

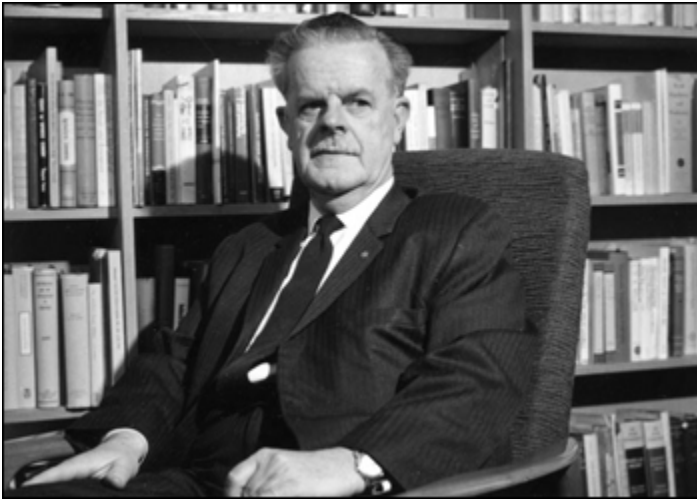
SECOND CRAWFORD NISHI LECTURE
ON AUSTRALIA-JAPAN RELATIONS

Kazumasa Iwata

Australia-Japan Research Centre
Crawford School of Economics and Government

Crawford-Nishi Lecture on Australia-Japan Relations

This Crawford-Nishi Lecture Series on Australia-Japan relations commemorates the pioneering efforts by the late Sir John Crawford, then Secretary of the Department of Trade and later Vice Chancellor of the Australian National University, and Japan's first Ambassador to Australia, HE Mr Haruhiko Nishi, formerly Head of the Japanese Ministry of Foreign Affairs and Ambassador in Australia from 1952-55, to encourage the development of Australia-Japan trade.



Sir John Crawford

H.E. Mr Haruhiko Nishi



Their efforts throughout the period of Ambassador Nishi's assignment culminated in the Australia-Japan Commerce Agreement of 1957. While this agreement was founded in the mutually advantageous commercial interests of both countries at the time, it was also a key instrument in furthering Japan's acceptance into the post-World War II international community. Both Crawford and Nishi understood this very clearly and were eventually able to mobilise political, bureaucratic and public support for the Commerce Agreement.

The Lecture Series, which is expected to become an annual event, has been generously supported by funding from the Australia-Japan Foundation.

The inaugural lecture was delivered in March 2009 by the Australian Minister for Foreign Affairs, the Hon Stephen Smith MP.



Professor Jenny Corbett
Executive Director
Australia-Japan Research Centre



Second Crawford-Nishi Lecturer

The second lecturer invited to present a lecture on Australia-Japan relations was Professor Kazumasa Iwata, President of the Economic and Social Research Institute (ESRI) of the Japanese Cabinet Office.

Mr. Iwata assumed his current position as President of the Economic and Social Research Institute (ESRI), in the Japanese Cabinet Office in 2008. He was deputy governor of Bank of Japan from March 2003-2008. He is the most senior economic advisor to the Japanese Government to visit Australia since the inception of the Hatoyama Cabinet in 2009.

Previously, he was a Director-General in charge of economic assessment and policy analysis for the Japanese Cabinet Office and a Professor at the Department of Advanced Social and International Studies at The University of Tokyo. During his academic career, he served as a visiting professor at the University of Alberta and at Yale University. He was a Visiting Fellow at the Australia-Japan Research Centre at the Australian National University in 1985.



Second Crawford-Nishi Lecture on Australia-Japan Relations

**Crawford School of Economics and Government
The Australian National University
23 March 2010**

Prospects for APEC and the Australia-Japan Relationship

Kazumasa Iwata

**President
Economic & Social Research Institute
Cabinet Office of Japan**

I am very much honoured to be invited here to deliver today's Crawford-Nishi Lecture. Let me start with few words about my own personal relationship with Australia. Way back in the fall of 1985 I stayed at the Australia-Japan Research Centre for about four months as Visiting Fellow, at the kind invitation of Professor Peter Drysdale. I wrote a paper on the financial deregulation in Japan and gave several talks at public seminars organised by the Australian National University and the University of Adelaide. I enjoyed my great stay, which deepened my understanding of the Australian economy.

This time, I am pleased and honoured that Professor Jenny Corbett invited me to speak with you today at the ANU. My talk focuses on the prospects of APEC in the context of the Australia-Japan relationship. The year 2010 is particularly important for Japan, because we will host the APEC Ministerial Meeting and APEC Leaders' Summit in November, followed by the United States in 2011.

This year is also a milestone for APEC, since it is the target year of the Bogor Goals for the industrialised economies of the APEC. At the same time it is the end-year of the 'Leaders' Agenda to Implement Structural Reform' (LAISR). The Bogor Goals were set in 1994 and they aimed to achieve the long-term goals of free and open trade and investments in the Asia-Pacific region in a GATT/WTO consistent manner. The declaration led to the 'Osaka Action Agenda' (1995) and the 'Mid-Term Stocktaking of the Progress Towards the Bogor Goals' (2005 at Busan).

