●Awards Committee Chairman's Prize●

Japan and Australia to hope to lead world through "Win-Win-Win" relations that bring economic stability in Asia

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【Essay Abstruct】 - Translation

Asia is the largest trading partner of both Japan and Australia, so Asia's economic stability directly affects the economic stability of those nations. For example, because the Asian economy is somewhat weakened by its immature bond market, Japan and Australia, with their close connection to the Asian economy, suffered severely as a consequence of the global financial crisis.

If the Japanese and Australian economies are to be restabilized, the fragility of the Asian economy must be addressed.

Bond markets in Japan and Australia have developed beyond those in other Asian countries, as the two countries have been quicker in issuing massive amounts of public bonds and taking deregulation measures regarding the financial sector. There are two roles that Japan and Australia can play in helping to resolve the fragility of the Asian economy. Firstly, they can support the effort of Asian countries to issue public bonds, by purchasing those bonds. Secondly, they can support the development of Asian countries' bond markets by providing know-how in matters relating to efficient bond issuance and financial deregulation.

Japan and Australia should work together in addressing these challenges, for three reasons: first, the two nations are facing common issues; second, more efficient results can be expected if both countries collaborate, rather than tackling the various issues independently, and third, both Japan and Australia are advanced in terms of their bond market development; moreover, their markets have developed in different ways, meaning that they can be ideal partners. Through such cooperation, the two countries can help Asia establish a bond market that is well balanced with fiscal conditions within Asia.

Appropriate development of the Asian bond market would benefit Japan and Australia economically in two ways: (1) they would gain greater economic stability, and (2) they would enjoy more robust economic revitalization. Two advantages can also be expected from the countries' overall bilateral relations: (1) promotion of mutually complementary relations between Japan and Australia, and (2) deepening of Japan-Australia bilateral relations. By joining together to trigger progress in Asian bond markets, Japan and Australia will be helping to stabilize the Asian economy as a whole. Under such circumstances, benefits can be expected not only for Japan-Australia relations, but for third parties as well. Such "win-win-win" bilateral relations would be highly beneficial for both countries, and could be presented to the world as a model case for other countries and regions to emulate.

Chapter 1 Relations between Japan and Australia, and other Asian countries

Negotiations between Japan and Australia toward forging their Economic Partnership Agreement (EPA) began in April 2007. Since then, the two countries have held[1] 15 rounds of talks, as of May 2012. Trading is one of the most advanced fields for Japan and Australia, and the two countries are important trading partners. The biggest trade area for both countries is Asia, which means Asia plays an important role in the growth of their economies. According to Figure 1, Asia accounts for 57% of Australia's overall exports and 44% of its overall imports.[2] Figure 2 shows that Asia represents 55% of Japan's overall exports and 45% of its overall imports. These figures suggest that Asia's economic stability is indispensable for the economic stability of both Japan and Australia. The two countries' trade relations with other Asian countries have been expanding in line with economic growth throughout Asia. Figure 3 indicates that since 2001 Asian countries' economies have been growing at a faster pace than those of the Group of Seven advanced countries. In addition, Figure 4 and Figure 5 show that Asian-bound exports from Japan and Australia and imports to the countries have been expanding since 2001, a phenomenon that has taken place alongside high economic growth in Asia. According to Figure 3, Asian countries are expected to show economic growth rates comparable to those posted in the past, making Asian countries even more important trading partners for Japan and Australia. Hence, Asia's economic stability will become more important for the economic stability of Japan and Australia. One challenge that Japan and Australia share is how to stabilize the overall Asian economy for the sake of their own economic stability. This essay is designed to show that the fragility of the Asian economy resulted from the global financial crisis, and it will show that Asia's destabilized financial situation had a significant impact on Japan and Australia. An analysis reveals roles to be played by Japan and Australia in overcoming the fragility of the Asian economy, and shows that closer relations can be built between Japan and Australia as they carry out their roles in addressing the fragility.

The purpose of this essay is to show that Japan and Australia can further advance their relations by working together to address common issues facing them and that deeper relations will lead to greater economic stability in the two countries.

The essay is divided into five chapters. The next chapter, Chapter 2, will analyze the impact that the global financial crisis has had on Japan and Australia, and will examine the process by which the crisis spread; that is, via Asia. Chapter 3 is intended to list and sort out various issues specific to the Asian economy (revealed in Chapter 2) under a broader context of the fragility of the Asian economy. Chapter 4 will explain why it is necessary for Japan and Australia to tackle the issue of Asia's fragility, and will show the merits expected to arise from tackling the issue. Chapter 5, the final chapter, will show that Japan and Australia could see improved their relations by addressing the fragility issue.

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[1] Refer to Economic Partnership Agreement between Japan and Australia shown in the Web of the Ministry of Foreign Affairs of Japan. http://www.mofa.go.jp/mofaj/gaiko/fta/j_australia/index.html, accessed May 27, 2012.

[2] "Asian" figures shown here are the combined total of figures for China, Hong Kong, South Korea, Taiwan, ASEAN and India. Data for other Asian economies are disregarded as they are deemed negligibly small in terms of their impact on the overall trend.

Figure 1 Australia's trading partners (2011)[3]

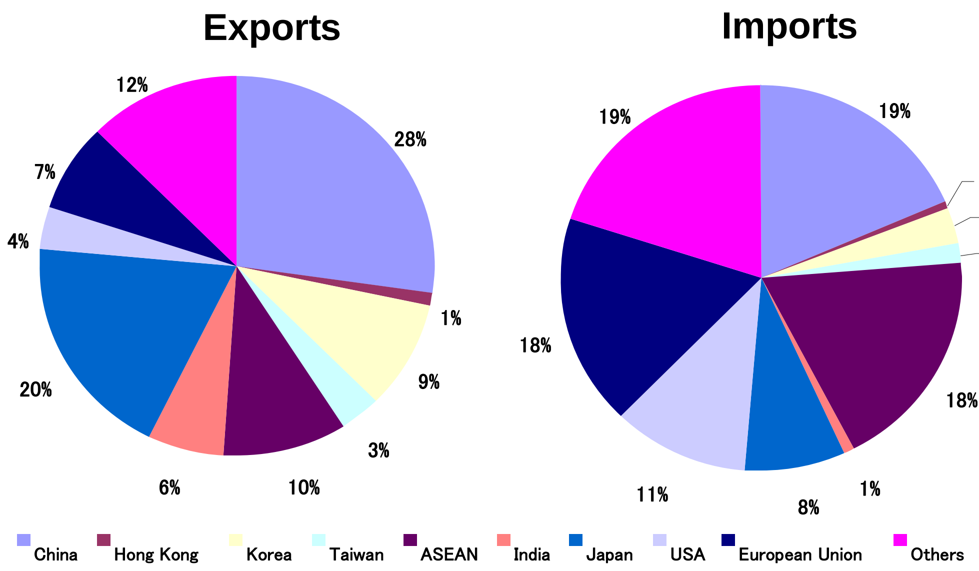
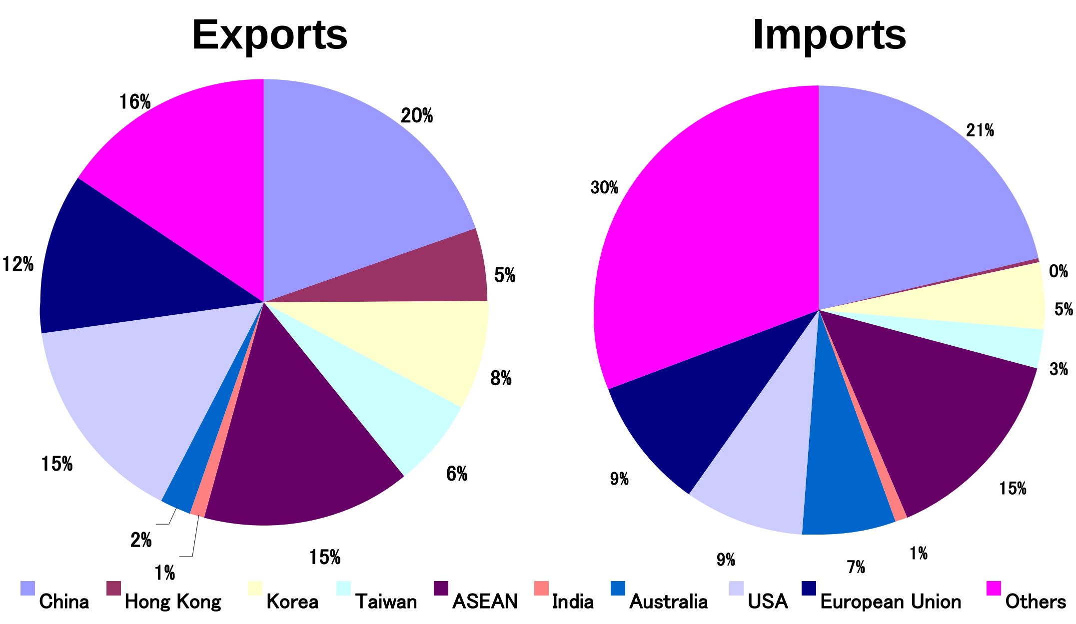


Figure 2 Japan's trading partners (2011)[4]



[3] Australian Bureau of Statistics, (http://www.abs.gov.au/AUSSTATS/abs@.nsf/mf/5368.0), accessed May 10, 2012.
[4] Japan External Trade Organization (JETRO), http://www.jetro.go.jp/world/japan/stats/trade/), accessed May 10, 2012.

Figure 3 Nominal GDP growth rates
(Figures for 2011 and after are projections. 2001 figures are set at 100.)[5]

