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Japan and Management of the Transatlantic Crisis: International Responses and Domestic Struggles[1]

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Abstract

In addition to the perceived transformation of the international system brought about by the relative materialistic decline of the U.S. hegemonic power, the crisis has also intensified ideational rivalry and tensions between the U.S.-led capitalist model and the "Beijing Consensus". This article aims to examine how the structural transformations in both materialistic and ideational contexts, symbolised by declining U.S. influence and growing Chinese voices, has influenced Japan, a key U.S. ally in the region and China's regional competitor. Based on a neo-classical realist framework which stresses the need to analyse domestic political processes, this article sheds light on the influence of these structural transformations on Japan's efforts to formulate its new growth strategies by rearranging policy priorities and engaging in regional and international collaborations. Since the crisis took place during a period which saw the demise of LDP's five-decade rule and the advent of the DPJ government, the article analyses to what extent the economic stimulus programmes (launched by both old and new governments respectively) differed, and assesses how they have been effective in terms of stimulating domestic demands. The article also highlights Japan's efforts under the crisis-led structural transformations to involve fast growing Asian economies in its new growth strategy and to engage in the regional financial cooperation including the Chiang Mai Initiative Multilateralisation.

Introduction

The collapse of the U.S. banking sector in September 2008 has had an adverse impact on the global financial system. Economies across the world experienced severe strains in their finance industries, compelling many governments to nationalise their banks while putting in place stimulus packages to reinvigorate their domestic markets. As former U.S. Deputy Treasury Secretary Roger Altman (2009, 1) argues, one of the most significant implications of this crisis is related to power shift: 'the financial and economic crash of 2009, the worst in over 75 years, is a major geopolitical setback for the U.S. and Europe'. While financial institutions in Asia are relatively unscathed from the economies which depended heavily on the American and European markets suffered from the consequence of an overall decline in world demand and a pervading pessimistic business climate. Japan was no exception, having (then) the second largest economy in the world which relied heavily on both markets as its key export destinations. This article aims to examine how structural transformations in both materialistic and ideational contexts, symbolised by declining U.S. influence and growing Chinese voices, have influenced Japan, a key U.S. ally in the region and China's regional competitor.

Based on the neo-classical realist framework which stresses the need to analyse domestic political processes alongside structural considerations, this article sheds light on the influence of these structural transformations on Japan's efforts to formulate its new growth strategies by rearranging policy priorities, and engaging in regional and international collaborations. This article firstly looks at how the crisis has intensified the ideational rivalry and tensions between the U.S.-led capitalist model and the Beijing Consensus and the perceived transformation of the international system in which the relative materialistic decline of the U.S. hegemonic power has been challenged by China. It then gives an overview of Japan's economic conditions and its key considerations in the current ongoing crisis, including the launch of a series of stimulus packages by the Democratic Party of Japan (DPJ)-led government which has strove to manage the impact of the financial upheavals. Since the crisis took place during a period which saw the demise of Liberal Democratic Party (LDP)'s five-decade rule, this article examines the extent to which the economic stimulus programs, launched by both the old and new governments respectively, were effective in terms of stimulating domestic demands. Finally, the article explores Japan's international endeavours to manage the problems created by the financial crisis through cultivating new export markets in overcoming the tailspin in demand from its tradition markets in the West. It highlights Japan's efforts under the crisis-led structural transformations to involve fast growing Asian economies in its new growth strategy and to engage in the regional financial cooperation including the Chiang Mai Initiative Multilateralisation and an East Asian community idea.

Materialistic and ideational transformations of the international structure

The collapse of Lehman Brothers in September 2008 was seen as the trigger of the global financial crisis. However, signs of an impending financial catastrophe were on the wall as early as in August 2007 when France's largest bank, BNP Paribus suspended three of its funds linked to investments in U.S. subprime mortgages. This was shortly followed by the failures of government-backed U.S. financial giants such as Fannie Mae and Freddie Mac. The primary cause of the crisis was the U.S. housing boom fueled by the availability of and ease of access to bank credits, resulting in massive lending to aspiring home-owners with poor credit records, known as subprime borrowers. The subprime loans, in turn, were securitized innovatively by the financial institutions in the form of collateralised debt obligations to attract more investors through the lure of higher returns. As interest rates climbed, the number of home loan defaults and foreclosures also increased, bringing about a loss of investor confidence and injecting the chain effect of a contagious global financial crisis.

Historically, developments of a worldwide consequence such as the 9.11 terrorists' attacks have a tendency to reshape the international political and economic landscape (Ong 2010). Economic crises, in particular, unsettle prevailing entrenched interests and regional arrangements, and provide opportunities for new reformist coalitions to form (Jayasuriya 2008). While the ongoing crisis, second only to the Great Depression of the 1930s, is a global phenomenon in nature, the economic and reputational damage solely to the U.S. hegemonic power was unprecedented. The International Monetary Fund (IMF) (2009, 30) in its *Global Financial Stability Report* attributed US$2.7 of the US$4.1 trillion global losses in the current crisis to the U.S. banking sector alone. By the end of 2008, U.S. banks had reportedly accumulated write-downs amounting to US$510 billion (*New York Times* 2009). At the micro-level, the crisis also forced U.S. financial institutions to severely curtail their investments overseas. For example, the Bank of America was compelled to sell its stake in China Construction Bank (CCB) in January 2008 and again in May 2009 to boost its own capitalization, a move which reduced its holding of the prominent Chinese bank from 30 to 11 percent (*Xinhua* 2009a). Likewise, Citigroup had to give up its holdings of Nikko, Japan's top three securities groups, less than three years after gaining a foothold in the Japanese market (*Japan Times* 2009a).

