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East Asia's Economic Potential for the 1990s: A Speculative Essay

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An Intelligence Assessment

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December 1987

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East Asia's Economic Potential for the 1990s: A Speculative Essay [redacted] 25X1

An Intelligence Assessment

This paper was prepared by [redacted] 25X1
[redacted] Office of East Asian Analysis, and 25X1
[redacted] Office of Global Issues. [redacted] 25X1

Comments and queries are welcome and may be
directed to the Chief, Regional Issues Staff, OEA, [redacted] 25X1
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East Asia's Economic Potential for the 1990s: A Speculative Essay

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Key Judgments

Information available as of 1 December 1987 was used in this report.

Before the turn of the century, Western observers could be confronted by several indicators confirming that East Asia is indeed "number one" from an economic perspective—a development that would entail decidedly mixed blessings for US economic, financial, and political-military interests. Current trends, for example, suggest the national incomes of East Asian economies will surpass those of both the United States and the European Economic Community sometime during the 1990s; the volume of East Asian savings and capital formation, the root of productivity growth, already has. At the same time, the area's continued high savings rate suggests the regional current account surplus, currently about $100 billion, will grow further if area governments do nothing to focus growth inward or are not forced to do so by protectionism. When taken together, the extrapolated growth trend and the continued excess of savings over investment suggests that East Asia will occupy a position of both the world's most productive economic block and the world's largest net creditor—a position that, until 1982, was occupied by the United States.

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Recent market- and growth-oriented initiatives in East Asian policymaking, chiefly financial integration and trade liberalization, suggest that the region will do even better than historical trends suggest. Such a policy course will further improve productivity and will accelerate a transformation of regional output from agriculture to services and an even sharper shift in sectoral employment in the same direction. Between now and the turn of the century, we believe services will grow at least 6 percent annually on average, pulling regional GNP in volume terms to about twice what it is currently, and one-third more than present US GNP. At the same time, we think further currency appreciation in Japan and the Newly Industrializing Countries (NICs) will pull East Asian GNP at market prices past $6 trillion. Structural adjustment in the region's two largest economies, a maturing Japan and a developing China, will drive the process from each extreme of the technological spectrum. 25X1

In regard to foreign trade competitiveness, technological advances, a high rate of investment, and a shift away from manufacturing will move the mix of Japanese exports up the technology scale, enabling the NICs to concentrate increasingly on more sophisticated product lines, and shifting comparative advantage in lighter manufactures increasingly to the region's LDCs. At the same time, efficiency gains in China will press the LDCs toward greater price competitiveness in export markets. China will retain a

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large foreign borrowing capacity and, by the mid-1990s, probably will be in a position to run the largest current account deficit in the region if Chinese development policy is committed to such a course. Finally, as Japan's savings rate falls with the aging of the population, the NICs will replace Japan as the locus of the regional current account surplus. 25X1

We believe market forces will drive the region's evolution, principally in the form of currency realignments, the first of which is almost complete with the strengthening of the yen and revaluation of the currencies of the Asian NICs. Similar price adjustments will accompany, and even promote, a series of shifts in trade competitiveness among the region's economies. Although we see little on the horizon to suggest substantially more official economic cooperation among East Asian governments, we believe private-sector initiatives in a more market-oriented policy environment will gradually integrate the region to the point that more than 40 percent of trade is conducted within the region itself—up from about one third currently. Further, East Asian financial centers will become increasingly linked to each other and thus more competitive with the West. 25X1

The primary risks to East Asian economic supremacy are the possible failure of Japan to mature into a service economy because of structural rigidities and political obstacles, the chance that political shifts in Beijing will produce economic policies that direct China's economy inward or back toward the Soviet Bloc, or disruptions in market-oriented economic policy caused by unstable political transitions in the region's LDCs. We are inclined to believe the most likely of these developments is a "stalled Japan," but fairly rapid economic adjustment to the high yen during the last two years suggests Japan will mature as we project. 25X1

East Asia's success will have a dramatic impact on the United States, chiefly through its improved competitiveness in high technology and other product lines. The United States will for the first time since World War II be confronted by a larger, potentially more influential, economic bloc—one that a more independently minded Japan will dominate. 25X1

Accordingly, East Asia's success means that the United States will have somewhat less influence over international economic affairs. For example, international prices and interest rates will be far more independent of US

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policy instruments—a consequence of East Asia's role as primary originator of international trade and primary creator of financial assets. The United States will also have less latitude in setting its own fiscal and monetary policy, especially if US financial obligations to East Asian creditors continue to grow. 25X1

But East Asian success will also generate new opportunities for US exports, particularly agricultural goods, as the East Asian market for imports more than doubles. Continued East Asian current account surpluses will also provide sources of funds for US investment. Further, East Asian heterogeneity will limit the region's ability to use its increased economic clout to the disadvantage of the United States. 25X1

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Scope Note

This paper is the fifth in a series of regional economic assessments on East Asia published by the Directorate of Intelligence. It has two primary objectives. First, it attempts to project the evolution of the most dynamic economic region of the world over the next decade or so. Second, it investigates a claim increasingly made by academic and business analysts: that East Asia will surpass the West in a variety of key economic, financial, and technological indicators by the turn of the century. We summarize the academic case for East Asian supremacy in the text. 25X1

This paper is in many ways the most speculative of the East Asian regional assessments we have published. The time frame is the long term, and this makes it difficult to deal with evolving trends with precision. We do not, for example, attempt to factor in discrete changes in international oil prices such as those of 1978-80, largely because we cannot foretell when, or if, they will occur; we do note that East Asia has weathered such disturbances better than most economic regions in the past. 25X1

The most important qualification of all is that US economic policy will be an important determinant of the path East Asia takes between now and the turn of the century. If US budget deficits were substantially reduced, for example, East Asia's current financial position as largest net creditor would be at risk. And US trade policy will clearly have a substantial impact on the region's international competitiveness. 25X1

Accordingly, this paper begins by considering recent trends in relative US and East Asian economic performance as a baseline. We then consider the most likely future course of economic policy by East Asian governments and assess the degree to which such a course may enhance regional growth and trade performance. We assume no major policy departures on the US side. Our forecasts draw heavily on the expertise of our own country analysts, but our task is to "age" the region in a manner that, by considering competitive relationships among East Asian states, is internally consistent. Thus our forecasts for some countries are either rosier or darker than a narrow view of the country would have suggested. And to ensure that our forecasts for individual countries make sense, we have tested them against World Bank research results on structural change in developing economies. 25X1

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East Asia's Economic Potential for the 1990s: A Speculative Essay

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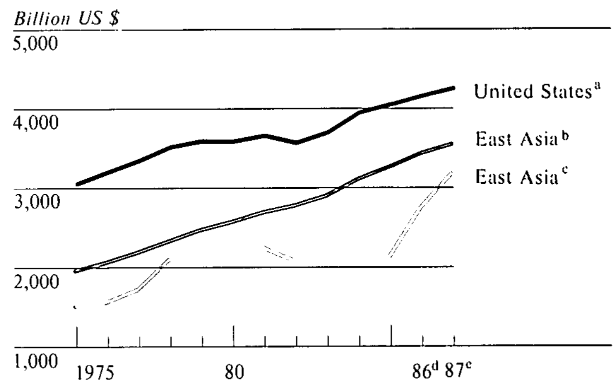
Discussion

Ingredients of the East Asian Edge [1]

Academics and journalists have devoted considerable attention in the last several years to the relative weakness of US economic performance when compared to that of its East Asian trading partners. Concern that corrective adjustments in conventional economic variables such as exchange rates and prices are not working as textbook economics predicts they should has even prompted the introduction of legislation designed to accomplish through administrative measures what competitive markets presumably may not—reduce US trade deficits. Broader concerns among some observers are prompted by more rapid East Asian growth rates and the possibility that Japan's higher per capita income is not an accident produced by volatile exchange rates, but a deeper reflection of an Asian decisionmaking system attuned to late 20th century economic realities.

Figure 1
The United States and East Asia: Gross Domestic Product



[a] Constant 1986 US $.
[b] Constant 1986 US $ using 1986 exchange rates based on United Nations estimates of purchasing power parities.
[c] Constant 1986 prices at prevailing exchange rates for the US $.
[d] Estimated.
[e] Projected.