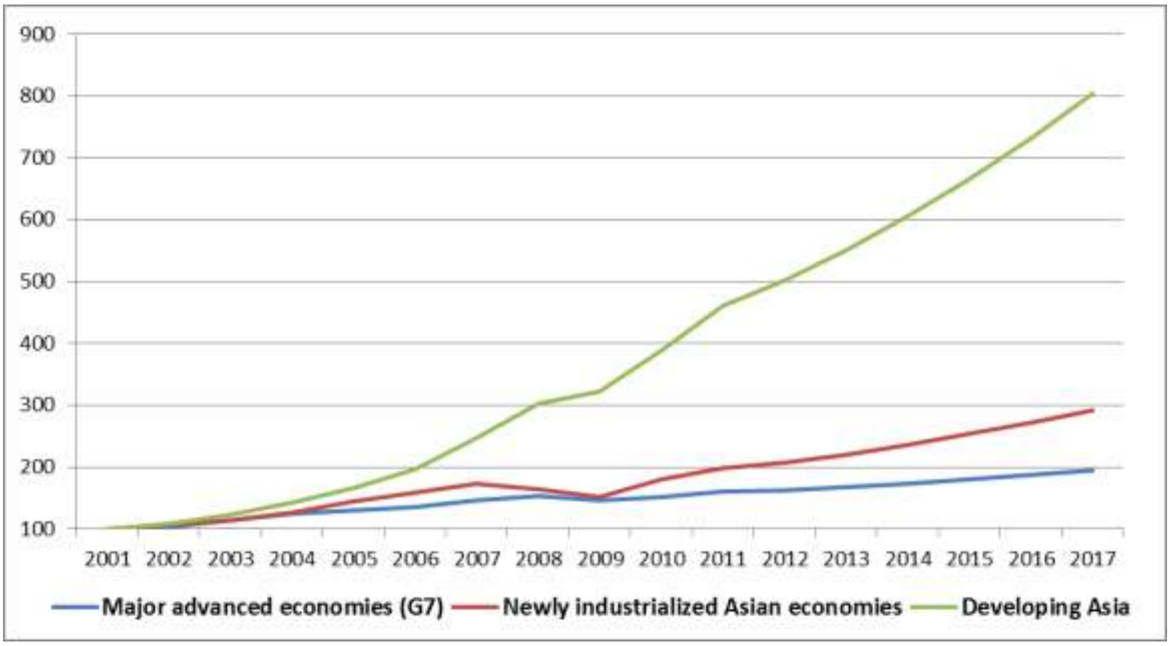
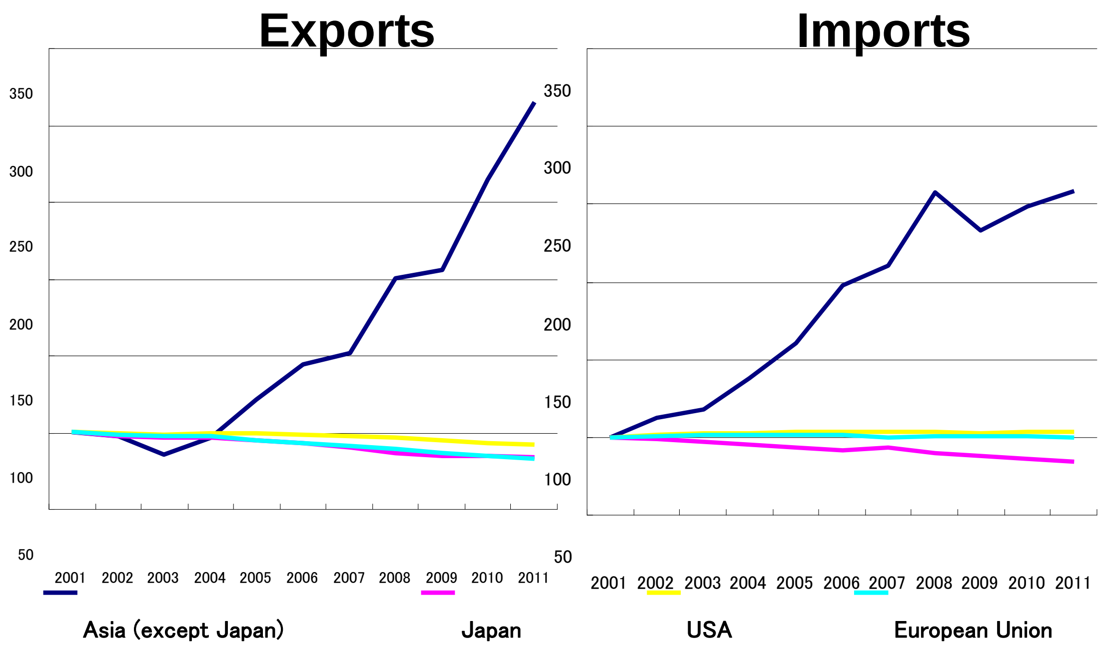


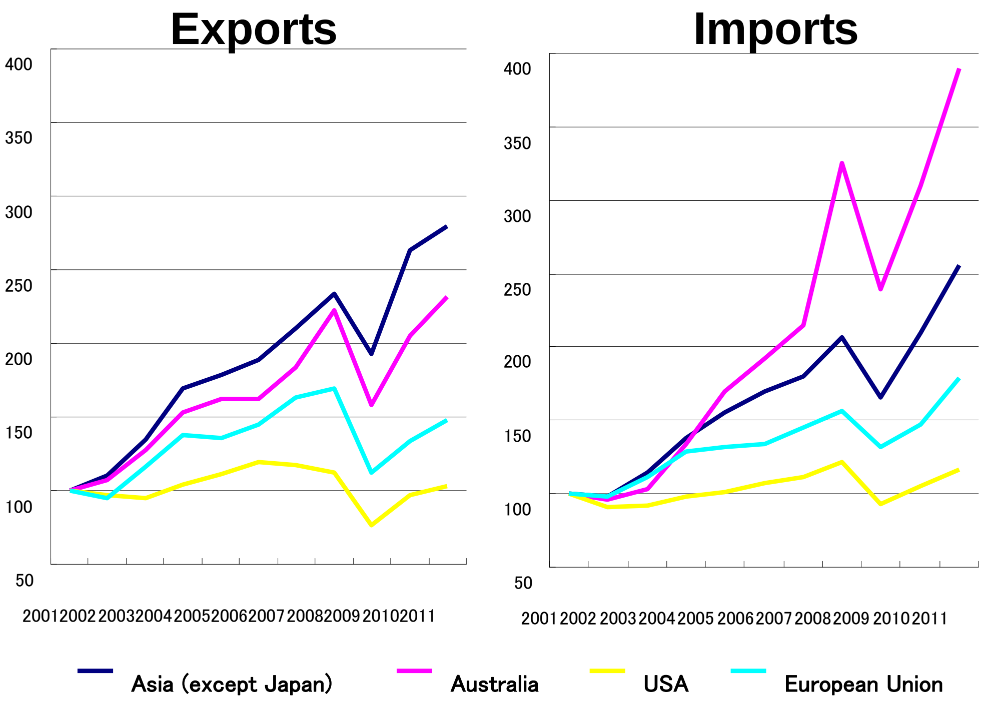
Figure 4 Trends in Australia's trade with other economies (2001=100)[6]



[5] International Monetary Fund, World Economic Outlook Database, April 2012, http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx, Accessed May 12, 2012. Newly industrialized Asian economies are Hong Kong, Sough Korea, Singapore and Taiwan. Developing Asia consists of 27 economies – Afghanistan, Bangladesh, Bhutan, Brunei, Cambodia, China, Fiji, India, Indonesia, Kiribati, Laos, Malaysia, Maldives, Myanmar, Nepal, Pakistan, Papua New Guinea, the Philippines, Samoa, Solomon Islands, Sri Lanka, Thailand, Tonga, Tuvalu, Vanuatu and Vietnam.

[6] Australian Bereau of Statistics, (http://www.abs.gov.au/AUSSTATS/abs@.nsf/mf/5368.0), accessed May 10, 2012.

Figure 5 Trends in Japan's trade with other economies (2001=100)[7]



Chapter 2 Spread of the global financial crisis

The global financial crisis triggered by the 2008 Lehman shock—a crisis deriving from Europe and the United States—dealt a serious blow to the European and U.S. economies. Real GDP growth plunged in Europe and the United States after 2007 (see Figure 6). The epicenter of the crisis was Europe and the United States, but the effects spilled over to Japan and Australia, as indicated by sharp real GDP growth declines in those countries since 2008 (see Figure 7).

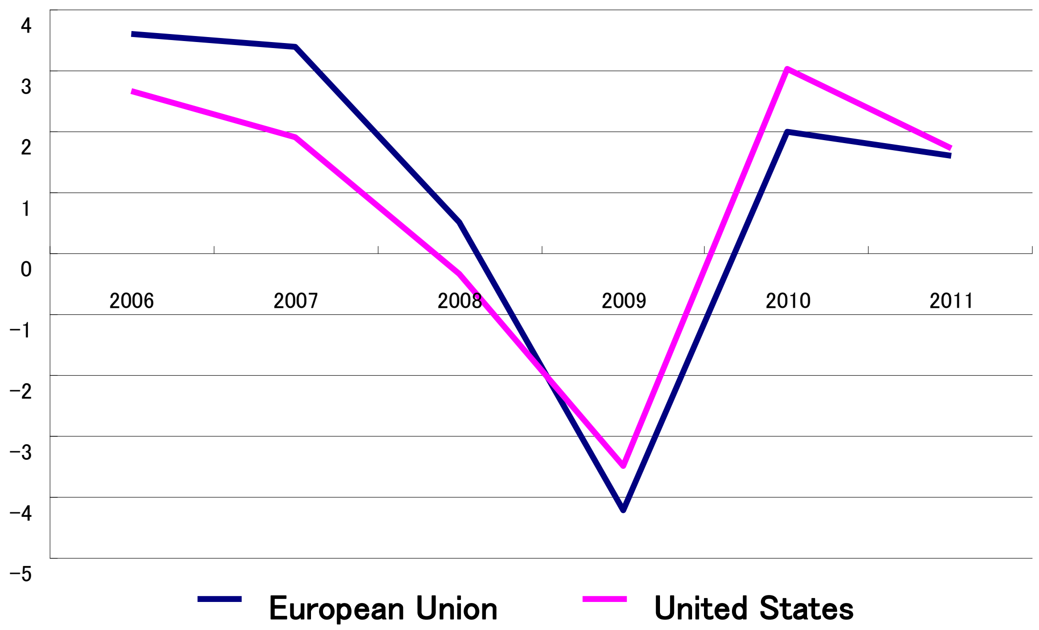
It is possible to analyze the process through which effects of the global financial crisis spread to Japan and Australia, whose economies shrank following contractions in their exports in the wake of the crisis. As Figure 8 shows, exports from Japan and Australia declined after the global financial crisis broke out. Scrutiny of how the outbreak of the global financial crisis impacted exports of Japan and Australia reveals that three elements[8] were behind the process: (1) contraction of

[7] Japan External Trade Organization (JETRO), http://www.jetro.go.jp/world/japan/stats/trade/), accessed on May 10, 2012

[8] According to II6 and III 6-8 of Kaji (2006), trade balance (TB), under the open system of Keynesian economics, is defined as a difference between exports (EX) and imports (IM). EX is determined by GDP (Y*) of the second country and the second country's real currency exchange rate (eP/P*; e is the nominal exchange rate of the first country while P is the price level of the first country. P* is the price level of the second country). IM is determined by GDP (Y) of the first country and the first country's real currency exchange rate (eP/P*; e is the nominal exchange rate while P is the price level of the first country. P* is the price level of the second country). The second country's GDP increase and the depreciation of its currency's real exchange rate are a factor pushing up exports ($dEX / dY^*>0$, $dEX / d(eP^*/P)>0$,). Meanwhile, the first country's GDP increase will push up imports while the depreciation of its currency's real exchange rate will push down imports ($dIM / dY>0$, $dIM / d(eP^*/P)<0$). Assuming that Japan or Australia is the first country while Europe and the United States or Asia are the second country, a decline of exports is believed to derive from a decline of GDP in the second country, which is the same as slackened demand and the appreciation of the real currency exchange rate. Under Keynesian economics, price rigidity is assumed. This means that if P and P* are at the same level, a factor pushing down exports is slackened demand in the second country and the appreciation of the nominal currency exchange rate. In the essay, I made an inference on the process of the global financial crisis spreading to Japan and Australia on the basis of such macroeconomic theory, and confirmed such inference is correct by showing actual statistical data in graphs.

European and U.S. demand, (2) appreciation of the Japanese yen and Australian dollar, and (3) contraction in demand in Asia. Deceleration of demand in Europe and the United States is shown in Figure 9 and Figure 10, indicating that European- and U.S.-bound exports from Japan and Australia shrank as demand and economic growth slackened in the U.S. and Europe as a result of the financial crisis. The appreciation of the Japanese yen and the Australian dollar resulted from capital transfers from Europe and the United States to Japan and Australia by investors seeking safer assets, such as those available in Japan and Australia in the wake of the financial crisis. Figure 11 indicates a rapid appreciation of the value of the Japanese yen and the Australian dollar following the outbreak of the global financial crisis. This led to the weakening of price competitiveness for Japanese and Australian exports in international markets. Consequently, exports of the two countries decreased. Contraction of demand in Asia is shown in Figure 12. There was a steady decline in exports from Japan and Australia to other Asian countries, where growth had slackened in the face of demand shrinkage after the financial crisis.

