"Abenomics", Asia & ASEAN

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Japan has received more attention and generated more optimism in the first six months of 2013 than perhaps during all of the preceding six years. This has been triggered by the return of Shinzo Abe as prime minister of Japan for a second time and the Liberal Democratic Party (LDP) to government. But beyond personalities and party politics, the major factor behind the attention and optimism comes from the new administration's promise of bold actions and reforms — dubbed "Abenomics" — and the grand vision of reviving Japan's long-stagnant economy.

There are "three arrows" to Abenomics: first, quantitative easing to release money and credit into the market to stimulate growth and end deflation; secondly, fiscal policies to stimulate demand; and thirdly, structural reform to generate sustainable growth.

None of these components is especially new. The Americans have led other central banks in responding to the global financial crisis with unconventional monetary policy to expand the monetary base through a succession of quantitative easing programs. Japan has previously tried fiscal stimulus with government spending that has ballooned public debt. Hopes for structural reform in Japan have been raised before but then stalled due to political squabbles. There is some scepticism whether or not Abenomics can succeed.

Few can doubt, however, that there will be impacts and changes. As Japan tries to restart its economy — still the world's third largest in absolute size, and with considerable strengths in the corporate sector and technology — what will be the repercussions for others in Asia and especially in the Association of Southeast Asian Nations (ASEAN)?

There are few clear answers at present. The policies have been announced, and the first arrow of quantitative easing has been shot, generating market responses and movements in currencies. However, the impact of the second arrow of fiscal reform will take longer to discern. As for the third step of structural reform, details are only now emerging. Six months is not long enough to see the impact and judge the reality of policy changes, especially as these come after decades of stagnation.

Predictions are also complicated by external factors. Abenomics comes at a time of global turbulence and uncertainty. The US Federal Reserve is shifting from quantitative easing to a more restrictive monetary policy — as it must — given that the underlying economy now shows more positive signs. The Chinese government is facing a slowdown in growth, sharper than anything since the start of the global financial crisis, and it remains to be seen how Beijing will deploy financial, fiscal and other tools to avoid an economic hard landing.

The three largest economies in the world are at important junctures in their policy paths to navigate the post-crisis world. What one does affects the other, and the interactions among the three giants affect us all. Yet there is no guarantee that the policy changes will be coordinated or even sufficiently and clearly signalled in advance.

Nevertheless, ASEAN and the rest of Asia are beginning to respond to the policies of Abenomics. This essay will begin with an overview of the reactions that differ between Japan's Northeast Asian neighbors and ASEAN. It will then look closer at the three different arrows of the strategy and their implications. The essay will go on to sketch the possible impact at the company-level and people-level for ASEAN, as foreign direct investment is trending upwards and structural reforms in Japan may allow a deeper integration through trade and other pacts. It will close by briefly considering the political issues that might arise from Abenomics and a reawakened Japan.

Asian Reactions to Abenomics

In reacting to Abenomics, there is quite a clear line between Northeast Asia and ASEAN. The former is sceptical and views it negatively. ASEAN responses, in contrast, have largely been positive.

Some Chinese commentators believe that Abenomics will fail. They note that in 2012, Japan's current account trade surplus was only one-fourth that of 2011 and expect the downward trend to continue. If so, there is less room for manoeuvre. Some Chinese see Abenomics as a gamble — the failure of which would trap Japan in currency depreciation and recession ("The gamble that is Abenomics", *China Daily*, June 7, 2013). The view from Beijing may, in part, be read in a political context: ties have been strained over territorial and other issues and there is a sense of political and security friction and competition.

South Koreans are equally negative — but in the opposite direction. While China believes that Abenomics might well fail, South Koreans instead worry that Abenomics might be too aggressive in bringing down the value of the yen, thereby making Japanese products more price competitive in the many sectors where companies from the two countries are direct rivals.