Japan, as chair-economy of APEC in 2010, should play a leading role in assessing the extent to which the Bogor Goals have been achieved, while at the same time setting a new agenda on the growth of the region.

As the start of APEC 2010 process, the first Senior Officials Meeting (SOM) was held in Hiroshima in February. It was confirmed that three issues were to be set as the main agenda this year: Regional Economic Integration, New Growth Strategy and Human Security.

Growth Strategy

Let me start with the New Growth Strategy. This is a critical moment to assess when and how fast the world economy can successfully move out from the unconventional policy regime under the economic and financial crisis triggered by the Lehman Brothers' bankruptcy. Although Australia is moving ahead to normalisation in monetary and fiscal policy management, a common concern for APEC remains how to reconstruct a new growth paradigm after the crisis.

In the United States there are two contesting views on the strength of recovery. One is the 'new normal' view, which predicts about a 2 to 2.5 per cent growth rate in the recovery process. Another is the 'new mix' view, which assumes a 4 per cent growth path supported by exports and business investment. Since the latter half of 2009, the average growth rate was about 4 per cent, with the result that the latter view has so far dominated the former. Yet there is great uncertainty in the exit process from an unconventional policy regime. It can be quite bumpy, as demonstrated by the Greek fiscal crisis. It is critically important for the success of an exit strategy to choose and carry out the right growth strategy over the longer run.

At the SOM in Hiroshima, the new growth strategy was identified as needing to have four dimensions: balanced growth, inclusive growth, sustainable growth and knowledge-based growth (known as BISK). Broadly speaking, these four dimensions correspond to the Hatoyama government growth strategy that was announced in December 2009; green growth (sustainable growth), Asia economic strategy (balanced growth), life innovation in the area of medical and elderly cares (balanced growth), employment and manpower strategy (inclusive growth), revitalisation of local areas (inclusive growth), and science and technology (knowledge-based growth).

The Asia economic strategy addresses directly the issue of establishing the Free Trade Area of Asia-Pacific (the FTAAP) by 2020, while the science and technology strategy aims at achieving the R&D investment target of 4 per cent in terms of nominal GDP. It must be noted

that both the United States and the EU set a target of 3 per cent R&D investment of nominal GDP.

Balanced Growth

With respect to balanced growth, rebalancing the global economy is the overarching challenge for the world economy; most notably, it is a crucial issue regarding how the current account imbalance between the United States and China is to be rectified.

I would like to stress that the demographic changes in Asia (except Japan) can mitigate the global imbalance problem, in addition to the V-shaped recovery prominent in Asian region. For instance, the share of working age population in China will peak in the mid-2010s, while the US working age population share has already reached its peak in 2007, when the global liquidity shock occurred. We observe that the increase in the working age population share is accompanied by the increase in per capita consumption due to the inverted U-shape in the age profile of consumption.

According to some estimates, China's consumption will exceed that of the United States in 2020. In 2008 the consumption of emerging economies was already above that of the United States. The shift of the main engine of global growth from the United States to emerging economies tends to enhance the rebalancing of world demand.