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Growth Possibilities Abound. The academic and business analyst case that East Asia contains the ingredients for economic dominance—based on technological trends, relative rates of investment, natural resource endowments, and coherent Asian economic policymaking—is not difficult to summarize. In Japan, this analysis begins, the region has a source of technological expertise that exceeds that of the United States in some industries. East Asian growth potential is being enhanced by Japanese direct investment in the region to an even greater degree than Japanese direct investment is expanding productivity in the United States, since countries such as Indonesia and Thailand are just entering the more sophisticated stage of their industrial development and high returns on investment are thus easy to come by. The high rates of savings that prevail in the region—even relatively poor China saves as much as 30 percent of national income—ensure that the required financial capital is available.

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[1] The term "East Asian Edge" is taken from a by now well established body of literature extolling the economic advantages of the region. Best known among the many books on the subject are *The Eastasia Edge*, by Roy Hofheinz and Kent Calder, Basic Books, New York, 1982, and *Japan As Number One*, by Ezra Vogel, Harvard University Press, Cambridge, 1979. A more technically rigorous academic account, which predates either of these, is provided by Edward Dennison, *Why Growth Rates Differ*, Brookings, Washington, 1967. The definition of East Asia adopted in this paper is somewhat different from that found elsewhere: Japan, Australia, New Zealand, South Korea, Taiwan, Hong Kong, Singapore, Indonesia, Malaysia, Thailand, the Philippines, and China. We exclude some states, such as the Indochina countries, on the grounds that they conduct little trade with the West.

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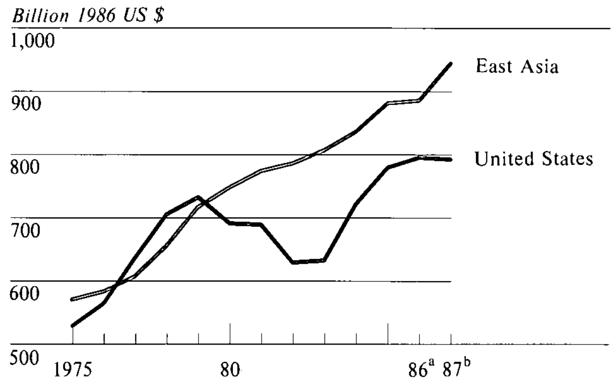
At the same time, Japan and the NICs assure the region's other countries that the large pool of potential investable resources is being internationalized, and thus available to other East Asian states, in the form of current account surpluses—an estimated $110 billion in 1986. The high rates of return on investment that prevail among the region's developing countries provide reason to believe they will receive a substantial share of these funds for productive capital formation. The development of better integrated regional capital markets, underway for several years, ensures that institutional arrangements are encouraging rather than blocking such transfers. 25X1

The region is rich in productive inputs and will grow richer. Rapid labor force growth—already locked in place as a result of high birth rates over the last several years—augment an abundant supply of regional natural resources in most countries (Japan, Singapore, and Hong Kong are the exceptions). Labor force growth among the region's LDCs, for example, ranges to nearly 3 percent. At the same time, the region's relative youthfulness—and the absence of Western-style social insurance schemes in most countries—ensures that high rates of savings will persist in most countries. 25X1

Figure 2
The United States and East Asia: Gross Fixed Investment



[a] Estimated.
[b] Projected.

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Business analysts agree that area governments continue to conduct economic policy in such a way that the region's competitive advantages are realized. East Asian regimes are bolstered by social mandates that traditionally have emphasized superior economic performance and, for the most part, by homogeneous populations that reach consensus quickly. 25X1

At the same time, a trend toward deregulation, financial liberalization, and freer trade regimes—which has proceeded partly because of pressure from the West and the sponsorship by the IMF and World Bank of structural adjustment programs in East Asian LDCs—is further bolstering regional efficiency (see inset). Smaller distortions in interest rates, coherent prices for traded goods, market-determined exchange rates, fewer restrictions on capital movements, and enhanced access by foreigners to local financial markets suggest that investment is being directed to the highest rate of return in the region and thus to its most logical location. This pattern contrasts with those observed in Latin America and Africa, where policymaking often distorts market signals, suppressing trade and instructing private economic actors to avoid the risks that would advance national levels of income and wealth. 25X1

Glimpses of the Future 25X1

Critics of literature extolling the virtues of East Asia would argue that the case for East Asian economic supremacy is closer to an essay than to rigorous analysis. Indeed, the region has had lagging economic performers—the Philippines being the foremost example—and Japan faces different challenges today than those that it met in the 1960s and early 1970s by importing technology and keeping wage growth, and consumption expenditures, sluggish. 25X1

Table 1
East Asia: Regional Labor Force Trends, 1985-2000

Millions of persons
(except where noted)

Country	1985 Population	1985 Labor Force	2000 Population	2000 Labor Force	Annual Labor Force Growth *(percent)*
Japan	120.8	59.3	129.0	65.8	0.7
Australia	15.8	7.2	18.0	8.7	1.3
New Zealand	3.3	1.4	4.0	1.7	1.1
South Korea	41.2	15.4	49.0	20.4	1.9
Taiwan	19.1	7.6	25.0	10.1	1.9
Singapore	2.6	1.2	3.0	1.4	1.1
Hong Kong	5.4	2.6	6.0	3.0	1.1
China	1,045.0	488.0	1,245.0	657.0	2.0
Indonesia	163.4	67.0	212.0	91.5	2.1
Thailand	51.3	26.5	66.0	35.1	1.9
Malaysia	15.6	6.0	21.0	9.1	2.9
Philippines	54.4	20.6	76.0	30.3	2.6
East Asia	1,537.9	702.8	1,854.0	934.0	1.9
United States	239.3	115.2	263.0	131.8	0.9
EEC	321.6	138.4	336.0	146.9	0.4

Source: *World Development Report*, IBRD, 1986. Totals may not add because of rounding.