Exports account for about half of South Korea's GDP — with both Japan and South Korea exporting similar products to similar markets, from electronics to automobiles and shipbuilding. The depreciation of the yen — depending on calculations between 16% and 25% over six months against the US dollar — has led to a major challenge to South Korea, whose won has depreciated just 2.7% in the same period. South Korean industries are starting to feel the pressure, although Seoul has the advantage of free trade agreements with the United States.

ASEAN responses differ. In general, Southeast Asia is reacting positively to Abenomics and stands to gain from a Japanese resurgence. Japan was and remains an important partner and major economic player in the region.

In the decades of stagnation, China has, however, closed the gap. Take trade. In 2000, total two-way ASEAN-Japan trade was $128.1 billion, while ASEAN-China trade only reached $38.5 billion — less than a third of the size. Fast forward a decade to 2011 and the trends are clear: ASEAN-Japan trade was $273.3 billion, while ASEAN-China trade was estimated to be $280.4 billion (ASEAN Secretariat and ASEAN-Japan Centre figures) *(Chart 1)*.

In contrast, investment figures show Japan ahead. It remains the second-largest source of external investment into ASEAN with $15.0 billion in FDI inflow in 2011 and while China is third with $6.0 billion in FDI to ASEAN, there is a considerable gap *(Chart 2)*.

These trade and investment figures underscore a basic difference in the economic relationship that the two Asian giants have with ASEAN. Chinese trade, especially in resources, has boomed but many of its corporations compete against ASEAN companies. In contrast, while trade demand from Japan has not grown, its more advanced economy is complementary to ASEAN's, and Japanese multinational corporations have long looked to invest in Southeast Asia as a production base.

It does therefore make a difference to ASEAN if Abenomics can succeed in revitalizing the Japanese economy. There have already been some immediate signs of a renewed interest. For example, Japan is specifically embarking on increased investment in Myanmar, Indonesia and Vietnamese industries as part of the Abe government's policies.

1st Arrow of Quantitative Easing

The quantitative easing measures announced by the Bank of Japan (BOJ) as the first arrow are considerable; not only in setting a very different policy direction but also in its ambitions and the size of the effort. The government aims to double money in circulation and reach a 2% inflation target. As a result, the yen has been depreciating considerably over the past year, by about 16% against the dollar.

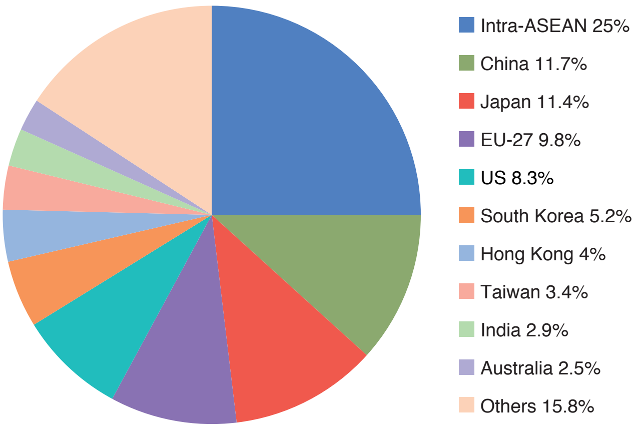
From a rational perspective, a revaluation of the yen makes sense and is overdue. In fact, the current levels of the yen are approximately where they were before the US took up quantitative easing and, in that sense, restores the relationship. But in the immediate term, and from the perspective of different nations, some are concerned about a lower yen.

South Korea is perhaps the clearest case, as a lower yen increases competition by making Japanese products cheaper in markets like the US and Europe. This is notwithstanding that the won crashed heavily in the aftermath of the global financial crisis whereas, as already noted, the yen appreciated.

No other Asian nations are as concerned as South Korea, although currency and competitiveness do matter. Take Thailand, which has major manufacturing dealings with Japan, with automakers having their regional base in Thailand, and a strong export-orientation. The Thai baht has appreciated notably over the last year and, while the administration of Prime Minister Yingluck Shinawatra at first said that this was not a major concern, the government is now seeking measures to stabilize the baht.

