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Volume 1, Issue 1 The Rise of China: Its Impacts on Asia and the World

China's Recent Economic Performance and Future Prospects

Dwight H. PERKINS

Our forecast of China's economic future is based primarily on the supply side growth accounting model. The life cycle model of household saving provides us with the most plausible explanation for a continued high rate of savings and investment. China's labor force will soon stop growing, but migration out of agriculture should have little impact on farm output while providing a steady stream of labor to the modern more productive sectors. There is also room for rapid expansion of human capital. Maintaining high productivity growth will depend primarily on strengthening currently weak institutions, notably the financial sector and, more importantly, the legal system.

Trade Impacts of China's World Trade Organization Accession

Elena IANCHOVICHINA, Will MARTIN

This study examines China's World Trade Organization (WTO) accession commitments and assesses their implications for China and the world using a model reflecting the importance of duty-free intermediate inputs in China's exports. The WTO agreement built on earlier reforms that introduced competition into the trade regime, eliminated nontariff barriers and exchange rate overvaluation, and reduced tariffs. The reforms associated with accession were conservatively estimated to increase global real incomes by \$74 billion per year, with \$29 billion accruing to China and the remainder primarily to those countries trading directly with China. Some lower-income developing countries faced greater competition from China in third markets.

How China is Reorganizing the World Economy

Barry EICHENGREEN, Hui TONG

We analyze the impact of China's integration into the global economy on other countries, Asian countries in particular. We first examine how the growth of China's exports is affecting the exports of other countries in Asia and the rest of the world. Our innovation is to distinguish exports of capital goods, consumer goods, and intermediates and to disaggregate textiles and consumer electronics, the most visible sectors where China's presence is felt. We next look to the impact of China on direct foreign investment flows. Here our innovation is to distinguish vertical and horizontal foreign direct investment (FDI) and to consider how they are affected by supply-chain relationships. We then look more closely at factors influencing the articulation of these supply chains, the fragmentation of production, and the emerging international division of labor, focusing on two industries, electronics and autos, that exhibit very different responses. The

results suggest that countries specializing in the production and export of components and raw materials feel positive effects from China's growth, while countries specializing in the production of consumer goods feel negative effects. Similarly, countries that compete with China for horizontal FDI find it more difficult to attract foreign investment as a result of that country's emergence, while countries that are potentially attractive destinations for vertical FDI find it easier to attract foreign investment as a result of trade links, especially in components and intermediates, that allow them to take advantage of supply chains involving their large and dynamically growing neighbor.

The Economic Rise of China: Challenges and Opportunities for ASEAN

Siow Yue CHIA, Chalongphob SUSSANGKARN

This paper looks at the economic rise of China and its impacts and implications for the Association of South-East Asian Nations (ASEAN) region. The issues of complementarities and competitiveness of ASEAN and China in trade and investment and the opportunities and challenges arising from China's emergence and the ASEAN-China Free Trade Area are discussed. The message from China's emergence is clear and strong; it is that size does matter. To increase ASEAN competitiveness, the paper highlights the need for a deeper and more rapid economic integration of ASEAN in order to exploit scale economies. The important role of Japan in this process is highlighted. Finally the issue of ASEAN economic diversity is discussed. It is suggested that while ASEAN is fairly diverse, this should not be a critical stumbling block to a more rapid economic integration of ASEAN.

China's Energy in Transition: Regional and Global Implications

Tianshu CHU, Fereidun FESHARAKI, Kang WU

China is the largest energy user in Asia and the second largest in the world after the US. This paper documents substantial changes of the structure of China's energy use over the past decades. It explores the puzzling phenomena of China's low gross domestic product elasticity of energy consumption. Econometric analysis applying the AutoRegressive Integrated Moving Average model finds that factors such as institutional reforms and structural change can account for a substantial fraction of the downward impacts on the elasticity level. The paper also studies the future energy growth and energy security issues in China, and examines the regional and global impacts of China's rapidly growing energy consumption.

Environmental Consequences of Rising Energy Use in China

Warwick J. McKIBBIN

China is already the world's third largest energy producer and second largest energy consumer accounting for 10 percent of global energy use. This share is expected to rise to 15 percent by 2025. Energy use in China has important environmental consequences which are explored in this paper. A range of policy options are also discussed. It is argued that each major environmental issue requires a policy response that is a mix of direct government intervention as well as market based incentives. In coming decades, the choices made by China of how to tackle the environmental consequences of expanding energy use will have important implications for China, Asia and the world.

Global and Regional Geo-strategic Implications of China's Emergence

Akihiko TANAKA

Now that China's "re-emergence" as a world center of production is obvious, concerns about its implications are being raised throughout the world, in general, and particularly in East Asia. China's economic growth is nothing but spectacular. If all parties are rational, however, a peaceful rise for China is possible. Peaceful management of the Taiwan Strait is critical in this respect. There are two possible scenarios for the peaceful rise of China: a unilateralist China in the multipolar world of competition, and a multilateralist, postmodern China embedded in an East Asian community. It is in the interest of Japan, the United States and other countries in the international society to induce China to take the latter scenario. To realize this goal, efforts on the part of China are critical, but the efforts of other countries such as the United States and Japan are also very important.

Volume 1, Issue 2 Regional Integration in East Asia

Regional Integration in East Asia: Achievements and Future Prospects

Hadi SOESASTRO

Economic integration in East Asia has been largely market driven. Attempts in the late 1980s to establish an East Asian regional economic grouping failed to materialize for a number of reasons. The financial crisis in 1997–1998 has strengthened the realization of regional countries that they need to have some self-help mechanisms to overcome that crisis and to prevent future crises. This led to the development of several functional integration programs, including the network of bilateral swap arrangements known as the Chiang Mai Initiative. However, progress remains slow. The question that has arisen is how far these efforts need to be supported by institutional integration. Should the ASEAN Plus Three, the main regional cooperation process in East Asia involving the 10 South-East Asian countries plus China, Japan, and South Korea, be deepened institutionally? Meanwhile, the region has seen the establishment of a new process, the

East Asia Summit, involving the above 13 countries plus Australia, India, and New Zealand. How will these different arrangements contribute to East Asia's economic dynamism and prosperity as well as peace and political stability?

The Race to Connect East Asia: An Unending Steeplechase

T. J. PEMPEL

East Asia has become more integrated as a region over the past quarter century. In looking ahead, this article identifies five central obstacles to further regionalism. Three address the composition of any future East Asian region: the arenas in which cooperation is sought, the geographic scope of any future region, and the extent to which regional ties are formalized. The other two variables will influence the future regardless of how the first three are resolved: the structure and balance of domestic political forces, and leadership. The complex interactions of these five are then examined in the recent moves toward preferential trade pacts, increased regional monetary and financial cooperation, and security.

Deep Economic Integration: Is Europe a Blueprint?

Charles WYPLOSZ

This article revisits the long process of deep integration in Europe, asking which elements belong to a blueprint that could be used elsewhere, particularly in Asia. To that effect, it delves into those features that are not desirable and that should be avoided. The underlying theme is that integration is thoroughly controversial: delegation of power is of the essence but it comes at the expense of sovereignty; and economic integration is globally beneficial but creates losers alongside winners. As a consequence, compensating measures and diplomatic compromises are unavoidable, often at the expense of economic logic. This paper offers a number of suggestions designed to mitigate the negative effects of such unavoidable developments.

Macroeconomic Linkages and Regional Monetary Cooperation: Steps Ahead

Gordon De BROUWER, Arief RAMAYANDI, David TURVEY

There is a growing appetite for economic cooperation in East Asia. Although the region has forums to facilitate this, economic cooperation has focussed largely on discussion of issues and policies – cooperative action is confined to functional cooperation in finance. There is scope for further cooperation in strengthening markets and institutions, with a view to accelerating convergence and stability in the region and deepening shared preferences about policy objectives, including on monetary and exchange rate issues. Although monetary policy in East Asia is generally focussed on controlling inflation, differences remain in economic structure and preferences about policy trade-offs,

markets, and institutions.

Free Trade Agreements and the Prospects for Regional Integration in East Asia

Razeen SALLY

Trade policy in East Asia has switched from non-discriminatory unilateral liberalization, reinforced by General Agreements on Tariffs and Trade/World Trade Organization (GATT/WTO) commitments, to discriminatory free trade agreements (FTA). The paper surveys the FTA activity of the major regional players: China, the ASEAN countries, Japan, and South Korea. It concludes that emerging FTAs are weak and partial. A hub-and-spoke pattern of dirty FTAs will not drive regional economic integration or further integration with the global economy. Rather, it could be a force of regional economic disintegration – especially if the multilateral trading system weakens further. At the same time, FTA activity is distracting attention from the WTO, and, more fundamentally, from unilateral liberalization and domestic structural reforms. Hence, East Asian trade policies need to be rebalanced, with better-quality FTAs and more focus on the WTO. However, more important than the WTO and FTAs is a fresh spurt of unilateral liberalization and structural reform outside trade negotiations.

International Production and Distribution Networks in East Asia: Eighteen Facts, Mechanics, and Policy Implications

Fukunari KIMURA

International production/distribution networks in East Asia developed in the 1990s and after have distinctive features in their significance, extensiveness, and sophistication. This paper first lists “18 facts” on production/distribution networks in East Asia that have been identified by a number of studies using international trade data, microdata of Japanese multinational enterprises, and casual observations. It then presents a concept of two-dimensional fragmentation as a starting point of theoretically formalizing the phenomena of fragmentation and agglomeration. It finally discusses the policy environment in which the formation of production/distribution networks has been accelerated and policy implications of the existence of such networks for economic integration in East Asia.