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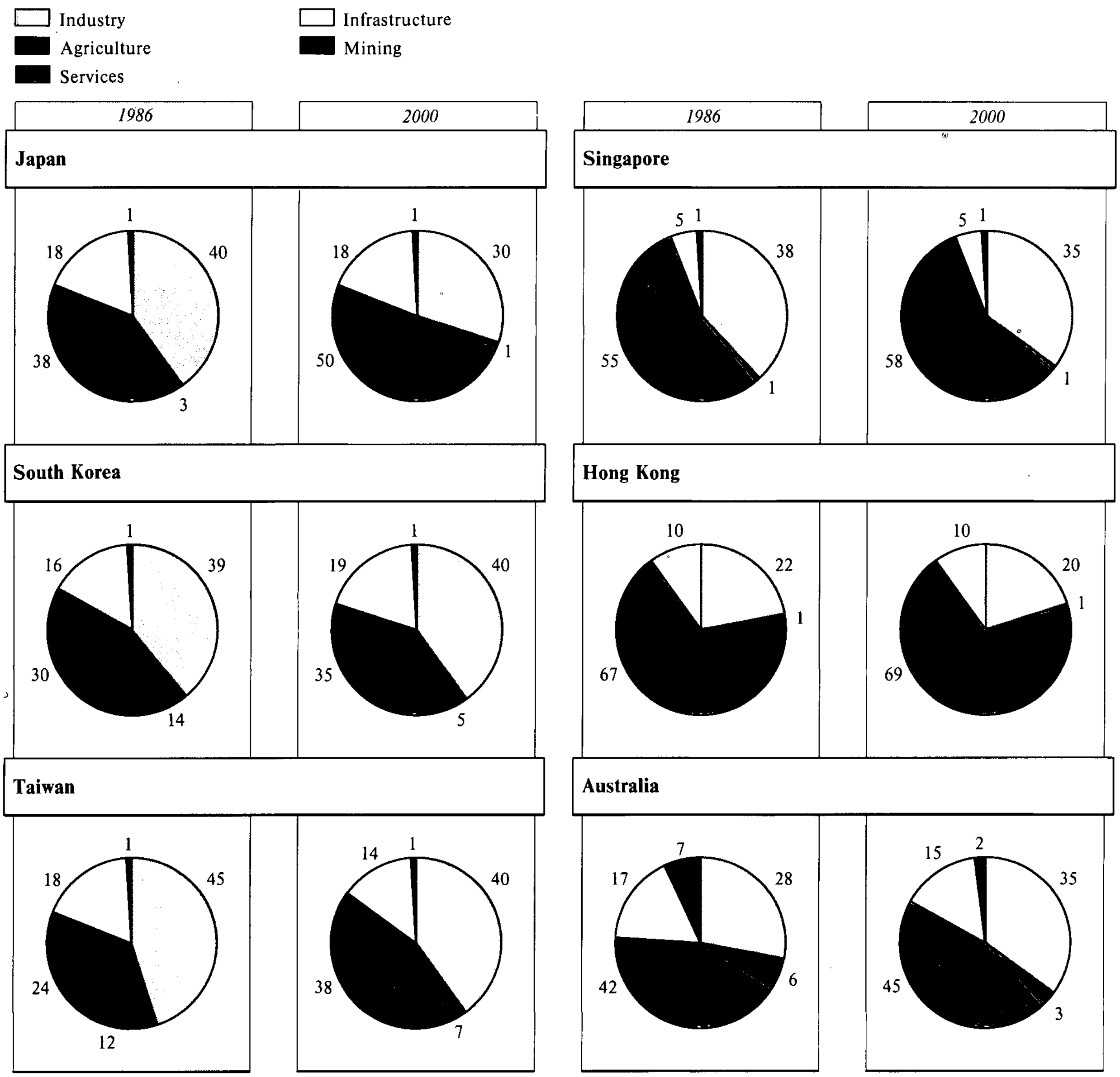
Country-specific analysis nevertheless suggests that the business and academic approach to forecasting East Asia's future can be done with some modification. In particular, using estimated growth trends for individual countries and using them to "graduate" each economy into the economic structure the World Bank judges is commonly associated with that income level, we believe two broad trends will develop during the 1990s. First, the region's more mature economies will develop a trend already observed in the United States, becoming increasingly service-sector oriented. Second, the region's LDCs will deemphasize agricultural output in favor of industrial growth, as LDCs in other regions of the world have. Statistical analysis suggests this trend will be most evident in Thailand, which is just beginning to turn its attention to longer term industrial development and is attracting considerable foreign investment. From a regional perspective, we believe the result will be a shift in production into services at the expense of agriculture—with the share of industrial output remaining more or less the same. Assuming these trends prevail, the region's exports will increasingly involve services, such as finance and transportation, at the expense of extractives such as oil, and at the expense of agricultural commodities such as rubber and rice. 25X1

The regional technological hierarchy—wherein Japan occupies the higher rungs along with Australia, the NICs and New Zealand the next set of rungs, with the region's LDCs bringing up the bottom—will probably still apply. But over the next decade or so the technological capacities of each country could grow as productivity improves. The key to this evolution will be Japan's ability to climb the ladder, vacating the rungs it currently occupies for the NICs, which in turn will be making room for the region's LDCs. We

Figure 3
East Asian Output:
Profile of Structural Change, 1986-2000[a]



[a] Projected, using 1986 as a base year.

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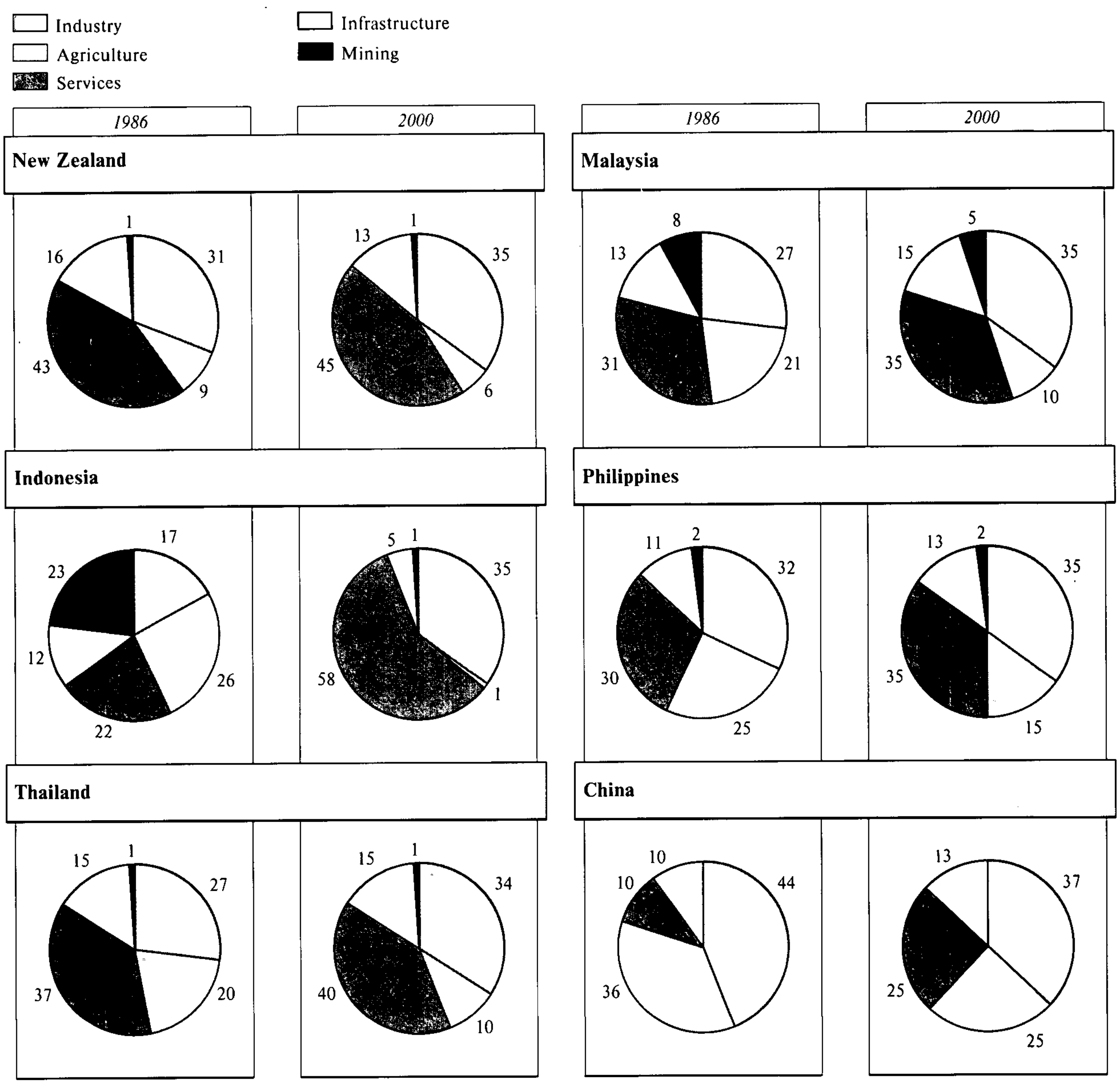
Figure 3, Continued
East Asian Output:
Profile of Structural Change, 1986-2000[a]



[a] Projected, using 1986 as a base year.

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believe this process is already under way with the appreciation of the yen, which is forcing Japanese firms to adjust their operations and move their product lines upscale technologically in order to remain competitive, vacating the middle ground—in steel, shipbuilding, textiles, and other industries—to countries such as South Korea. The next step will be the completion of the process of currency appreciation by the NICs, probably by mid-1988, which should benefit more advanced LDCs, such as Malaysia and Thailand, in the same way.