The material damage to the U.S. economy extended to the non-financial sectors. US multinational companies, which were once considered prospective challengers to replace the traditional role of the state, such as General Motors (GM), collapsed one after another like a deck of cards. In automobiles, for example, the sales of new vehicles fell to a 25-year low in the U.S. in 2008. Total auto production and domestic sales by GM, Chrysler and Ford, collectively known as the Detroit Three, registered almost a 25 percent decline in 2008 (DOC 2009, 59). The subprime crisis, coupled by rising fuel price, led to a drastic fall in motor sales. The U.S. government eventually had to bail out GM and Chrysler. The woes of the U.S. automobile industry hurt not just the automakers but also its upstream and downstream peripheries, including parts suppliers and car dealers. The magnitude of damages to U.S. assets was so overwhelming that McKinsey & Company concludes in its analysis of the crisis that the U.S. role in the world economy, its leadership of capitalism and democracy, and its 'moral authority', had been severely weakened (Webb 2009). Others point to the 'lack of basic crisis leadership' by the U.S. and the failure to take decisive action in dealing with the crisis (Fisher 2008, 6). The crisis's 'tsunami effect' on the U.S. economy, coupled with the perceived poor handling of the economic upheaval by the U.S. administration, marks the genesis of an increasingly disgruntled international community towards the U.S. capitalist model.

On the other hand, while the Chinese economy has not been spared from the impact of the crisis, Beijing was in a far better position than the U.S. to ride out the crisis, and to emerge as an ever more important global actor. In the finance sector, for example, the Chinese banks now dominate the ranking of the world's best banks by market capitalisation (*Economist* 2009), while the Chinese stock market was forecasted to surpass that of the U.S. to become the world's largest by value within three years (*Bloomberg* 2009). Outside of the finance sector, 43 Chinese companies were listed in *Fortune*'s world's 500 largest companies, marking a sharp increase from only eight Chinese companies a decade ago (*Xinhua* 2009b). These figures indicate China's growing economic influence, as was shared by U.S. Treasury Secretary Timothy Geithner, who declared that 'China is playing a very important stabilizing role in the international financial system' (*Wall Street Journal* 2009).

Aside from the transformation in the international structure in terms of material capabilities between the U.S. and China, the crisis has also brought to the fore the ideational rivalry between the 'Washington Consensus' and 'Beijing Consensus'. Despite Williamson's (2008) claims on the misrepresentation of his original intent for the Washington Consensus, it has become to be viewed as synonymous with neoliberalism and market fundamentalism. For Stiglitz (2008, 49), 'the failures of the Washington Consensus became increasingly evident - especially after the crises, beginning with the Mexican crisis and followed by the East Asian crises, the Russian crisis, and the Argentine crisis'. Stiglitz's criticisms of the Washington Consensus bear resemblance to the key tenet of the ideas espoused by Ramo (2004, 5) on the Beijing Consensus which, he argues:

> contains many ideas that are not about economics. They are about politics, quality of life, and the global balance of power. Inherently, this model sets China and its followers off against the development ideas and power needs of the status quo.

The Beijing Consensus sounded attractive for nations which strive not only to develop but to:

> fit into the international order in a way that allows them to be truly independent, to protect their way of life and political choices in a world with a single massively powerful centre of gravity (Ramo 2004, 3).

In other words, the Chinese were seen as wanting to:

> control, localize and administer their own global future. This has instinctively set them up against the kind of mail-order prescriptions of the Washington Consensus and distanced them from the whole history of first-world economic advice. Beijing is determined to find its own route (Ramo 2004, 33).

The ongoing crisis could thus be seen as a vindication of the Beijing Consensus in many ways. For example, the anti-thesis against state interference in the markets, as promoted by the Washington Consensus school, has lost some footing in the wake of Obama Administration's strong push to overhaul the U.S. banking sector by placing its banks and financial markets under stricter government supervision. In effect, the proposed banking bill empowered the U.S. government to 'constrain the activities of big banks, including forcing them to divest certain operations' and expands 'the regulatory reach of Washington's major agencies' (Holzer 2010). On the other hand, the pragmatic ideas of economic development espoused by the Beijing Consensus camp have won more supporters after this crisis. Beijing's quick and decisive injection of a four trillion-yuan package in November 2008 was touted as a crucial state intervention which lifted China out of the global economic doldrums in double time. *The Economist* (2010, 41) reports that the Chinese development model has attracted many admirers from developing countries which now seek 'to copy 'the China model''. This observation is echoed by Halper (2010, 134) who insists that a 'growing number of countries are starry-eyed about the new alternative development model – and its billboard in Beijing'. In one of the strongest indication of the ideological shift, the crisis has intensified the partnership between the four developing BRIC (Brazil, Russia, India and China) countries. At a meeting to discuss the global financial crisis in Russia in June 2009, the BRIC countries reportedly advanced the possibility of dumping the U.S. dollar as the world's reserve. This ideological swing away from the Washington Consensus is encapsulated in Brazilian President Lula da Silva's pronouncement after the meeting that 'a new global economic geography has been born' (*Asia Times* 2010).