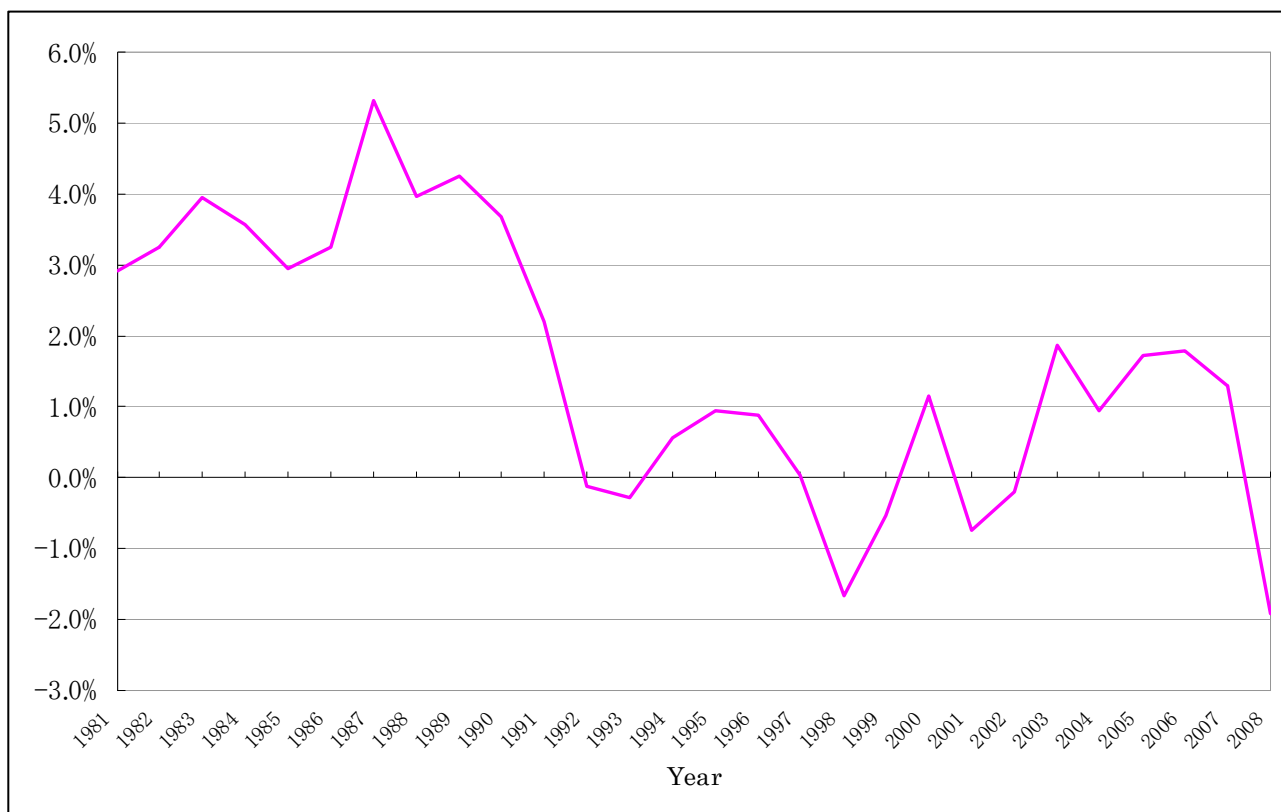
In economic theory the concept of 'balanced growth' is employed in the context of optimal growth path. One notable example is the 'golden rule' of economic growth popularised by Professor Edmund Phelps (1967). On the optimal growth path, the economy expands with the economic growth rate being equal to the rate of return on capital. At the same time, labour input grows at the same rate as the capital stock. The problem the Japanese economy faces is that the population growth rate turns to negative over time. To maintain the labour input growth in efficiency unit, labour productivity must increase more markedly than in the past.

Moreover, Japan faces the problem of an aging society with the increasing share of retirement-age population. Once, Paul Samuelson (1975) pointed out the existence of the 'goldenest golden rule' of economic growth. He argued that there is a lower limit of the rate of return on capital to sustain the life of the elderly after retirement. It is affected by the ratio of per capita consumption after retirement to capital intensity.

I calculated the lower limit by employing the Cobb-Douglas type utility and production function. The critical value on the rate of return on capital is high, at about 6–7 per cent, assuming the capital income ratio is 0.3 (Iwata 1999) [1]. Prior to the bubble bursting in

1990–91, the labour input in efficiency unit increased by 3–5 per cent. Yet, after the bubble burst, the growth rate of labor input hovered at around zero per cent, with the exception of the most recent expansion phase covering from 2002 to 2007.

Chart 1 Growth Rate of Labour Input (Efficiency Unit) in Japan



This points to the importance for Japan to improve its human skills and to undertake reallocation of human resources within a company by promoting the active manpower policies on the labour market, in addition to higher labour participation rates for women and elderly people.