Economic theory suggests that relative prices in the region—wages, interest rates, and commodity prices—will adjust as financial markets become better developed and more fully integrated and as countries such as China continue to open further to foreign trade. China's larger regional role will tend to bid down wage rates and bid up returns on capital in each country, a process that will promote investment and protect East Asian competitiveness in manufacturing, although at the same time ensuring sluggish growth in living standards in the LDCs of the region. Better integrated financial markets will mean that capital transactions will begin to have the same potentially powerful effect on exchange rates presently at work in Western financial centers, where the volume of securities traded internationally exceeds the volume of transaction in goods and services by 25 times. This process is well along in Japan and also has begun in Australia and New Zealand, whose currencies in the last two years have become among the world's most commonly traded in the wake of financial deregulation. Finally, the region will face more favorable terms of trade with its trading partners as it shifts away from exporting mining and agricultural commodities—a gain in purchasing power that will exagerate the region's emerging advantage in GNP and income with respect to the United States and European Economic Community.

Japan. In our judgment, Japan, which produced almost three-fourths of East Asian output in 1986, will see its share drop to perhaps 60 percent at the turn of the century, mostly as a result of faster growth in the region's NICs and LDCs. But the structure of the economy will also change as it matures. The shift already under way from manufacturing to service sectors of the economy—officially endorsed by reports issued by the government-appointed Maekawa Commission in April 1986 and April 1987 and encouraged through the market adjustments by the appreciating yen—will be more pronounced by the year 2000. The Ministry of International Trade and Industry estimates that domestic restructuring and the flow of jobs overseas through foreign investment will eliminate over 500,000 manufacturing jobs during this period. Tokyo hopes to replace many of the lost jobs with new ones in the information sciences and applied technology through a 30-year plan to create 19 Japanese counterparts of California's Silicon Valley, part of a process Tokyo refers to as the "softicization" of the economy. The shift to services is being aided by Tokyo's growing role as an international money center—four of the world's top five banks ranked by assets are already Japanese—and financial reform already under way promises to accelerate the transition.

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Demographic change will accompany the maturation of the economy. Japan at the turn of the century will have one of the oldest populations in the world, with 16 percent of its people over 65, versus 13 percent in the United States. The burden of health and retirement benefits, currently spread easily over six workers, will have to be spread over four. This demographic change will accelerate the move to services. It will also depress Japan's savings rate, and the current account surplus—which is ultimately based on the excess of liquid savings over investment—will drop sharply as a result.

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The biggest test for Tokyo in meeting the challenge of maturity will be managing the domestic political strains that will accompany the gradual internationalization of the economy, which industrial restructuring will mandate. Agricultural reform and stepping up manufactured imports from the rest of the region may be the most difficult issues to address in the process. But most indicators, including the fact that the ruling party, in the face of considerable opposition, initiated opening agriculture to competition this year with the first cut in rice subsidies, suggests such a development

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is inevitable. In the industrial sector, imports of consumer goods are on the rise and the strong yen has also forced many firms to look abroad to cut costs throughout sourcing assembly operations, with the result that nearly half of Japanese manufacturing companies now have employees overseas.

Further, Tokyo has programed a $4 billion escalation in its foreign aid program, mobilizing private money for the most part, to the region's LDCs to increase its presence and consolidate its diplomatic relations, increasingly with aid that is no longer tied to being spent on Japanese exports. Together, these trends suggest that, by the turn of the century, Japan will have assumed an international role roughly equal to that presently played by the United States—whether measured in terms of GNP, foreign investment, or global trade and finance.

The NICs. We project that the NICs' share of regional output will rise by half, to about 12 percent, or $650 billion, by the turn of the century, as the four outpace all other East Asian economies. In contrast to Japan's falling savings rate and vanishing current account surplus, the NICs' relatively younger populations will continue saving more than their business communities can invest. Thus the majority of internationally recyclable capital generated by East Asia by the early 1990s will be produced by the NICs rather than by Japan.

We expect that the NICs will undertake various forms of industrial restructuring as they prepare for the next century, each program tailored to local political and economic circumstances. South Korea, in particular, will lead the way into areas customarily dominated by Japan—microelectronics, vehicles, and steel. NIC governments will promote the restructuring by adopting commercial policies that force domestic firms to increase value-added, and thus move upscale technologically, in traditional industries such as textiles, clothing, and footwear—which will capture the increasing attention of the region's LDCs. The result will be a higher technological content for NIC manufactures, which will cede the lower end of product lines to the LDCs. This trend will be most pronounced in the NICs with the greatest Japanese economic presence, notably South Korea and Singapore, where Japanese firms will be repeating a transformation they undertook themselves at home in the late 1970s and early 1980s. 25X1

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Existing differences in income levels and technology among the NICs themselves will probably widen during the 1990s. Singapore and Hong Kong, the two city-states, in particular have divergent futures. Although Singapore's growth into higher technology products will require a continued emphasis on manufacturing, Hong Kong will move more heavily into services as it becomes China's trader and financier with the anticipation of a return to Chinese rule in 1997. A less wide-open political environment in Hong Kong as the transfer approaches will reduce the relative weight of Western investment in favor of investors who meet priorities established in Beijing. 25X1
Meanwhile, a relatively conservative leadership in Taiwan will pursue mildly protectionist economic policies that gradually widen the developing gap between Taiwan and the more dynamic South Korea. 25X1

It is possible that the group of East Asian NICs in the mid-1990s will include new entrants into the club by several of the region's more advanced LDCs, notably Thailand and Malaysia. Each, indeed, is likely to be a major player in the regional microelectronics industry and, along with China, may have automotive industries nearly capable of export. But we believe that even with good economic performances and astute policymaking in Bangkok and Kuala Lumpur, substantial gaps will still exist between NIC and LDC income levels and production technology in all but a few industries. Linkages between more advanced industries and the rest of the economy in both countries, moreover, are likely to remain modest. 25X1

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The LDCs, Australia, and New Zealand. We believe that several East Asian commodity exporters will undergo economic transformations nearly as dramatic as Japan's. Many of these changes will be a product of long-term structural adjustment programs presently under way, most financed and sponsored by the IMF and the World Bank. The gradual "deprotection" of import substitution industries in Thailand, the Philippines, Australia, and New Zealand, for example—coupled with financial reforms designed to channel investment funds to their most efficient uses—will streamline indigenous manufacturing in these countries. In Thailand and the Philippines, this process should produce a new export potential in light manufacturing, where the two have clear comparative advantages. In Australia and New Zealand, manufacturing will become less of a drag on domestic productivity growth and will free labor and raw material resources for use in other export enterprises. Structural adjustment programs in Indonesia and Malaysia, initiated unilaterally and undertaken without IMF–World Bank sponsorship, will produce less dramatic—but still noticeable—improvements in manufacturing efficiency. 25X1

Declining petroleum reserves and rising oil consumption in Indonesia and Malaysia, along with less severe depletions of timber and tin reserves, also will prod the two toward the industrial development long expected by Western economic analysts. The key mechanism for this transformation will be weakened external financial accounts and drastically depreciated currencies, which will make domestic manufactures more price competitive with those produced elsewhere—a process already under way. Indonesia's conversion from major oil exporter to large-scale oil importer will entail considerable political pain and require overhaul of the petroleum-based tax system. But it will do more than any other single event to internationalize what has so far been East Asia's most inward looking market economy. 25X1

The continued opening of China is potentially the most important development in the evolution of the region, if also the least certain. Price reforms in agriculture during 1982-85, coupled with more effective distribution of agricultural inputs such as fertilizers, demonstrated the potential gains from market-oriented policies by producing 14 percent annual growth and spawning countless new rural enterprises. But the main thrust in China's export drive is likely to continue to be manufacturing, where the volume of output has expanded 13 percent annually since 1979.