Figure 6 Real GDP growth rates in the EU and U.S.A.[9]



[9] International Monetary Fund, World Economic Outlook Database, April 2012, http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx, Web access was made on May 12, 2012.

Figure 7　Real GDP growth rates in Japan and Australia[10]

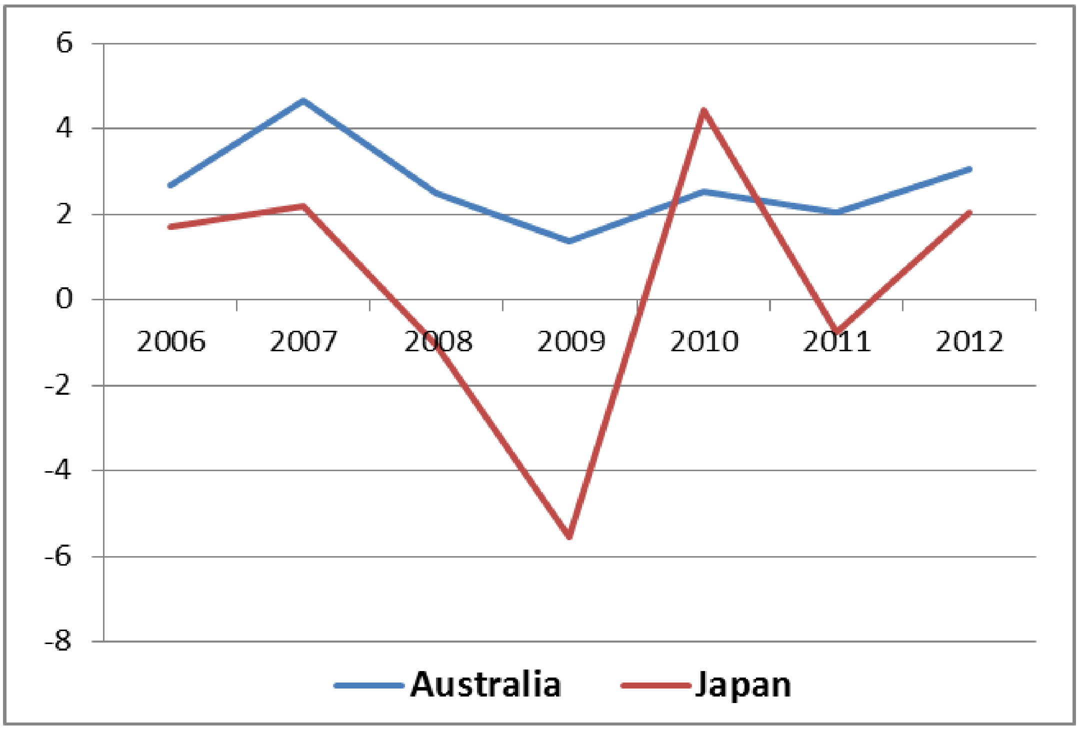
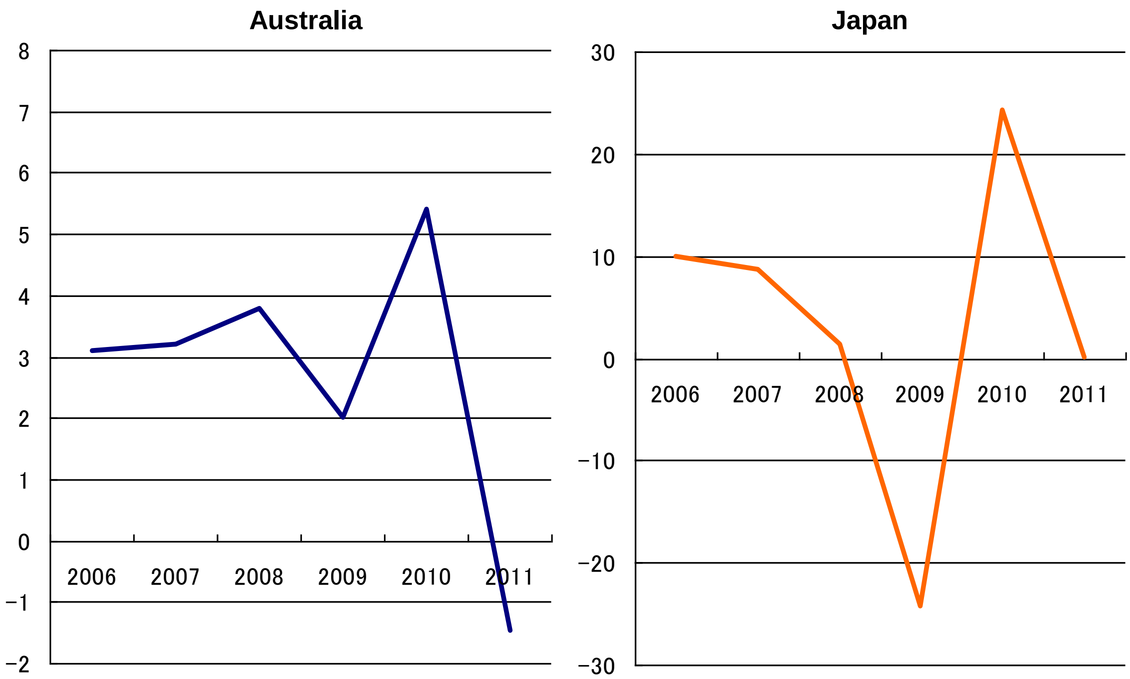


Figure 8　Export growth rates in Japan and Australia[11]



[10] International Monetary Fund, World Economic Outlook Database, April 2012, http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx, Web access was made on May 12, 2012.

[11] International Monetary Fund, World Economic Outlook Database, April 2012, http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx, accessed May 14, 2012.

Figure 9 Changes in real GDP growth rates in Europe and the U.S.A., and changes in European- and U.S.-bound exports from Australia[12]

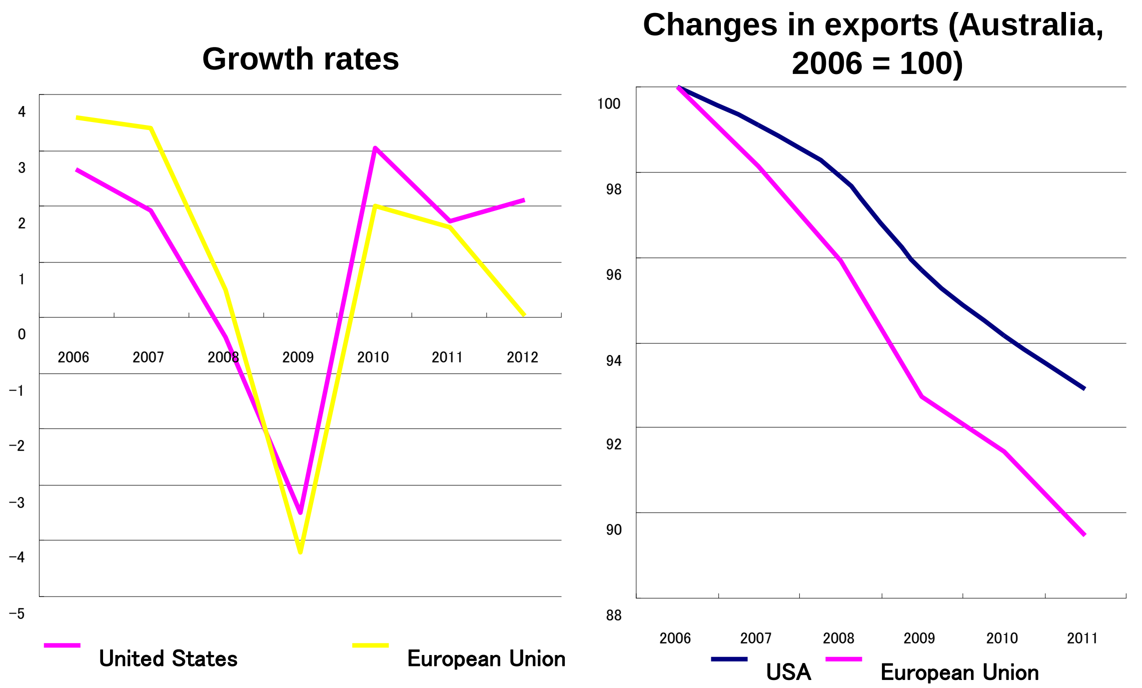
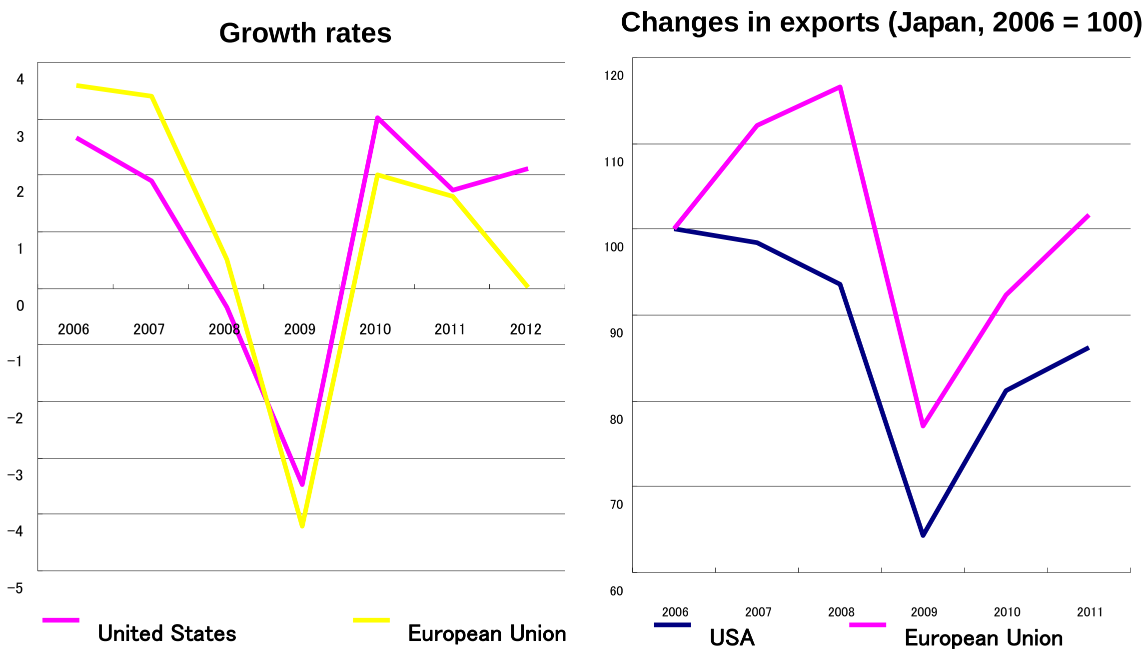
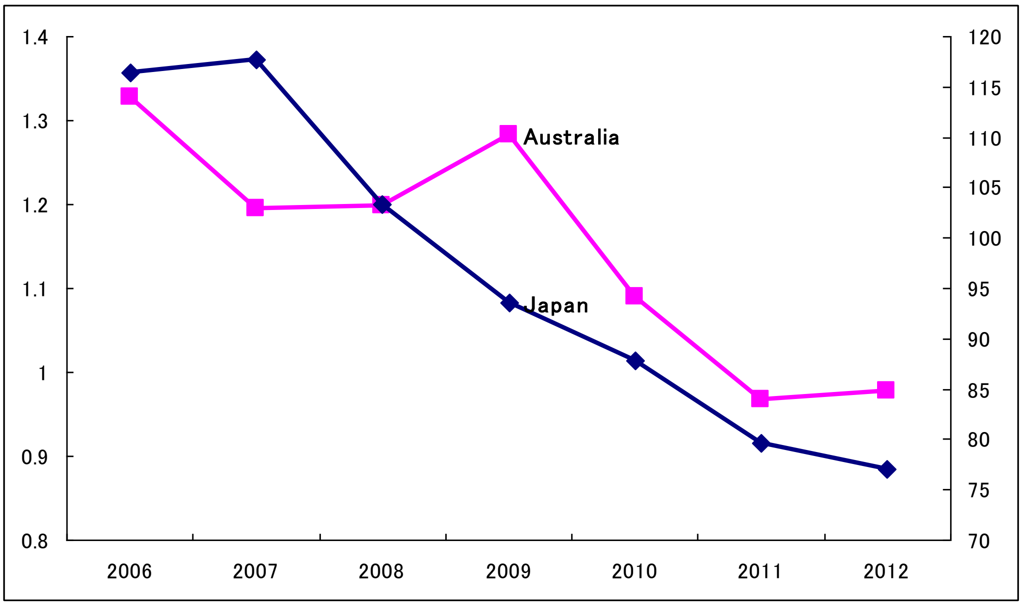


Figure 10 Changes in real GDP growth rates in Europe and the U.S.A., and changes in European- and U.S.-bound exports from Japan[13]



[12] International Monetary Fund, World Economic Outlook Database, April 2012, http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx, accessed May 14, 2012.
[13] International Monetary Fund, World Economic Outlook Database, April 2012, http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx, accessed May 14, 2012.