Labor Mobility and East Asian Integration

Siew Yue CHIA

East Asian economic integration is commonly analyzed in the context of trade in goods and services and capital flows, while labor flows have been very much neglected. Yet labor flows in the region are rapidly growing, given the diversity in levels of economic development, employment opportunities and wage levels, and the existence of labor

surplus and deficit countries. Labor migration poses more benefits than costs for both sending and receiving countries, but there are more sensitivities toward labor flows than trade and capital flows. The characteristics and government policies are different for the unskilled and semiskilled foreign workers and for the professionals and highly skilled. Regional cooperation among countries is needed to manage the flows, reduce the incidence of illegal and undocumented workers, reduce the transaction costs of migration, and protect the rights of these workers.

Volume 2, Issue 1 Ten Years After the Asian Crisis: What Have We Learned or Not Learned?

Asian Currency Crisis and the International Monetary Fund, 10 Years Later: Overview

Takatoshi ITO

This paper is an overview of the Asian currency crisis in Thailand, Indonesia, and South Korea in 1997–1998, with an emphasis on the role of the International Monetary Fund (IMF). It provides a detailed account of the development of the crisis and analyses and evaluates the content of IMF advice and its consequences. The size of the IMF package for each of these three countries is judged to have been too small. This paper also has a comparative perspective; the Mexican crisis is reviewed as a precursor to the Asian crisis to see what the IMF learned, and how it prepared, for future crises. The causes of the crises and IMF conditionality for the post-Asian crisis countries, Russia, Brazil, Turkey, and Argentina, are also compared to the Asian crisis countries. By agreeing to maintain a fixed exchange rate, for example, the IMF is judged to have been “softer” in its approach to the post-Asian crisis countries.

Regional and Global Responses to the Asian Crisis

Stephen GRENVILLE

This paper examines how economic policy-making changed as a result of the Asian crisis of 1997–1998, in the countries affected, in the region, and at the global level. It is perhaps surprising how little change has occurred in the broad approach to economic policy, but there is a much greater awareness of the vulnerabilities posed by large international capital flows. The broad tenets of the Washington Consensus, with its market-based policies, remain in place, but there is a recognition that well-functioning markets require complex institutions, rules, and procedures, and that these take time and effort to develop. Most of this institutional development will have to take place at the national level, but regional arrangements can offer support, and multilateral agencies, such as the International Monetary Fund, have learned from the crisis.

Are Banking Systems in East Asia Stronger?

Philip TURNER

The Asian crisis was severe because local banking systems were weak. The major policy effort to improve supervision and strengthen banking systems that followed has achieved substantial results. But these achievements have been somewhat uneven across the region. The current favourable environment should not lull governments into complacency: new risks are arising and continued reforms are needed.

Ten Years After the Financial Crisis in Thailand: What Has Been Learned or Not Learned?

Chalongphob SUSSANGKARN, Pakorn VICHYANOND

The 1997 financial crisis provided many lessons about the weaknesses of Thailand's economic and financial system before the crisis, weaknesses that eventually led to the crisis. Since then, these lessons have led to many economic and financial reforms. This paper reviews the lessons and reforms that have been carried out. These include improvements to the data system needed for adequate macroeconomic monitoring, changes to the macroeconomic management framework and monetary policy regime, and various aspects of financial sector reforms. This paper also indicates the lessons that might not yet have been sufficiently learned and new risks to future economic stability. These include political interference in financial institutions, leading to inappropriate or excessive lending, and lack of transparency in fiscal liabilities that could mislead macroeconomic management

Indonesia After the Asian Crisis

Hal HILL, Takashi SHIRAIISHI

Indonesia was deeply affected by the 1997–1998 crisis, more so than its East Asian neighbors. Its economic contraction was deeper and more prolonged. It was the only one to experience a (temporary) loss of macroeconomic control. It also suffered “twin crises,” in the sense that its serious economic and financial problems were accompanied by regime collapse. Consequently, recovery was a slow and complex process, as new institutions had to be created, and old ones reformed under successive short-lived administrations. But this process is largely over. The directly elected president with a strong popular mandate is in power. The new institutional framework for economic policy-making is in place. Macroeconomic stability has been restored. Although growth has yet to return to pre-crisis levels, by 2004 per capita income and poverty incidence had recovered to levels prevailing in the mid-1990s, and in the circumstances economic recovery has arguably proceeded about as quickly as could reasonably have been expected.

Crisis and Recovery: What We Have Learned from the South Korean Experience?

Jong-Wha LEE, Changyong RHEE

This paper analyzes the process of recovery from the 1997 financial crisis in South Korea, and draws some lessons from it. The fast restoration of financial stability due to early closure of non-viable financial institutions and quick resolution of non-performing loans was critical for the speedy recovery of the South Korean economy. The swift adjustment in fiscal and monetary policies in addition to the large depreciation of real exchange rates also supported the fast recovery. Corporate and government bond markets played an important role in the financial restructuring and macroeconomic adjustment process. Structural reforms helped to alleviate the weaknesses in the corporate sector, particularly in chaebol groups. However, the fast recovery also generated unwelcome side-effects. Because of aggressive fiscal expansion through government-guaranteed bonds and public credit guarantee programs, sovereign liabilities increased greatly and transparency of the official fiscal stance deteriorated. Thanks to structural reform, corporate and financial sectors began to recognize the importance of micro risk management, but increased risk aversion contributed to the slowdown of corporate investment and, therefore, reduced long-run growth perspective in South Korea. How to revive long-term growth rates remains an important question in South Korea despite fast recovery from the crisis.

Volume 2, Issue 2 Japan: Where To From Here?

Japan's Lost Decade: What Have We Learned and Where Are We Heading?

Hiroshi YOSHIKAWA

The lost decade has provided us a number of lessons. One of them is the limit of standard macroeconomics. This paper attempts to show that uncertainty plays a much more important role in the macroeconomy than most economists recognize. Once the economy is caught in an uncertainty trap, the effectiveness of standard policy necessarily weakens. The zero-interest rate may well be a consequence of an uncertainty trap. In fact, whether or not the economy is caught in such an uncertainty trap distinguishes “depression” from the normal cyclical “recession.” The significance of demand-creating innovation is another point I emphasize in this paper. In my view, a lack of demand-creating innovation is a part of explanation of the lost decade. At the same time, this paper offers prospects for the future of the Japanese economy.

Japan's Security Policy in East Asia

Michael AUSLIN, Michael GREEN

Japan's strategic thinking has been driven by three main factors: a fear of isolation, calculation of the geopolitical strength of China (and to a lesser extent, Korea), and accommodation to the prevailing international power structure. During the Cold War Japan aligned with Washington, but maintained sufficient distance to explore a mutually beneficial relationship with China based on Japan's dominant economic position. As Chinese power has grown and Japan's own economic tools for statecraft have slowed, Tokyo has moved closer to the United States to balance Chinese power. Japan has also had to seek new ways to shape the security environment in Asia, turning to multilateral diplomacy such as the Changmai Initiative. Where Japan's diplomacy in Asia in the 1980s and 1990s emphasized Japan's unique ability to champion "Asian" values with the West, increasingly Tokyo has emphasized its unique ability to champion universal values of democracy and rule of law in Asia. This theme has been used by conservative governments to improve Japan's brand over China, but also builds on a tradition of Japanese diplomatic efforts to take a lead in rule-making in the region. Prime Minister Koizumi's assertive foreign policy helped to reinvigorate Japan's international position, but he moved from the traditional three part formulation of Japan's orientation – the U.S. alliance, the UN system and Asia – to a simpler two part formulation of "the U.S.-Japan alliance and international cooperation." The lack of focus on Asia has contributed to growing tensions with South Korea and China over history issues, even as Japan's global and broader regional standing has increased according to most opinion polls. These regional challenges will continue to confront future Prime Ministers well past Koizumi.

Japan's New Foreign Economic Policy: A Shift Toward a Strategic and Activist Model?

Mireya SOLÍS1, Shujiro URATA

This article analyzes key departures in Japanese foreign economic policy: the development of an extensive network of free trade agreements thereby abandoning the exclusive focus on the multilateral system as the vehicle for trade liberalization, and the revamping of the official development assistance (ODA) program by slashing its budget, emphasizing national interests in aid giving, and phasing out yen loans to China. We argue that the remarkable degree of policy activism in both trade and ODA represents the Japanese government's attempt to respond strategically to common challenges: domestically the economic recession, internationally the pressure for policy convergence and competition with China. However, in both issue areas the ability of the government to embark on swift policy changes has been compromised by domestic politics: opposition from vested interests and politicization of policy-making, bureaucratic

sectionalism, and weak executive leadership. We conclude with some policy recommendations to improve the coherence of foreign economic policy formulation in Japan.

From Industrial Policy to Innovation Policy: Japan's Pursuit of Competitive Advantage

Marcus NOLAND

Japan faces significant challenges in encouraging innovation and entrepreneurship. Attempts to formally model past industrial policy interventions uniformly uncover little, if any, positive impact on productivity, growth, or welfare. The evidence indicates that most resource flows went to large, politically influential “backwards” sectors, suggesting that political economy considerations may be central to the apparent ineffectiveness of Japanese industrial policy. Rather than traditional industrial or science and technology policy, financial and labor market reforms appear more promising. As a group, Japan's industrial firms are competitive relative to their foreign counterparts. Where Japan falls behind is in the heavily regulated service sector. The problems appear to be due less to a lack of industrial policy than to an excess of regulation. Japan may have more to gain through restructuring the lagging service sector than by expending resources in pursuit of marginal gains in the industrial sector.

Financial Crisis and the Lost Decade

Mitsuhiro FUKAO

Japanese banks incurred heavy losses in the early 1990s due to the bursting of the bubble economy of the 1980s. Japanese regulators allowed undercapitalized banks to operate under a very lenient application of capital requirement rules. At first, the regulators did not have strong institutional mechanisms and budgetary funds to take care of weakened banks. Even after obtaining strong power and money in 1988 to tackle the banking problem, the regulators would not nationalize a large number of banks because they could not manage nationalized banks themselves. The recent recovery of the Japanese economy gives the Financial Services Agency a chance to make up for the lost decade of regulatory discipline.