If China's GNP grows 7 percent annually on average—which, in view of the growth record of the last several years, is easily within reach—and opens to the degree of many of its Asian neighbors, China's exports could reach $175 billion in the year 2000, six times the present level. This would place China on a par with France or the United Kingdom as a trader. China would have begun to dismantle its inefficient system of provincial self-sufficiency in favor of regional specialization, and its demand for industrial raw materials from the region's other LDCs would replace much of Japan's gradually deindustrializing materials. China at the same time would provide considerable competition for the region's slower growing LDCs in third-country export markets for light industrial products, a prospect that will promote continued structural adjustment in countries like the Philippines and Indonesia. 25X1

Regional Integration Possibilities. Private initiatives in a business environment featuring lower tariffs and more liberal financial regulations will gradually refocus a portion of East Asia's exports inward during the next decade or so. Closer private cooperation between the NICs and Japan have already followed direct investment in the NICs by Japanese firms. Links between China and Japan have also evolved rapidly following China's decision to allow a more rapid infusion of direct foreign investment and a more liberal environment for imports. These ties will grow closer with the maturing of the Japanese economy and Japan's continued opening to a broader range of manufactured imports. 25X1

We believe formal government-to-government cooperation, such as an East Asian trading club or customs union, is far less probable, in view of the region's considerable political and economic heterogeneity. And, under present circumstances, it is far less necessary than private initiatives. We believe only the region's LDCs would find cause to establish common tariffs, and even this seems remote in view of competition among them in trade relationships. 25X1

We believe the region will integrate more rapidly, and that public-sector cooperation will play a more prominent role in the process, if its exports are threatened by outside protectionist barriers. A decline in Western demand for East Asian exports would for a time retard regional growth, in view of the heavy dependence of especially the NICs on Western markets for their exports. But, because the capacity to produce regional output could roughly double between now and the turn of the century, we believe adequate demand for East Asian exports is ensured from within the region itself once adjustments in marketing efforts take place—and it is probable that area governments would spur such adjustments if access to the West were denied. We believe a greater threat to regional development would be posed by diminished access to US goods. The evolution of East Asian production away from agriculture and commodities toward services and a broader spectrum of manufacturing enterprises would most likely be slowed by a loss of the ability to import agricultural products at relatively favorable prices.

East Asia's Potential for Economic Supremacy
East Asia as Largest Economic Bloc. Our analysis suggests, on the basis of observable savings rates and policy initiatives already in place, that East Asia will have little trouble matching, and could exceed, its 1975-85 record of 4.9 percent annual growth between now and the turn of the century.[2] Our country-specific forecasts for East Asia suggest the region could produce a combined GNP that exceeds that of both the United States and the EEC at exchange rates that prevail in the year 2000.

Actual East Asian GNP in the year 2000 will reflect both expansion in volume terms and improvements in relative purchasing power over the next 12 years. In volume terms alone we believe East Asian output will double. By comparison, US GNP will reach $5.8 trillion if it records the trend growth most Western forecasting services think it will, 2.4 percent annually; EEC GNP will reach $3.4 trillion if the EEC follows predicted trends, expanding 2.2 percent annually. Although exchange rates are impossible to forecast with any precision, we calculate that East Asian currency appreciation of only 0.4 percent annually over the next 12 years would be sufficent to establish the region as the largest economic bloc at market prices; since 1980, the region's foremost currency, the yen, has appreciated an average of 3 percent annually. Alternatively, using international comparisons of purchasing power done by US academics under World Bank auspices, we calculate that East Asian output will exceed US output at the turn of the century by about 15 percent, reaching about $6 trillion.

One reason to expect the gap to turn out to be this large is that present trends in East Asian policymaking can be expected to foster further productivity improvements—a result of liberalization trends in financial, trade, and foreign investment policy. This will produce a more efficient industrial base as time passes by removing distortions in prices and profitability. Such a development will produce particularly pronounced improvements in foreign trade competitiveness if governments outside East Asia, particularly in Western Europe, persist in protecting sunset industries, thus locking in place low productivity manufacturing firms such as those producing standard filament textiles and cold rolled steel. The result will be stronger East Asian currencies and a mix of East Asian exports that commands the highest available prices in international markets.

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Another argument in favor of East Asian success is that the region is using its higher rate of investment to amass what will probably soon be the world's largest and most modern stock of industrial capital. We calculate, for example, that the region is investing nearly 20 percent more in real terms than the United States, an annual gap of roughly $120 billion. Foreign direct investment by East Asian firms in the United States is unlikely to grow by more than a small fraction of this total, and thus will not erode the emerging East Asian advantage. The investment gap 25X1

[2] The treatment of a number of technical issues, including the choice of exchange rates to arrive at cross-country comparisons of GNP, could slightly alter the calculations contained in this paragraph. But the basic judgment—that East Asian output will be the largest among the three economic blocks at the turn of the century—would probably not change.

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Table 2
Trends in East Asian Economic Policy Liberalization

Country	1985-87 Initiatives	Projected for 1988-90
Japan	Controls on capital outflows eased: some deregulation of deposit rates, foreign banks allowed entry, foreign firms get access to equity market, offshore banking established; some easing of agricultural subsidies, privatization of several public-sector firms.	Tax reform widens tax base. Continued capital market reforms, restructuring aid for distressed manufacturing firms, some easing of quotas protecting agriculture, further privatization and interest rate decontrol.
Australia	Currency float, interest rate deregulation, foreign bank entry allowed as part of sweeping financial reform, tax reform, including value-added tax.	Tariff reductions to be phased in over seven years, reform of wage setting system to improve manufacturing competitiveness.
New Zealand	Currency float, interest rate deregulation, foreign banks allowed entry, foreign exchange decontrolled, tax reform, subsidies cut, state enterprise autonomy introduced.	Subsidies to be phased out, import restrictions eased.
South Korea	Tariff reductions, import restrictions eased, barriers to foreign bank branching and local currency loans eased, foreign investment allowed in almost all manufacturing, restructuring of distressed firms, copyright and patent laws strengthened.	Foreign access to capital markets broadened, further tariff cuts, currency appreciation, gradual opening of service sector to foreign investors.
Taiwan	Tariff reductions on 1,700 consumer items begun, some import restrictions eased, modest tax reform, some easing of foreign investment restrictions.	Some easing of foreign exchange restrictions, further tariff cuts, more realistic exchange rate.
Singapore	Business tax cuts, reduced social insurance contributions, wage hikes rolled back to aid competitiveness, financial reform in wake of several business failures.	Opening of secondary stock market, market for government bonds, new regulations allow broadened corporate access to equity market, new financial hedging instruments, privatization of some state firms.
Hong Kong	Personal income tax cuts to reduce budget surplus.	Reevaluation of currency, legal status after 1997 resolved.
China	Bankruptcy legislation, devaluation, several experiments with market prices for raw materials and interbank funds, labor law reform; fiscal, monetary instruments refined; agricultural price reform for overplan production. Tax reform allows profit retention, bond issuing authority begun as part of reform of banking system.	Management reforms in manufacturing, some urban price and wage reform, value-added tax as part of tax reform, subsidies reduced, some profit repatriation allowed, some foreign exchange decontrol.
Indonesia	31 percent devaluation, value-added tax as part of measures to broaden tax base, food subsidies reduced, tariffs on 300 producer goods slashed, import monopolies abolished, import quotas liberalized, reform of customs service.	Further devaluation, more easing of duties on producer goods, further easing of restrictions on trade. Some reform of foreign investment regulations and those affecting domestic firms.
Thailand	Tax reductions, reform of banking system designed to streamline finance companies, open equity market. Tariff reductions, easing of foreign exchange controls, devaluation and currency float.	Tax reforms to broaden tax base, foreign access to equity market broadened, easing of foreign investment regulations.
Malaysia	Revenue collection improved to cut budget deficit, reduced interest rate subsidies, new foreign investment incentives.	Foreign investment rules eased, tariff reductions on imports of producer goods, devaluation.
Philippines	Tariff reductions, tax reform, some privatization, export taxes slashed, most controls on imports removed, trade monopolies dismantled, agricultural export quotas removed.	Devaluation, import restrictions further liberalized, some deregulation of foreign investment, value-added tax system implemented.

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also means that East Asia is replacing old equipment at a faster pace than the United States or the EEC, so that, by the turn of the century, the region will have in place not only the largest stock of capital equipment in the world, but that of the most recent vintage and technology.

East Asia as World's Largest Creditor. The emergence in the last several years of Japan as the world's largest net creditor and of the United States as the largest net debtor illustrates the potential combined effects of more liberal restriction on capital exports in East Asia and simultaneous large fiscal deficits in the United States. Last year, Japanese financial institutions alone financed one-third of the US budget deficit through purchases of US Government securities. Assuming US budget deficit reductions were to follow Gramm-Rudman guidelines in the years ahead, this trend could continue, along with upward pressure on US interest rates, to recruit the required foreign capital. Competing demands for Japanese funds—and, in the 1990s, for surplus capital from East Asia's NICs—will come from Latin America, Africa, and the commodity exporters of East Asia, giving the Japanese and the NICs a greater ability to influence international financial affairs.