The crux of this ideological debate sparked by the global financial crisis on the part of Japan is whether Japan supports the Chinese or Washington consensus and how the financial crisis affects the policy diagnosis preferences. Japan used to be at loggerheads with the U.S. over attempts to open up its markets in the 1980s and 1990s, and was accused of promoting a developmental state model which shared elements such as the governmental intervention in the markets with the Beijing Consensus. As will be discussed in more detail, there is a strong impulse to lean towards the Chinese approach, with Prime Minister Yukio Hatoyama's interest in working together with China in his attempt to create an East Asian community an example of this turn to the East. However, China and Japan differ over political and economic values such as the promotion of democracy, human rights or intellectual property rights, and this fundamental difference will never allow Japan to fully join the Beijing Consensus camp, leaving Japan in a delicate position in its relations with China.

Japan's responses to the crisis: domestic measures

In Japan, the crisis has heightened policy-makers' awareness to the transformation of the international structure caused by the rapid growth of the Chinese economy and its rising influence in the global economic and political landscapes. While the international structure is the springboard for this analysis, Japan's foreign policy responses in the crisis can be explained more precisely through the examination of its domestic political situations by tracing the perceptions, ideas, or roles of individuals or organizations in domestic politics (Terada 2010). Christensen and Zakaria, for example, highlight the ability of 'perceptual 'shocks', in which single events suddenly make decision makers aware of the cumulative effects of gradual long-term power trends' (cited in Rose 1998, 160). While recognizing that structure is an important independent variable, this article maintains that foreign policy is contingent on the capacity of the state to mobilize resources and implement policy changes as 'a domestic-level intervening variable' (Rose 1998, 153). Neoclassical realism utilises domestic politics 'to explain why states do not heed the imperatives of the system' (Rathbun 2008, 298). Furthermore, a neoclassical realist approach to this discussion is appropriate given that the present crisis coincided with the cessation of the LDP's rule of more than half a century and the subsequent installation of a new coalition government led by the DPJ. In his analysis of the current crisis, Chief Adviser to the China Banking Regulatory Commission, Andrew Sheng (2009, 409) declares that 'all financial crises are crisis of governance… All crisis have to be solved by governments, and if not satisfactorily, by the next government'.

In Japan, the magnitude of U.S. banking failure had not been perceived so destructively during the early stage of the crisis. In fact, Japanese financial institutions greeted the collapse of Lehman Brothers and other U.S. institutions with a sense of optimism, and went on a spree to procure cheap U.S. assets at fire-sale prices during the onset of the crisis. For instance, Mitsubishi UFJ Financial Group acquired a 21 percent stake in Morgan Stanley while Nomura Holdings bought over the Asia-Pacific and European operations of Lehman Brothers in a deal pronounced by Nomura President Kenichi Watanabe as 'a once-in-a-generation opportunity' (*Kyodo News* 2008). On a global scale, Japan under the former LDP government, in the run-up to its own domestic election, also tried to assume a global leadership role by offering to steer the world economies out of the crisis. At the Group of 20 (G20) Summit in November 2008, then Prime Minister Taro Aso explained that Japan's experience in coping with a banking crisis in the late 1990s put the country in good stead to play a key role in addressing the global financial turmoil, and offered to provide up to US$100 billion to the IMF as an interim stop-gap measure (Cabinet Secretariat, 2008a).

As was the cases of Germany and Mexico which heavily relied on the U.S. markets for exports, the Japanese economy was also hit by the tailspin in world demand for its products. In automobiles, for example, the U.S. was a major market to the Japanese automakers, with Toyota and Honda selling more vehicles in North America than in Japan (DOC, 22). A major reason for Japan's exit from its decade-long recession in the 1990s, for example, was attributed to its strong exports, which accounted for approximately two-thirds of Japan's real GDP growth since the early-2000s (*Japan Times* 2009b). The falling demand for Japanese goods overseas due to the U.S. banking crisis began to worsen the economic conditions in Japan. The 2009 White Paper on International Economy and Trade (METI 2009a, 316) shows that Japan suffered the biggest decline in exports among the major countries, recording a 39.1 percent fall in its exports growth on a year-to-year basis in 2009. While Chinese exports also dropped by nearly 17 per cent year on year, Chinese companies primarily exported basic products such as general machineries and apparels to the U.S. Japan, on the other hand, exported higher value-added products to the U.S. particularly in automobile and transportation equipment sectors which were more responsive to the negative effects of a global financial meltdown helping to explain the relative severity of the decrease in Japan (METI 2009a, p.328-9). Adding to its exports woes, the Japanese economy also lacked the injection of a strong FDI inflow. IMF estimates that the stock of FDI inflow to Japan's GDP was less than one-tenth the average of other G7-countries (Khatri 2008, 210). Symbolically, Japan's status as the world second largest economy was lost against China by the second quarter of 2010 when the Japanese economy was valued at US$1.28 trillion compared to China's US$1.33 trillion (*New York Times* 2010). While it remains unclear as to how China's ascendance to the world second largest economy was directly associated with Japan's decreasing exports to a less import-oriented U.S., this symbolic replacement was partly attributed to Japan's futile struggle to recover from the decade-long depression.