Aging, Savings, and Public Pensions in Japan

Charles Yuji HORIOKA1, Wataru SUZUKI, Tatsuo HATTA

We analyze the impact of population aging on Japan's household savings rate and on its public pension system and the impact of that system on Japan's household savings rate and obtain the following results: first, the age structure of Japan's population can explain the level of, and past and future trends in, its household savings rate; second,

the rapid aging of Japan's population is causing Japan's household savings rate to decline and this decline can be expected to continue; third, the pay-as-you-go nature of the public pension system, combined with rapid population aging, created considerable intergenerational inequities and increased the savings rates of cohorts born after 1965, which in turn slowed the decline in Japan's household savings rate; and fourth, the 2004 public pension reform alleviated the intergenerational inequities of Japan's public pension system somewhat but will in the long run exacerbate the downward trend in Japan's household savings rate.

Volume 3, Issue 1 Growing Inequalities?

What's Not Converging? East Asia's Relative Performance in Income, Health, and Education

Charles KENNY

This paper discusses East Asia's performance in terms of per capita gross domestic product growth rates over the past 40 years and compares that performance to progress primarily on measures of health. It also compares the region to the rest of the world on a set of broader development measures. It looks at the evidence of East Asian regional and global convergence in health and education, alongside evidence from the region matching global evidence of a comparatively weak link between income growth and health and education growth. This finding is echoed by available within-country evidence from the region. This paper discusses what might be behind these results, suggesting the importance of a few simple supply-side interventions coupled with the spread of demand for health and education services as sufficient to drive quality-of-life convergence.

Globalization, Inequality, and Local-level Dynamics: Indonesia and the Philippines

Hal HILL

Subnational disparities and center–region relations are increasingly important issues in both the development economics literature and East Asian policy circles. Almost all developing countries in East Asia are actively decentralizing power and resources from the center. Analytically, there is growing interest in spatial economics, arising out of the fusion of economics and geography. This paper examines these issues with reference to Indonesia and the Philippines. Both countries are well suited to such a study: they are the two largest archipelagic nations in the world, they both feature great subnational diversity, and they have both adopted major decentralization programs, in similar circumstances. We conclude that, in aggregate, there have been no major changes in regional inequality in either country, although this conclusion is sensitive to the

selection of economic indicators. In general, the regions that are the best connected to the global economy have grown more rapidly.

Shares of the Rich and the Rest in the World Economy: Income Divergence Between Nations, 1820–2030

Angus MADDISON

This paper analyses the forces determining per capita income levels of nations over the past millennium and the prospects to 2030. In the year 1000, Asian countries were in the lead. By 1820, per capita gross domestic product in Western Europe and the USA was twice the Asian average. The divergence had grown much bigger by 1950, but by the 1970s, several Asian countries – Japan, South Korea, Taiwan, Hong Kong, and Singapore – had achieved considerable catch-up. Since then, there has been a major surge in China and the beginning of a similar phenomenon in India. As a result, the Asian share of world income has risen steadily and, by 2030, will be fairly close to what it was in 1820. I conclude by comparing my projections for 2030 with those of Goldman Sachs, Perkins and Rawski, and Fogel.

Inequality in Japan

Fumio OHTAKE

This paper analyzes income inequality, based on government income statistics and an attitude survey. First, the paper describes the present income inequality in Japan by using Gini coefficients, the income share of the top and bottom income classes, and mobilities among income classes. Second, by using the Japan–USA international survey, this paper analyzes the cause of the increasing awareness that Japan's income gap is widening. In these two countries, their distinct value judgments about the causes for the gap influence how they perceive it. The Japanese have negative perceptions about the income gap because they perceive it to be influenced by talent, academic background, or luck, and this perception seems relatively uncommon in the USA. A large percentage of Japanese also think one's income is decided by talent, academic background, or luck, although it should not be. Such disagreements between the desired and perceived determinants of income are thought to raise their negative perception of the gap.

Income Inequality in Malaysia

Haji Mat Zin RAGAYAH

The objective of this paper is to examine the changes in Malaysian income distribution during the last three and a half decades and the reasons for the changes. It was found that the Gini ratio for Malaysia peaked in 1976 and fell thereafter to 1990. However, inequality seems to reverse its direction since then. Policies that could explain the

changes in income distribution include the promotion of export-oriented industrialization, education, and training, and the restructuring of equity ownership and assistance in asset accumulation. While the various other redistributive measures in the form of rural development helped in poverty eradication, their effectiveness in redistribution needs to be improved. Several hypotheses have been forwarded to explain the widening of income inequality after 1990. These include the difference in the growth rates of incomes of the rural and urban areas, trade and globalization, and impediments to the process of internal migration.

Reform, Growth, and Inequality in China

John KNIGHT

This paper provides a survey of the literature on inequality in China – level, change, causes, and consequences. It attempts to answer six main questions. How much has inequality risen? What is its relation to poverty alleviation? What has happened to wealth inequality? What are the main dimensions of rising income inequality? The dimensions examined are: the rural–urban divide; urban labor market reform; regional divergence; rural–urban migration; and entrepreneurship, rent-seeking, and corruption. Was it inevitable that inequality should rise so much? Does it matter that inequality has risen? Income distribution in China is bound up with both economic reform and economic growth. This paper concludes by considering the countervailing forces that will determine the path of inequality in future years.

Volume 3, Issue 2 New India

Rapid Economic Growth: Contributing Factors and Challenges Ahead

Isher Judge AHLUWALIA

The sustained improvement in the underlying conditions for growth for more than two decades has resulted in lifting the Indian economy from the bottom of the growth heap to one of the fastest growing economies in the world. This paper presents the factors that have contributed to the growth acceleration in India over the past 25 years and the challenges faced by the growth process in the years ahead. The inadequate and poor quality of infrastructure, particularly electricity, the emerging scarcity of skilled labor, and a lagging agricultural sector pose serious medium-term challenges to the sustainability of high growth, while management of the macroeconomic environment poses more immediate challenges in view of the proliferation of unsustainable and sometimes invisible subsidies, sharp increases in the world prices of food and fuel, and pressure on the exchange rate executed by strong capital inflows.

The Role of Fiscal and Monetary Policies in Sustaining Growth With Stability in India

Rakesh MOHAN

The performance of the Indian economy in recent years has attracted increasing international interest. This paper focuses on the role of fiscal and monetary policies in the evolution of the Indian economy over the years, with particular attention being given to the reforms undertaken in these policies since the early 1990s. The coordination of fiscal and monetary policies has been crucial in the sequencing of the economic reform process carried out since the early 1990s. Monetary policy aims to maintain a judicious balance between price stability and economic growth. With the opening up of the Indian economy and the spread of financial sector reforms aimed at functional autonomy, prudential strengthening, operational efficiency, and competitiveness of banks, considerations of financial stability have assumed greater importance in recent years alongside the increasing openness of the Indian economy. The biggest challenge facing the conduct of fiscal and monetary policy in India is to continue the accelerated growth process while maintaining price and financial stability. Therefore, the self-imposed rule-based fiscal correction at both the national and subnational levels has to be consolidated and carried forward. The existence of a high level of fiscal deficit also contributes to the persistence of an interest rate differential with the rest of the world, which then also constrains progress toward full capital account convertibility. The success achieved in revenue buoyancy through tax rationalization and compliance has to be strengthened further.

Internationalization of Indian Enterprises: Patterns, Strategies, Ownership Advantages, and Implications

Nagesh KUMAR

The recent spate of large cross-border acquisitions – for example, Tata Steel–Corus, Hindalco–Novelis, and Tata Motors–Jaguar/Land Rover – and greenfield investments by Indian companies have helped in focusing attention on the emergence of new corporate players on the global scene. India's emergence as a source of foreign direct investment outflows is impressive for its level of development. It is argued that the destinations, sectoral composition, motivations, and entry strategies of Indian investments have been changing with magnitudes. This paper examines the sources of Indian companies' ownership advantages and trends, patterns, and implications. It has been argued that the source of their ownership or competitive advantage lies in their accumulation of skills for managing large multilocation operations across diverse cultures in India and in their ability to deliver value for money with their "frugal engineering skills" honed up while catering to the larger part of income pyramid in

India.

The Role of Trade and International Economic Policy in Indian Economic Performance

Anne O. KRUEGER

India's economic policies have undergone major reforms since the early 1990s. Before that, government regulation and control of economic activity was pervasive, and the trade sector did very poorly. One consequence was that imports were highly restricted and their scarcity was itself a major constraint on growth. After the crisis of the early 1990s, trade policy was substantially liberalized. In this paper, the pre-1990s regime is first briefly described. Thereafter, the economic policy reforms that impinged most directly on the trade sector are set forth, and the response of exports and imports to those changes is outlined. Exports have grown rapidly, from about 5% of the gross domestic product to around 15%, and they continue to grow at an average annual rate of 20%. Improved performance of the trade sector has been a major contributing factor to India's dramatically accelerated growth performance. A final section of this paper assesses the current situation, and sets forth the major policy challenges that will need to be met if that performance is to be sustained, if not improved upon.

Economic Reforms and Human Development Indicators in India

Raghbendra JHA

This paper sketches the contours of progress in India across a broad range of human development indicators, especially those related to the Millennium Development Goals. This paper also considers the slackening of the drop in poverty reduction since the 1990s (as compared to the 1980s) and the theme of increasing personal and regional inequality in India in the post-reforms period. It also considers the even more persistent incidence of hunger in India and concludes by assessing the potential role of public policy in addressing the twin problems of slowdown in poverty alleviation and reduction of hunger.