East Asia's ascendancy as largest creditor would have a marked effect on the competitiveness of private financial institutions. Japanese banks already have surpassed US banks as the largest group of private lenders, accounting for 32 percent of global bank assets, according to Bank for International Settlements data. Much of this activity is in the interbank market where Japanese banks have become the dominant players because of a variety of factors, including their entry into new securities markets, their role in the management of interest rate positions, and the opening of the Tokyo offshore banking center. Accordingly, seven out of the top 10 banks in the world are Japanese when ranked by deposits. In the years ahead, they will be joined by South Korean–, Taiwanese-, and Hong Kong–based financial institutions.

The form of East Asia's lending can be expected to continue to evolve. Although Japan has become premier net creditor with assets of $600 billion, 70 percent of its assets are in foreign securities; foreign lending and direct investment account for only 16 and 12 percent, respectively, of the total. The growth of overseas loans has slowed considerably because of LDC debt problems, but direct investment by not only Japan but also South Korea has picked up sharply in recent years, and we expect this to continue. East Asia 25X1
will probably eventually use direct investment as its preferred tool for recycling its surplus to the rest of the world, with what lending does occur confined to short- and medium-term, trade-related credits. Direct investment, for one thing, will allow Japan and the NICs to promote joint ventures that facilitate access to foreign markets. 25X1

East Asia as Technological Leader. On the basis of existing technological capacities in the United States and Japan, research and development efforts under way in key industries in both countries, and Japan's demonstrated ability to graduate more electrical engineers annually in absolute numbers, there is every reason to believe East Asia will enjoy at least some technological edge over the rest of the world by the turn of the century. After surveying trends in nine key industrial technologies, we judge that Japan by then can achieve a clear lead in four—semiconductors, advanced structural materials, manufacturing tech- 25X1
nology, and biotechnology—rough parity in two—telecommunications and data processing—and will still lag slightly in three—aircraft, space, and nuclear power (see table). 25X1

The technological capacities of the region as a whole will be strengthened to the extent that US investors or the Japanese, themselves at the leading edge in these areas, disperse second-tier technological know-how through direct investment and outsourcing production. To a degree, this is under way. The region's NICs, for example, are already a large part of the regional semiconductor industry and are known to be focusing future investment efforts on biotechnology.
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The structure of East Asia's foreign trade would reflect this technological superiority to the same 25X1
degree that trade reflects country resource endowments. Regarding the region's exports, we believe

East Asian Financial Centers at the Turn of the Century

East Asia will play a far more prominent role in international finance 12 years hence and can be expected to be the dominant player if it becomes the largest global creditor, as current trends suggest.

Tokyo, by liberalizing its markets, is already competing more directly with far larger international financial communities in London and New York. The establishment of the Tokyo offshore banking center in 1986, and ongoing developments in Japanese commodities and futures markets, are examples of Tokyo's push to create a linkage to London and New York for a 24-hour business day. When this is achieved, the importance of the locale in which transactions are initiated will be reduced, and London and New York will lose an advantage that they have presently. A key remaining obstacle for the Japanese is allowing more foreign banks and securities firms into the domestic market. The Japanese have traditionally been cautious in removing such barriers to entry because of the risks of being "over banked," a concern exacerbated by numerous bank failures in the United States in the last two years. Nonetheless, we foresee Tokyo as a completely open market by the turn of the century.

Hong Kong and Singapore will continue to be leading financial "bridges" in the years ahead, but their roles will begin to diverge in the 1990s, and neither will compete with Tokyo. Hong Kong will act as China's chief private financial agent with the return to Chinese rule in 1997. Singapore, on the other hand, appears determined to promote itself as a provider of portfolio management services, at the same time 25X1 *establishing broader access by foreigners to local markets for equity and government bonds. Singapore also will be attractive to outsiders as a result of its willingness to ensure the confidentiality of transactions, similar to Switzerland.* 25X1

Smaller scale financial centers will continue to develop in Australia and New Zealand, both of which will be promoting development of their service sectors. Taiwan has great potential, especially as it develops as a capital surplus country and the international demand for Taiwanese Eurodollars grows. But a lack of communications facilities—attributable to the securities' authorities fears of outside financial manipulation—will stunt development of Taipei as a rival to Hong Kong or Singapore. Indeed, Seoul may achieve more, given South Korea's emerging capital surplus and the government's long-term plan to internationalize Korean financial markets. For their part, the LDCs of the region will concentrate on developing their domestic banking systems and will provide little 25X1 *competition for the rest of the region.* 25X1

Japan will market a different product mix than at present, deemphasizing motor vehicles and steel in favor of higher technology telecommunications and data processing equipment, as well as pharmaceuticals and possibly medium scale commercial aircraft. The region's motor vehicle exports are increasingly likely to come from NICs such as South Korea, which should also be a major producer of office machinery and possibly the processing of biotechnology products. Singapore, Hong Kong, and, to a lesser degree, Taiwan should share in the gains from Japanese electronic spinoffs as Japanese production moves upscale in product lines. Meanwhile, the LDCs, especially China, will produce a significantly greater share of East Asia's textile and light industrial exports. 25X1

Regarding imports, technological change should shift the region's demand for ores and other raw materials from a maturing Japan increasingly to the NICs, and

Table 3
Current Japanese Technology Relative to the United States and Prospects for the Turn of the Century

Technology	1987			2000		
	Lag	Parity	Lead	Lag	Parity	Lead
Semiconductors						
Silicon devices		X				**X**
Nonsilicon devices			X			X
Fabrication equipment		X			**X**	
Data processing						
Supercomputers	X				**X**	
General-purpose mainframes	X			X		
Peripherals	X					**X**
Telecommunications						
Transmission	X				**X**	
Switching	X			X		
Terminals	X				**X**	
Advanced structural materials						
Ceramics			X			X
Composites	X					**X**
Metals	X				**X**	
Manufacturing						
Machine tools		X			X	
Robotics			X			X
Aircraft						
Propulsion	X				**X**	
Avionics	X			X		
Aerodynamics/structures	X			X		
Space						
Launch vehicles	X			X		
Remote sensing	X				**X**	
Ground stations			X		X	
Comsats	X			X		
Nuclear						
Reactors	X				**X**	
Fuel cycle	X				**X**	
Fusion power	X				**X**	
Biotechnology						
Genetic engineering	X				**X**	
Bioprocess industry			X			X

Boldface indicates improvement in Japanese position. The nine categories selected for this table were chosen for their military as well as commercial applications.

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the region as a whole will rely on oil imported from the Middle East and the United States to a greater degree than at present as its own production falls. The NICs, China, and the other LDCs will account for a larger share of the region's imports of Western-manufactured capital equipment and data processing machinery to support their technological growth in industry. At the same time, the shift from agriculture into industry and services will boost East Asia's demand for agricultural products, even as it increases regional production of processed foodstuffs. [redacted]

Risks to Continued Growth

We believe the principal risks to our forecast are the possible failure of Japan to adjust policy and change economic structure to eliminate its surpluses, a possible reversion to autarky in China (see inset), and various country-specific political uncertainties, which may produce discontinuities in economic policy. The most likely of these contingencies is probably stunted adjustment in Japan, where political opposition to deemphasizing agriculture could prove a more difficult obstacle over the longer run than we think it will, and where future gains from investment in high technology could be less certain as time passes. [redacted]

Political Uncertainties. We believe that political development in most of East Asia greatly lags recent gains in economic sophistication, and continuity in economic policy is at greater risk there as a result. In the years ahead, the most dramatic changes may come in China and Taiwan, where uncertain succession arrangements are already having a bearing on prospects for economic reform. Beijing's leadership can be expected to continue to weigh the merits of employing various export-promoting market mechanisms, including decentralizing control over a variety of economic decisions at both the plant and provincial level, at the expense of some loss of traditional decisionmaking power for the Communist Party. At stake, because of the potentially powerful effects of even marginal economic reforms, is the degree of China's openness to foreign markets. Because reformist elements are probably better entrenched in the younger generation of party leadership, which will have a chance at increasing its power at party congresses in 1992 and 1997, the passage of time will make a reversion to economic isolationism less likely. [redacted]