To curtail the negative effects of the crisis on the economy, the Japanese government, under both the LDP and DPJ administrations, launched a string of initiatives to stimulate the domestic markets. Three months after assuming power and a year into the crisis, the DPJ government outlined its ambitious economic targets to increase Japan's nominal GDP growth by 1.4 times to 650 trillion yen, and to lower jobless rate to less than 3 percent by 2020 (*Yomiuri Shimbun* 2010). Nonetheless, a huge deficit spending by the previous LDP administrations left the DPJ government with an unprecedented level of government debt. IMF data suggests that Japan's net public debt amounted to over 85 percent of its GDP, which was one of the highest among OECD countries (Botman, *et al*. 2008, 47). The concern over Japan's fiscal health was so severe that it led to a stern warning by Standard & Poor's that Japan's grading would be downgraded unless the country took more steps to reduce its fiscal debts (*Financial Times* 2010).

In the meantime, in January 2010, the government launched a 7.2 trillion yen supplementary budget containing another slew of stimulus measures to boost the economy. The DPJ government will therefore face an uphill task to fulfill its election promises, which include the child-care allowance, the abolishment of highway road tax, and not raising the consumption tax. Yet Japan collected merely 9.5 percent of its tax revenue from consumption tax as compared to an average of 19.3 percent among OECD countries, and its overall tax ratio of about 26 percent is lower than most developed countries according to IMF estimates (Keen 2008, 64&69). Japan's worsening fiscal condition compelled the Kan government to consider reversing its election promise of not raising its consumption tax for at least four years. In February 2010, Kan, then the finance minister, announced that the government would accelerate discussion on tax revision. To fund these projects, the DPJ government announced the issue of new bonds worth 44.3 trillion yen, the largest in history despite DPJ's previous criticisms of the excessive issuance of government bonds by the previous LDP administrations. These domestic challenges, coupled by the scandal involving DPJ Secretary-General Ichiro Ozawa's illegal land purchases, caused the approval rating of the former Hatoyama Administration to fall from 79 percent to 37 percent in February 2010 (*Asahi Shimbun* 2010a). Hatoyama was eventually forced to relinquish his post to Kan in June 2010, which was due to Hatoyama's vacillating statements over the relocation of the U.S. bases in Okinawa as well as his political fund scandal. However, shortly after taking over the premiership from Hatoyama and beating Ozawa to become the new DPJ President in September 2010, the public approval rating for Prime Minister Kan and his cabinet plunged from 67 to 26 percent in November 2010 as a consequence of both the deteriorating Japanese economy and the perceived poor handling of the Sino-Japanese territorial dispute (*Mainichi Shimbun* 2010).

The DPJ government therefore found itself facing tremendous domestic political problems in the wake of current crisis, slightly over a year of coming into power. One way of offsetting the criticism was to divert public discontent over politics by putting the blame on the previous ruling party for causing the current massive fiscal deficits. As former Prime Minister Hatoyama declared: 'we succeeded in identifying a large amount of waste that had been ignored under previous governments' (Cabinet Secretariat 2009a). In addition to quick implementation by the relevant ministries, public popularity is a key to the smooth approval of proposed stimulus packages in the Diet as well, and one of the approaches the DPJ took was the introduction of a review process where selected major budgetary requests had to be screened by the DPJ politicians and private sector practitioners in front of a public audience. The review was expected to identity where taxes were wasted as a way of reducing the fiscal spending, but the budgetary review did not impose any legally-binding obligations on the ministries and relevant public corporations, leading to its effectiveness being questioned. What has been important for the DPJ was that it soon turned to be a useful weapon to gain the public support by putting direct pressure on the bureaucracy for curtailing the budget. The review succeeded in appealing to the public that a number of public corporations, where ex-senior bureaucrats were appointed as executives with extravagant salaries, wasted their taxes. Thanks to the review, many in Japan came to know, for the first time, that some of the spacious offices with a small number of working officials, mainly located at the central areas of Tokyo, were rented by government corporations. This had never been practised under the LDP government, and it surely attracted the public interest as the financial crisis led to a decrease in family incomes.

To help businesses deal with a rising yen, the DPJ-government under Kan's leadership submitted a supplementary budget to finance an additional 5.1 trillion yen stimulus package to the Japanese Diet for approval. As profit margins of export-dependent companies are highly susceptible to swings in foreign exchange rates, the performance of Japanese companies most reliant on the U.S. and Europe deteriorated during the crisis. Sony, for example, disclosed that the company lost 2 billion yen in operating profits for every one yen increase against the U.S. dollar (*Asahi Shimbun* 2010b). Yoshito

Sengoku, Chief Cabinet Secretary, explains that the '[new] measures are aimed at preventing another dip in the economy triggered by the decline of the economies in Europe and the United States' (*Japan Times* 2010). The new budget proposal came on the heels of several earlier approved stimulus packages, which included the 15.4 trillion yen budget plan (under LDP's Prime Minister Aso) in April 2009, 7.2 trillion yen in December 2009 (under the Hatoyama government) and 0.9 trillion yen (first package offered under Kan) stimulus budgets in September 2010.

Despite the above measures, METI's (2011a) monthly industrial production index in 2010 reflected a persistent gap of 10 percentage point below the pre-crisis level in 2007. On scrutiny, electronics, manufacturing and transportation were the main sectors responsible for the fall in industrial production. Furthermore, the national demand for steel, a key component in the construction and manufacturing sectors, had also yet to recover to the pre-crisis level. Based on METI's (2011b) estimates, total steel demand in the 1st quarter of 2011 would register a modest increase of 0.2 percent from the previous quarter. However, the total crude steel production for the whole of 2010 maintained at about 90 percent of the pre-crisis level in 2007. The necessity for the series of stimulus measures in a span of less than two years, couple with the sluggish economic data, suggest that the stimulus plans are both insufficient and ineffective yet to pull the Japan out of its economic doldrums.