The Political Economy of India's Economic Reforms

Rahul MUKHERJI

This paper analyzes the history of the relationship between the state and the private sector in India. It concludes that India's economic reforms, which made development policy more dependent on international trade and private initiative, depended on the evolution of technocratic and political conviction. Reformers needed the support of financial crises for overcoming the powerful vested interests opposed to reforms. Successful reforms involved largely homegrown strategies of policy and institutional

change. They have produced impressive growth rates and have benefited the rich and the middle class. The challenge for development and sustainable reforms is to make it more inclusive for poor farmers and unorganized workers.

Volume 4, Issue 1 Demographic Change and Asian Dynamics

Long-term Forecast of the Demographic Transition in Japan and Asia

Takao KOMINE, Shigesaburo KABE

The demographic structure of Asia is expected to change rapidly from around 2020 up to around 2050. Following Japan, which is already at an advanced stage of aging and birthrate decline, China, South Korea, Thailand, and Singapore will also witness a further decline in their birthrates and an aging of their populations. Next in line will be the remaining countries of the Association of South-East Asian Nations as well as India. Such changes, accompanied by a decline in the labor force, will not only adversely affect economic growth, but also have a major impact on voting structures, savings rates, and social security systems. Moreover, the process of demographic aging in Asia will be faster than in Japan, and its extent will be substantial, both of which exacerbates the negative effects. On positive side, these trends will give rise to the emergence of new markets.

Demographic Change and Economic Growth in Asia

David E. BLOOM, Jocelyn E. FINLAY

Trade openness, high savings rates, human capital accumulation, and macroeconomic policy only accounted for part of the 1965–1990 growth performance in East Asia. Subsequently, demographic change was shown to be a missing factor in explaining the East Asian growth premium. Since 1990, East Asia has undertaken major economic reforms in response to financial crises and other factors. We reexamine the role of the demographic transition in contributing to cross-country differences in economic growth through to 2005, with a particular focus on East Asia. We highlight the need for policy to offset potential negative effects of aging populations in the future.

Aging, Asset Markets, and Asset Returns: A View From Europe to Asia

Axel BÖRSCH-SUPAN, Alexander LUDWIG

The extent of the demographic changes is dramatic especially in some Asian and European countries. This paper investigates the effect of aging on global asset markets and asset returns, focusing on markets for productive capital, and especially on interactions between European and Asian economic development. Aging has complex effects on the markets for real capital. If elderly people save less than younger people,

interest rates will increase. At the same time, however, the younger generation becomes smaller, which reduces the demand for new investment. The equilibrium effect is thus uncertain. Our multicountry computational equilibrium model delivers a subtle picture: there will be some decline in the return from productive capital, but it is relatively small. We find noticeable interaction effects between labor market and pension reforms in Europe on the one hand, and the demographic and economic developments in Asia, especially India and China, on the other hand.

How to Make the Japanese Public Pension System Reliable and Workable

Noriyuki TAKAYAMA, Yukinobu KITAMURA

This paper has two objectives. The first is to identify current problems in Japan's pension administration. The chief problem is a weak governance structure. In particular, the current governance structure ignores the role of pension participants. A rigorous division and clear assignment of responsibilities to each of the pension participants, the Social Insurance Agency, and the Ministry of Health, Labor and Welfare is urgently needed. Given rapid demographic change, the second objective is to consider the case for full tax financing of the National Basic Pension. It is estimated that the net burden would vary across different cohorts, but we demonstrate that the net burden can be smoothed across different cohorts. This result is quite different from that in the 2008 Interim Report of the Japanese National Council on Social Security.

Ultrasonography and Sex Ratios in China

Hongbin LI, Hui ZHENG

This paper directly measures the causal effects of sex-selective abortions on the sex ratio at birth by exploiting the exogenous county-level variation in the availability of B-ultrasound machines. Using data from the 1990 Census of Fujian Province and local records on the introduction time of B-ultrasound machines, we find that the availability of B-ultrasound machines increases the sex ratio at birth by 0.025 in rural areas and 0.117 in urban areas. The rise of sex ratio is especially significant for second births in rural areas when the first birth is a girl.

Demographic Change and Asian Dynamics: Social and Political Implications

Takashi INOBUCHI

This article describes the demographic change and its social and political implications in East and South-East Asia with a trajectory up to 2050. It selectively touches on inequalities, migration, social policy, and international security. In the course of this exercise, I present two hypotheses: one relating to the formation of the new middle class, and the other relating to the geriatric peace argument. The first hypothesis posits that

when the growing inequalities in terms of per capita income aggravate the sense of happiness among the low- and middle-income strata as contrasted to high-income strata, the formation of a new middle class becomes more difficult. The second hypothesis posits that when the aging population carries a large demographic weight, it tends to be transformed into strong political voice, which is, in turn, translated into larger government spending on social policy items often accompanied by a likely decline in the defense expenditure budget. These hypotheses paint a provocative picture of East and South-East Asia in the next four decades, especially in the wake of the deepening economic difficulties prevailing over the entire globe. I present these hypotheses for further conceptual elaboration and empirical analysis.

Volume 4, Issue 2 The United States and East Asia

American Economic Relations with Asia

Marcus NOLAND

Asian Economic Policy Review Volume 4, Issue 2, pages 181–199, December 2009

The USA and Asia have an enormous stake in each others' continuing prosperity. This outcome is linked to the preservation of the open international economic order, which in turn faces challenges at both the interstate diplomatic level and at the domestic political level. The global financial crisis is probably the worst since the Great Depression and the domestic politics makes it increasingly difficult to formulate a constructive trade policy. In the absence of adequate reform at the global level, the alternative could be further fragmentation into competing regional blocs. Asia holds the key, combining both dissatisfaction with existing global arrangements with the resources to reconstitute, at least at the regional level, an alternative set of institutions and practices. How Asia responds, acting to strengthen reformed global institutions or undermine them in favor of regional alternatives, will partly depend on the policies of the dominant global power, the USA.

US Credit Crisis and Spillovers to Asia

Morris GOLDSTEIN, Daniel XIE

We review key highlights of the global credit crisis. We then consider how financial turmoil in the largest advanced economies might be transmitted to East Asia. The focus is on foreign trade links, international capital flows, currency market pressures and mismatches, financial sector fragilities, and countercyclical monetary and fiscal policy actions. We introduce a set of vulnerability indicators and explore whether an ordinal ranking of East Asian economies according to these vulnerability indicators seems to be related to the cross-country differences in estimated slowdowns of economic growth

during the crisis. Finally, we discuss how Asian economies might encourage the adoption of a stronger regulatory and supervisory framework in the USA and whether some Asian economies and the USA might pursue a more “balanced” growth strategy after the crisis

Politics of Trade in the USA and in the Obama Administration: Implications for Asian Regionalism

Claude BARFIELD

Over the next four years, the Obama administration will face a series of strategic choices in forging policies to respond to a growing momentum for advances in Asian regional structures. Though faced with domestic political challenges; not least from within his own Democratic party – President Obama and his advisers will need to set a course for the reassertion of US leadership in constructing a trans-Pacific vision, through new US-based free trade agreements, signing on to existing agreements such as the P-4 (Singapore, New Zealand, Brunei, the Philippines), or consolidating existing free trade agreements among Asia Pacific Economic Cooperation (APEC) nations. In pursuing this vision, the US should take advantage of the fact that the next three APEC leaders meetings are in Singapore (2009), Japan (2010), and the USA (2011); a sequence ripe for synergistic teamwork.

US Foreign Direct Investment in East Asia: Strategy and Policy Issues

Mahani ZAINAL ABIDIN, Nor Izzatina ABDUL AZIZ

East Asian trade and investment policies have attracted US investment into the region, but these policies should be fine-tuned for the region to compete effectively for US investment inflow and increase their global share of US foreign direct investment. The changes should consider the needs of the US investors and East Asia's own economic development. Bilateral free trade agreements with the US are the likely channel for these changes, but the question is whether East Asia is ready for a comprehensive and deep liberalization. East Asia should work toward a regional investment policy framework to facilitate and expand the regional production network developed by the US foreign direct investment.

Window of Opportunity Opens: Asian and American Views of the International Economic Architecture

Wendy DOBSON

This paper compares US and Asian views of the international economic architecture including Asia's evolving regional institutions. Lessons from the global financial crisis are used to assess reforms of the financial institutions better to prevent and manage future crises. While G-20 leaders have increased the resources of the International

Monetary Fund, much work remains to restore its legitimacy and independence and to define clearly the Financial Stability Board's mandate to strengthen financial oversight and regulation. The paper critiques proposals for a global super-regulator and concludes that while the global architecture is important, the tests of its success will be fewer government actions to self-insure and the willingness to heed warnings of future problems and take timely corrective actions.

US and East Asian Security under the Obama Presidency: A Japanese Perspective

Yoshihide SOEYA

The most important factor determining the structure of East Asia will continue to be the strategic relationship between the USA and China. It is the key component of the six party talks on the North Korean problem as well as nuclear nonproliferation. Japan is obviously a lesser strategic player, which is in a position to encourage middle-power security cooperation among the East Asian countries breathing between the USA and China. There is a conceptual, if not geopolitical, competition between Japan and China over an ideal future of East Asian regionalism, which the East Asian countries and the USA should join in a constructive manner.

Volume 5, Issue 1 The Environment and Climate Change

Policy Framework for Transition to a Low-Carbon World Economy

Ross GARNAUT

Volume 5, Issue 1, pages 19–33, June 2010

Climate change mitigation policy is the most difficult to come before our polity in living memory. There can be no solution without international agreement involving all substantial economies, and yet each country has an incentive to free ride on others. The international agreement must have five parts: agreement on the objective in terms of concentrations of greenhouse gases in the atmosphere, agreement on allocation of an emissions entitlements budget among countries, agreement on rules for international trade in entitlements, agreement on developed countries taking the lead on development of low-emissions technologies, and agreement on assistance from developed countries for climate change mitigation in developing countries. Two sources of market failure must be corrected to achieve emissions reduction targets efficiently: the external costs of emitting greenhouse gases and the external benefits of private investment in innovation in relation to low-emissions technologies.