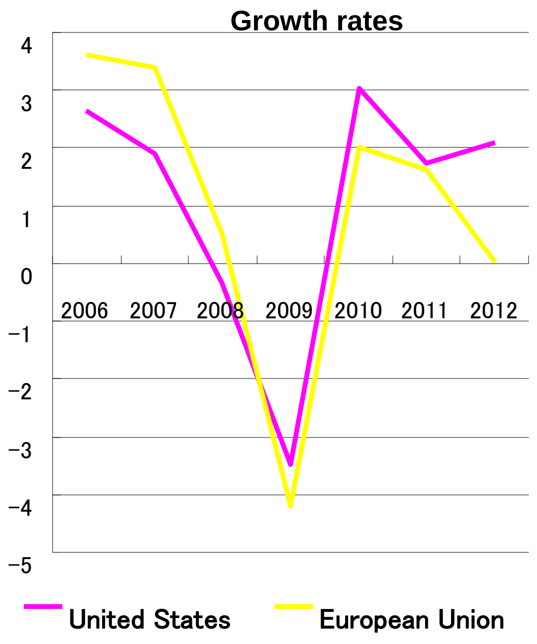
Figure 11 Changes in nominal exchange rates of Australian dollar and Japanese yen against U.S. dollar[14]



The following analysis illustrates factors that led to deterioration of the Asian economy. Asia was affected by the global financial crisis, although the region was not the epicenter of the crisis. Two key factors were responsible for the slowdown in Asia's economic growth following the outbreak of the crisis. First, declining economic growth in Europe and the United States after the crisis, and the subsequent decline in demand there, resulted in declines in European- and U.S.-bound exports from Asia. Figure 12 indicates that economic growth slowed in Europe and the United States following the financial crisis; correspondingly, Asian exports to the two economies decelerated. Second, a significant decline in investment into Asia from Europe and the United States occurred. Massive amounts of capital that had been invested in Asia were withdrawn from the region, leading to a freeze in the region's financial markets. Figure 13 shows that capital-account balances reverted to deficits in Europe and the United States; in 2008, their deficits increased sharply, indicating that fund transfers overseas declined significantly. According to Nishimura (2012), Asian countries relied heavily on capital inflows from Europe and the United States for investment activity, and a fall in such fund inflows along with withdrawals of capital funds from Asia made it difficult for the region to secure investment funds. As a result, fund procurement costs in Asia increased both in the public and private sectors.[15] In addition, Figure 14 indicates that credit risks heightened for five-year government bonds issued in Asian countries following the outbreak of the global financial crisis. Given that higher credit risk leads to reduced financial activity, investment into and within Asia shrank, contributing to lower economic growth in the region.

[14] OECD, Economic Outlook No 90 - December 2011 - OECD Annual Projections, http://stats.oecd.org/Index.aspx?QueryId=32413, accessed May 14, 2012.
[15] Nishimura (2012) pp.2

Figure 12　Growth rates in Europe and the U.S., and changes in Asian exports[16]



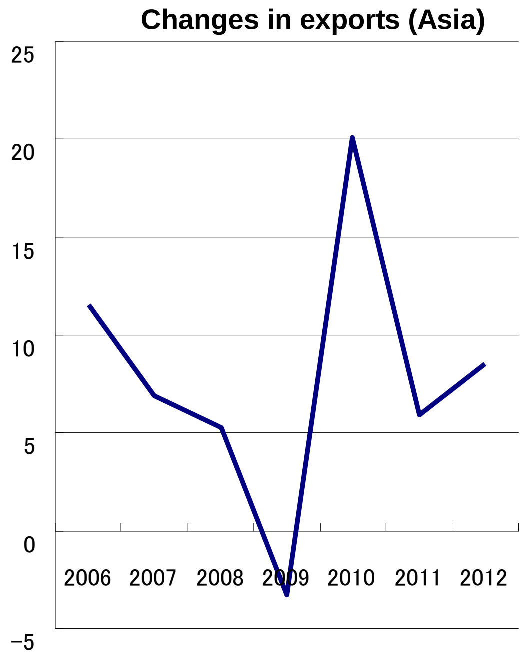
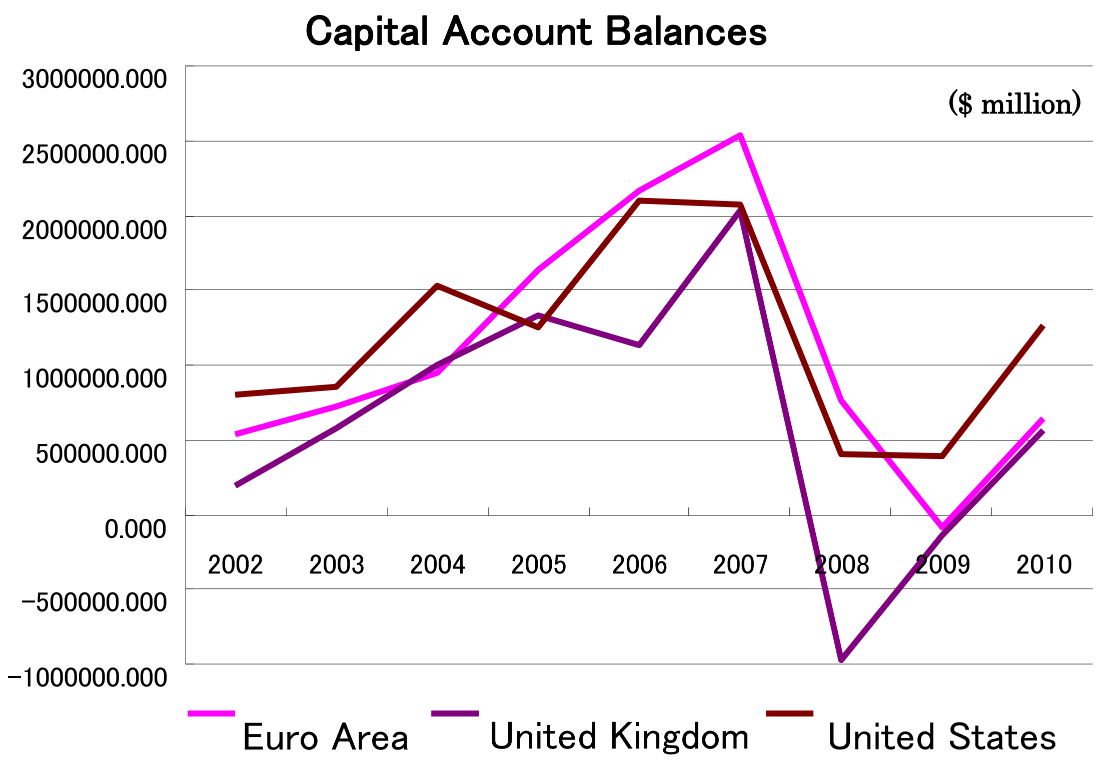
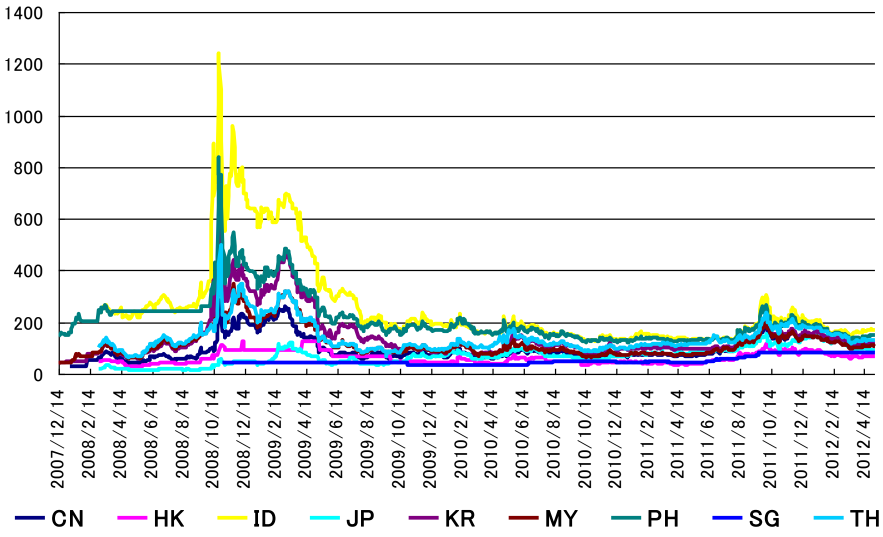


Figure 13　Capital account balances of Europe and the U.S.[17]



[16] International Monetary Fund, World Economic Outlook Database, April 2012, http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx, accessed May 14, 2012.
[17] International Monetary Fund, Balance of Payments Statistics (BOPS), http://elibrary-data.imf.org/FindDataReports.aspx?d=33061&e=170784, accessed May 29, 2012.

Figure 14 CDS spreads for five-year government bonds issued in Asian countries[18]



The financial crisis that originated in the United States and Europe, and the subsequent credit shrinkage in Asia, prompted investors to move their investment funds into safer assets in pursuit of lower risk. Behind the appreciation of the Japanese yen and the Australian dollar, cited earlier as part of the process of the financial crisis affecting Japan and Australia, was an investor preference for avoiding investment risk.

As explained earlier, the process of the global financial crisis affecting Japan and Australia occurred in three stages, and two of the three stages involved Asia (the appreciation of the Japanese yen and the Australian dollar, and decreased demand in Asia). These two phenomena reveal how strongly Asia had relied on capital inflows from Europe and the United States for investment capital.