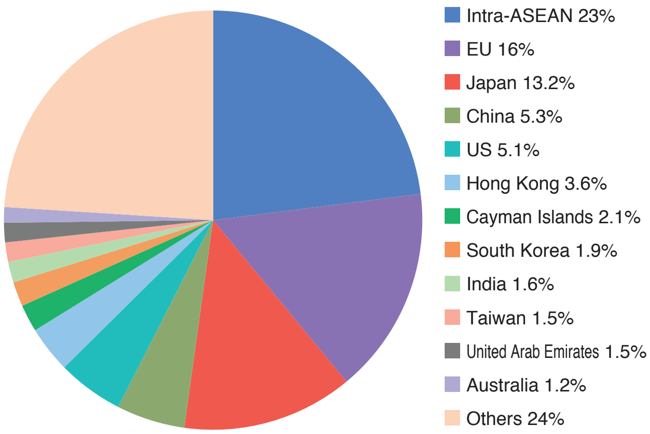
For our present discussion, it is however important to note that these concerns are expressed primarily *vis-à-vis* the dollar and not the yen. A weaker yen has mixed impacts on the Thai economy given that there are intermediate goods and other imports from Japan that then become cheaper. The same is true of other ASEAN economies and their currencies.

CHART 1
ASEAN's trade by partner (2011)



Note: Total trade value for ASEAN is US$2.4 trillion. 'Others' includes United Arab Emirates, Saudi Arabia, Switzerland and all countries with under 1% share
Source: ASEAN Merchandise Trade Statistics Database, ASEAN Secretariat 2012

CHART 2
Sources of FDI inflow to ASEAN (2011)



Note: Total FDI inflow to ASEAN is US$114 billion. 'Others' includes inflow from Canada, Russia, New Zealand, Pakistan and all countries with under 1% share
Source: ASEAN Foreign Direct Investment Statistics Database, ASEAN Secretariat 2012

2nd Arrow of Fiscal Policies

The Abe government has begun investment in public works and renovation of infrastructure, coupled with support for companies to invest more in research and development, hire more workers, pay higher salaries, and other measures. This aims to strengthen Japan's industries while stoking domestic demand.

Yet, even if Japanese domestic demand increases, some think this will not benefit Japan's trade partners. There is some concern that as the yen gets weaker, imports become more expensive so that consumers will buy fewer foreign goods, and exports from other Asian countries to Japan may in fact decline. This is, however, premised on a static equilibrium model of demand. If there is palpable growth and increases in Japanese demand — at corporate and consumer levels — then these dynamics may well generate an increase in the *total* amount of imports, even if the ratio of imports (as compared to products made in Japan) is unchanged. Even more so if reform leads the Japanese economy — still largely driven by domestic demand — to become more open.

This is especially true when we look at the nature of the Japanese economy and the imports into the country from the rest of Asia. The majority of imports from ASEAN especially are not primarily in final goods (except where these are manufactured by Japanese companies themselves). Instead, Japanese production networks have deeply intertwined their national economy with others. Consequently, imports from ASEAN are traditionally more in resources and intermediate goods and managed within that supply chain or even the same company.

This relates to Japanese FDI across ASEAN. Abenomics has coincided with a push for Japanese companies to come back out into ASEAN. Japanese domestic production cannot absorb all the funding from Abenomics, given that labor and other costs remain high. The triple tragedy of 2011 also shows the potential vulnerability of keeping too much production at home. For these reasons, Japanese companies have been pushing out into the region. ASEAN too is out-performing other regions and the Japanese are keen to tap into these markets.

Notable recent investments from Japanese companies include Toyota's $2.7 billion investment to expand production facilities in Indonesia (on top of its existing and still growing commitments to Thailand). Another was the bid to buy Thailand's Bank of Ayudha by the Japanese financial group MUFG, worth about $5.9 billion (depending on acceptance of the bid by shareholders and approval by the Bank of Thailand).