Reaching a Global Agreement on Climate Change: What are the Obstacles?

Gary Clyde HUFBAUER, Jisun KIM

A successor accord to the Kyoto Protocol was supposed to be wrapped up in Copenhagen in December 2009, but negotiations are now expected to extend through the South African UNFCCC conference in 2011 since the Copenhagen talks failed to yield a binding agreement. To reach a comprehensive deal, major gaps between developing and developed countries must be narrowed. The gaps include the character of common but differentiated responsibilities, financial support, technology transfer, and trade subsidies and sanctions. The paper concludes with some options and recommendations.

Climate Change Policy Options for Asian Economies: Findings from an Integrated Assessment Model

Dominique VAN DER MENSBRUGGHE

This study outlines potential futures for the global economy through the 2050 with a specific focus on the countries of Asia. With underlying assumptions about population and output growth, a baseline scenario assesses the growth of greenhouse gas emissions and the ensuing impacts on the climate. Under the baseline scenario, Asia's high growth leads to a strong rotation in global output and emissions by the year 2050. The analytical framework traces back the changes in temperature to economic damages – limited to the agricultural sectors. Parts of Asia are likely to see much higher dependence on food imports as a consequence of these damages. Various carbon tax scenarios are implemented to assess the potential for reducing carbon emissions. Because of the structure of their economies, Asian countries are likely to bear the greatest burden in reducing emissions in an efficient global tax scheme, but there is significant scope to ease this burden through financial transfers.

Multi-level Governance and Global Climate Change in East Asia

Miranda A. SCHREURS

Climate change is an issue that requires integrated action at multiple levels of government and within the spheres of politics, economics, and society. National, regional, and local governments have both distinct and complementary roles in developing climate mitigation and adaptation strategies. Compared with the attention that has been given to international and national activities in East Asia, relatively limited attention has been paid to the role of urban and regional governments in combating global climate change. Cities and provinces are initiating their own climate action plans, positioning themselves as environmental model cities, and joining local, national, and international networks for climate change. This article examines urban and prefectural climate policies in China, Japan, and South Korea within a multilevel governance framework.

Reconciling Economic Growth and Carbon Mitigation: Challenges and Policy Options in China

Jing CAO

As the biggest carbon emitter in the world, China is facing tremendous pressure domestically and internationally. To promote the international efforts to tackle climate change, the Chinese government announced its 2020 carbon intensity target and is actively taking part in the international climate negotiations. In this paper, we review some of the climate burden-sharing proposals raised by Chinese scholars to shed some light on China's perspective on the post-Kyoto climate architecture. Then we summarize China's current pollution abatement policies and measures, and analyze some potential policy instruments for China to reconcile its future economic growth and carbon mitigation, as well as some practical design and enforcement issues to be considered for the near term.

Volume 5, Issue 2 Asia Reshaping the Global Economic Order

International and Regional Cooperation: Asia's Role and Responsibilities

Peter DRYSDALE and Shiro ARMSTRONG

Asia has emerged from the global financial crisis as an important stabilizing force and an engine of global economic growth. The establishment of the G-20 gives Asian economies the global forum that they need to both represent their interests in global governance and deliver on responsibilities concomitant with their growing weight in the global economy. The region has a host of cooperation arrangements in APEC, ASEAN+3, and EAS (East Asian Summit), all with ASEAN as the fulcrum. They are huge assets, but they need to be repositioned to relate effectively to the G-20 process and other global arrangements. They also need to comprehend the politics of the changing structure of regional power. This paper discusses the challenges that Asia faces in aligning regional and global objectives in financial, trade, and other areas of cooperation, such as climate change and foreign investment. It argues that Asia is now a critical player in the global system and has a central contribution to make in strengthening global governance and international policy outcomes. The paper sets out ways to fill gaps in regional cooperation and link the agenda for regional cooperation more effectively to Asia's new role globally. This is essential to sustain Asia's superior growth performance, correct imbalances, and support the global economic system.

Asia and the Reform of Global Governance

Miles KAHLER

Asia's growing economic weight in the world economy is unlikely to produce substantial

changes in global economic governance. National economic capabilities are not easily translated into influence over governance outcomes or institutions. Governments must deploy strategies of engagement with key institutions; incumbent powers will attempt counterstrategies. Coalition-building within and outside the region confronts substantial obstacles that reduce Asia's bargaining leverage. Asian preferences over institutional design and policies are unlikely to diverge from the status quo. A more pessimistic scenario includes resistance to global surveillance, spillover from other issue-areas, and defensive regionalism that undermines global institutions.

Global Imbalances and the Financial Crisis: Reassessing the Role of International Finance

Claudio BORIO and Piti DISYATAT

This is an abridged version of “Global imbalances, interest rates and the financial crisis: A reconsideration” (mimeograph). We would like to thank Stephen Cecchetti, Anthony Courakis, Ettore Dorrucci, Mitsuhiro Fukao, Joseph Gagnon, Peter Hördahl, David Laidler, Axel Leijonhufvud, Bob McCauley, Pat McGuire, Götz von Peter, Hyun Shin, Edwin Truman, and Kazuo Ueda for helpful comments and discussion. We are also grateful to participants of the Tenth Asian Economic Policy Review Conference, held in Tokyo on April 10, 2010, for comments. Thomas Faeh, Swapan-Kumar Pradhan, and Jhuvesh Sobrun provided excellent research assistance. All remaining errors are ours. The views expressed are those of the authors and do not necessarily represent those of the Bank for International Settlements or the Bank of Thailand.

Financial Crisis, “New” Industrial Policy, and the Bite of Multilateral Trade Rules *Vinod*

K. AGGARWAL and Simon J. EVENETT

The recent Great Recession has triggered substantial government intervention – not all of it macroeconomic. This article presents evidence that the sectoral incidence and forms of government intervention appear to have changed from pre-crisis regularities. Once the commercial significance of a sector is taken into account, pre-crisis measures of trade policy intervention poorly predict the crisis-era sectoral incidence of discriminatory state measures imposed by Asian governments. Qualitative evidence focusing on three key countries in Asia – China, Japan, and South Korea – is also marshaled to sustain the contention that Asian governments have used the recent economic crisis to reinvigorate industrial policies, targeting apparent growth poles and apparently environmentally friendly technologies and sectors. Implications for the expansion of World Trade Organization rules and their effectiveness are discussed

China as Number One: How about the Renminbi?

Takatoshi ITO

Using simulations projecting Chinese economic growth into the future, this paper first examines when China will overtake the USA to become the largest economy. Demographic changes that affect economic growth are taken into consideration in these projections. China is expected to become number one sometime in the mid-2020s, unless its growth rate of gross domestic product per worker declines dramatically, à la the lost decade of Japan. Next, the paper examines whether China becoming the number one economy will mean its currency, the renminbi (RMB), will become the international key currency. According to the basket currency regressions during the period that Chinese currency was gradually appreciating against the US dollar from July 2005 to August 2008, it is shown that the RMB has already acquired a strong influence on the Asian currencies. This shows that the RMB is fast gaining the status of a regional anchor currency for a possible regional joint float. As the Chinese government proceeds with internationalization of its currency, the RMB is expected to gain in the ranking of other aspects of international currency, such as the store of value and the medium of exchange.

Dissecting the China Puzzle: Asymmetric Liberalization and Cost Distortion

Yiping HUANG

We attempt to explain the China Puzzle, the coexistence of accelerating economic growth, and a worsening growth outlook. The root cause lies in China's unique liberalization approach, that is, the combination of a complete liberalization of product markets and continued distortions in factor markets. Repressed costs of labor, capital, land, and resources artificially raise the profits of production, increase the returns to investment, and improve the international competitiveness of Chinese products. The asymmetric liberalization approach not only promoted economic growth, but also caused structural risks. It also contributed to global imbalances as well as regional integration. Therefore, future reform policies should focus on the liberalization of the factor markets and the elimination of cost distortions.

Volume 6, Issue 1 ASEAN Economy: Diversity, Disparities, and Dynamics

Politics of Association of Southeast Asian Nations Economic Cooperation

Rodolfo C. SEVERINO

This paper discusses the political motivations behind the evolution of economic cooperation in the Association of Southeast Asian Nations (ASEAN) from its founding to the measures agreed upon to integrate its economy. Those measures include the

reduction and elimination of tariffs on and the removal of nontariff barriers to intra-ASEAN trade, customs reform, the harmonization of product standards, the liberalization of trade in services, and the strengthening of transportation links. The paper analyzes the failure to fully carry out those commitments, ascribing it partly to domestic political obstacles. Finally, it discusses the efficacy of the ASEAN Charter in this regard and the prospects of achieving an ASEAN Community by 2015.

Association of Southeast Asian Nations Economic Integration: Developments and Challenges

Siow Yue CHIA

The Association of Southeast Asian Nations (ASEAN) was formed in 1967 for geopolitical reasons, but faced with the competitive threat from the North American Free Trade Agreement and the European Single Market, it embarked in 1992 on the ASEAN Free Trade Area in goods, followed by liberalization of services trade and investment flows. A subsequent competitive threat from the rise of China and India led to the ASEAN Economic Community in 2003, targeted at creating a single market and production base and a competitive region with equitable economic development and integrated with the global economy. The ASEAN Economic Community is not quite a common market as it allows for only freer flows of capital and free flows of skilled labor. ASEAN's economic diversity led to difficulties with implementation and the need to narrow the development gap. ASEAN's dependence on global markets and investors led to the emphasis on open regionalism, support of the World Trade Organization, and free trade agreements with its major trade and investment partners.