Finally, one of the features in Japan's stimulus package was environmentally-conscious, which major developed nations tended to promote. For instance, the sales of energy-saving vehicles and ecologically-friendly household products were encouraged by the government through tax exemptions. They were also partly in response to Prime Minister Hatoyama's ambitious announcement at his first United Nations Summit on Climate Change in September 2009 on Japan's commitment to a 25 percent reduction in greenhouse gas emissions from the level in 1990 by 2020 (Cabinet Secretariat 2009b). Other environmentally-friendly arrangements such as 'eco-points' system, through which consumers would receive points for purchasing green electronics, and eco-subsidies to promote the household use of solar energy, stood in a sharp contrast to China's stimulus packages. The four trillion yuan of the Chinese package was mainly used for infrastructure constructions including five new highways in Sichuan Province, which was hit by a huge earthquake in May 2008, and nuclear power plant construction in Fujian Province, a coastal area where the number of bankruptcies was substantial due to the decline in exports. The conspicuous difference between the focuses and areas which Japanese and Chinese stimulus packages promoted respectively, illustrates the unlikelihood of Japan's support for the Beijing Consensus approach even if the global crisis has made it more acceptable to challenge the tenets of the Washington consensus.

Japan's responses to the crisis: external measures

While pursuing fiscal policy measures at home, the DPJ government responded to the crisis by cultivating Asia as a new export market as a result of the collapse of the U.S. market. This perspective is reflected in Prime Minister Hatoyama's confession that '… while we will still consider the alliance with the United States as important, we also want to create policy that places more emphasis on Asia' (*Asahi Shimbun* 2009a). Yet, Japan's foreign policy in the wake of the global crisis has been continuously constrained by its strong alliance with the U.S. For example, unlike China, Japan has been extremely hesitant in reducing its holding of U.S. dollar-dominated foreign reserves. Indeed, as Chinese holdings declined in 2009, Japan had in fact raised its holdings of U.S. treasury bonds by US$11.5 billion to US$768.8 billion, regaining its position as the top foreign holder of U.S. treasury securities, a spot which was lost to China in 2008. Explaining such a policy stance, then-Japan's Minister of Banking and Postal Services Shizuka Kamei revealed that 'the U.S. is having difficulty due to a lack of funds ... It is only natural that we should support the U.S. when it is weak' *(Wall Street Journal* 2010). Despite a growing concern among credit rating agencies on

Japan's fiscal health, Kamei went as far as to call on the Japan Post Bank to buy more U.S. treasuries and corporate bonds (*Financial Times* 2010).

As mentioned earlier, to reduce the impact of the crisis, Japan intended to increase its exports to regions less affected by the crisis. The METI White Paper (METI 2009b, 14) explains that the Asian economic zone and markets of emerging economies provide Japanese companies 'great opportunities', given 'Japanese-owned companies, under pressure due to the ongoing world economic crisis, have come to have a growing awareness that their important task is to explore markets of emerging economies and the Asian economic zone' (METI 2009a, p.402).

In support of its Asia-centered strategy, Japanese finance and foreign affairs officials scaled up Japan's Official Development Assistance (ODA) contributions to Asia from 1.5 to 2 trillion yen based on the new Asian Growth Initiative first unveiled by Prime Minister Taro Aso in 2009. Japan had once abandoned an Asia-centered ODA provision approach to focus on cultivating other friendly states, especially in Africa, which had been expected to support Japan's international ambitions including the permanent seat in UN Security Council. As a result, the major recipients of the enlarged-ODA budget came to include Indonesia, the Philippines, Vietnam and Mongolia. Significantly, these ODA projects are geared towards the development of new infrastructure in the recipient countries with the aim to improve Japanese access to these new markets.

One of the Asian states which the DPJ government found crucial for both economic and political Asia-centred strategies was India. Highlighting the potential of its market, Prime Minister Hatoyama explained that Japan-India trade remains at one-twentieth to that of Japan-China's, and further stressed the need to conclude a Japan-India Economic Partnership Agreement (EPA) 'at an early date' when he met Indian Prime Minister Manmohan Singh during the Japan-India Summit Meeting in

December 2009 (Cabinet Secretariat, 2009c). The Japan-India EPA was eventually concluded in October 2010 between Prime Minister Kan and Prime Minister Singh. This agreement, the first FTA under the DPJ government, was a means to boost Japanese exports to India and, more significantly, to catch up with South Korea which had overtaken Japan in the FTA competition through signing agreements with the EU, India and the U.S. This motivation also drove Japan to make a decision to participate in the Trans-Pacific Partnership (TPP) agreement, a high-quality FTA with virtually all products and all sectors to be included among all participating economies.