Chapter 3 Fragility of the Asian economy

The previous chapter explained that credit shrinkage in Asia—derived from decreased capital inflows and capital withdrawals from Asia mainly by Europe and the United States—was part of the process in which the global financial crisis affected Japan and Australia via Asia. Asian credit shrinkage, the appreciation of the Japanese yen and Australian dollar, and slackened demand in Asia led to declines in Japanese and Australian exports. These factors negatively affected the two countries' real economies. But Asia's credit shrinkage was a problem that could have been prevented. The impact on Japan and Australia of the global financial crisis spilling over from Europe and the United States to Asia moved beyond the effects caused by the Asian credit shrinkage. As mentioned in the previous chapter, the financial crisis in Europe and the United States led to credit shrinkage in Asia, reflecting the fact that Asia had relied too heavily on Europe and the United States for securing investment funds. The reality surrounding capital markets in Asia is that funds have still not returned there, mostly because the bond market there has yet to

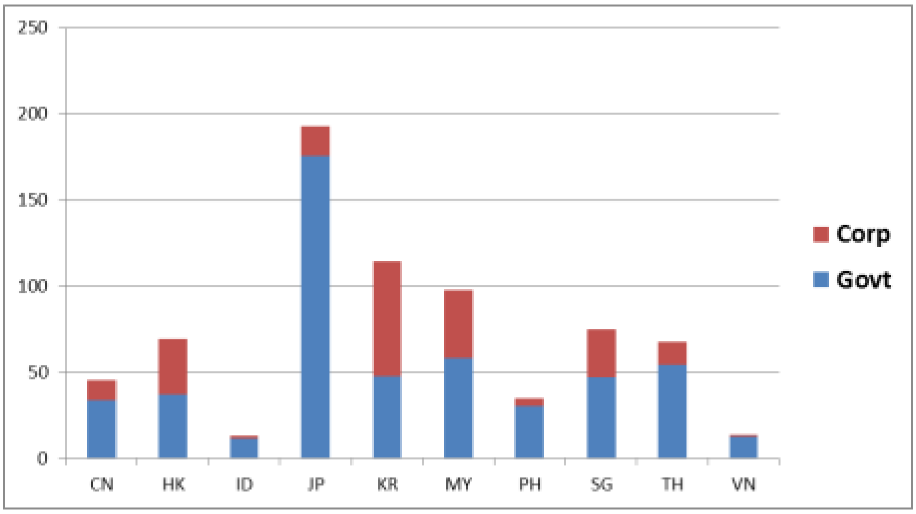
[18] Asian Bonds Online, http://asianbondsonline.adb.org/, accessed May 15, 2012. CN represents China, HK represents Hong Kong, ID represents Indonesia, JP represents Japan, KR represents South Korea, MY represents Myanmar, PH represents the Philippines, SG represents Singapore, and TH represents Thailand.

develop sufficiently. If the bond market in Asia had developed sufficiently, massive credit shrinkage would not have occurred there. In that sense, the credit shrinkage is an issue that could have been avoided. And if the credit shrinkage had not occurred in Asia, the effects of the global financial crisis on Japan and Australia would not have been so damaging. This chapter explains the current situation in the Asian bond market and what has been done to help develop the market since the Asian currency crisis, while pointing out the immaturity of the Asian bond market as a major weakness of the Asian economy.

The graph in Figure 15 indicates the size of bond markets in selected Asian countries, calculated in each country's currency and shown in terms of percentage share against GDP. The graph in Figure 16 shows value-based bond transactions in each Asian country, with figures shown along the left vertical axis indicating the value of bond market transactions (in units of $1 billion). The larger each figure becomes, the larger the country's bond market size becomes. Figure 15 and Figure 16 reveal that the size of bond markets in Asian countries, except Japan, remained small as of December 2011. Because bond markets have yet to be developed fully in Asia, funds in the form of savings are not being efficiently invested in the region; ideally, they should be smoothly channeled into capital investment.

As Figure 17 shows, Asia sustains current account surpluses. This attests to the fact that savings were excessive while investment was lacking in the region.[19] According to Nakajo (2011), because investment is not being funneled back to Asia in sufficient amounts, Asian investors are turning to funds in Europe and the United States for investment.[20] This means that if it becomes difficult to raise funds in overseas markets, or if funds procured overseas are withdrawn from Asia, liquidity will evaporate, leading to credit shrinkage. The Asian capital markets are therefore in a state in which they are susceptible to financial trends in Europe and the United States. The immature bond market—the Asian economy's weak point—is a structural problem.

Figure 15 Size of bond markets measured in each country's currency (percentage share against GDP, data as of December 2011)[21]



[19] According to II 4-14, Kaji (2006), under the open system of Keynesian economics, current account balance (CA) is defined as a difference between savings (S) and investment (I). The formula shown as CA = S-I represents a condition for maintaining equilibrium in the goods market. Elements on both sides of the equality are determined simultaneously. This means that if the current account balance shows a surplus, savings always surpass investment.

[20] Nakajo (2011) pp.94-129

[21] Asian Bonds Online, http://asianbondsonline.adb.org/, accessed May 15, 2012.

Figure 16　Value of bond market transactions[22]

(unit: $ billion; data as of December 2011)

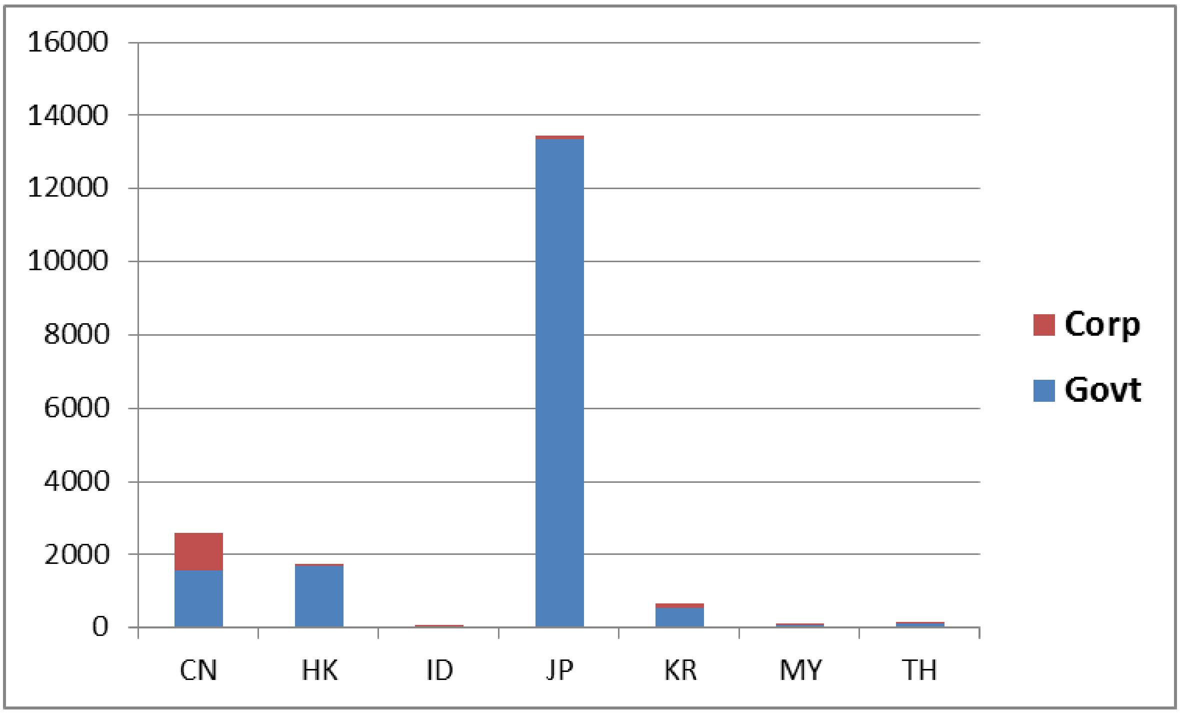
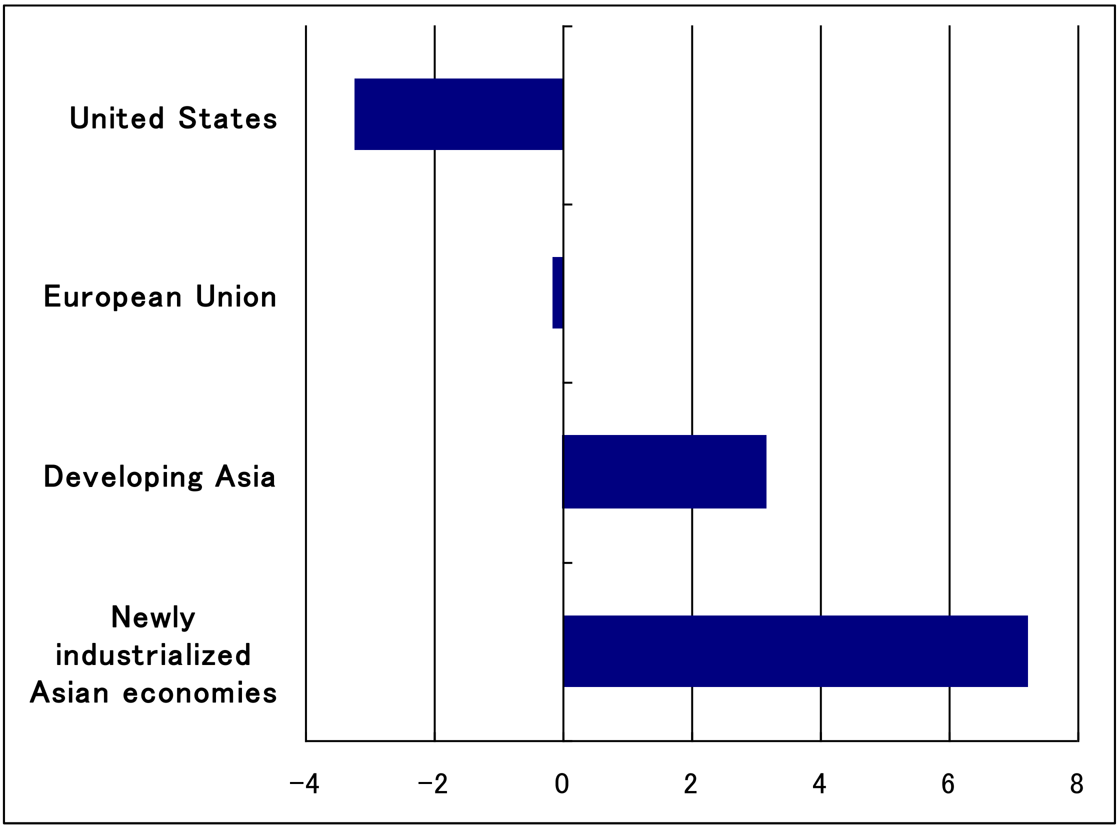


Figure 17　Current account balances of Europe, the U.S. and Asia (comparison against GDP)[23]



[22] Asian Bonds Online, http://asianbondsonline.adb.org/, accessed May 15, 2012.
[23] International Monetary Fund, World Economic Outlook Database, April 2012, http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx, accessed May 14, 2012.

According to Nishimura (2012), the Asian economy's fragility was revealed when the Asian currency crisis hit the region in 1997.[24] That crisis was caused by dual mismatches—a mismatch of currency used in the financing market and a mismatch of maturity periods presented for financing.[25] At that time, Asian countries raised short-term foreign currency funds from Europe and the United States, while they used their own currencies for domestic investment. Given such circumstances, the liquidity crisis occurred in Asian countries when European and U.S. investors reduced or withdrew their funds from Asian capital markets. Nakajo (2010) cited two factors triggering the Asian currency crisis: Asian countries' reliance on short-term foreign currency funds for investment (dual mismatches), and lack of a safety net system for emergency lending using foreign currency funds.[26] As a means of reducing Asia's reliance on foreign currency funds in the event of crisis, efforts are under way to foster an Asian bond market and build a safety net system for emergency financing.