Thailand after 1997

Siamwalla AMMAR

The years following 1997 divide themselves into three roughly equal periods. The first was the painful period of deleveraging from the excesses of the bubble before the crisis, from which the economy emerged with more dependence on exports. The second period covered the government under Thaksin Shinawatra, who faced a mostly favorable external environment, and was therefore able to pursue many populist policies. Eventually, he was brought down by the military. The brief military government was followed by a number of short-lived governments, the last one of which was left to tackle the consequences of the global financial crisis, which led to a very deep downturn but a quick recovery.

Indonesian Growth Dynamics

M. Chatib BASRI and Hal HILL

An earlier version of this paper was presented to Asian Economic Policy Review conference, Tokyo, October 1, 2010. We thank conference participants for their useful comments, particularly the editors and our two discussants, Chalongphob Sussangkarn and Yuri Sato. We also thank Rizki Nauli Siregar for research assistance. This is a much condensed version of our earlier paper, which also contained more tables and figures. The earlier version is available as an Australian National University working paper.

Revisiting Exports and Foreign Direct Investment in Vietnam

Vo Tri THANH and Nguyen Anh DUONG

Since 1986, Vietnam has undertaken various reform measures in the trade and foreign investment area. This paper finds significant contributions of world trade, and competitiveness and liberalization effects to Vietnam's export growth over the period 1997–2008. Vietnam's exports became more competitive and better complemented the import demand of Vietnam's trade partners. In addition, dynamic comparative advantage became evident in many products, but significant room remains for improving export competitiveness. Foreign direct investment (FDI) inflows also increased and helped stimulate Vietnam's exports. FDI inflows have increased in both the short- and long-term, yet are only of a limited magnitude. This necessitates more effective measures to enhance the linkages between FDI and domestic enterprises.

Fundamentals of Myanmar's Macroeconomy: A Political Economy Perspective

Sean TURNELL

The serial underperformer of the region, Myanmar's economy is largely without the institutions and qualities necessary to achieve genuine economic growth. This paper explores the fundamentals of Myanmar's economy, from a perspective that emphasizes policy and institutional failure as the principal determinants of the country's present circumstances. The paper explores Myanmar's economy in a multifaceted way, examining concerns over economic growth, public finances, monetary and financial policies, corruption, and international trade. Notwithstanding the change in the form of Myanmar's governing institutions following the elections of November 2010, the paper concludes pessimistically as to the likelihood of meaningful economic reform in the foreseeable future.

Volume 6, Issue 2 Developments in Asian Finance

Financial Integration in Emerging Asia: Challenges and Prospects

Cyn-Young PARK and Jong-Wha LEE

Using both quantity- and price-based measures of financial integration, the paper shows an increasing degree of financial openness and integration in emerging Asia. Assessing the impact of a regional shock relative to a global shock on local equity and bond markets, the findings suggest that the region's equity markets are integrated more globally than regionally, although the degrees of both regional and global integration have increased significantly since the 1997/1998 Asian financial crisis. However, emerging Asia's local currency bond markets remain generally segmented, being neither regionally nor globally integrated. There are potential benefits from increased regional integration of financial markets. Financial integration at the regional level allows for the region's economies to benefit from allocation efficiency and risk diversification. Policymakers in the region must strike the right balance between maximizing the net benefits from regional and global financial openness, and minimizing the potential costs of financial contagion and crisis.

Chiang Mai Initiative Multilateralization: Origin, Development, and Outlook

Chalongphob SUSSANGKARN

This paper discusses the Chiang Mai Initiative Multilateralization (CMIM) – its origin, development, and outlook. The experiences of the 1997–1998 East Asian financial crisis that led to the creation of the Chiang Mai Initiative (CMI), the evolution of the Chiang Mai Initiative to become the CMIM, and the setting up of the ASEAN+3 Macroeconomic Research Office (AMRO) to support CMIM are reviewed. Proposals are made on how to make the liquidity support role of the CMIM more effective. These involve changing the International Monetary Fund link from that based on using more than a certain percentage of a country's CMIM quota to that based on the number of times the 90-day CMIM swap needs to be rolled over, supplementing the size of the CMIM through linked bilateral swaps, allowing “contributing partners” beyond the current CMIM members, and developing the effectiveness of AMRO and its evolution into an East Asian monetary organization.

Changes in Development Finance in Asia: Trends, Challenges, and Policy Implications

Toshiro NISHIZAWA

There have been shifts in the composition and nature of development finance in Asia, such as the mainstreaming of private sources of finance and the emergence of domestic resources potentially available for development purposes. In parallel, new trends and challenges are identified in such areas as the transformation of development aid, public–private partnerships, and green finance. A common challenge is how to

strengthen financial intermediaries for longer term sustainable financing from domestic and external sources for investment serving development purposes. To address this, policymakers should bear in mind policy coherence and consistency from macro, sector, and micro perspectives. For various financial resources to bring about tangible benefits, policymakers should take account of complementarities and synergies among the full range of available financial resources. The effective utilization of private sources of finance depends on commercial viability. The key to success is incentive design and risk mitigation measures.

Are Asian Sovereign Wealth Funds Different?

Edwin M. TRUMAN

Sovereign wealth funds have become a prominent feature of the international financial landscape. However, legitimate concerns have been raised about these funds. Many of those concerns can be addressed via increased accountability and transparency by the funds. The Santiago Principles are a good start in doing so. My sovereign wealth funds scoreboard points to areas where these Principles can be improved. At the same time, the OECD effort to address concerns from the host-country side has not resulted in the erection of new barriers to that form of cross-border investment, but the OECD failed to reverse the creeping financial protectionism of the past decade. Because of their size and the source of their funding, some Asian funds stand out. As a result, those funds will be held to a higher standard of accountability and transparency.

If the Banks are Doing So Well, Why Can't I Get a Loan? Regulatory Constraints to Financial Inclusion in Indonesia

Jay K. ROSENGARD and A. PRASETYANTOKO

Indonesia's financial sector has two paradoxes: (i) Indonesia has been a global leader in microfinance for the past 25 years, but access to microfinance services is declining; and (ii) Indonesia's commercial banks are liquid, solvent, and profitable, and the Indonesian economy has been doing well over the past decade, but small and medium enterprises are facing a credit crunch. Although Indonesia is underbanked, most commercial banks have been unresponsive to unmet effective demand. The behavior of banks has been in their own short-term best interests, primarily because of the unintended consequences of Indonesia's financial sector reregulation after the East Asian crisis and contradictory monetary policies, which have produced a prudentially sound but inefficient, narrow, and homogenized banking oligopoly. Indonesia should not respond to financial exclusion by artificially pumping out and administratively allocating more credit. Instead, it should promulgate smart regulation so that banks maintain their sound risk management without pursuing noncompetitive and noninclusive business practices.

Islamic Banking in Malaysia: Unchartered Waters

Mohamed ARIFF and Saiful Azhar ROSLY

This paper explores the Islamic banking business in Malaysia since its beginning in 1983. The Islamic banking sector has achieved its target of 20% market share in assets and deposits in 2010. To boost the industry's competitiveness and efficiency, the demands of the market forces will have to be delicately balanced with the dictates of the Shari'ah. The search for niche Islamic banking products warrants enhancements in the current regulatory, legal, and fiscal infrastructure for Islamic banking, without which these products cannot be a viable alternative to the conventional ones. While the prevailing infrastructure is conducive to Islamic banking products that hold similar characteristics with interest-bearing loans, Shari'ah compliance can be a futile exercise when the purpose of the law (maqasid al-shari'ah) is overlooked, for there is much more to Islamic banking than the elimination of interest.

Volume 7, Issue 1 Korea in Transition

Korea's Growth Performance: Past and Future

Marcus NOLAND

South Korea is arguably the premier development success story of the last half century. Rapid growth coincided with extensive state interventions in the economy, and considerable controversy exists as to how much this performance should be credited to the country's state-led development strategy and to what extent the lessons from that experience might be portable or applied elsewhere. The salience of this issue has grown as South Korea has become a more important provider of development assistance and advice. Now the country faces challenges in maintaining its superior economic performance, notably interrelated problems revolving around the country's demographics, long-term fiscal position, and lagging productivity in the services sector domestically, and a taxing environment externally. Finally, the country confronts scenarios involving potential instability, collapse, and/or absorption of its neighbor, North Korea.

Lessons from the 1997 and the 2008 Crises in Korea

Hangyong LEE and Changyong RHEE

The Korean economy was hit harder than anticipated by the global financial crisis. In the first phase, large capital outflows led to a severe liquidity strain in the foreign exchange market, resulting in a rapid depreciation of the exchange rate. Then, in the second phase, the contraction of global demand led to a collapse of exports and a sharp

decline in economic activity, raising concerns about a full-fledged financial crisis in Korea. This paper describes how the global financial crisis spilled over into the Korean economy and how the Korean government responded to the financial turmoil. It also provides the background and rationale for the Korean government's decisions to adopt specific policy measures. Based on Korean experiences during the 1997 and the 2008 crises, this paper documents the lessons learned from the past two crises and identifies several important policy issues.

Chaebol and Industrial Policy in Korea

Wonhyuk LIM

Although the degree of sectoral targeting changed dramatically from the 1960s to the 1970s and then from the 1980s onward, Korea maintained an outward-oriented, bottom-up, and integrated approach to industrial policy, relying on close public-private consultation and international benchmarking. The government and the chaebol systematically studied what had to be done to fill the missing links in the domestic value chain and move up the quality ladder, through technology acquisition, human resource development, and construction of optimal-scale plants aimed for the global market. As the capacity of the private sector increased and sectoral targeting became a more difficult proposition, Korea shifted to a more sector-neutral approach, which provided support for industry rationalization and R&D regardless of sectors. This was in line with a larger shift from industrial policy to competition and corporate governance policy, starting with the enactment of the Monopoly Regulation and Fair Trade Act in 1980.

