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The China-Japan Cooperation and the Asian Century

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# The China-Japan Cooperation and the Asian Century <sup>1</sup>

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## **Abstract**

If the gravity of the economic power shifts from West to Asia, but West keeps taking leadership, the discrepancy between leadership and economic power will undermine the world. The cooperation between China and Japan gives a hint to solve this mismatch. This paper propose how China and Japan cooperates. It covers a lot of dimensions, including leadership, Globalization, International rules, One Road and One Belt, the AIIB problem, Yen and Yuan internationalization, and the Asian monetary integration.

## **Asia as a World Leader**

The world economy's center of gravity is shifting from West to East. Without a major distraction, Asia is likely to produce half of the world GDP by 2050. Asia is destined to be the center of international trade, investment and finance. The question is if Asia is prepared to lead everything, economically, politically, militarily, and technologically. It is going to be difficult without strong foundations of technological advancement, innovation, and institutional quality.

United States and West are going to lead the world in terms of politics, security, economy, and technology. They play a dominant role in the international system based

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<sup>1</sup> This paper is written as the final chapter in the book entitled, "China and Japan in the Global Economy".

on the multilateral arrangement: a UN system for political order, WTO and other mechanism for economic and trade order, and World Bank, IMF for the financial order. However, the Donald Trump's election has done substantial damage to American-West soft power, which is based on the value system of freedom, human rights, and democracy.

If the gravity of the economic power shifts from West to Asia, but West keeps taking the leadership, the discrepancy between leadership and economic power will undermine the world. A town prospers when the rich become the bank and police.

The cooperation between China and Japan gives a hint to solve this mismatch. However, one may be afraid of the China-Japan cooperation. Indeed, China and Japan competes for the regional leadership. While Japan had been a political and economic power in Asia, China has been catching up with Japan. Some degree of trust has to be restored for both to cooperate effectively. There are political, military, and historical disputes in the nation level. Due to the vicious spiral of medias and politics, public opinion polls say that about 80 percent of Japanese do not trust China and about percent of Chinese do not trust Japan. On the other hand, there is an increasing interdependence at the citizen levels. Past 30 years, China and Japan have been closely integrated through bilateral trade and capital flows. Increasing numbers of travellers visit Japan. Additionally, increasing numbers of undergraduate and graduate students from China seek jobs in Japanese big companies, and hope to live in Tokyo, the most beautiful and fantastic city in Asia.

## **Leadership**

There will be two constraints for the Asian leadership, the one for China and the other for Japan. Japan has been autarkic until the openness forced by the West in the mid of the 19th century. Since the revolution called Meiji Restoration, Japan ascended and attempted to take the hegemon in Asia. However, since the defeat of the WW2, Japan is militarily subject to the US by the US-Japan military alliance, which would work as constraints on the prosperity and stability of the future Asia. If Japan's decision making is controlled or manipulated by the United States, and if United States can force Japan to make a decision that is against the interest of Japan, other Asian countries do not believe that Japan is a leader. Japan has to become a "normal country", which means that all the decisions are to be made on the interest of its own country. This does not mean that Japan should have nuclear weapons, but means that Japan has to decide if Japan has nuclear weapons.

Historically, China has not been globalized except for the old Tang Dynasty. Since the defeat of the Opium War, China was semi-colonized by West and invaded by Japan. China is insular and xenophobic. The style and rationale of China's ascendance to the international and regional order are not compatible with the 21th value system of freedom, human rights, and democracy. In 2013, China's President Xi Jinping unveiled China's new national strategy collectively known as One Belt One Road, a key part of the country's "going-out" strategy. China seeks to force the core-periphery relation to neighbouring countries. ASEAN are afraid of the China's outward policy against multilateral diplomacy and core interests for territorial claims and sovereignty. The historical fact that both China and Japan have had poor experiences of having equal partnership internationally has been the obstacle to their leadership. However, the emergence of the Trump presidency will be a turning point for the establishment of the

Asian leadership. His protectionism and military expressions that are lack of consistency are the force to have a common interest for China and Japan. The rejection to TPP by the president Trump is against China and Japan who have a common interest in trade globalization. The US's weakening military power in Asia will promote Asia to be independent of the US and help the leadership of China and Japan in Asia.

### **Asia as a Winner of Globalization**

Over the past three decades, the progress of financial globalization has been accompanied by the convergence in per-capita income between the Advanced and the Emerging. Capital inflows from the capital-rich Advanced to the capital-poor Emerging supposedly contributed to convergence, but the reality is different. Capital has flown from the Emerging to the Advanced since the late 1990s. What contributed to this surprising pattern between growth and capital flows is Asia. Several Asian countries realized export-oriented economic growth and ran current accounts. Asia is the winner of globalization. In contrast, the West is a loser of globalization. Many western countries were defeated by the trade war with Asia, and imported the unemployment.

