster will demand tremendous human and financial effort. Some estimates have been as high as 25 trillion yen (\$309 billion), although recent official estimates have been in the range of 10-12 trillion yen (\$125-152 billion). Two relief bills totaling 6 trillion yen have been passed and expectations are that a third of 10 trillion yen will be passed before the end of 2011. Such numbers constitute 3%-4% of Japan's total output and will put great strains on the annual budget, threatening to bring major program cutbacks and/or significant tax increases. Quick calculations, however, show that Japan could nonetheless deal with such costs. Despite its two 'lost decades' and the high costs of servicing a debt that is now more than double its annual GDP, Japan is still a rich country with a relatively low tax burden compared to other industrial democracies.

More problematic is the question of whether policymakers and government officials will return the affected area to some version of its prior existence – an area populated largely by the elderly and heavily dependent on agriculture, fishing, and subcontracted manufacturing (as well as dangerously sited but income-generating nuclear power plants). Surely there will be intense pressures from a host of constituencies, not least of all currently displaced residents, to do so.

A more politically courageous alternative would be to 'recreate' the region with an eye toward forging a dynamic and future-oriented model for the rest of the country and the East Asian region. Specific details can be debated, but consider among other things: vastly more energy-efficient housing that could become an exportable model to the rest of Japan and the world; a multilingual university freed from existing

Ministry of Education restrictions partnered with the best four or five universities in Asia, North America and Europe, a facility capable of attracting faculty, students and research that aspire to be the best in the world; or an export-free zone and research park designed as a magnet for leading domestic and foreign technology and services firms. The specifics can be debated, but the central goal would be to use the devastation as an opportunity to create a global beacon rather than a technological backwater.

In considering its future, Japan could well look to the experiences of current East Asian success stories. Korea came out of the 1997-'98 financial crisis by deregulating substantial sectors of its previously cosseted financial and manufacturing sectors. It entered into free trade agreements with both the US and the EU; it has encouraged its students to gain fluency in foreign languages, and today large swaths of teenage Koreans study in the US, Singapore, China, Australia and Britain. Shanghai has become a truly global city with seamless and speedy maclev transportation from its state-of-the-art airport, for example, on to Hangzhou, 200 kilometers and 45 minutes away. With their extensive multilingual labor forces, Singapore and Hong Kong vie to attract global companies in finance, services, architecture, transportation and communication. There is no inherent reason why a reconstructed Fukushima could not, with sufficient political will, rival these places and spur further reforms in the rest of Japan.

The future of Fukushima and of Japan more generally *can* be linked in positive and dynamic ways to the East Asian region. Can the country collectively demonstrate the levels of energy, generosity, teamwork and diligence shown by the Japanese women's soccer team, and the many volunteers and local political activists aiding the Fukushima area? Can the country learn from and compete effectively with neighboring countries now transforming themselves in ways that engage the rest of the globe through a mixture of selective emulation, international exchange, enhanced trading openness, and an embrace of foreign languages and technologies? Or will Japan instead allow its future to be hamstrung by petty political squabbling and blind adherence to artificially constricting bureaucratic regulations? **J.S.**

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