In economically more advanced Taiwan, a similar generational transition is in evidence in a similar political system, except that the current ruling elite has pursued a notably conservative course on policy issues affecting foreign trade and finance, such as foreign exchange decontrol and financial deregulation. Thus a fairly radical change of political direction could occur without jeopardizing the economy. Indeed, we are inclined to agree with some Asian analysts who argue that Taiwan's economic future would benefit from such a development, since Taiwan will require industrial restructuring that the current leadership has not yet planned if it is to keep up with its NIC partners. [redacted]

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Indonesia—the region's second most populous country—and the Philippines face the greatest succession uncertainties among the region's LDCs because of the highly personalized nature of politics and less firmly entrenched elites. A sharp change in political direction in either country probably would sharply circumscribe its economic role in the region. The alternative to the leadership of President Soeharto in Jakarta, for example, is probably a more conservative government that would rely less on market forces and that would focus growth inward to an even greater extent than at present. In the Philippines, a weak political center could give way to forces from the right or the left. Either change in direction would sharply diminish the economy's growth and trade prospects by limiting the moderating influences of Manila's technocrats and its foreign creditors on economic policy. [redacted]

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Nevertheless, we are inclined to believe that, in the aggregate, our basic forecasts will hold. South Korean experience demonstrates that political instability need not take a toll on economic achievement, and postwar Asian history is replete with political transitions that resulted from personal contests for power rather than differences over policy issues. This suggests that even political transitions that unseat established elites may not change economic policy direction. Furthermore, in Japan, where the Liberal Democratic Party has held power continuously since the Second World War, the same mix of political constituencies seems certain to be making economic policy during the 1990s, and their LDP factions are for the most part in favor of

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Japanese and Chinese Scenarios

We considered several possible paths for East Asia's two key economies in preparing this assessment.

The ***Graying Giant Scenario*** *assumes that Japan undergoes two related transformations, one produced by a transfer to services, the other a function of demographics. Here, Japan in the 1990s is buffeted by more or less the same forces that drove the United States in the 1970s. One difference, which may slow the process of change in Japan, is that Tokyo is less receptive to imports. On the other hand Japan will age demographically, whereas the United States in the 1970s admitted many young, inexperienced workers to the labor force. This suggests Japan may have less trouble improving labor productivity than in the case of the United States. Some commercial bankers in Japan, combining these changes with the recent attempt by Japanese firms to escape the high yen by moving manufacturing production into firms in Southeast Asia and the NICs, but managing operations from Tokyo call this the* ***Designer Boutique Scenario****, a reference to fashion industry outsourcing.*

The ***Holding Company of the World Scenario****, the principal alternative, assumes that Japan does not reduce its savings rate or current account surplus, instead building up claims on both the public and private sectors in the United States, East Asia, the EEC, and Latin America. Japan would be prepared to fund the US budget deficit more or less indefinitely, its current account surplus would be based on interest earnings, and only direct investment in the United States would slow the process. In this case, Japan does little to aid the region, steps up competitiveness with the NICs by hanging on to obsolete product lines, and suffers anemic local investment demand because of rigidities in government policy, which continue to favor agriculture. Because this scenario entails even more friction between Japan and its trading partners than at present and assumes industrial adjustment already under way is interrupted, we lean to the more optimistic case.*

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For China, the most pessimistic case is the ***Reversion to Autarky Scenario****, in which ongoing factional infighting in Beijing is resolved in favor of the conservatives. China recentralizes economic decision making, reorients its economic relations toward the USSR and CEMA, and closes to foreign investment. A closed China remains essentially irrelevant in the evolution of the regional economy, as trade volumes shrink to levels observed in the early 1970s—less than 1 percent of world exports—because of the preference of planners to satisfy locally pent-up demand for consumer goods.*

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The ***Market Forces Reform Scenario*** *is the most jarring for China, the rest of the region, and the world. It assumes Beijing moves within the next five years or so to introduce far-reaching reforms of the price and trading system that would equalize domestic and international prices, producing a more efficient distribution of resources in China and greater incentives to export. China would have to weather considerable short-term economic dislocation and would require decisive political leadership from the reformists in Beijing at the same time the role of the Communist Party in manufacturing is loosened in favor of factory management. For this reason and those cited in the text, we are inclined to believe China's path will fall somewhere between these two scenarios.*

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the economic transition we believe Japan must make if the region as a whole is to prosper. The impact on economic policy of changes in government in Australia and New Zealand, where labor parties dominated by rightwing factions are pursuing conspicuously conservative courses of action, would be only slightly greater.

East Asia and the Global Balance

East Asia's probable ability to handle the risks and realize most of its potential means that, by the turn of the century, Western analysts will be confronted by a variety of indicators that suggest East Asia is indeed the "number one" regional economic bloc. East Asian output, investment, and trade almost certainly will exceed that of the United States and the EEC. East Asia will be a dominant player in international financial affairs and may be the world's largest creditor. The region also will possess clear leads in a variety of industrial technologies and will be competitive with the West in several others.

The heterogeneity of the region will nonetheless limit its ability to use its leverage to advantage in international economic and political-military affairs. Ten governments will manage economies producing over 40 percent of the region's output (Hong Kong will be under Chinese control, and Japan will manage 60 percent) and ten Central Banks will control at least one-third of the region's money supply. Relations among the industrializing countries of the region and among its commodity exporters will remain in many cases competitive. Only if forced by protectionism to turn inward do we believe that East Asian states will engage in formal, substantive economic cooperation such as a trading club or a common currency area. As a result, the region's ability to convert its economic clout into an international order that better serves its interests will depend on the emergence of a yet-to-be-developed East Asian leadership with a coherent and convincing vision of what that order should be.

Pax Niponica. Japan, which at the turn of the century will dominate the world's largest regional economic bloc, would be the natural choice for such a role, as several recent US academics have currently speculated.[3] That Japan has much to offer in economic leadership is already openly acknowledged by such East Asian states as Malaysia and Singapore, where governments have in one form or another officially designated Japan as the "model" to emulate. Divisive memories of Japanese military domination during World War II, indeed, are giving way to generational change, and even Australia and New Zealand in recent years have begun to reassess their relationship with Tokyo and have begun to view their future as Asian, rather than as essentially European, states. What remains is for Japan to consider its own role in the international economy, an issue that the Japanese press suggests has just begun to attract popular attention.

However this is resolved, we believe Japanese individuals will exercise more international leverage collectively than their government. Private-sector Japan will have the opportunity to exert considerable influence in financial affairs as its status as creditor grows. For example, Japanese investors already hold $22 billion in equity in California banks, including five of the largest 11 and the share is likely to grow further not only in the United States, but in South Korea and Taiwan. In addition, Japanese securities firms will be influential players in other forms of corporate finance. Tokyo has already lifted restrictions preventing Japanese firms from participating in US futures markets, and Japanese portfolio transactions will carry increasing weight in determining rates of return in similar markets.

Tokyo will have the opportunity to expand its influence in multilateral institutions, including the Bank, the Fund, and The Asian Development Bank (ADB), if it wishes. The United States has always been the member with the largest voting bloc in these institutions, but Japan could challenge for leadership with further contributions. Indeed, Japan currently holds equal voting shares in the ADB. Whether such a development would change Bank and Fund policy is far less certain. In 1986, Tokyo increased its contribution to the International Development Association,

[3] See, for example, "Pax Niponica?" *Foreign Affairs*, Spring 1986, by Ezra Vogel.

Benchmarks of Regional Economic Growth at a Glance

A number of key economic developments are almost certain to occur if East Asia's economy evolves the way we think is most likely between now and the turn of the century.