Three policy approaches were taken after the Asian currency crisis to prevent a recurrence. The first, called the Asian Bond Markets Initiative (ABMI), was taken by the ASEAN Plus Three (APT) countries with an aim of fostering the regional bond market by improving market infrastructure, promoting regulatory harmonization, and supporting issuance of bonds denominated in each Asian country's currency.[27] The second policy approach was the Asian Bond Fund (ABF), a scheme initiated by the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), comprising central banks of East Asian and Oceania countries. Founded with foreign currency reserves held by each member Asian country, the ABF aims to foster the bond market in Asia by promoting bond purchases in the region.[28] The third policy approach is called the Chiang Mai Initiative (CMI), taken by the APT countries as a means to provide liquidity, through currency swap arrangements, to countries experiencing fund shortages. [29] The CMI was a bilateral scheme until 2010. In that year, however, the scheme became multilateral and is currently known as the Chiang Mai Initiative Multilateralization (CMIM). CMI plays a safety-net role set up for contingencies; thus, it is also tasked with macroeconomic surveillance activity. As a way to strengthen CMI's surveillance function, a special organization called the ASEAN+3 Macroeconomic and Research Office (AMRO) was established in 2011.[30] Japan has been involved in all three approaches while Australia has been engaged only in the second approach (ABF).

These efforts show that Asian countries have taken various policy approaches as means of stabilizing the Asian economy following the outbreak of the Asian currency crisis. But according to Nakajo (2011), the Asian economy's fragility has yet to be overcome.[31] Specifically, the Asian bond market has yet to develop sufficiently. This problem was revealed by the fact that the Asia's credit

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[24] Nishimura (2012) pp.2

[25] Dual mismatch of currency and maturity is a state in which short-term funds are borrowed in dollar while long-term funds are lent in domestic currency. Under this state, two kinds of mismatch are being observed simultaneously – the mismatch of dollar versus domestic currency and the mismatch of short-term borrowings versus long-term lending.

[26] Nakajo (2011), pp.36-59.

[27] Finance Ministry, Asian Bond Markets Initiative (ABMI), http://www.mof.go.jp/international_policy/financial_cooperation_in_asia/abmi/index.html, accessed May 27, 2012.

[28] Nishimura (2012), pp.3.

[29] Nakajo (2011) pp.65-75, All information for CMI excluding AMRO is taken from Nakajo (2011), pp.65-75.

[30] AMRO, http://www.amro-asia.org/, accessed on May 27, 2012.

[31] Nakajo (2011), pp. 94-129.

market shrank after the global financial crisis, an analysis of which is presented in the previous chapter.

Chapter 4 Collaboration between Japan and Australia, and their roles

Analysis herein has shown that (1) the Asian market remains frail and that (2) the global financial crisis dealt a blow that was more severe than expected to Japan and Australia—both closely connected to the Asian economy—due to the Asian financial market's fragility. The lesson learned from the global financial crisis is that measures must be taken to stabilize the Asian economy for further stabilization of the Japanese and Australian economies, and that efforts action needs to be taken to reduce the fragility of the Asian economy and bring greater economic stability to Asia. The essential challenge facing Japan and Australia is to work together to strengthen the Asian economy and make its financial markets more durable, flexible and impervious to outside shocks. This chapter will present roles Japan and Australia need to play in building stronger Asian financial infrastructure, and will explain why the two countries need to cooperate in addressing the weakness of the Asian economy, by making comparisons between financial markets in Japan and Australia.

Figure 18 shows the outstanding balance of domestic currency-quoted bonds issued by selected countries. A country with a large bond issue balance indicates that the country's bond market size is large. Thus, Figure 18 illustrates that bond markets in Japan and Australia developed beyond markets in Asian countries (excluding Japan). According to Yoshino, Asano and Kawakita (1990), the development of a country's bond market is closely connected not only increases in bond issuance but also to financial regulations imposed in each country. Usually, a country with fewer regulations will see its bond market develop more extensively.[32] The following is an analysis of how bond markets have been fostered in Japan and Australia from the viewpoints of bond issuance balances and financial deregulation.

[32] Yoshino, Asano, Kawakita (1990), pp. 2-9.

Figure 18 Outstanding balances of domestic currency-denominated bonds issued in major developed countries and BRIC and Asian countries[33]

Economy	September 2011		1996	
	LCY Bonds Outstanding	% of World Total	LCY Bonds Outstanding	% of World Total
United States	26,176	38.7	10,926	42.9
Japan	12,626	18.7	4,456	17.5
France	3,384	5.0	1,261	4.9
Germany	2,648	3.9	1,888	7.4
United Kingdom	1,745	2.6	678	2.7
Emerging East Asia	5,479	8.1	528	2.1
of which: PRC	3,247	4.8	62	0.2
Emerging East Asia excl. PRC	2,232	3.3	466	1.8
of which: Korea, Rep. of	1,179	1.7	283	1.1
of which: ASEAN-6	883	1.3	149	0.6
Indonesia	111	0.2	7	0.03
Malaysia	263	0.4	71	0.3
Philippines	75	0.1	28	0.1
Singapore	188	0.3	25	0.1
Thailand	229	0.3	18	0.1
Viet Nam	17	0.03	–	–
Memo Items:				
Australia	1,012	1.5	248	1.0
Brazil	1,368	2.0	299	1.2
PRC (excl. policy bank bonds)	2,216	3.3	–	–
India	649	1.0	81	0.3
Russian Federation	88	0.1	43	0.2
South Africa	179	0.3	82	0.3

– = not available, ASEAN = Association of Southeast Asian Nations, LCY = local currency, PRC = People's Republic of China.
Source: Bank for International Settlements and *AsianBondsOnline*.

Bond markets have been intensively developed in Japan and Australia. Their bond markets have been able to expand on the back of issuance of public bonds following the 70s oil crunch. Issuance of public bonds is effective not only in directly expanding a bond market through the boosting of the secondary market but also in indirectly expanding the market through the promotion of financial deregulation.[34] The reason public bonds, instead of corporate bonds, can lead to rapid development of a country's bond market is that, in general, state-issued bonds have firmer credit standing than bonds issued by private businesses.[35]

Saito (2003) pointed out that Japan's public and corporate bond markets expanded both directly,

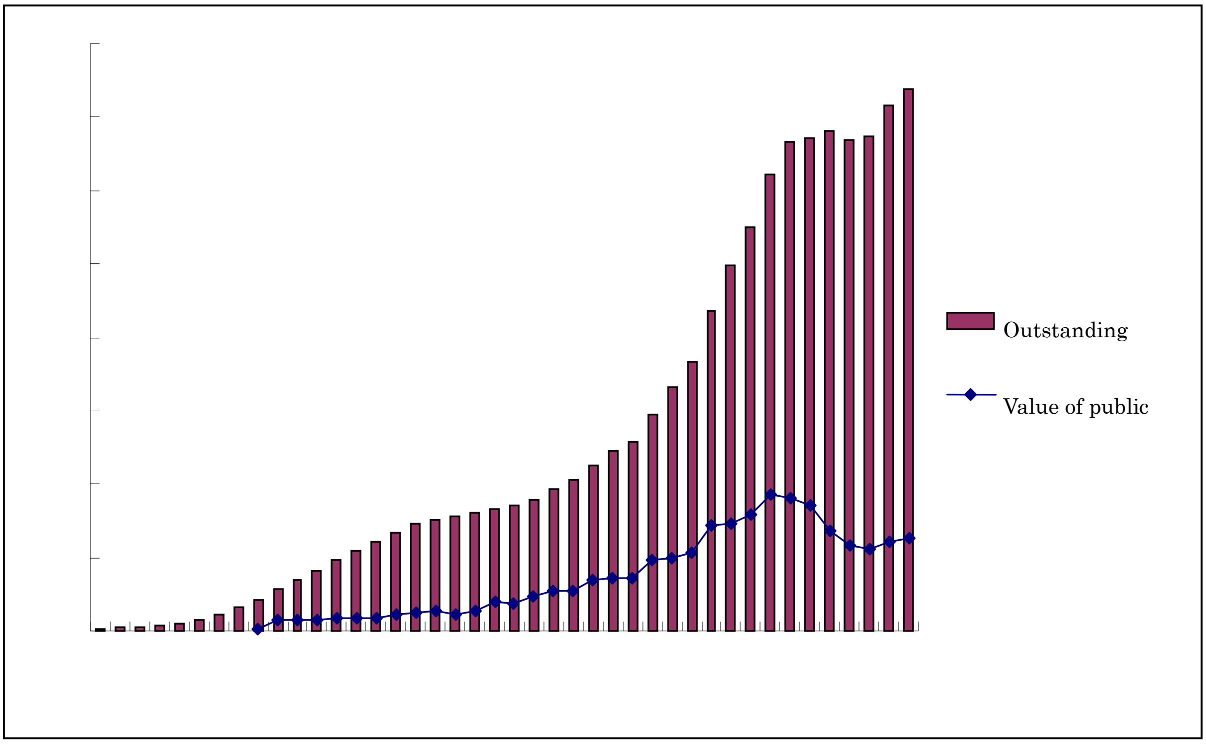
[33] Asian Development Bank, Asia Bond Monitor, April 2012.

[34] A state issues public bonds to finance fiscal deficits. Fund-raising costs of the state—costs for issuing public bonds—are represented by coupon rates set on the bond issue. If there are many potential buyers of the bond, the coupon rate for the bond will bet set at lower levels. On the other hand, if there are few buyers, the coupon rate will be set higher. If the state wants to reduce fundraising costs in bond issuance as much as possible, there needs to be many potential buyers in the bond market. In other words, the size of the market needs to be large. In order to expand the size of the bond market, restrictions imposed on bond purchases and ownership need to be removed to the level at which potential buyers find the bond an attractive alternative to bank deposits. Thus, financial deregulation can be an incentive for the state if it wants to lower fundraising costs in bond issuance.

[35] Even if a state or private businesses tries to issue bonds as a tool for raising funds, bonds will not be traded on the secondary market if there are no people willing to buy them. Whether or not a certain bond will attract a buyer is determined by the issuer's credit standing. Market players judge the issuer as having no credibility if they have no confidence in the redemption of the bond upon maturity. If bond redemption is deemed difficult, the bond will attract no buyers.