In the past decade, the outward push of many Japanese companies was into China. But with a slowing Chinese economy and, even more, the tensions between Beijing and Tokyo over disputed islands increasing since the end of 2012, ASEAN has increasingly been the focus.

3rd Arrow of Structural Reform

The first and second arrows have already been fired. Signs are that Japan's real economy is already picking up, with GDP rising due to more consumer spending, a higher employment rate and some increase in wages . But many see that these efforts are only the beginning — like the ignition and starter motor of a larger engine.

For the medium and longer term, Japan must restructure its economy — both the public and private sectors — not only to enable investments abroad, but also to ease and facilitate investment within Japan itself. Only then — to continue the analogy — will the engine itself begin to run and drive the economy. Domestically, this will involve structural reform in major economic sectors, increasing productivity and stimulating demand — from both corporations and consumers.

Details have yet to be finalized but the Abe administration has begun to outline some of the priority areas. These include efforts to improve Japan's human capital and provide better working opportunities for young people, including women, and also for older workers (provided they are healthy and willing). Productivity rises and innovation will be key. Providing the right environment for active R&D and innovations by the private sector is critical to improving technology and productivity ("Challenges of Abenomics" by Masahiro Kawai, ADB Institute, June 14, 2013).

Japan's example here is being watched closely by other Asian governments as they face, now or in the future, similar challenges — in managing aging societies for instance. Moreover, there is increased scope for interaction between Japan and the rest of Asia in some areas.

At a macro-level, Japanese structural reform can benefit from being tied to ongoing negotiations on economic and trade agreements, especially the Trans-Pacific Partnership (TPP) that also includes the US and 10 other countries. Meant to be a "high standard" agreement, the TPP goes further than measures in other regional agreements and the World Trade Organization negotiations to try to deal with issues behind borders.

Another key agreement is the Regional Comprehensive Economic Partnership (RCEP) that is centred on ASEAN and brings in all major Asian countries, including China and India (which are not in the TPP). Negotiations have only begun in 2013, and it is not clear how quickly the RCEP will move or what its level of ambitions might be. Japan is now a key player in these economic agreements as a major economy involved in both the TPP and RCEP (in contrast, the US is not in the RCEP and China stands presently outside the TPP).

This can be useful to Abenomics not only in trade diplomacy, but also and more fundamentally for the third arrow of structural reform. Reform will bring some pain from the adjustments and will generate opposition. But these can, through the TPP and RCEP, be balanced by gains from concessions by others. Once agreed, moreover, these agreements with other governments can provide external anchors for Japan's domestic reform.

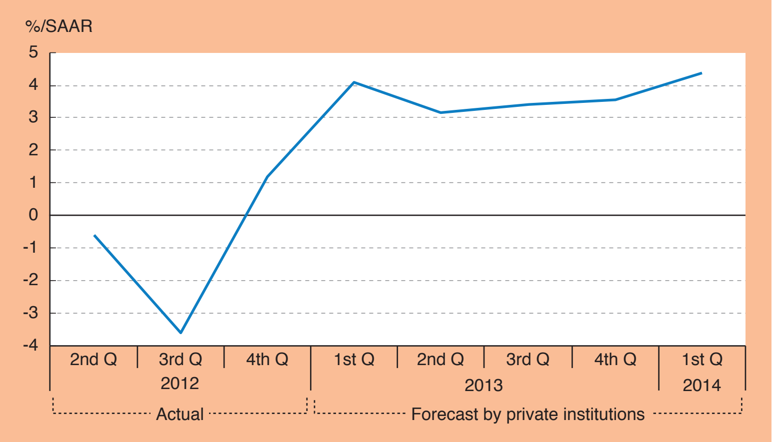
While traditional flows of investment have been from Japan to the rest of Asia, there is potential for a growing number of Asian firms to invest in Japan. To boost foreign inward-investment, deregulation is necessary, and Japan must incentivise new sectors, perhaps through tax incentives and tax reform. A fair business environment is critical, and the Abe administration is working to create a single window of procedures to make it easier for companies to invest, specifically targeting Singapore and other ASEAN members.