The Composition of Regional Output. *Regional GNP expands 4.9 percent annually, reaching roughly $6 trillion at the turn of the century—or about double what it is currently. Service output grows about 6 percent annually, about twice the pace of agriculture and extractives. This means that agriculture's share of output will shrink in favor of services, with manufacturing's share remaining about the same. The regional shift reflects more dramatic change in the region's LDCs, from agriculture into manufacturing, and a simultaneous shift in Japan away from manufacturing into services.*

Regional Foreign Trade Competitiveness. *With the transformation to services in Japan, manufactures produced by the region's NICs and LDCs become more competitive in international markets. Japan's exports are increasingly high-technology items spread across a broader spectrum of product lines. NIC exports are produced increasingly by Japanese-owned firms in the early 1990s, but the diffusion of production technology limits the share of Japanese "platform exports" by the turn of the century. The NICs' share of world exports grows from 6 percent in 1986 to 8 percent in 2000; similarly, the NICs exhibit the region's strongest import growth. Meanwhile, the share of total trade conducted within the region grows from 35 percent in 1986 to slightly over 40 percent in the year 2000, as closer relationships are forged between the NICs and Japan—based on Japan's imports of goods previously manufactured at home and thus sold by the NICs in well-established markets—and between the NICs and the LDCs—based on the NICs' demand for raw materials that formerly were sold to Japan.* 25X1

Regional Price Adjustments. *A variety of price changes accompany and even facilitate the region's economic transformation. East Asia's terms of trade improve at a rate of about 1 percent annually—they deteriorated slightly during 1975-85—as world commodity and agricultural prices remain somewhat depressed and prompt the transfer out of agriculture. Interest rates in regional financial markets and returns on equity edge up as markets become more open and trade volumes grow. The upward trend is most likely to be observed as a series of small but discrete increases, as monetary policy by regional central banks adjusts to new demands for liquidity and new institutional arrangements. Regional currencies undergo a similar transformation, with several discrete "realignments" comprising a gradual upward trend in purchasing power for Japan and the NICs. The first such realignment, under way currently, is completed by mid-1988. The second accompanies renewed trade surpluses in the NICs in the early 1990s.* 25X1

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The Locus of Change. *Adjustment in the region's two largest economies, Japan and China, drive the growth process from each end of the technological spectrum. The external effects of change in Japan are felt most acutely in the NICs; change in China is felt most acutely in the LDCs. The variation in output and technology in the NICs widens; Taiwan at the turn of the century more closely resembles Thailand and Malaysia than South Korea.* 25X1 the soft loan window of the Bank, and Washington decreased its voting share to accommodate new shares for Tokyo. This was conditional, however, on US retention of veto rights over major policy initiatives, and a similar constraint would undoubtedly operate in the future. [redacted]

It is difficult to predict the results of a more independent course for Japanese political-military interests, since Tokyo itself has not given priority to such a contingency since the reconstruction. The government presumably would be less likely to acquiesce on a variety of international issues, such as arms control, that it has traditionally agreed on with Washington. Change in the political-military arena, however, would come more slowly than on the economic front. Tokyo's decisionmaking bureaucracy is set up to establish economic priorities, and much time would be required to establish the same policymaking capacities in other fields. [redacted]

Risks to US Interests: The Consequences of "Relative Smallness." Japan's pursuit of its own international priorities need not work against US economic interests in East Asia. We believe, for example, that a refocusing of Japanese attention on the East Asian region would do much to reinforce market pricing mechanisms in East Asian countries where the Japanese private sector has an established presence, such as Indonesia and Thailand. The Japanese are already using their increased clout in the IMF and World Bank to promote conditionality on lending that requires market reforms and more liberal foreign investment regulations. [redacted]

But whatever role Tokyo chooses for itself in East Asian affairs, the fact that the United States will be a relatively "smaller" economy by the year 2000 is of potentially great consequence for US independence in policymaking. Most important, in our view, is that East Asia will make its presence felt in international markets to an even greater degree than comparisons in income suggest because of the openness of East Asian economies. This will occur primarily in two ways: as foremost originator of foreign trade and as primary creator of financial assets. Both will potentially give the region extra weight—at the expense of the United States—in the process of determining international prices and interest rates. With respect to trade volumes, for example, East Asia's share of global exports could rise from about 20 percent at present to more than 25 percent in the year 2000 if current trends continue. One result will be greater East Asian influence in the forums that govern the rules of international commerce, such as the General Agreement on Tariffs and Trade and in individual commodity trading institutions, such as the London Metals Exchange, the International Rubber Association, and the International Tin Council. [redacted] 25X1

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We believe the changes in the global balance will be far more dramatic with respect to finance than with respect to changes in merchandise trade. More rapid rates of real economic growth—and particularly ongoing financial liberalization—will sharply boost East Asia's share of global money creation over the next decade. We judge that East Asian Central Banks will manage money stocks of perhaps US $4.0 trillion by the year 2000—roughly equal to the US $3.9 trillion estimated by a noted private forecasting service for the United States. The primary impetus for this growth will be the development of private financial markets in the NICs and LDCs, which will allow new money creation to expand far more rapidly in real terms than output, a similar phenomenon to that experienced by South Korea in the 1960s, when the real money supply expanded sevenfold in just five years following banking and interest rate deregulation. [redacted] 25X1

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The consequence for the United States of these trends is that Federal Reserve control over both global and domestic interest rates will become far less independent of portfolio actions undertaken by central banks in the Far East. The United States, in such a case, may find domestic interest rates going the way of those that prevail abroad despite attempts to influence them with open market operations. [redacted] 25X1

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In addition, East Asian states may continue the recent trend of accumulating claims on US institutions as a result of large US government budget deficits and

The Wall Street Perspective

The emergence of East Asian financial centers in the years ahead suggests that Wall Street will play a less prominent role in global financial affairs by the turn of the century. [redacted]

New York already shares the limelight in equity trading with Tokyo, where the stock market is of roughly the same size and accounts for more than one-third of global stocks. In addition, Tokyo can be expected to improve its standing in foreign exchange transactions, which, at over $50 billion in daily turnover, roughly equals New York, behind London. Meanwhile, New York–based securities firms will have far more Japanese rivals worldwide; Nomura Securities, Japan's largest, already does business in 25 stock exchanges in over 18 countries. [redacted]

With the rise of the Japanese, New York will be forced to share control over financial markets and the power that accompanies it. A major concern for New York–headquartered financial institutions will be their ability to attract depositors and investors, especially reaching through branches in East Asian countries, which will be the world's premier capital exporters. The development of more open Japanese financial markets could, combined with the proximity of Tokyo, leave New York as second choice. This may lead to a painful adjustment process for Wall Street, as less competitive firms are pushed out of the market. [redacted] 25X1

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The winners in this scenario will be both US and foreign investors, who will be presented with expanded options—new instruments in new markets—for placing their funds. Some problems will emerge because of the potential for rapid movement of funds globally and the attendant increase in foreign exchange risks. One challenge for Wall Street thus will be developing the financial instruments that will allow depositors to hedge their portfolios against such developments. In addition, the potential for swings in exchange rates will make for a riskier environment for Wall Street financial institutions, and this may favor the larger firms, which are better positioned to absorb variations in costs and earnings. [redacted] 25X1

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private-sector trade deficits. In that case, large interest payment outflows will narrow Washington's options in conducting monetary policy by associating large foreign exchange losses with any potential rise in global interest rates, while East Asia's options will expand as interest earnings buoy Central Bank reserves. [redacted]

Opportunities for the United States in East Asian Success. The two primary benefits to the United States of a significantly more successful East Asia will be larger markets for US exports and enhanced opportunities to fund US investment in plant and equipment with East Asian savings, thus expanding employment. The East Asian import market, in 1986 prices, would expand to $1 trillion, up from nearly $500 billion currently, if regional development goes the way we think it will. In all, this means the East Asian market would expand by at least 5 percent per year on average. The market for US agricultural goods should be especially strong, growing roughly twice as fast. [redacted] 25X1

East Asian annual savings should reach $1.6 trillion at the turn of the century. Of this, $110 billion or so would be internationalized in the form of current account surpluses even if the surplus's share of regional GNP were to fall by half—a reasonable assumption since we believe the current 3.8-percent capital export rate is not sustainable. Thus, the volume of East Asia finance available to US investors is likely to remain strong, more or less indefinitely. [redacted] 25X1

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