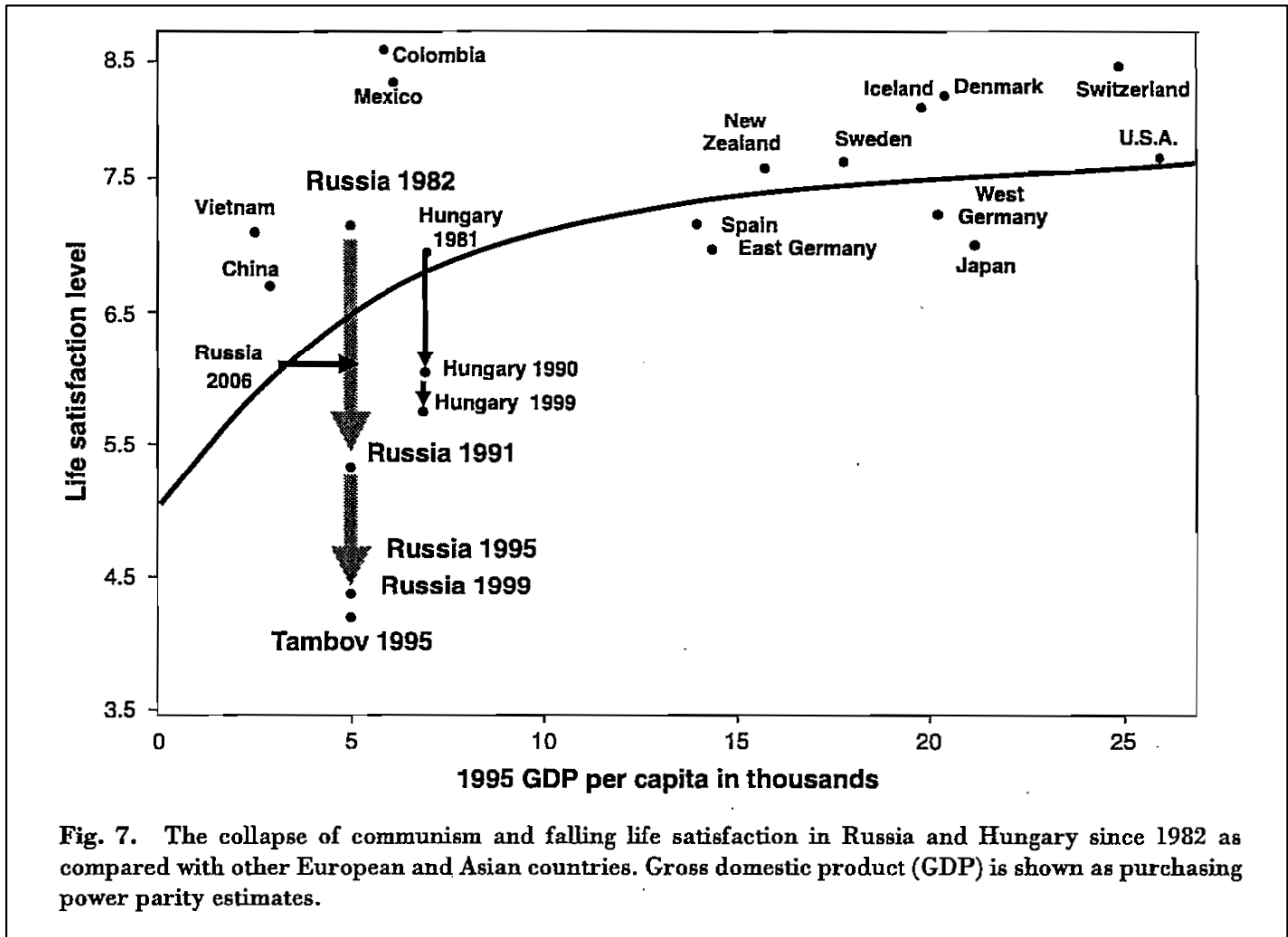
Inclusive Growth

The improvement of human skill is related to the issue of inclusive growth. Inclusive growth touches upon the issue of providing opportunities for growth and a high quality of life to everyone in the process of globalisation.

The Hatoyama government aims at achieving the improvement of quality of life of workers through life innovations.

On the quality of life, the index of Japanese People's Life Satisfaction in 1995 was relatively low, as compared with countries of the same per capita income level

Chart 2 Life Satisfaction



Source: Inglehart and Klingeman 2000.

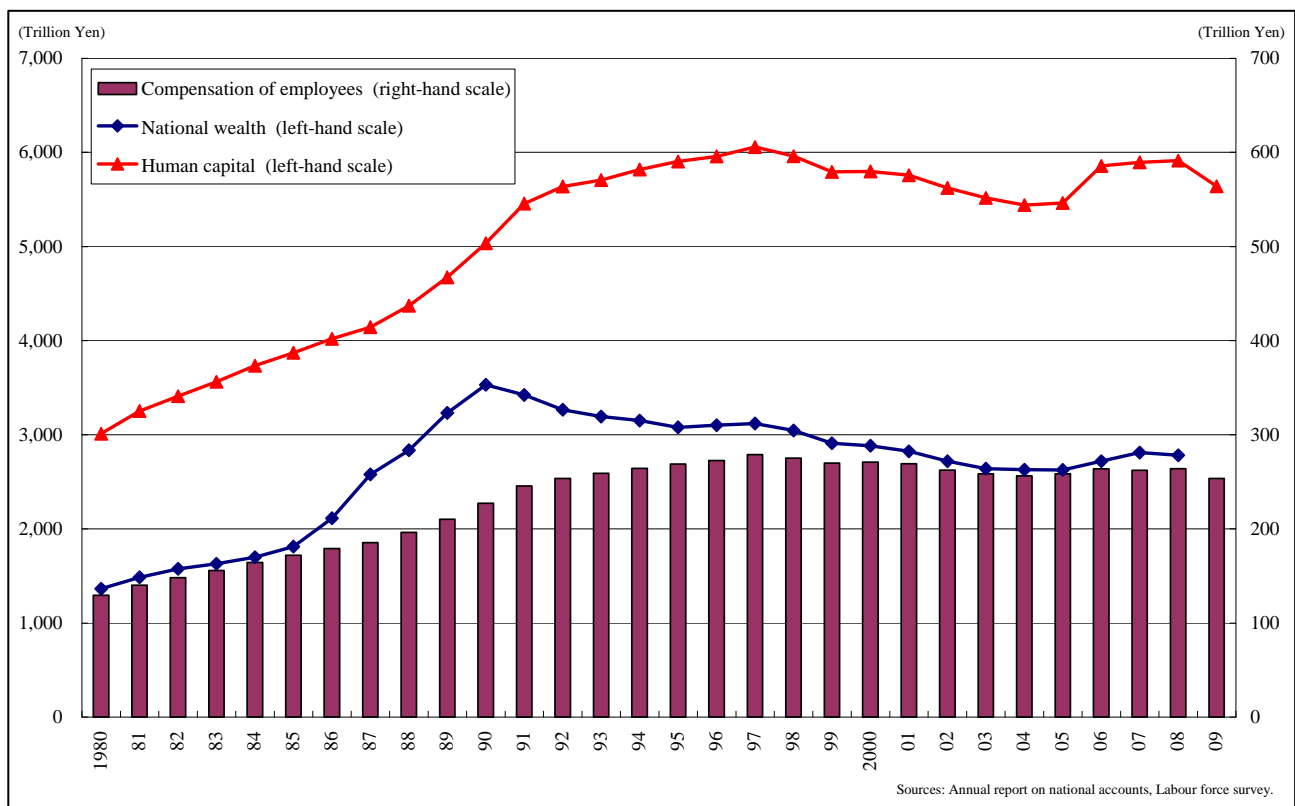
Historical data of individual countries show that it remains flat after the per capita income reached the level of \$10,000 to 15,000. This fact seems consistent with the 'Easterlin paradox' on life satisfaction. He argued that the index of life satisfaction based on the cross-section data is positively associated with per capita income, while the historical data show no relation between the two. However, recent studies based on ample data demonstrates that per capita income is positively associated with life satisfaction, with the cyclical movements being affected by changes in unemployment [2].