Populism prevailed in Western Europe or the entire Europe which means the entire European continent will be politically more conservative, economically maybe lean towards protectionism, and social culturally will be more chauvinism and in terms of decision-making, policy-making may become more fragmented.

Both China and Japan achieved their economic miracles by adopting export-oriented strategy. These two countries have benefited considerably from the unprecedented trade liberalization and globalization. With the Trump administration, the progress of trade liberalization and globalization is highly likely to be interrupted, or

even reversed. The two countries are in a good position to work together and jointly take the leadership to promote regional economic integration and defend the global trading system. Both countries and the whole Asia Pacific region will benefit from the close cooperation of the two countries.

With the demise of the Trans-Pacific-Partnership (TPP) negotiations, which included Japan, Malaysia, Brunei, Singapore, and Vietnam, it is all the more necessary for the RCEP members to conclude the negotiations. The RCEP agreement not only coalesces FTA partners but also replaces nine economic partnership agreements and the ASEAN+1 FTAs into a single agreement, between the negotiating countries. In establishing the RCEP, it would facilitate and accelerate the development of regional supply chains and boost the flow of trade and investment

### **International Rule**

The establishment of Asian Infrastructure Investment Bank (AIIB) in December 2015 and the One Belt One Road (OBOR) were the epoch-making progress of the Chinese international commitment. China now intends to provide an organization or a conceptual framework for infrastructure development in the world. Although the US and Japan have some resistance in accepting the new initiatives, less developed countries (LDCs), potential recipients of the financial support, basically welcomed China's new initiatives.

Two principals have steadily advanced in the context of the World Trade Organization (WTO), free trade agreements (FTAs), and bilateral investment treaties (BITs). One is the liberalization principle, and the other is a backup for liberalization to level a playing field. The former prohibits any country from discriminating foreign

countries in trade in goods and services, investment, and government procurements. The latter includes the concept of the fair competition, including discipline or remedies for subsidies, and the treatment of SOEs and other government's involvement.

Although TPP was not agreed, it includes a path-breaking chapter on the international rules for implementing high-quality infrastructure investment. If private companies and SOEs compete in bidding for a foreign infrastructure project, a SOE subsidized by the government may win the bidding although this SOE does not have any highest-quality project if there were no international rules. The competitive environment to realize the high-quality projects is necessary for the development of the global value chain in Asia.

### **One Belt One Road**

In 2013, China's President Xi Jinping unveiled China's new national strategy collectively known as One Belt One Road(OBOR), a key part of the country's "going-out" strategy. OBOR is a development strategy that builds the network of highways, railroads, and ports between China and other Eurasian countries. It is reminiscent of the Marshall Plan, an American initiative to help rebuild Western European economies after the end of World War II. The goals of that plan were to rebuild war-devastated regions, remove trade barriers, modernize industry, make Europe prosperous once more, and prevent the spread of communism.

China has to make others trust the goals of this plan. The success of OBOR relies on if China builds the complementarity in economic relation with neighboring economies. One may be afraid if OBOR is the tool of the demand creation for the overcapacity of the steel production. Or one may be afraid if OBOR is the means of

establishing the China's hegemon by colonizing neighboring Eurasian countries economically.

### **Cooperative competition between ADB and AIIB**

Since the establishment in 19xx, the Asian Development Bank (ADB), which Japan and the U.S. are leading shareholders, has had a significant role in developing, researching, and financing integration initiatives. The establishment of Asian Infrastructure Investment Bank (AIIB) is a challenge to call for the change in the international order in the field of Asian development finance.

The concern is whether ADB and AIIB compete or cooperate. The essential point lies ultimately in the trust between China and Japan. Unfortunately, currently there is the lack of trust between Prime Minister Abe and President Xi Jinping. Japan sees the lack of transparency in the governance because China has a strong power of decision making at AIIB, and anybody joining the AIIB has to have trust with the Chinese decision maker, who may include President Xi Jinping.

In reality, ADB could not catch up with an increasing demand for infrastructure investment in Asia. The establishment of AIIB emerged as a reaction to that criticism. ADB applied the strict loan standards to developing countries, and is blamed for this "under-investment". In contrast, AIIB is supposed to supply loans with far looser standards than ADB, and raises the concern about the potential "over-investment" to low-quality projects.

