

## **Japan's growing Asia focus: Implications for Korea**

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## **Japan's growing Asia focus**

Over the past decade the Japanese economy has increasingly turned toward Asia. Perhaps the first indication of this was the 'Asian flu' episode of 1996-7 when the Japanese and other Asian financial markets collectively nose-dived. After the collapse of Japan's 'bubble economy' at the end of 1989, outward FDI (especially toward the US) virtually collapsed. This initial collapse was then followed by an investment boom in Europe, as a countermeasure to 'fortress Europe.' The most recent phase, which we might date from 1999 (after recovery of the Asian countries from the crisis of 1997), has been quite different. This new phase has been characterized by a new Asia focus of outbound Japanese FDI. Furthermore, the changing patterns of trade, which have seen China and Korea become increasingly important trade partners for Japan. In this paper, I explore these stylized facts, and the implications for the economies of the countries involved, particularly Japan and Korea.

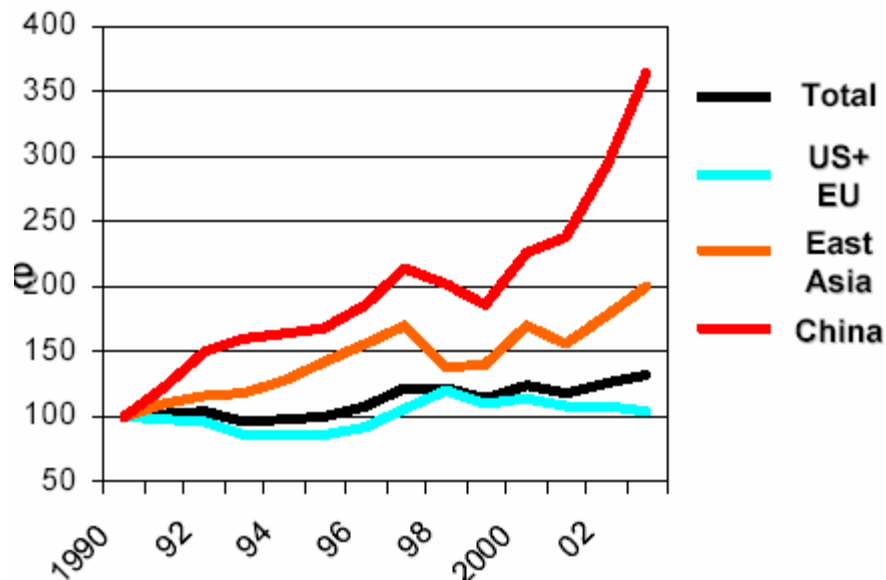
While export growth has been reasonably strong for Japan since 2000, this has been far more pronounced with respect to export growth to East Asia in general, and especially to China.

While exports to the US and EU grew by 40% since 1990, those to East Asia in its entirety have doubled, and those to China have more than tripled (Canadian Embassy, 2004). Indeed, most of this growth has occurred since 2000. Not surprisingly, this export growth has been focused on components and capital goods, supporting both indigenous manufacturing growth in the region, and Japanese FDI. This boom has helped to support not only high tech components manufacturers, but also otherwise moribund producers in industries such as steel and heavy equipment.

Recent Japanese export growth is sometimes dismissed as some sort of orchestrated attempt for the country to 'export its way out of stagnation.' It is difficult to understand how the authorities could somehow simply create export growth by fiat. Furthermore, many observers fail to understand that Japan is not terribly dependent on trade. The value of Japanese imports and exports both tend to hover in the 10-13% range, about the same level of openness as the U.S. This contrasts sharply with the countries of Europe and Canada. By contrast, Korean export growth has been an important part of the recovery story since 1997. Indeed, Korea is heavily trade dependent, with the total value of trade equaling roughly 65% of GDP (WTO, 2002).

Japan's growing Asia focus with respect to trade should be viewed as directly related to economic restructuring. Unable to reduce manufacturing costs at home, Asia has increasingly become the home of affiliates of Japanese manufacturers. Such a trend naturally results in growth in both exports to and imports from the rest of Asia. Japan's shrinking and aging population also adds to these trends. Inefficiencies in the agricultural sector and reduction in protection of that sector has helped to increase food imports from the rest of Asia.