Japan's participation in the TPP is politically very difficult as the current TPP members include big agricultural exporters such as Australia, the U.S. and New Zealand. Japan has established FTAs with ASEAN as an organisation and individual ASEAN member nations, but given its dominant trade and economic position it has an overwhelming advantage over partner countries such as Thailand or the Philippines in terms of bargaining power. As a result, in the majority of cases Japan has been able to shelve considerations of the elimination of its agricultural tariffs and the FTAs have ultimately reflected Japan's pre-eminence. This may represent 'liberalization without political pain' (Ravenhill 2003), but to persuade its potential FTA partners, Japan has in return utilized its economic power to offer benefits in the form of economic cooperation. The use of this pattern has, up to the present, enabled Japan to conclude FTAs that have avoided any promise of agricultural liberalisation. For this very reason, however, it is questionable whether Japan will be able to play an active role in the TPP or the Free Trade Agreement for the Asia-Pacific (FTAAP), first proposed by U.S. President Bush in 2008. Within such multilateral FTAs, blocs are likely to be formed during negotiations between the numerous exporting nations that share a common objective of gaining access to Japan's agricultural markets.

The U.S. in particular presents a challenge, since Japan's participation in the TPP would mean it would establish a U.S.-Japan FTA. The DPJ government had initially included the conclusion of a U.S.-Japan FTA into its 2009 election manifesto, but the term 'conclusion' was eventually eliminated and replaced with 'promotion' as a result of increasing farmer protests against an FTA with the world's largest agricultural exporter. The DPJ needed the farmers' votes, which proved to be instrumental in securing a landslide victory for the DPJ in the 2009 Lower House election. Thus, Japan's eventual decision to join the TPP and the FTAAP would depend on whether political momentum to promote agricultural liberalization can be gained by taking advantage of the direct income compensation system for all farmers, a campaign promise made by the DPJ during that Lower House election.

Proxy battle with China

China has now become a key consideration in Japan's effort to seek new markets and cultivate Asia. The share of Japanese total exports to China more than doubled from 6.3 percent in 2000 to 16 percent in 2008, so the Japanese business community is increasing looking at China 'not only as a manufacturing base but also as a market' (METI 2009a, 153). With the intention to kick-start relations with the Chinese leadership on a cordial note, then-Prime Minister Hatoyama pledged not to visit the Yasukuni Shrine when he assumed premiership. The Kan government has also avoided visiting the shrine. The DPJ's interest to develop greater economic linkages with China was not, however, bilaterally pursued, and it was approached partly through its engagement in the Northeast Asian Trilateral Summit, together with South Korea. At the summit, Prime Minister Hatoyama called for the three Northeast Asian countries to advance a trilateral FTA beginning with the conclusion of a trilateral investment agreement in 2010. While the leaders of the three countries had annual summits since 1999 on the sidelines of ASEAN+3 meetings, it was not until December 2008 in

Fukuoka, Japan, when the summit meeting was formalized and held for the first time within Northeast Asia. At the inaugural Northeast Asian Trilateral Summit in December 2008, then Prime Minister Aso acknowledged that 'it is rather unnatural that we have not had this sort of meeting before … the financial crisis, I believe, encouraged or promoted this trilateral summit' (Cabinet Secretariat 2008b). Even prior to the Leaders' Summit in 2008, the finance ministers of Japan, China and Korea met for an informal trilateral meeting in November 2008, during which they agreed to an increase the size of bilateral currency swap arrangements among the three countries (MOF 2008). The three countries also took the first step to formalize the annual summit through the establishment of a Trilateral Cooperation Cyber Secretariat (TCCS) in 2009, shortly after the crisis. Following the leaders' summit, the three countries are also expected to begin a joint study on the feasibility of a trilateral FTA involving government officials, scholars and businessmen (*Xinhua* 2010). Revealing the importance that the Northeast Asian countries place on the Trilateral Cooperation, the three leaders met successfully for their Fourth Trilateral Summit in Hanoi in October 2010, on the sidelines of the ASEAN+3 meeting, despite the tense relations between China and Japan over the Senkaku/Diaoyu Islands, thanks to South Korean President Lee's intention to reconcile them. In response to Chinese retaliatory measure to ban the export of rare resources to Japan during the bilateral spat, Prime Minister Kan skillfully used the opportunity of the trilateral summit to call for the maintenance of a stable supply of earth minerals especially those required in the manufacturing of electronic products in Northeast Asia, according to *Yonhap News* (2010).

As METI's White Paper declares: 'while Asia presents the greatest opportunities for Japanese companies, it is also the region where 'competition with South Korean and Chinese companies is severe' (METI 2009b, 14). Japan saw an urgent need to check the influence of China while seeking new resource-rich markets. For instance, after just two rounds of Japan-China policy dialogues on the Mekong Region at the senior official level, Japan proceeded to propose the formalization of a

Japan-Mekong Region (JMR) Summit in June 2009. The intense competition for regional influence is evident from the composition of the JMR, which parallels the membership of the Greater Mekong Sub-region (GMS) with the exception of China. Ruling out the establishment of a Japan-China-Mekong Region framework, China explained that Beijing would prefer to focus on the existing architecture under GMS which was supported by the Asian Development Bank (ADB) (MOFA 2009a). Against the backdrop of the financial crisis, Japan hosted the inaugural Japan-Mekong Region leaders' Summit in November 2009. After the Summit, Prime Minister Hatoyama and his counterparts from Cambodia, Laos, Myanmar, Thailand and Vietnam issued a joint declaration announcing their intention to meet in Japan every three years and on the sidelines of the ASEAN Summits in the other two years (MOFA 2009b). At the Summit, Japan also pledged more than 500 billion yen of ODA to the Mekong region in the next three years.