In principle, the organization that supplies the international public goods is best to be a monopoly so long as its organization is efficient. Otherwise, there is the room for competition although there is the inefficiency of the wasteful resources related to the

duplicative investments. Indeed, ADB and AIIB could complement with each other by pooling the fund together to support infrastructure projects which needs large inputs, and share the risk of investment. On the other hand, the cooperation of far different organizations in terms of international rules and conditionality could give rise to huge organizational inefficiencies. Particularly, if there are no international rules to discipline subsisted SOEs who would bid for an infrastructure project, inefficient and wasteful infrastructure will be built at the large scale in Asia.

We have to discuss the ADB versus AIIB problem in terms of how to realize the efficient stock of infrastructure in Asia. A “cooperative competition” is a keyword to solve the problem. Both institutions can benefit from competition because they are disciplined to use more flexible and innovative rules to find good projects. In particular, via competition, AIIB certainly need to be more open for their governance structure. As a result of competition, AIIB could grow up to benefit from the good track record of ADB in project management and knowledge. The competition is an input for the successful cooperation, which welcomes the international development part of the China-Japan collaboration.

### **Triangle among China, Japan, and ASEAN**

China and Japan have played a foundational role in institutional development and facilitating regional integration, but the rationale and style behind China and Japan strengthening ties differ. These differences may have significant implications for ASEAN going forward. While Japan’s approach towards ASEAN and regional integration shifted from bilateral basis to multilateral engagement, China rationale for bolstering its involvement in ASEAN’s regional integration agenda differs significantly.

However, the Sino-Japan rivalry instead of having a detrimental effect on the region and integration actually benefitted ASEAN by spurring institutional development and mechanisms to facilitate regional integration. The Sino- Japan rivalry benefited the development of the Chiang Mai Initiative Multilateralisation (CMIM). In setting up the new CMIM, the members agreed that 80 per cent of the funds would come from China, Japan, and South Korea, with the other 20 per cent coming from ASEAN.

In order to strengthen Japan and ADB's support for the initiatives, Japanese Prime Minister Shinzo Abe in 2015 announced that Japan and the ADB would be providing U.S.\$110 billion in infrastructure funding over the next five years. This is part of Japan's new development program, seen as a direct response to China's established AIIB. In 2016, the AIIB has begun signing framework agreements and memorandums of understanding with both the World Bank and ADB, respectively. The presidents of the AIIB and ADB signed a cooperation memorandum on strengthening cooperation in international development.

ASEAN takes the casting vote. ASEAN is so diversified, so different in all kinds of issues and second, ASEAN has no leadership. One might wonder if ASEAN is divided over issues such as the South China Sea. ASEAN is one of most growing areas in the next three decades, and need cooperation among member countries in order to behave as a glue to draw the cooperation from Japan and China, which will in turn facilitate regional integration and the Asian century.

### **The Yen and the Yuan:**

Since the link to the gold was abolished in 1971, the credibility of the US dollars is declining, giving rise to several epoch-making events, the Plaza agreement, the

emergence of the common currency euro, and Global imbalances. China and Japan have emerged as the world's largest creditors, while the US is the world's largest debtor in terms of net foreign assets. Nevertheless, the US Dollar (USD) has maintained its dominant role as the world's reserve currency. After the eruption of the financial crisis triggered by the Lehman shock, the US dollar was rather strengthened, showing that the US dollar looks really truly global currency and it is backed by the sound private capital markets.

In contrast, the two major Asian currencies, the Japanese Yen (JPY) and the Chinese Yuan (CHY), play a marginal role in the world economy. When China and Japan trade goods, the Chinese Yuan is first converted into the US dollar, and then the US dollar is converted into the Japanese Yen. This would be a perverted world from the lens of the world under the gold standard. If the gold standard were to be adopted, JPY and CHY are the two major international currencies because the valuation of currency is then backed by the country's gold reserves, which in turn is proportional to the net foreign assets.

Japan once attempted to make an independent move from the US. Japan proposed the creation of an Asian Monetary fund (AMF) during the 1997 Asian financial crisis at the G7-IMF meetings. It was aimed towards securing a regional network funded by Asian currencies, particularly by JPY to overcome the current crisis. This proposal of the AMF stirred conflict between Japanese authorities and the United States, and rejected. Part of the proposal of the AMF was succeeded to the Chiang Mai Initiative (CMI). It was agreed by ministers of finance of several Asian countries to expand the network of bilateral swap arrangement of foreign reserves against possible financial crises.

However, the attempt to push JPY up to the international currency was suspended along with the long-lasting stagnation of the Japanese economy. In 1990, the Tokyo market measured by the total amounts of stocks and private bonds dominated the New York or London market. Although financial markets were freely liberalized by 2000, the monetary policy set the nominal interest rate almost zero for the two decades, which in turn prevented the development of the Tokyo financial center.