At the micro-level of people-to-people contact, we can hope that structural reforms will bring more Asians into Japan as its service and other sectors, and university education systems, are liberalized. Employment possibilities for other Asians with skills and qualifications may also become more available — at least in selected sectors and perhaps some special economic areas.

If these come to pass, then the structural reform of Abenomics will not only revitalize Japan but also enable an even deeper integration with ASEAN, with greater volume of exchange and a two-way direction.

CHART 3

Japan's real GDP growth rate (2012-2013)



Note: SAAR refers to Seasonally Adjusted Annual Rate. ESP Forecast Survey shows the average of forecasts by 41 institutions.

Source: National Accounts of Japan, Cabinet Office 2013, ESP Forecast Survey, Japan Center for Economic Research 2013

Conclusion: Political Questions

While Abenomics is an economic policy, there are clearly political dimensions — both domestically and externally. The Abe government has made a point of prioritizing its diplomatic outreach to ASEAN countries. At the start of 2013, Abe made his first foreign visit since becoming prime minister to Vietnam, Thailand and Indonesia. Other cabinet members did likewise: Finance Minister Taro Aso visited Myanmar, while Foreign Minister Fumio Kishida travelled to the Philippines, Singapore, Brunei and Australia. Some might say that the Abe administration has followed the US and Obama in pivoting toward Asia and, especially, ASEAN.

But (also like the Obama administration), the Abe government has faced increasing tension with China. Triggered by arguments over disputed islands in the East Asian Sea which Japan controls and China claims, this flared first into riots on the mainland against Japanese manufacturers and products, and now seems to have changed the overall tone of Beijing-Tokyo relations for the worse.

Reviving the Japanese economy in this political context means that many Japanese are looking to ASEAN not only for its intrinsic attractions but also as part of a policy that is "Anywhere but China". Japanese-Chinese competition in economic and trade diplomacy may also heat up, as it did in the earlier period of the 2000s when both sides were negotiating free trade agreements with ASEAN.

Abenomics also has another political dimension in bolstering Abe's approval ratings. Following the upper house election in July, the ruling coalition led by the Liberal Democratic Party now controls both houses of parliament and can smooth the passage of legislation to support reforms and new initiatives. With this political consolidation, Abe is positioned for a three-year term in office — much longer than any premier since 2006 — and can make bold changes. Yet some wonder what his priorities will be.

Keeping up reforms will be a challenge. The first quarter of 2013 has seen a growth of 4.1% in the economy, while the Japanese stock market has soared by 80% in the same period. But with a public debt of 240% of GDP, quantitative easing and public-works spending cannot last into the long term. Financial consolidation and structural reform remain critical, and will be difficult and painful to some vested interests. It remains to be seen if Abe will focus and expend his political capital on this task *(Chart 3)*.

To the contrary, some judge him to be an assertive nationalist who will, given tensions with China, try to gear Japan to strengthen its defense forces and seek to amend the relevant Constitutional provisions. While some argue Japan has the right to be a more normal country, these steps will be controversial both at home and abroad — especially in Beijing. The danger is then that Beijing-Tokyo tensions and competition increase and spill over into relations with ASEAN and negatively impact regionalism.

Japan is important to the world and ASEAN. Abenomics is correctly being watched for both its potential benefits and possible problems. If Japan succeeds in finding a path to sustainable growth, its role in the region will grow.

But even if Abenomics succeeds, Japan's role will also change. It will not return to the past when Japanese dominated the region, and invested mainly for cheap land and labor, with little or no other competition. The coming relationship between a rising ASEAN and a revitalized Japan can and should instead be more two-way, and more of a partnership in which both gain and are more deeply integrated. This should then be a key pillar in community building for Asia and the Asia-Pacific region. JS

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