Japanese exports (1990=100)

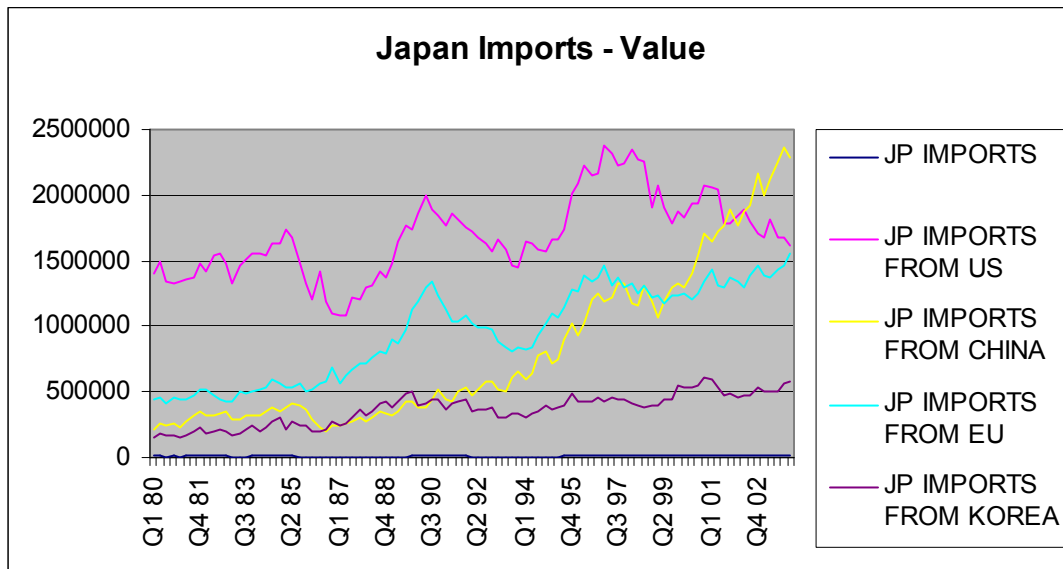


These trends are part of a growing East Asian interdependence. Japanese firms export the capital goods, steel, heavy machinery and components necessary to support the growth of East Asian manufacturing, and in turn import many of the components and consumer goods produced in the rest of the region. For example, Japanese firms produce 22% of all goods imported by other East Asian countries. Furthermore, 24% of Japanese exports are to affiliates of Japanese firms located in China (Canadian Embassy, 2004). It is this growth in firm to firm trade in the region that is behind the explosion of Japanese trade in East Asia.

For Japan, these changing trade patterns are essential. Naturally, growth in trade between Japan and the US and EU has been limited by the modest economic growth rates to be expected among these mature economies. On the other hand, Japan is situated in a region that is characterized by more rapid economic growth (excluding Japan). This trend has been one of the few bright points in an otherwise bleak economic outlook for Japan. This has been reflected in recent economic

statistics, which have recently shown growth in Japan's private sector, and has been reflected in profitability and a reduction in corporate bankruptcies and debt.

For Korea and the rest of East Asia, this growing Asian focus of the Japanese economy is similarly positive. Japanese imports from the region have exhibited rapid growth, especially relative to those from the US and EU. This, in turn, has helped to fuel the relatively strong economic growth in East Asia ex-Japan. Indeed, this growth in Japanese imports from the rest of the region was an important factor in helping countries like Korea overcome the difficulties associated with the Asian crisis of the late 1990's. Far from the dire predictions of a Japan that would hold the rest of East Asia back from recovery, the robust growth in Japanese imports from the region was a significant contributing factor in East Asian economic performance since the crisis.



Of course, this begs the question of why the Japan's trade with East Asia has remained robust despite its sluggish economy, and also whether it is a sustainable trend. This is of crucial importance to economies like Korea's. If growth in interdependence of East Asian trade has made Korea more dependent upon trade with Japan, any diminution in this trade could have negative consequences for the Korean economy. Indeed, while Japanese imports from Korea have been growing, the growth has been insignificant when compared with China. We must ask, therefore, whether Korean export growth to Japan is sustainable, and whether there is any reason for it to expand.