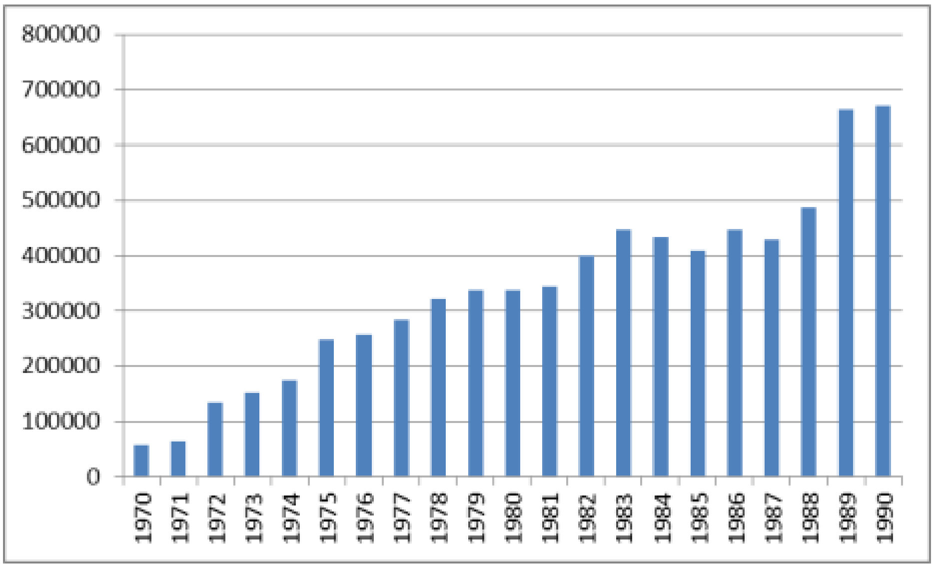
in terms of increased issuance amounts, and indirectly, through greater financial deregulation, thanks to a sharp rise in the flotation of bonds following the Arab oil embargo.[36] Yoshino, Asano and Kawakita (1990) pointed out that not only public bonds but also financial instruments, such as bank debentures, contributed to the expansion of Japan's bond market after the oil embargo.[37] This is a uniquely Japanese phenomenon. Debentures are bonds floated by private sector bank and non-bank financial entities. In Japan, many private sector financial institutions have enjoyed high credit standing by virtue of the Finance Ministry's banking "convoy" system, in which banks—large or small, strong or frail—are protected and kept solvent. Strong confidence in bonds issued by financial institutions also contributed to the development of Japan's bond market. Figure 19 shows the trend in the amount and outstanding balances of public bonds issued in Japan. Figure 20 shows the trend in the amount of bank debentures issued. What is clear from these figures is that issuance of public bonds and debentures grew after the OPEC oil squeeze. The drive for deregulation of the Japanese financial industry, which the government initiated in 1997 under the leadership of then Prime Minister Ryutaro Hashimoto, is referred to as the Japanese Big Bang, an initiative that resulted in substantial easing of rules and regulations in the financial sector. According to Figure 19, issuance of public bonds and their outstanding balance increased at an accelerated rate from 1998 to the first half of the 2000s. These figures support the fact that Japan's public and corporate bond market expanded due to increased flotation of public bonds and corporate debentures after the oil shock of the 1970s, and later, as an outcome of the Japanese Big Bang of the late 1990s.

Figure 19 Issuance of public bonds in Japan, and outstanding balances[38] (unit: ¥ trillion)



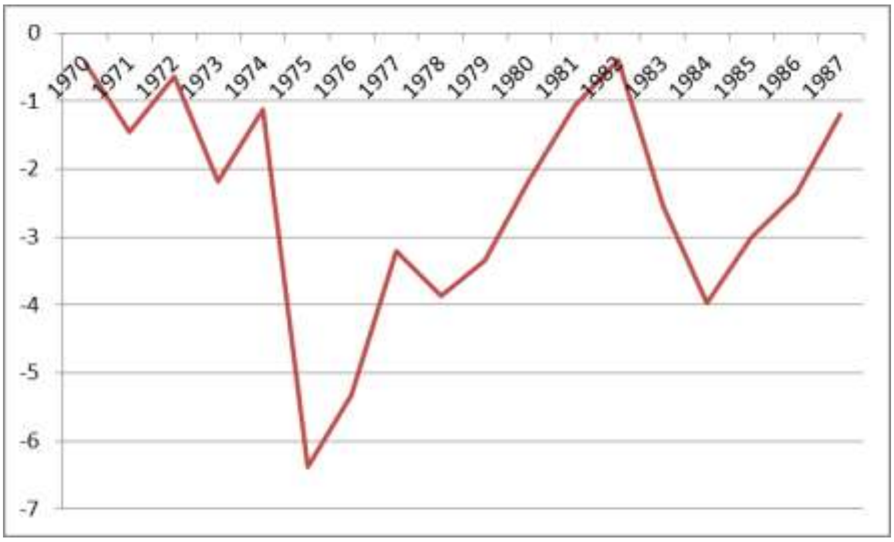
[36] Saito (2003), pp. 54-75.
[37] Yoshino/Asano/Kawakita (1990), pp .2-9.
[38] Bank of Japan, chronological statistics data retrieval site, http://www.stat-search.boj.or.jp/index.html, accessed on May 27, 2012.

Figure 20 Issuance of bank debentures in Japan[39] (unit: ¥ million)



Regarding the bond market in Australia, Ishida (2005) pointed out that Australia began steadily issuing massive amounts of public bonds following the oil embargo, and soon thereafter took financial deregulation steps. Australia's financial policy is believed to have played a role in fostering its bond market directly and indirectly.[40] In 1979, Australia launched the so-called Campbell Committee as part of its efforts to drive reform in the financial industry. Financial deregulation measures were implemented in the country in line with a deregulation recommendation put forward by the Campbell Committee in 1981.[41] Figure 21 shows that Australia recorded massive budget deficits from the mid-1970s to the early 80s. Drastic financial deregulation reform in the country, including a reform drive led by the Campbell Committee, contributed to development of the country's public and corporate bond market.

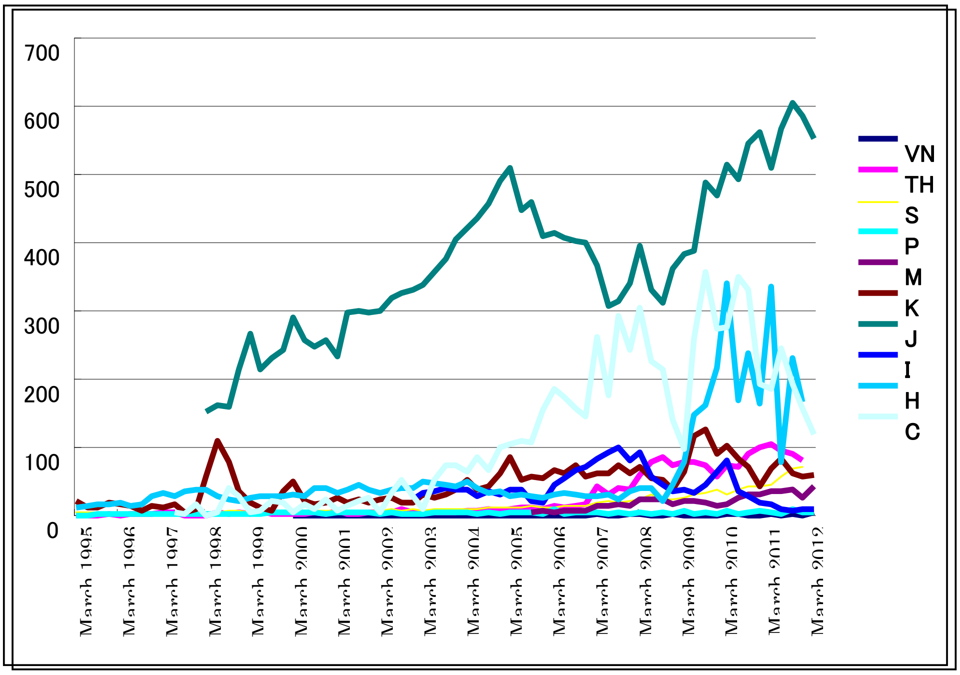
Figure 21 Trend of government fiscal balances in Australia[42]



[39] Compiled by Tokyo Stock Exchange, annual report on securities statistics, v.H9-H9:(1997-1997), pp. 102.
[40] Ishida (2005), pp. 373-375.
[41] Ishida (2005), pp. 356, 368-375.
[42] International Monetary Fund, International financial statistics, vol.31, nos. 11-12: (1978) pp. 70-71,vol .36, nos. 11-12:(1983), pp. 72-73, vol. 42, nos. 9-10:(1989), pp. 100-101.

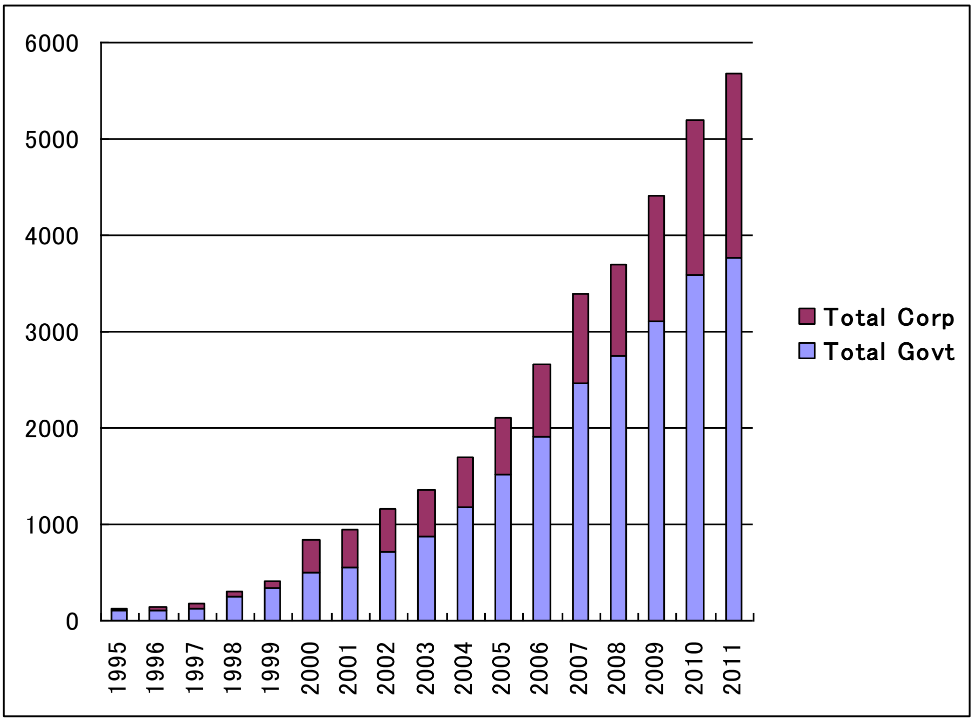
Meanwhile, Asian countries (excluding Japan) were slow in issuing public bonds and driving financial deregulation. As Figure 18 indicates, Asia’s bond markets (excluding that of Japan) have remained relatively small and have seen limited development. Figure 22 shows the amount of public bonds issued in Asia. What can be confirmed from Figure 22 is that it was after the year 2000 that public bond issuance began to increase in Asia. Kosaka (1993) revealed that Asian countries began deregulation of their financial sectors from the 1980s to the 1990s.[43] According to Figure 23, which shows the balance of bonds issued in Asia, the bond markets in Asia have been growing gradually. Asian countries lagged behind Japan and Australia both in issuance of public bonds and financial deregulation. That is why bond markets in Asia developed more slowly than markets in Japan and Australia. Limited expansion of public bond issuance and a short history of financial deregulation are key factors for bond markets having yet to be fully established in Asia.

Figure 22　Amount of domestic currency-denominated bonds issued in Asia (shown in dollar terms)[44]



43 Kosaka (1993), pp. 6-19.
44 Asian Bonds Online, http://asianbondsonline.adb.org/, accessed on May 25, 2012.

Figure 23 Outstanding balances of bonds in Asia[45]



As previously explained, prerequisites for the development of a bond market are public bond issuance and financial deregulation. Thus, if Asian countries are to foster their bond markets, they need to continue efforts to issue public bonds and relax financial sector regulations. As discussed in Chapter 3, the Asian Bond Fund (ABF) was established to support development of bond markets in Asia through purchase of bonds issued in the region. Meanwhile, the Asian Bond Markets Initiative (ABMI) is designed to foster not only bond issuance in Asia but also the upgrading of bond market-related infrastructure, regulatory harmonization and financial deregulation in the region. Efforts currently under way to foster Asian bond markets under these initiatives are consistent with the analysis presented in this essay. But as outlined in Chapter 3, development of Asia's bond markets has yet to reach satisfactory levels—further efforts to promote development are required. Development of bond markets in Asia is an urgent task that calls for the attention of, and has important implications for, Japan and Australia.