In addition, the life satisfaction may be associated more with the future prospects of the society. The transition economies of, for example, Russia and the Eastern European countries had seen a downward shift in the mid-1990s. The Hatoyama government has recently carried out a new survey on life satisfaction. The survey found a lower life satisfaction among Japanese People than those in the United Kingdom and Denmark.

A lower level of life satisfaction in Japan may be related to structural changes on the labor market and the diminished expectation over the future carriers of workers. Japan's working age population began to register a decline in the mid-1990s. This change eroded the traditional employment system, coupled with incentive structures of workers, while it tended to undermine the sustainability of the social security system. The share of non-regular workers increased significantly after the mid-1990s, registering 34 per cent of the total number of workers in 2008. At the same time, the suicide rate jumped in 1997 and has remained high level ever since. Recently the suicide rate of among the younger generations has increased substantially.

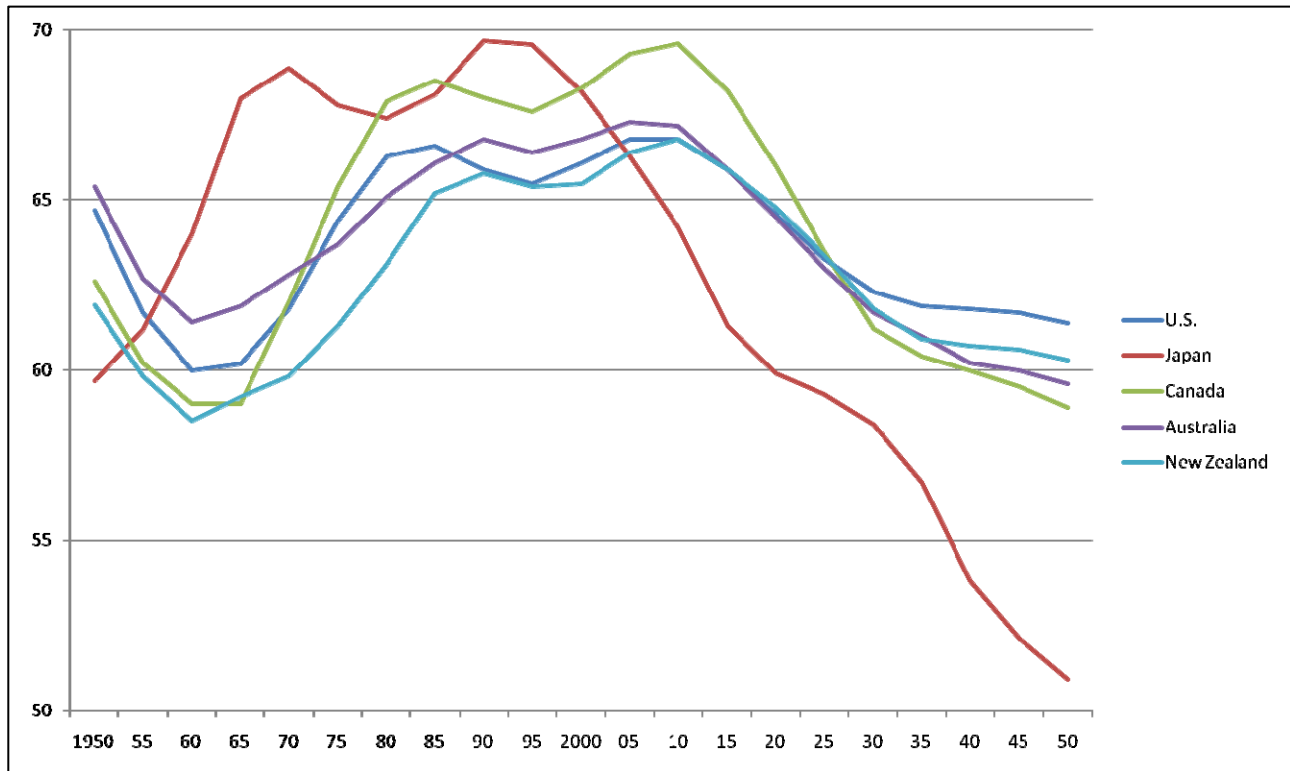
Improvements in human skills can be reflected in wage payments. I estimated for the first time the size of human capital in Japan, based on the assumption that human capital can be defined as the present value of life-time wages of workers. Under the assumption that the expected growth rate of wages is equal to the sum of depreciation of human capital and the discount rate, the value of human capital can be approximated by the number of years to reach the retirement age multiplied by employee compensation. The obtained value doubles the size of national wealth, conventionally measured in the System of National Accounting [3]. It also peaked in 1997.