In order to consider these issues, we must first understand what has underpinned Japan's increasing Asian focus. After the Asian Crisis, structural reforms in East Asia ex-Japan were rapid and dramatic. Korea's recovery in particular was far more dramatic than had been predicted. While much of this success was no doubt related to the implementation of structural reforms, restructuring at the microeconomic level cannot be ignored. Combined with the relatively cheap currency that prevailed after the crisis, the cost structure and productivity of many Korean firms improved dramatically. At the same time, China with its relatively undervalued currency increasingly became the factory for the world. Japan, on the other hand has experienced great difficulty in improving the cost structure of its manufacturing sector, primarily due to the very slow pace of restructuring in that country since 1990. This has meant that many Japanese firms have become increasingly dependent upon imported materials and components from East Asia in order to reduce production costs (WTO, 2002).

This trend has contributed to something of a breakdown in the keiretsu-style of supply

management. Bankruptcies and downsizing have been heavily focused among the small-medium sized firms that have traditionally supplied larger Japanese firms. This substitution of imported components for domestically produced components should be viewed as a 'permanent shock' to the supply management system, rather than a temporary phenomenon. Rebuilding the parts of the keiretsu-style supply management system that have been eroded by imports of relatively cheaper components would be costly and essentially impossible with the cost structure of many larger Japanese firms (Beason and Patterson, 2004). It would appear that Japan's East Asian trading partners will continue to enjoy their current position in the supply chain for the indefinite future unless there is a radical change in the pace of Japanese restructuring, a radical depreciation in the yen or both.

It would be unfair to say, however, that this growing interregional interdependence is of one-sided advantage to East-Asia ex-Japan. It would be unreasonable to expect radical restructuring of the supply chain domestically in a country with a shrinking, largely white-collar labor force. Japan's growing dependence on imported components from East Asia allow it to gracefully exit from production of goods where it has no cost advantage. This, in turn, has allowed many larger manufacturing firms a new lease on life. The recent resurgence in the Japanese automobile industry is due at least in part to the more competitive approach to supply chain management, of which imported components are a major factor.

Furthermore, as outlined earlier, growth in component production in East-Asia ex-Japan has benefited Japanese exports. Japan is still a major supplier of sophisticated capital goods and heavy machinery, and this helps to explain the large proportion of total East Asian imports from

Japan. That 24% of all Japanese exports are to affiliates of Japanese firms in China helps to illustrate the two-way nature of the relationship. Indeed, capacity constraints throughout East Asia have helped to boost sagging Japanese heavy industries like steel and shipbuilding, sectors that just a few years ago were given up for dead.