Meeting the Social Policy Challenges Facing Korea

Randall S. JONES

Korea faces the fastest population aging among Organisation for Economic Cooperation and Development countries and increasing levels of income inequality and relative poverty. While economic growth will help address these challenges, growth alone is not sufficient, making it necessary to introduce policies to promote social cohesion. First, the National Pension Scheme and the National Health Insurance need to be improved. Second, Korea should develop well-targeted social programs and expand the earned income tax credit. Third, it is important to reduce labor market dualism, a major cause of inequality due to the large wage gap between regular and non-regular workers. Fourth, education reform is needed to lower the financial burden of tertiary education, reduce the heavy reliance on hagwon and increase spending on preprimary education. At the same time, it is essential to maintain a sound fiscal position by increasing tax

revenues, primarily through indirect taxes and environmental taxes, to cover rising social spending.

Determinants of Labor Market Participation and Wages of North Korean Female Refugees in South Korea

Shi-Eun YU, Byung-Yeon KIM, Woo-Taek JEON and Seung-Ho JUNG

This paper uses data from a survey on 289 North Korean female refugees who arrived in South Korea in 2007 to understand the determinants of their economic adaptation in the South Korean labor market. More specifically, we look at the effects of job finding channels and government policies on the labor market participation and wages of these women. We find that job finding through both personal contacts and public employment networks increases the probability of finding employment, but the former, especially job finding through contacts with South Koreans, is the most effective route to finding employment. In addition, jobs with higher wages are acquired in employment attained from South Korean referrals, followed by South Korean government agencies and those from North Korean refugee contacts. We further find that labor market participation is negatively affected by both public benefits and private transfers possibly because of increases in the reservation wages of job seekers.

Volume 7, Issue 2 Fiscal Policy and Sovereign Debt

The Fall and Rise of Keynesian Fiscal Policy

Alan J. Auerbach

This paper reviews the recent evolution of thinking and evidence regarding the effectiveness of activist fiscal policy, including how policy multipliers might vary with respect to economic conditions. Like many other countries that were hit by the “Great Recession,” the USA responded initially with active fiscal policy measures. But a more positive view of fiscal intervention appears to have developed earlier in the decade, and estimated decision rules confirm that there was an increase in policy activism. While this positive view has been tested by the unclear effects of fiscal policy during the Great Recession, recent evidence does suggest that fiscal policy may be especially effective in recession. Fiscal policy activism has also been tempered by recent concerns about growing government debt, a development which potentially might also undercut the effectiveness of expansionary fiscal policy.

Fiscal Challenges in the Euro Zone

José Manuel Campa

Fiscal challenges in the Euro zone have been at the center of global economic concern in the last 2 years. Despite lower debt burdens, and higher fiscal efforts taken by Euro

countries, a perception of high fiscal risk remains. This paper reviews the fiscal challenges facing the Euro area countries and the measures taken at the Euro area level to manage short-term pressures and to enhance long-term functioning of the area, as well as the main lines of national specific reforms. The paper shows the unique characteristics of the Euro area that still raise concerns to foster stability and the challenges to address them.

Fiscal Prudence and Growth Sustainability: An Analysis of China's Public Debts

Gang Fan and Yan Lv

This paper analyses and assesses China's current fiscal system, including its basic institutional arrangements, the relationship between central and local governments, and the fiscal balance and public debt. This paper pays special attention to the local government borrowings that have increased dramatically in recent years, and tries to measure the "overall public debt risk" by including all kinds of eligible debts. This paper finds that although the large expansion of local government debt during the fiscal stimulation response to the global financial crisis was devastating, the all-inclusive total public debt to gross domestic product ratio remains under 50%, and as long as the local debt stops growing, the risk is quite manageable. This paper also points out that more attention should be paid to improving and reforming the Chinese fiscal system, particularly the reform of the fiscal relationship between central and local governments, and the legal framework for local government debt management.

Estimating Non-Keynesian Effects for Japan

Keigo Kameda

Is a fiscal stimulus effective? This classical question has received significant research attention since the collapse of the global financial services firm Lehman Brothers. Although most studies agree on the existence of Keynesian multiplier effects, several studies also demonstrate the existence of non-Keynesian effects. What explains this lack of consensus in the literature? In this paper, we aim to bridge the two views by estimating a near-vector autoregressive system that includes interaction terms of fiscal instruments, and the debt-to-gross domestic product (GDP) or the primary-deficit-to-GDP ratios. Moreover, to embed the dynamics of the debt-to-GDP ratio in the analysis, we explicitly incorporate the government budget constraint. By computing and comparing the impulse response functions, we find Keynesian effects when fiscal conditions are sound, and non-Keynesian effects when the primary deficit is large.

Global Financial Crisis and ASEAN: Fiscal Policy Response in the Case of Thailand and Indonesia

Kanit Sangsubhan and M. Chatib Basri

Sound macroeconomic and financial fundamentals, plus quick and forceful fiscal policy responses contributed to Thailand's and Indonesia's economic recovery in the aftermath of the global financial crisis. This paper reviews the impacts of the recent global financial crisis on the Thai and Indonesian economies, and identifies the characteristics of the fiscal stimulus package in each economy and their implications to counter the negative impact of the global financial crisis.

Volume 8, Issue 1 ASEAN's New Frontiers

ASEAN's New Frontiers: Integrating the Newest Members into the ASEAN Economic Community

Richard Pomfret

Since Vietnam, Lao People's Democratic Republic (PDR), Myanmar, and Cambodia joined the Association of Southeast Asian Nations (ASEAN) in the 1990s, concerns have been raised over a Development Divide. The real division is between ASEAN members participating in the integrated East Asian economy and those that do not. The older ASEAN members have become more efficient traders, and Cambodia, Laos, Myanmar, and Vietnam must reform faster if they are to catch up. Cambodia, Lao PDR, and Myanmar are not meeting the challenge, but Vietnam may be leaving the laggards, and the Philippines is lagging the leaders. The challenge is how to avoid a two-tier ASEAN with fast-growing modern economies coexisting besides inward-looking poor countries.

Cambodia: Rapid Growth with Weak Institutions

Hal Hill and Jayant Menon

We acknowledge with thanks the excellent research assistance of Anna Cassandra Melendez, the support of the Asian Development Bank Cambodia resident mission, and very helpful discussions with friends and officials during our various visits to Cambodia. For helpful comments on an earlier draft, we thank the review editors, our discussants, Sothea Oum and Peter Warr, together with Hang Chuon Naron, Chan Sophal, and Dyna Heng. The views expressed in this paper are those of the authors and do not necessarily reflect the views and policies of the ADB or its Board of Governors or the governments they represent.

The Lao Economy: Capitalizing on Natural Resource Exports (pages 70–89)

Jayant Menon and Peter Warr

We are grateful to Anna Cassandra Melendez and Ramesh Paudel for excellent research assistance. Comments of Sothea Oum, Hal Hill, and other participants in the Japan Center for Economic Research symposium are gratefully acknowledged. The views

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Toward Myanmar's New Stage of Development: Transition from Military Rule to the Market

Fumiharu Mieno

The economic reforms implemented by the Thein Sein government face several challenges, some of which continue from the past military regime and some of which are new. The government is starting to overhaul institutions in order to obtain market-based macroeconomic policy tools, which will possibly eliminate a long-lasting fundamental cause of economic instability. One essential challenge is to design policies to encourage private capital, and to promote the agricultural and manufacturing sectors, which have already shown a high potential. At the same time, a regulatory framework and a well-functioning financial system, which are essential to encourage private capital with market discipline, must be developed. A recent rise in natural resources exports created both a fiscal cushion and balance-of-payments surplus, which seems to have promoted reforms. However, the government should be aware that the recent favorable conditions may not last for a long future.

Vietnamese Economy at the Crossroads: New Doi Moi for Sustained Growth

Van Tho Tran

Thanks to doi moi, Vietnam was successful in escaping the poverty trap and emerged as a lower middle-income country in the late 2000s. From that time, however, the Vietnamese economy entered a new phase, which has been characterized by slow growth, weak international competitiveness, and macroeconomic instability. Apart from short-term problems associated with the management of increasing foreign capital, the major factors accounting for the difficulties of Vietnam's current economic phase can be attributed to the Vietnamese style of the gradualist strategy of transition from a planned to a market economy, which protects state-owned enterprises, and consequently to the failure to respond to the rapid rise of China. For further industrialization and sustained growth, Vietnam should embrace a new doi moi that follows the efficient type of gradualist strategy, with a special focus on new reforms of state-owned enterprises and a policy that promotes the country's dynamic comparative advantage.

Regional Cooperation and Integration in the Mekong Region

Jean-Pierre A. Verbiest

Over the past two decades, several regional cooperation programs were initiated by multilateral and bilateral donors to address concerns about the development gap in the Mekong subregion. Programs such as the Greater Mekong Subregion program of the Asian Development Bank and the Mekong–Japan Cooperation program focused first on improving physical connectivity through transport corridors, regional power development and grid connection, and telecommunications linkages, and were successful. However, as transport and trade facilitation became a priority, the weak institutional capacity of Cambodia, Lao People's Democratic Republic, Myanmar, and Vietnam resulted in a slow progress and is a major challenge to regional cooperation. Other challenges are the pressure on the use of Mekong water resources and the planned construction of mainstream dams, which could threaten the Mekong River Commission's role, the regional rivalry for energy sources, and the lack of attention to unskilled labor issues. The relations between Mekong regional cooperation programs and China are also a main issue to address if cooperation programs are not to become instruments of geopolitical rivalry.