The global financial crisis also highlighted the growing impact, arising from the rise of China, in terms of financial cooperation in East Asia. China emerged as a leader in regional financial cooperation, a position that used to be predominantly occupied by Japan who played a prominent role in the Asian financial crisis. Japan's competition with China over the leading role in regional financial cooperation can be seen as a proxy battle between China and the U.S. at the global level, as far as the global financial crisis represents both the eroding U.S. international influence and the growing international role of China.

The battle between China and Japan over 'which country pays more' was also seen in the multi-lateralisation of Chiang Mai Initiative (CMI) in May 2009; again, the negotiations were prolonged until both sides eventually agreed to provide equal contributions of 38.4 billion dollars for the settlement, although the Chinese contribution included that of Hong Kong's. In the end, the total amount of 120 billion dollars was broken down with 32 percent by China and Japan each, 16 percent by Korea and 20 percent by 10 ASEAN countries. Japan's status as the largest contributor was again matched by China, but in an international financial institution for the first time. One reason why the size of the contributions is so contested between China and Japan is the tendency for nations to consider their contributions as voting power in the new arrangements, culminating in the prolonged negotiations. In fact, the distribution of contributions can be seen to reflect power in East Asian politics, as a senior MOF official confessed and Japan's position that the amount of contribution by each member in the multi-lateralisation of CMI should be proportionally allocated was consistent with its national interest. The total loans Japan can provide in bilateral swap agreements within the existing CMI exceeded US$40 billion, which more than doubled China's total amount in the same arrangement (*Asahi Shimbun* 2009b). Therefore, Japan tended to stress the fact that it provided a much larger contribution than China to international financial organisations such as IMF and ADB as the second largest economy in the world; Japan's quotas in IMF and ADB are 6.12 and 15.571 percent, respectively, while China's current contributions are 3.72 and 6.429 percent. Yet, Japan did not push its claim strongly because it thought the equal amount of contribution by both nations would serve to put an end to the battle over 'which country pays more' which Japan would find it difficult to win given China's continued economic growth and the growing foreign exchange reserves (*Asahi Shimbun* 2009b). This view indicated Japan's hope that the equal contribution would be perpetually kept in the regional financial architecture to maintain Japan's influence. Eventually, China, Japan, and ASEAN came to acquire voting shares of approximately 28 percent each, while Korea was provided a 14 percent voting share, making it impossible for any single economy to have decisive power in the CMI system.

Another case in point is the intense currency competition between the Chinese yuan and the Japanese yen. Disclosing Japan's intention to raise the profile of the Japanese yen in Asian trade, former Prime Minister Aso (MOFA 2009c) mentioned: 'to advance regional financial cooperation still further, there is a need to promote the use of local currencies for intraregional trade and capital transactions'. This remark was made largely in response to China's expressed intention to internationalize the yuan. In February 2009, a currency swap agreement between China and Malaysia was concluded under which China would provide up to 80 billion renminbi to Malaysia in the event of a financial crisis, and similar types of swap agreements were subsequently signed with Indonesia as well. This was followed by another decision to allow the yuan to be used in overseas trade settlement in five Chinese cities following a trial run with Hong Kong, Macau and ASEAN in December 2008 (*China Daily* 2009a). China's intent became more evident after announcing the renminbi-denominated settlement of trade between a limited number of Chinese cities such as Shanghai and some ASEAN nations since 1 July 2009. According to *the China Daily* (2009b), after the first successful completion of cross-border trade deals amounting to 14.38 million renminbi by three Shanghai companies, business entities in Singapore, Indonesia and Malaysia have shown great interest to switch to using the renminbi in their trade. Furthermore, in September 2009, China issued yuan-dominated two-year sovereign bonds to the amount of US$879 million in Hong Kong, for the first time, and a former PRC central bank official disclosed that the Chinese government could use Hong Kong 'as a trial ground before the Chinese yuan leapfrogs to the international markets as a transaction currency' (*China Daily* 2010).

The Japanese MOF saw China's arrangements in the renminbi as an attempt to increase the presence of China's currency in the payment of trades and investments in East Asia and responded to China's challenge by deciding to offer swap arrangements in yen (US$60 billion equivalent) with ASEAN members in a form separate from CMI and to guarantee $5 billion in yen-denominated government bonds (Samurai Bonds) issued by ASEAN members in the Japanese market. The Japan Bank for International Cooperation (JBIC) concluded an agreement with the Philippine government to provide a guarantee totaling up to 100 billion yen for the latter's issuance of Samurai bonds in February 2010.

The impetus behind Japan's first kind of proposal to increase the utilisation of the yen in Asian trades and investments was obvious even to an official from the Korean finance ministry who observed that 'Japan took a very aggressive move to curb the increase in the Chinese influence on the Asian market' (*JoongAng Daily* 2009). The China-Japan battle over the usage of their currencies in East Asia became intense, but it also represents their common interest in creating a stable business environment to avoid the risk of currency exchanges in the region.

However, it is well acknowledged that the exchange of the renminbi with other currencies is still strictly controlled by the Chinese financial authority, so it is doubtful that foreign companies are motivated to utilise the renminbi to settle their trade and investment transactions. Also, Japan's plan of emergency yen loans to countries falling into a foreign exchange shortage has a problem as well. The fund is supposed to stem from Japan's foreign reserves held in U.S. dollars, so selling such a substantial amount of U.S. dollars in the currency market for conversion into yen would trigger yen appreciation, providing trouble for Japanese exporting companies.