Chart 3 Human Capital and the National Wealth



Given the declining number of working age population over the future, Japan can achieve economic growth mainly through innovations and improvement of quality of workers, although there is still plenty of room to utilise women and the elderly people more effectively.

Chart 4 Proportion of Working Age Population



Actually, the slight recovery of human capital after 2006 can be attributed to the stepwise change in the starting year of the provision of public pension benefits from 60 to 65 years old. Another possibility is to allow the immigration of skilled workers from abroad at a larger scale, notably in the area of human care services, in addition to engineers and professionals. The adoption of 'points system' employed by the United Kingdom may serve to expand the acceptance of foreign skilled workers (Sugawara 2010)).

Sustainable Growth

Regarding sustainable growth, 'green growth' is one of the core parts of the growth strategy of the Hatoyama government. In March a law was legislated to embark on the ambitious attempt in attaining a 25 per cent reduction of CO2 emissions by 2020 with the base year of 1990, although the proportion of the use of international credit purchases has not yet been determined. Moreover it is not yet decided as to what extent the target of energy intensity will be applied in constructing the 'cap and trade' scheme.

I find it desirable to introduce the 'cap and trade' scheme in pricing the environmental costs. Certainly, the achievement of the ambitious target requires additional costs. The costs are estimated to be from 3.2 to 5.6 per cent of GDP. However the 10 per cent purchase of international credit will cut costs by half, given the assumption of a relatively low price of emissions rights, namely \$50 per CO₂ ton.

Furthermore, the CGE model simulation by the Economic and Social Research Institute (ESRI) indicates that the establishment of international market of emissions rights will lower prices significantly. In addition, it was shown that the spillover of Japanese environmental technology is important in reducing the global costs; it was estimated to bring about a reduction of 11.6 per cent [4]. We can expect that it will make the costs for developed countries bearable, if the developing countries join the commitment on the per-capital-income-weighted-population-based global emissions reduction.

At Sydney in 2007, APEC Leaders declared on 'Climate Change, Energy Security, and Clean Development': the APEC member economies will cut their energy intensity by at least 25 per cent by the year 2030 with the base year of 2005. In achieving the goal, it is crucial to establish a new mechanism to promote the emissions reduction cooperation with developing countries. It is absolutely necessary to diffuse clean technology and products, in addition to the infrastructure investment in water, energy, environment, and production facilities on environmental products.

With a view to introducing a new mechanism, I would favour the proposal on an 'Asian Basket' in securing the purchase of emissions rights by setting a common target for Asia as a whole. We must recall that the 'EU Basket' was employed by the EU to facilitate the achievement of the medium-term target, while the 'Assigned Amounts Units' are used by Russia and the East European countries. Moreover, the proposal on the 'Reduce Emissions from Deforestation and Degradation' favors the US initiative to attain the target.

Knowledge-Based Growth

Regarding knowledge-based growth, it aims at promoting smart socio-economic activities by ICT applications. This includes the protection of innovative technology, the improvement of logistics with IC tags, the E-health and E-government.

On the protection of intellectual property rights, Japan has recently concluded the Economic Partnership Program with Switzerland. In the text of the program the strong protection against the copy and pirated products is clearly prescribed. Further, Japanese enterprises can enjoy significant cost savings from supply chain tax burdens in the EU

through shifting the assembly and the intellectual property rights to Switzerland. This example demonstrates the importance of the FTA in promoting an economic growth strategy.

Free Trade Area for the Asia Pacific (FTAAP)

Since its inception in 1989, APEC started the promotion of 'open regionalism' on enterprises. Now the focus has been shifted from concerted liberalisation to an integrated 'Asia-Pacific Pact', or 'regional economic integration', which goes beyond the liberalisation of trade and investment.

The APEC economies have signed 111 RTAs/FTAs among member countries, with 43 being inter-APEC agreements as of November 2009. Japan has concluded 11 FTAs/EPPs with six in pipeline. The coverage of FTAs in the total trade is still low (16.4 per cent) and lags behind the United States, Korea, China and the ASEAN countries.