China attempts to promote the internationalization of CHY by increasing the CHY dominated transactions with the trading partners of ASEAN. Joining the member country of SDR in 2015 is also a first step of pushing up CHY to the international currency. Capital controls and other regulations on financial markets are the obstacle to pushing up CHY to the global currency. In principal, for an economy like China, which every year trades about \$4 trillion in goods and services with the rest of the world and has a liberalized current account, it is almost impossible to maintain a very rigid managed floating system. The persistent depreciation of the yuan and massive capital outflows since 2016 challenges the stability of the Chinese economy and may trigger financial crisis. This is the sign of a yellow lamp for the international currency.

What is common to Japan and China is that domestic financial markets are not matured as to push their domestic currencies up to the global currency. For the USD, it is obvious that the matured financial market serves as the collateral for the global key currency. Among the all the international settlement, financial transactions amount to nearly 97 percent, while those of trade is only 3 percent. As episodes of the Wall street and the Cities show, the internationalization of the domestic currency requests the supply of financial assets denominated by the home currency to foreign investors.

The central concern is how to develop the Asian financial markets, which will realize risk sharing, liquidity provision, and an efficient capital allocation in this region. The precondition for the developed financial infrastructure is to establish a settlement system that is useful for Asian currencies.

Related are other aspects than the financial development. The financial architecture should also be linked to growing energy demand in the region. Just as the commodity futures exchanges have grown explosively after the oil crisis in 1970s, when the US was the biggest crude oil importer, Japan is the largest natural gas importer today, and should establish a LNG price index in the JPY, as the WTI is indexed in the USD. Only then, the futures market will grow and the index will be used not only for buyer/seller settlement, but also for hedging against the JPY.

The use of the domestic currency in Asia is closely related to the pattern of trade transactions. To facilitate the further use of the yen in Asia, Japan needs to increase its imports from Asian countries. Indeed, Japan has expanded its imports of manufacturing goods from Asian countries. But, if most of imported intermediate inputs are used for final goods production destined for the US market, the USD tends to be chosen in Asia. Similarly, although Chinese government attempts to promote the CHY internationalization, the further use of CHY would not be expected unless China increased its role of final destination market for neighboring Asian countries.

### **Asian monetary integration**

The early experience in Europe, called the Werner Plan comprising three steps to achieve the European monetary integration, is useful to understand the procedure of the monetary integration. In the first stage, member countries are to be engaged in

narrowing the fluctuation band of their exchange rates to the target. The anchor of the target is the new currency unit, which should be a basket currency. In the second stage, they are to establish the regional monetary fund to supply liquidity. In the final stage, this fund is to turn into the central bank.

Establishing the multicurrency clearing system in Asia (MCSA) contributes to the first stage. In principle, the clearing arrangement across multiple currencies eliminates settlement risks for securities and currencies, and clears each currency on the payment-versus-payment basis, and facilitates financial transactions among Asian countries. Additionally, MCSA collects the data for financial transactions, and contributes to calculating the accurate ratio of the currency basket of Asia. Among the international settlement, financial transactions amount to nearly 97 percent of all the settlement.

If the Japan and China are in good positions to go on the second stage. Huge foreign reserves in both countries are effectively used for securing the stability of the fund. MCSA backed by the fund serves the role of providing liquidity safely. The third stage is straightforward once the arrangement reached the second state.

The US and other western countries may object to the establishment of MCSA. Given the dominant status of the CLS in the foreign exchange markets, what justifies a multi-currency system in Asian market although there is still a USD clearing system? The CLS is a most advanced multi-currency clearing arrangement covering major countries, but covers only 4 Asian countries, with the Western strict “global standard”. Toward the gravity shift of the world’ economic center, Asia is at the stage of taking the initiative of providing the international public goods.

The triangle relation among the JPY, the USD, the CHY are very complicated. If we try to promote the JPY and the CHY either for investment currency or as invoicing currency, definitely it would undermine the status of USD.

Asian monetary integration needs the research sector independent of IMF. Multilateral initiatives such as the ASEAN+3 Macroeconomic Research Office (AMRO) are under progress. About AMRO, what you talked is the IMF delink portion of Chiang Mai initiative which is currently 30 percent. The finance ministers already agreed to consider the possibility of 40 percent. Potential recipient countries argue for 40percent, while potential creditor countries including Japan and China, are more conservative and want to continue to hold it at 30 percent. Since there is call for an increase in the IMF delink portion, I think eventually 30 percent would be raised to 40 percent. In fact, I have been arguing that this delink portion should be ultimately 100 percent.