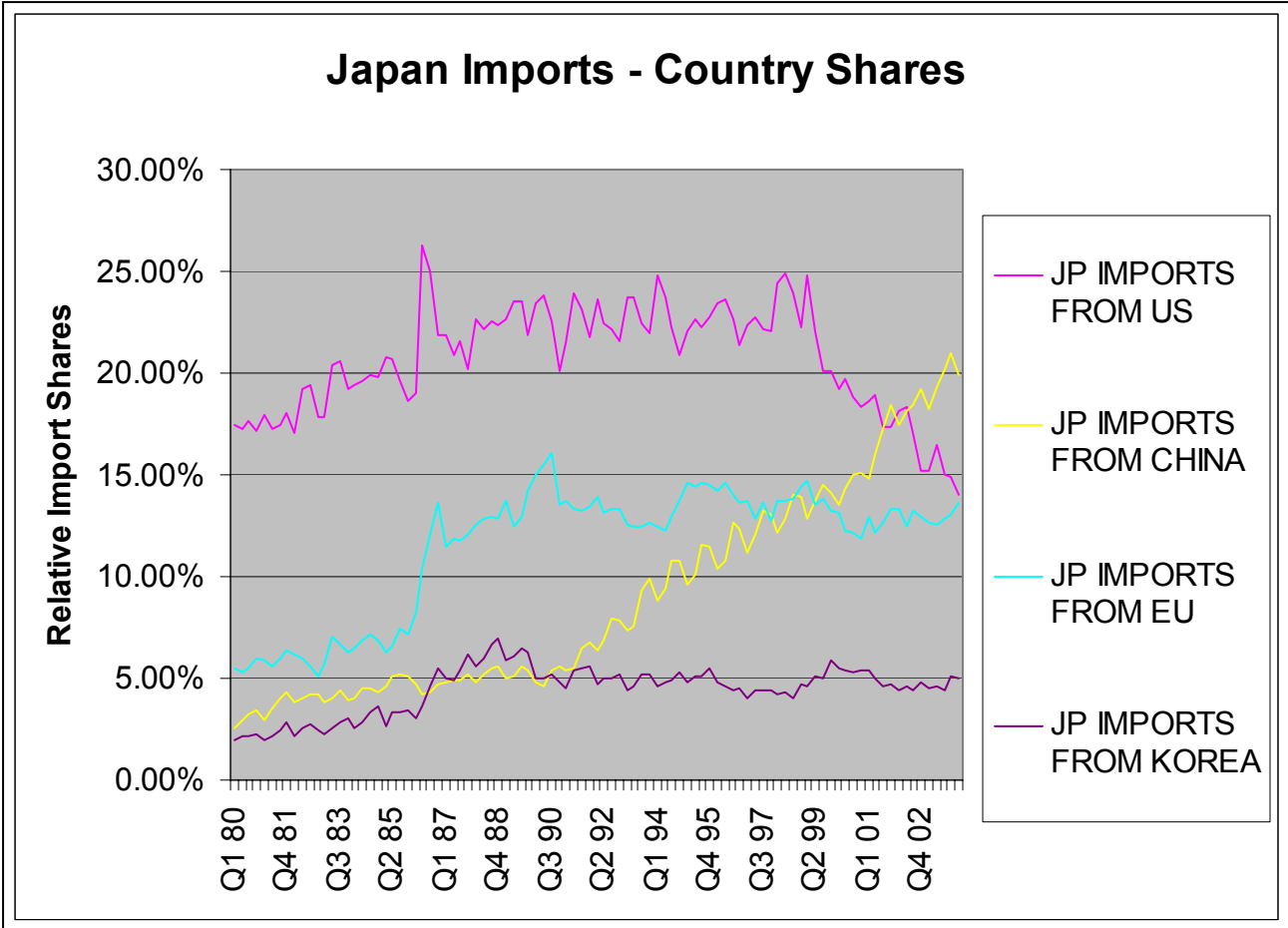
While growing interdependence in the supply chain is a big part of the story in terms of Japan's growing East Asian focus, it is not the only part. Like the US and EU, Japan is also a major importer of consumer goods from East Asia. Not surprisingly, goods such as food products, clothing and textiles have comprised a major portion of these imports. Production of consumer durable goods by Japanese firms has increasingly shifted to Asia, leading to further growth in imports of consumer goods by Japan (WTO, 2002).

### **The Korean story**

While the trends outlined above seem to bode well for Korea, and suggest sustainability, there is clearly room for improvement. Japanese imports from Korea have seen growth, but nothing at all like those from China. While there was a regime shift driving part of this, China's entry into the WTO, this is not the whole story. Since the formation of the WTO, Korea and Japan have also strengthened their multilateral approach. Especially for Korea after 1997, there has been rapid harmonization of tariff and other trade policy. Korea's average applied MFN tariff rate is now in the 13% range, roughly 7% for industrial goods and 50% for agricultural products.

While this is higher than Japan and most other industrial nations, it represents good progress (WTO, 2000). Quotas have largely been eliminated except for beef and rice, and further liberalization is expected.