Once Baldwin (2006) criticised the 'noodle bowl' FTAs in Asia, which lack top management to substitute for WTO discipline, in addition to low utilization and the 'Rule of Origin' hindrance. Kawai and Wignaraja (2009) responded to his criticism by showing the results of enterprise surveys on the hindrance of the ROO. Yet, it is desirable to establish high-quality FTAs to lead the multilateral trade liberalisation.

In February 2009, the APEC Senior Officials agreed that the APEC's best contribution to sustainable growth over the medium-term would be through accelerating regional economic integration. They discussed and identified the alternative avenues for establishing the FTAAP in the future.

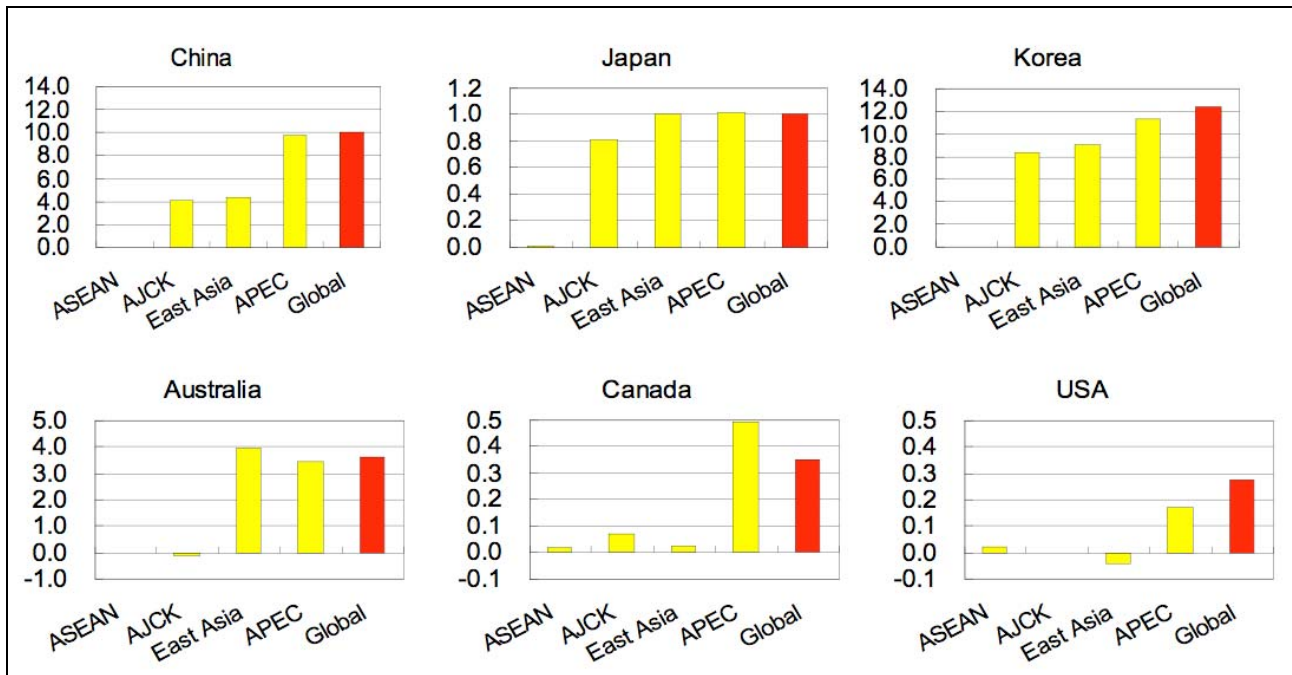
The Hatoyama government included the creation of a road-map to establish the FTAAP in its growth strategy. The government pointed out the importance of setting the growth target of doubling the GDP of developing Asian economies in 10 years. I would like to emphasise that the concept of 'East Asia' community expressed by the Prime Minister includes Australia, as indicated by the membership of the East Asia Summit and the ASEAN+6. The community is defined as the functional cooperation in various fields based on the principles of open regionalism.

Today, we have the following four paths to reach the stage of the FTAAP:

- (1) ASEAN+3
- (2) ASEAN+6
- (3) Trans-Pacific Economic Partnership
- (4) Japan-Korea-China or Japan-Korea-China-Australia

My former colleague, Kenichi Kawasaki, engaged in the simulation exercise on the likely impacts on regional economic integration (2006).

Chart 5 Regional vs. Global Trade Liberalisation (Real GDP Gains in per cent)



The main findings are as follow:

First, wider liberalisation is more beneficial, while the dynamic impacts through capital accumulation and resource reallocation over time, as opposed to static impacts, are more important.

Second, China's gain is significantly larger in the case of the FTAAP, including the United States, as compared with the FTA of the ASEAN+3.

Third, the benefits are larger, where the existing protection measures are stronger.

Fourth, a larger gain for Australia is registered in the case of ASEAN+6 rather than the

FTAAP or global liberalisation; this is mainly due to the competition with the United States in agriculture products.