Japan and Australia have two essential roles to play in assisting issuance of public bonds in Asian countries and promoting financial reform. First, the two countries should purchase government-issued bonds floated in Asia. As mentioned in Chapter 3, Japan and Australia have already invested in the ABF under the EMEAP framework, but they should provide more funding to the ABF. Second, they should make available to Asian countries their know-how and expertise on public bond issuance and financial deregulation to support efficient implementation of relevant steps in the development of the bond markets in Asia. These two important roles are currently being assumed by parties participating in the ABMI. But Australia is not involved in the scheme, as the ABMI is an initiative led by the APT countries. Japan and Australia are advanced countries in terms of bond market development, as they fostered such markets through the promotion of public bond issuance and financial deregulation. Japan (among APT countries) and Australia can provide

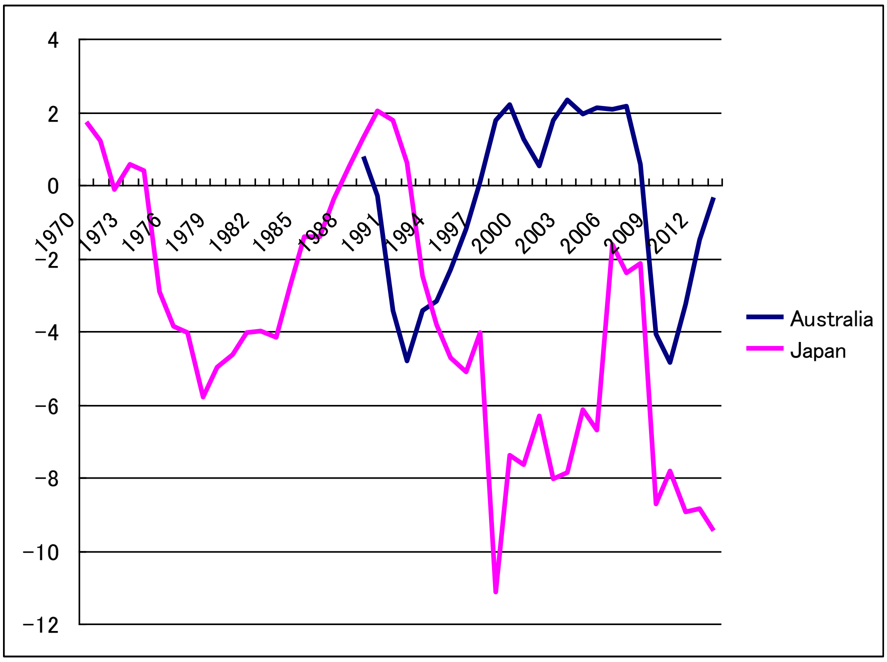
[45] Asian Bonds Online, http://asianbondsonline.adb.org/, accessed May 27, 2012.

other Asian countries with know-how backed by actual experience. There are two options regarding the possibility of cooperation by Japan and Australia in Asian finance. One is for Australia to join the ABMI, and the other is for Japan and Australia to collaborate outside the ABMI framework in providing know-how to their trading partners.

Japan and Australia should also work together in forging measures aimed at addressing the fragility of the Asian economy. There are three reasons for the two countries to join hands. First, the issues they face are more easily resolved if they work together work on common issues. Second, rather than dealing with the issues independently, Japan and Australia can provide more effective support to other Asian countries by teaming up in a division-of-labor approach that would prevent redundancies. The third reason derives from the fact that while Japan and Australia are "advanced" in terms of the current state of development of their bond markets, their markets developed differently; although both have been fostered based on efforts to issue public bonds and ease financial regulations, the financial conditions under which development occurred are significantly different. The graph in Figure 24 shows changes in fiscal balances reported by Japan and Australia. The graph in Figure 25 shows cumulative debt incurred by the two countries. These graphs illustrate that Australia has been steering sound fiscal policy, with its cumulative external debt being maintained at relatively low levels. This is in stark contrast to the case of Japan, whose state coffers have been replenished through deficit financing that has saddled the nation with excessive amounts of cumulative debt. But we should also heed data showing contrasting results, which shows that the Japanese bond market has grown to a far greater size than the Australian bond market (see Figure 18). Australia is fiscally healthier but its bond market is smaller. Japan's fiscal standing is being compromised as its bond market swells. If Japan and Australia cooperate to provide other Asian countries with bond market know-how, it will become possible for Asian countries to develop sound fiscal conditions and foster well-balanced bond markets.

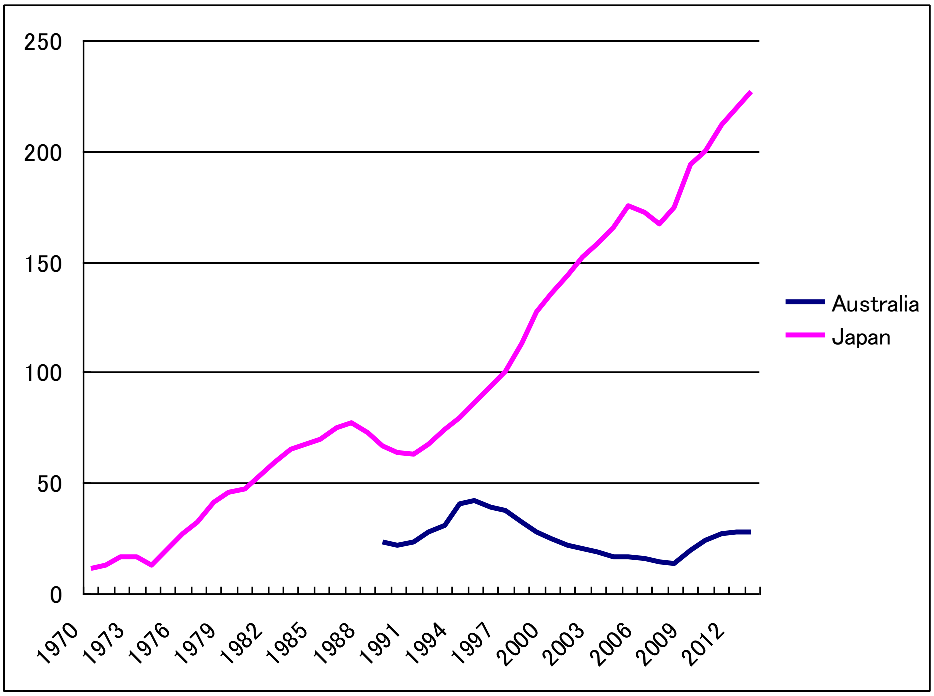
Nurturing an efficient bond market in Asia is a challenge that Japan and Australia should work on together. They are the best partners for each other in attaining this goal.

Figure 24 Fiscal balances of Japan and Australia[46]



[46] OECD, Economic Outlook No 90 - December 2011 - OECD Annual Projections, http://stats.oecd.org/Index.aspx?QueryId=32413, accessed May 27, 2012.

Figure 25 Cumulative debt incurred by Japan and Australia[47]



Chapter 5 **Future of Japan-Australia relations**

In the previous chapters, it was proposed that Japan and Australia work together to make the Asian economy less fragile and less exposed to external effects. Such cooperation would in turn help the two countries secure their own economic stability, since the Asian economy is closely connected to their economies. Specifically, the two countries should collaborate in providing Asian countries with financial resources and know-how. This chapter will explore the benefits Japan and Australia can expect to obtain by solving the weakness of the Asian economy, from the perspective of Japan-Australia bilateral and economic relations.

Japan and Australia can be expected to see two benefits if the Asian bond market is developed: economic stability and economic revitalization. With respect to expected economic stability, the possible impact on Japan and Australia from ongoing financial devastation in Europe and the United States can be reduced if Asia develops stronger financial wherewithal; that is, the ripple effects on Asia from a financial upheaval in Europe and the United States can be more effectively withstood through advancement and fortification of financial markets in Asia. At the same time, spill-over effects on Japan and Australia from the financial doldrums currently imperiling Asia can be also reduced. The Asian economy's fragility could lead to a full-scale Asian financial crisis. Such vulnerability lies in the fact that a fully functioning Asian bond market has yet to be established. The lack of a mature bond market is believed to have been responsible for the 1997 currency crisis in Asia, and as long as this kind of fragility continues to exist, the possibility of a similar currency crisis occurring will remain. A fully developed Asian bond market will overcome the fragility and therefore will lower the risk of another Asian currency crisis occurring. As pointed out in Chapter 1,

[47] OECD, Economic Outlook No 90 - December 2011 - OECD Annual Projections, http://stats.oecd.org/Index.aspx?QueryId=32413, accessed May 27, 2012.

Japan and Australia are now closely linked with other Asian countries in terms of trade and financial dealings. When a financial crisis breaks out in Asia, the Japanese and Australian economies are negatively affected. Therefore, preventing such a crisis is necessary for the stability of the two countries' economies.

Another benefit expected from the development of the Asian bond market is economic revitalization. The Japanese and Australian economies will rebound when their Asian-bound exports increase on the back of a pick up in global demand. Development of the Asian bond market, in the meantime, would help boost fund flows into Asia and likely stimulate investment in the region due to an expected drop in fund procurement costs. Consequently, the Asian economy would be further stimulated, pushing up demand in the region.

Meanwhile, if Japan and Australia join forces to further assist in development of the Asian bond market, two benefits can be expected for their bilateral relations: (1) promotion of mutually complementary relations between Japan and Australia, and (2) a deepening of their overall bilateral relations. Complementary relations can be expected mainly in the financial and services sectors. In the process in which Japan and Australia provide other Asian nations with know-how on financial reform, the two countries will further share with each other the past experiences in and information on their financial markets, including their bond markets. Through sharing of knowledge and experiences, mutual understanding will be deepened between Japan and Australia, supporting their efforts to build mutually complementary relations. At a Japan-Australia symposium held in Tokyo on June 26, 2006, Mr. Warwick Smith told a session of the Japan-Australia EPA that mutually complementary relations have been promoted for a long time between the two countries. He also pointed out[4848] that in the future, the two countries can further promote mutually complementary relations, not only in natural resource development and food security but also in the financial and services sectors. Developing the Asian bond market will lead to better mutual understanding of the financial and services sectors of each country.

Deepening of Japan-Australia relations can yield two benefits. First, their overall relations can become more solid if the two countries share their past experiences and promote mutual understanding. If the two countries work together in tackling common challenges, they can share past experiences, deepen their communications and promote mutual understanding. Another benefit is that the two countries can newly build strategic partnership relations as they explore ways to stabilize the Asian economy. Building out a strategic partnership would expand their relations, making them more multilateral.

As analyzed earlier, benefits can be expected, not only for the Japanese and Australian economies but also for the two countries' overall relations, if they collaborate in reducing the fragility of the Asian economy. If Japan and Australia successfully take the initiative in stabilizing the Asian economy, they will be recognized as Asian leaders in business and economic development. Building better relations between Japan and Australia would produce merits not only for the two countries and their relations but also for other countries and regions. Establishing "win-win-win" relations

[48] Japan-Australia symposium "Strengthening of the Japan-Australia economic partnership and economic integration of East Asia" (June 26, 2006) summary report, Japan-Australia Business Cooperation Committee, http://www.tokyo-cci.or.jp/about/international/file/06jpausympo.pdf, pp.3, accessed May 27,2012.

between Japan and Australia and third countries will bring about ideal bilateral relations for the two countries. The world has been changing in an accelerated manner. Meanwhile, Europe and the United States have been occupied with the task of coming to terms with the aftermath of the eurozone crisis. Under these circumstances, Japan and Australia can build ideal bilateral relations and present them to the global community as a model case. If successful in such endeavors, the two countries will be looked upon for leadership by other countries around the world. If the two countries join hands in dealing with the fragility of the Asian economy, they can build “win-win-win” bilateral relations in the future.

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