Also, restructuring in Korea has resulted in a more competitive labor market and manufacturing cost structure. The real question is whether these changes are adequate enough to allow Korea to move beyond its role as provider of steel (and other materials) and foodstuffs to Japan and increasingly become a base for Japanese manufacturing affiliates. It is unlikely that any such trend could mirror that in China. China benefits from exceptionally low labor costs and an undervalued currency that Korea could never hope to rival. On the other hand, for higher-end manufactured products, Korea has the right combination of highly skilled labor, relatively lower production costs (compared with Japan), proximity to Japan and liberal trading regime that suggest brighter export growth prospects in the future.

There are other trends that suggest that Korea, along with China, will continue to see growth in food exports to Japan. Population trends in Japan do not favor a long-term continuation of protection of the food sector. Until those trends become noticeable, however, Japan's current heavy reliance on quotas in the food and agriculture sector ironically favor imports from Korea. The lion's share of most quotas are allocated to Japanese trading houses, rather than directly to Japanese producers. These trading houses have an incentive to source cheaply, and as such tend to turn heavily to Asia (WTO, 2002). Relationships between the Japanese trading houses and their Korean counterparts have been favorable to growth in imports from Korea.

While not purely economic in scope, the elimination of restrictions on imports from Japan will doubtless spur greater two-way trade between Korea and Japan. In many cases, the restrictions made FDI difficult. This was not simply due to the restrictions themselves, but the fear on the part of potential Japanese investors that they would be unable to export components and capital goods to their affiliates in Korea (WTO, 2000). With these restrictions lifted, and an increasingly open attitude toward Japanese FDI, we can expect to see some of the same trends already witnessed in China, albeit somewhat muted. Specifically, we can expect growth in Japanese exports to Korean affiliates, and growth in exports from these same affiliates to Japan.

### **Other implications**

So far, the discussion has centered on Japan's growing East Asia focus in terms of trade and FDI. Perhaps the greatest implications of these trends, however, are in terms of business cycles. Diversification of trade partners (or diversification of the size of trade partners) allows for the

possibility of different business cycles among partners. That is, when a trade relationship is primarily bi-lateral (as in the Canada-US relationship, or the Japan-US relationship as it had been), then poor economic conditions in one country are obviously more likely to spill over to the trading partner. When the trade relations are more diversified, then it is less likely that a country will be negatively affected by the poor economic conditions experienced by one partner alone. Clearly, the growing importance of inter-Asian trade has been good for Japan in this sense, and has reduced the dependence on the US economy. Similarly, Korea, China and other countries have experienced increased demand for their products from Japan, and have similarly been able to reduce their dependence on the US. Furthermore, growth in inter-Asian FDI has deepened these relations, and laid the basis for further growth in regional trade.

From the perspective of Japan, increased interregional trade has also meant more rapid trade growth. As trade within Asia replaces trade with the US and Europe, the average economic growth rate of trade partners has risen. That is, Japan has increased the share of trade with rapidly growing economies as opposed to mature economies. This will imply more brisk growth in trade, and has already been an important factor in helping Japan emerge from its slump.

For the Korean economy the implications are similarly positive. Japan represents a very large and developed market with a proximity that allows for trade in products where transportation costs dominate. In particular, food products, steel and similar goods with high transport costs benefit significantly from the increasing Asian focus of Japan. For the time being, this trade

growth has remained modest for Korea, but we can expect this to change for the reasons outlined above. In the case of China, for example, growth of Japanese FDI was accompanied by capital goods and services exports to China, and the eventual growth of exports of goods to Japan. The Korean pattern, to date, has not involved dramatic growth in FDI from Japan, but the incentives for this to change are in place. Manufacturing costs in Japan have become prohibitive in a number of fields, and the result has been Asian-focused off shore production and the accompanying FDI. The accompanying diversification of trade should continue to be a positive factor in the mitigation of business cycles in the region.

Overall, the diversification of Japanese trade and FDI and its growing Asian focus has been beneficial to the economies of Asia, and Korea is no exception. We expect the trend to continue, and for the benefits to Korea to be substantial. The key factor for Korea, as it has been for China, will be its ability to attract Japanese FDI and growth of Japanese affiliates in Korea. Japanese restructuring and demographic trends essentially require that Japan increasingly turn to East Asia as a manufacturing base. Judicious public policy in Korea can help to accommodate this to Korea's benefit.

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