Volume 8, Issue 1 Japan at the Crossroads

Explaining Japan's Unproductive Two Decades

Kyoji Fukao

Using industry- and micro-level data, this paper examines why Japan's productivity growth has been slow for such a long time and how it can be accelerated in the future. Japan's capital–gross domestic product ratio continued to increase after 1991, and this increase in the capital–gross domestic product ratio must have contributed to the decline in the rate of return on capital in Japan by decreasing the marginal productivity of capital. On the other hand, Japan's accumulation of information and communication technology capital and intangible investment was very slow. Compared with large firms, which enjoyed an acceleration in the total factor productivity growth in recent years, Japanese small- and medium-sized enterprises were left behind in information and communication technology capital and intangible investment, and their productivity growth has been very low. Furthermore, as large firms expanded their supply chains globally and relocated their factories abroad, research and development spillovers from large firms to small- and medium-sized enterprises seem to have declined.

Is the Sky the Limit? Can Japanese Government Bonds Continue to Defy Gravity?

Takeo Hoshi and Takatoshi Ito

This paper presents a simulation model based on the growth rate, the inflation rate, and

the consumption tax rate in the future. Future tax revenues and fiscal expenditures are projected using regression models estimated from past data. The fiscal situation is called unsustainable if the outstanding amount of Japanese government bonds (JGBs) becomes higher than the level of private sector financial assets. We focus on the general account of the central government, which is the source of JGB issues. We find that the higher the economic growth, the more likely it is that the fiscal situation is sustainable. When a larger portion of interest income is reinvested in JGBs, the chance is higher that the fiscal situation is sustainable. Most importantly, raising the consumption tax to 20% guarantees fiscal sustainability in most cases. Our analysis shows that without a consumption tax hike beyond the 10% rate, a fiscal crisis will be almost a certainty, even with a real economic growth rate of 2% despite a shrinking labor force. A reasonably quick hike of the consumption tax, namely a hike by 1% a year, up to 20%, combined with high or moderate economic growth rates, seems to keep the economy out of a fiscal crisis, where a moderate growth rate is defined to be generated by a productivity increase per working-age population of 1.9%, which was the average during the Koizumi years.

Response of Asset Prices to Monetary Policy under Abenomics

Kazuo Ueda

In this paper, I investigate the causes of the recent sharp response of the yen and Japanese stock prices to the discussion of, and the subsequent implementation of bold monetary easing by the Bank of Japan as demanded by Prime Minister Abe. I present statistical evidence that the response of the two asset prices have indeed been unusually large relative to the past experience with nonconventional monetary policy (NCM) even after allowance is given for the rise in global economic activity and asset prices. I also point out that the rally has been led by speculative trading by foreign investors, while domestic investors have largely stayed on the sidelines. I discuss possible reasons for such foreign investor behavior. Simply put, the unprecedented political pressure raised hopes of the adoption of bold measures by the Bank of Japan. I discuss, however, the possibility that the room for further action by the Bank is quite limited apart from what might be called a targeted helicopter drop of money. I also point out the possibility that investor behavior may have not been based on economic fundamentals. The asset price volatility since April 2013 is interpreted in the light of such discussions.

Japan's Post-Fukushima Energy Policy Challenges

Ken Koyama

The Great East Japan Earthquake and the successive accidents at the Fukushima Daiichi Nuclear Power Station are stark reminders of the importance of energy, which is the basis of economic activity and national governance. Urgent responses have been conducted since March 11, 2011, including controlling the consequences of the nuclear accident, dealing with the short-term power shortages, and a comprehensive review of Japan's long-term national energy policy. Nationwide discussions and reviews of these issues are still continuing. Even today, more than 2 years after March 11, many problems remain unsolved and Japanese society has to face uncertainty and challenges about its energy future. In the current difficult situation, Japan needs to achieve “3Es (energy security, environmental protection, and economic efficiency)” plus “S” (safety) and “M” (macro economy protection) simultaneously, taking account of the new realities following the Fukushima accident. This paper tries to identify the energy-related challenges that Japan has to face and tries to recommend the concept of the “energy best mix policy” for Japan, by describing the present status of energy issues in Japan and the national debate on energy policy.

Industry-specific Real Effective Exchange Rates and Export Price Competitiveness: The Cases of Japan, China, and Korea

Kiyotaka Sato, Junko Shimizu, Nagendra Shrestha and Shajuan Zhang

This paper constructs a new dataset of the industry-specific real effective exchange rate, based on the producer price indices, for Japan, China, and Korea on a monthly basis from January 2001 to February 2013 in order to provide a better indicator for export price competitiveness. By conducting simulation analysis, we found that Korean electrical machinery firms substantially improved their cost competitiveness by lowering their production costs during the Korean won appreciation period, while Japanese firms' large plant investment caused by management misjudgments led to excessive production capacity, which resulted in the deterioration of Japanese export competitiveness. A structural vector autoregression analysis also reveals that industry differences of cost competitiveness as well as nominal exchange rate changes have significant impact on export performances of Japan and Korea.

Free Trade Agreements and Domestic Politics: The Case of the Trans-Pacific Partnership Agreement

Megumi Naoi and Shujiro Urata

What is the role of domestic politics in facilitating or constraining a government's decision to participate in free trade agreements (FTAs)? This paper seeks to answer this question by focusing on the domestic politics in Japan over the Trans-Pacific

Partnership Agreement (TPP). In particular, we ask why the opposition to the TPP encompasses a much broader segment of society than is predicted by trade theorems. We show that a broader protectionist coalition can emerge through persuasion and policy campaigns by the elites, in particular, powerful protectionist interests expending resources to persuade the uncertain public.

Volume 8, Issue 1 Japan's Persistent Deflation and Monetary Policy

Chronic Deflation in Japan

Kenji Nishizaki, Toshitaka Sekine and Yoichi Ueno

Japan has suffered from a long-lasting but mild deflation since the latter half of the 1990s. Estimates of a standard Phillips curve indicate that a decline in inflation expectations, the negative output gap, and other factors such as a decline in import prices and a higher exchange rate all account for some of this development. These factors, in turn, reflect various underlying structural features of the Japanese economy. This paper examines a long list of these structural features that may explain Japan's chronic deflation, including the zero lower bound on the nominal interest rate, public attitudes toward the price level, central bank communication, weaker growth expectations coupled with declining potential growth or the lower natural rate of interest, risk-averse banking behavior, deregulation, and the rise of emerging economies.

Micro Price Dynamics during Japan's Lost Decades

Nao Sudo, Kozo Ueda and Kota Watanabe

We study micro price dynamics and their macroeconomic implications using daily scanner data from 1988 to 2013. We provide five facts. First, posted prices in Japan are ten times as flexible as those in the US scanner data. Second, regular prices are almost as flexible as those in the USA and Euro area. Third, the heterogeneity of frequency and size of price change across products is sizable and maintained throughout the sample period. Fourth, during Japan's lost decades, temporary sales have played an increasingly important role in households' consumption expenditure. Fifth, the frequency of upward regular price revisions and the frequency of sales are significantly correlated with the macroeconomic environment, in particular indicators associated with a labor market, while other components of price changes are not.

Product Downsizing and Hidden Price Increases: Evidence from Japan's Deflationary Period

Satoshi Imai and Tsutomu Watanabe

In this paper, we empirically examine the extent to which product downsizing occurred

during the deflationary period in Japan, as well as the effects of product downsizing on prices and quantities sold. Using scanner data on prices and quantities for all products sold at about 200 supermarkets over the last 10 years, we find that about one third of product replacements were accompanied by a size/weight reduction. We also find that a 1-percentage point larger size/weight reduction is associated with a 0.45-percentage point larger price decline, resulting in an effective price increase. Finally, we show that the quantities sold decline with product downsizing, and that the responsiveness of the quantity sold to size/weight changes is almost the same as the price elasticity, indicating that consumers are as sensitive to size/weight changes as they are to price changes. Our results suggest that the Japanese consumer price index may be downwardly biased rather than upwardly biased.

Who Faces Higher Prices? An Empirical Analysis Based on Japanese Homescan Data

Naohito Abe and Kyosuke Shiotani

On the basis of household-level scanner data (called homescan data) for Japan, we construct a household-level price index and investigate the causes of price differences across households. We observe large price differentials across households, a result that is consistent with the previous research based on the data in the USA. However, the differences across age and income groups are small. In addition, we find that elderly people face higher prices than the younger ones, which is contrary to the results of the previous research. The most important determinant of the price level is the extent to which households rely on bargain sales; doubling purchases of goods at bargain sales decreases the price level by about 2%, while shopping frequency only has a limited effect on the price level.

A Pass-Through Revival

Etsuro Shioji

It has been found that the pass-through of the exchange rate and import prices to domestic prices has weakened over time. The most recent research, however, shows that this trend may have been reversed. Recent studies have applied various time series methods to the Japanese data, and estimated responses of domestic prices to the exchange rate and import prices in different time periods. Those studies have found signs that pass-through has made an impressive comeback since the early 2000s. This paper reviews the most recent evidence and discusses its policy implications. I argue that the exchange rate has likely regained its status as an important transmission mechanism of monetary policy to domestic prices.

Is Downward Wage Flexibility the Primary Factor of Japan's Prolonged Deflation?

Sachiko Kuroda and Isamu Yamamoto

By using both macro- and micro-level data, this paper investigates how wages and prices evolved during Japan's lost two decades. We find that downward nominal wage rigidity was present in Japan until the late 1990s, but disappeared after 1998 as annual wages became downwardly flexible. Moreover, nominal wage flexibility may have contributed to Japan's relatively low unemployment rates. Although macro-level movements in nominal wages and prices seemed to be synchronized, such synchronicity is not observed at the industry level. Therefore, wage deflation does not seem to be a primary factor of Japan's prolonged deflation.

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