Fifth, gains by sector through global liberalisation are large in textiles for China, transportation machinery for Japan, and agricultural products for the United States and Australia, as the trade theory predicts.

From the simulation exercise we can see that it is important to achieve a more thorough regional integration by bringing the various FTAs into convergence consistent with the GATT/WTO rules. At the same time we should aim at establishing the high-quality RTAs/FTAs in the Asia-Pacific region.

In addition it is sensible to promote a sectoral approach in areas such as the tariff-reduction of environment goods and services, supply-chain connectivity to deepen vertical integration, port infrastructure, customs and regulatory environment, and e-business infrastructure [5]. Recently, Japan has embarked on the internationalisation of Haneda airport and adopted its open sky policy [6].

The Australia-Japan Relationship

Finally, let me take up the issue of the Australia-Japan relationship in the context of regional economic integration. First, Australia and Japan hold much in common in terms of our vision for APEC and the future of the Asia-Pacific regional integration. Moreover, Australia has achieved high-quality trade liberalisation including services and government procurement in the six FTAs. Exceptions were sugar and dairy products in the US–Australia FTA. The conclusion of the high-quality Australia–Japan FTA can bring about the breakthrough to attain the goal of the FTAAP. It may be noted that the Australian government has expressed the intention to participate in the Trans-Pacific Economic Partnership Program, where a high-quality FTA has been achieved. The TPP target countries for the United States are Australia, Korea, Malaysia, and Vietnam.

Second, for Japan the Australia–Japan FTA is a vital stepping stone in facilitating the convergence of alternative avenues to reach the FTAAP. As a joint study in 2006 demonstrated, the benefits for the two countries from the Australia–Japan FTA (¥3.3 trillion and ¥2.3 trillion respectively) far exceeds the costs which mainly concentrate in agriculture products (¥790 million for Japan).

It is imperative for Japan to implement agricultural reform which can bring about higher productivity and stronger competitiveness in agricultural products. I hope that the

income compensation scheme in Japan should be suitably linked with medium-term trade liberalisation and further deregulation on the use of agricultural land and the easier entry into the agricultural business.

Third, we now see an increasing demand for infrastructure investment in the area of energy, water resources, and environmental protection. Global demand is estimated to amount to \$41 trillion in 2030. In Asia, the demand for infrastructure is increasing enormously. In particular, the Australian government has promoted an international project on pioneering R&D investments on the Carbon Capture and Storage.

Two countries can have good prospects for cooperation on infrastructure investment through applying the Public-Private Partnership to the projects, coupled with financing business to support the projects.

Concluding Remarks

In concluding my speech, let me say a few words on global trade and investment liberalisation. I found it unfortunate to observe an increasing number of trade protection measures after the Lehman shock. The anti-dumping measures have been frequently employed by a number of countries such as Brazil, Mexico, Taiwan, and Turkey. Protection measures have already cooled their imports by 6 per cent (Vanderbussche and Zanardi 2010).

Moreover, the trade friction between the United States and China has also revolved around anti-dumping measures; the origin of the trade friction seems to lie in government procurement issue such as the 'Buy Chinese' practice of government investment or the 'Buy American' clause. It seems to me that the US-China strategic talks or the G2 dialogue are not adequate forums to find constructive solutions. Rather, the WTO dispute settlement process is a better suited venue for solving the trade issue between the United States and China.

In addition, the Obama administration announced its export doubling program in January 2010. US exports in 2009 amounted to \$1.5 trillion. Doubling US exports over five years implies an increase in exports by US\$300 billion every year. Multilateral trade liberalisation will not be sufficient to bring about such a rapid expansion of US exports. It is dangerous, if the United States relies too much on the dollar depreciation and trade protection measures to achieve this goal. I hope that APEC will continue to voice its strong support for multilateral trade liberalisation.

Footnotes

[1] The optimal population growth rate (n^*) can be written as below, where 'a' denotes the capital income share (Iwata (1999)).

$$n^* = 2a / (1 - 3a)$$

[2] Given the accumulation of ample data based on various surveys, Deaton (2007) finds that positive relations exist between per capita income and well-being, contrary to the Easterlin paradox. In the case of Japan, Stevenson and Wolfers (2008) argue that the outcome of the survey on the 'Life in Nation' in Japan, compiled since 1958, is distorted by the series break due to the changes in the response categories in 1964 and questions in 1992. The corrected data for the series break show a positive trend in life satisfaction, instead of a flat movement after 1963.

[3] The calculated results on the size of human capital are broadly consistent with the micro-data based outcome by Takayama et al (1984).

[4] For more details, see Sakashita (2009)

[5] Wilson, J. Mann, C., and T. Otsuki (2007) estimated a significant increase in trade (\$377 billion) by the improvement of transportation/logistics.

[6] The United States has already concluded the open sky arrangements with 96 countries, while it was the first arrangement for Japan. Further, the full liberalisation was not achieved in the US-Japan case, because both the report and the approval are needed by the government in setting fare prices.

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