The Japan-China battle is instrumental in advancing the effectiveness of regional financial cooperation. One of the examples is the creation of regional financial mechanism similar to the Asian Monetary Fund (AMF) proposal through the multi-lateralisation of the CMI, as was agreed upon in May 2009. Through the multi-lateralisation of the CMI, for instance, the amount of funding could be increased, and negotiations could be consolidated; thereby the CMI could serve as a regional lender that would be capable of responding with multi-lateral assistance in the event of financial crisis.

One serious problem in the CMI was the links with the IMF through the 20 percent conditionality which made it difficult for East Asian countries to use CMI. This IMF conditionality means that only 20 percent of the total facilities of CMI can be utilised without linkages to the IMF programs.

Thailand, Indonesia, and Korea, all of whom had traumatic experiences in securing IMF-led rescue packages during the 1997 Asian financial crisis which included hasty deregulation and privatization, as represented by Washington Consensus, strongly wished to avoid using the CMI. In 2008, Korea borrowed directly from the U.S. by extending the bilateral swap agreement (30 billion dollars) and increased the amount of reserves in its arrangements with Japan and China to avoid relying on the IMF and the CMI. Korn, the Thai Finance Minister, stated that there was a widespread perception in East Asia that it was an act of suicide to rely on the IMF in light of domestic politics (*Asahi Shimbun* 2009c). Importantly, as the previous ASEAN+3 Finance Ministers had already indicated in February 2009, East Asian nations agreed that 'after the surveillance mechanism becomes fully effective in its function, the *IMF de-linked portion* may be increased from 20 percent'. The IMF conditionality was introduced with a premise that 'a financing arrangement that could lend too generously with too little conditionality might create moral hazard for the government at the receiving end' (Kawai & Houser 2007, 19). Yet, as Sussangkarn (2009), former Thai Finance Minister, declared, 'it would indeed be doubly hypocritical for those in the West or in the IMF to use this argument to try to block the establishment of such an organization again', given that concerns about the moral hazard problem did not prevent American programs from bailing out large American financial institutions and automobile companies.

The establishment of a new research office was announced at the ASEAN+3 finance ministers' meeting in May 2009 in order to provide strong financial surveillance and monitoring systems, which East Asia currently lacks. The establishment of those systems is a key initial step toward the multi-lateralisation of bilateral swap arrangements, which in turn is essential for the realization of the AMF. A senior official in the Bank of Japan once acknowledged that the ASEAN secretariat was unlikely to perform this function, but he added that the Regional Economic Monitoring Unit in the ADB could do so, reflecting a view that Japan sees the ADB as its own institution and thus does not wish to see it replaced (Terada 2004). Yet, the ADB includes staff and funds from the U.S. and European states in addition to ASEAN+3 members, so Western-oriented and more rule-based governance thinking also prevails. In this case, if the ADB started suggesting the renminbi evaluation – a politically sensitive issue to China – as the IMF did, China would not support the ADB as a surveillance and monitoring institution, predicting another case of Japan-China competition in the building of East Asian financial architectures. In this case, the decision to establish the ASEAN+3 Macroeconomic Research Office (AMRO) in May 2011 in Singapore to monitor regional financial situations is a good way to settle the China-Japan battle over the politics of regional financial mechanism and take a more cooperative step for the further institutionalization of East Asian regionalism.

Conclusion

The unparallel rise of China both in terms of material and ideological capabilities has propelled Japanese policy makers to inject greater fervency in their pursuit to retain the attractiveness of the Japanese economy. The evidence to date suggests that post-crisis Japan has sought to reduce its reliance on its traditional markets in the West by exploring new export markets and establishing closer partnership with the Asian region, especially in cultivating resource-rich countries in the Mekong region and India. Japan's new focus on Asia appears to have achieved some modest results. Japanese exports in 2010 rose 22.4 percent, which marked the first increase in three years. Exports to China alone accounted for more than 19 percent of its total shipment. (*Mainichi Shimbun* 2011). While it might be too early to assess if these measures were sufficient to lift the country out of its economic doldrums, they were in some ways perceived as necessary to retard the advances made by China in light of the global crisis. What is clear is that the global crisis has reinforced Japanese perceptions of the relative material and ideological powers of China vis-à-vis the U.S., urging Japan to take a couple of measures including more aggressive approach to the cultivation of Asian market and regional financial architecture. Despite the uphill task ahead in overcoming the sluggish economy, the crisis has also in some ways created opportunities for Japan given the fact that Japanese big banks were relatively unscathed from the global crisis due to the modest scale of their international operations, a basis for Japan to become a major financial hub to serve the rest of Asia, as Toshiro Muto, former Finance Vice-Minister of Finance, declared (*Yomiuri Shimbun* 2009).

The global crisis has also provided an impetus for East Asia, in which almost 70 percent of trades are settled in U.S. dollars, to consider the possibility of its own currency mechanism. Given that the total GDP of ASEAN+3 nations is expected to surpass that of the U.S. and eventually that of the EU in the near future, Masahiro Kawai, ADBI President, comments, ‘it's disturbing that the most vigorous economic bloc in the world does not have its own currency system and relies on another currency’ (*Nihon Keizai Shimbun* 2009). The crux of the argument rests on which currency East Asia will need to rely on within the regional financial architecture, yen or renminbi. The answer depends on whether China will carry out the internationalisation of the renminbi by making it float on the international currency market, as this reform would decide the battle.

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