



Troubled waters between China and Japan over the Senkaku/Diaoyu Islands



China, Japan, Korea and the US play a complex game of chess in the region



From disputes to status-quo, which implications for the FX in the medium-term?

THIRD ROCK FROM THE SUN

JAPAN, CHINA AND THE LAND OF RISING TENSION



時間過得就像流水 *Time passes like water* - Chinese Proverb

The start of 2013 has seen a shift in risk sentiment across global markets. However, there is a wild card issue that had threatened to overshadow market perceptions, that of the

Senkaku/Diaoyu Islands dispute between China and Japan. While the issue had seemingly calmed from the heights that saw mobs across the Chinese mainland target Japanese

businesses, tensions resurfaced with a vengeance in early 2013, with reports that Japanese and Chinese fighter aircraft were shadowing each other around the disputed islands.

The investment community and the blogosphere alike have raised questions over whether tensions were just those... tensions, or if there was any potential for armed conflict. Asian Second World War scars have not healed as smoothly as those in Europe, a fact that can be seen on the Seoul subway where full wall adverts in English are placed to educate visitors of the crimes committed by the Japanese Imperial Army during its occupation of mainland Asia.

There is little love lost across the water in Tokyo, where new Prime Minister Shinzo Abe has caused controversy by visiting the controversial Yasukuni war memorial. The LDP has even hinted interest in re-writing an apology for its aggressive colonization of East Asia. However, despite the anti-Japanese sentiment in the region, there appears to be an understanding that the counterbalance to the growing tide of Chinese influence in the region needs to be strengthened, a point highlighted by the recent Philippine Government's call for a comprehensive Japanese rearmament.

The point however, raises an interesting observation on the nature of the tension between Japan and China. Japan is not fully armed and on its own, completely unable to take part in any form of sustained conflict against Chinese military forces. Any action would require direct American support and approval and be almost completely unthinkable at this juncture. Conversely, China has marched straight to the top of



Troubled waters between China and Japan over tiny islands in the East China Sea

the regional food chain via rapid economic development and ever-deepening trade relationships with its neighbours. China, Japan and South Korea are estimated to account for close to 20% of global GDP at recent estimates. So, with this being the case, why were Japanese and Chinese leaders being so brazen in stoking tensions over a small collection of islands?

THE HISTORY

The Senkaku/Diaoyu Islands are seen as being strategically important. They are tactically positioned between Japan, China and Taiwan, have rich fishing waters and are believed to hold significant oil reserves. They have been administered by Japan since 1895, and owned by private Japanese owners over the period. At the point of nationalisation, Japan stated that they had observed the islands for ten years

to ensure that they were uninhabited before taking action.

After the end of the Second World War, Japan was forced to renounce a collection of territories and islands under the Treaty of San Francisco in 1951, which transferred the islands to under US trusteeship. In 1971, the islands were returned to Japan. A key foundation of Japan's argument is that China had no objections to the Treaty of San Francisco, but only took interest in the islands when the prospect of oil reserves was revealed. Conversely, China claims that over the long stretch of pre-colonial history, the islands have historically been theirs. Further, China claims that under the "Cairo Declaration" of 1943 and the subsequent "Potsdam Declaration" of 1945, the Senkaku Islands, as islands appertaining to Taiwan, reverted to China along with Taiwan.

Tensions started to surface in the mid 1990's when Chinese activists made attempts to land on the island. These moves were swiftly met by Japanese authorities, who arrested and then evicted them. The conflict took a new turn in the early nineties when the Chinese Government is reported to have concluded exploration agreements with leading oil development companies for the exploration and production of gas projects in the East China Sea in 2003. The Japanese Government is said to have expressed concern that the areas in question overlapped with Japan's exclusive economic zone. Requests for

information from Beijing were rejected and in 2004, the Japanese government confirmed that China had started drilling just 4km from Japanese waters.

After a period of relative calm, the issue flared up again in 2010 when a Chinese fishing boat was caught in Japanese waters and violently resisted arrest from the Japanese coastal patrol. Eventually the Chinese captain was taken into custody, stirring up the diplomatic issue once again and leading to a tit-for-tat diplomatic response by the Chinese. The Japanese eventually released the Chinese fisherman following the reported arrest of four

Japanese men who had been working on a Government funded project in China on contentious charges. Since then, tensions calmed until mid 2012 when the Japanese Government officially purchased three of the islands from their private Japanese owners. However, the end of 2012 saw both the Japanese General Election and the transition of power in the Chinese Communist Party. As both dates drew closer, tensions soared to unprecedented levels. Further, both nations have been experiencing times of economic uncertainty, albeit with differing levels of severity and instability.

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逆側はその逆側を持ってい
The reverse side also has a reverse side
Japanese Proverb

JAPAN – TEACHING AN OLD DOG NEW TRICKS



In Japan, the recent election of the LDP and its coalition partners ended the DPJ administration, which held the distinction of being the first non-LPD government since 1955. The election marks Prime Minister Shinzo Abe's second term in office, with his first being between 2006-07. Interestingly his first term was characterized by a concerted and public effort to improve relations with China. However, his return has been defined by a three-pronged plan of action, namely pitting fiscal and monetary reform alongside an aggressive foreign policy.



The Japanese Upper House elections are scheduled for July 2013 and many feel that Abe is looking to push through as much legislation, as quickly as possible

The Japanese economy has long suffered since the bursting of the asset price bubble in the late 80s and early 90s, leading to the 'lost decade' where incessant deflation led to economists coining the phrase 'Japanification' to describe such troubled circumstances. This period of extended economic stagnation has been compounded by the emergence of China as a leading exporter alongside regional peers like South Korea.

Further, Yen is considered to be a safe haven currency alongside USD and is primarily driven by risk sentiment. So naturally, when the US Sub-prime crisis exploded in 2007-08, followed shortly afterwards by the

start of the European Debt crisis, Yen strengthened to record levels against the Dollar and the Euro. Any economy that is predominantly geared towards exports requires a carefully managed currency. As such, the unprecedented levels of strengthening made Japanese goods increasingly less competitive. Additionally, the earthquake and Tsunami which shook Japan in 2011 not only caused severe infrastructural damage but led to a pivot away from cost efficient nuclear energy, which in turn placed further strain on the economy.

Throughout his election campaign, Shinzo Abe's tone has implied

that enough is enough and led commentators to herald the birth of 'Abenomics' (name given to a suite of measures introduced by Japanese prime minister to revive the sluggish economy). He has layered political blame and pressure on the Bank of Japan for their lack of aggression in preventing an excessively strong currency. He has strong-armed them into adopting a 2% inflation target and wants the bank to dramatically step up its asset purchase programme. Finance Minister, and also former PM Aso recommended a target price for USD/JPY of 90, a level that after a period of rapid appreciation from the 70's has been met. The final aspect of 'Abenomics', according to Marc Chandler, Global Head of Currency Research at Brown Brothers Harriman, is the stoking of nationalism and the reassertion of Japan as an international power.

Abe's sweep of the Japanese political scene has been characterised just as much by its aggression as its speed. The 'enough is enough' mantra of his campaign can be one explanation for his stance, but gradually analysts and observers are starting to suspect that something else may be afoot. Abe's previous post as PM was short lived before he was somewhat abruptly forced to resign due to a combination of terrible approval ratings, embarrassing losses in the Upper House and worsening health. Markedly, the Japanese Upper House elections are scheduled for July 2013 and many feel that Abe, scarred from his previous experience, is looking to

push through as much legislation, as quickly as possible. This view is supported by research by Richard Koo, Chief Economist at the Nomura Research Institute, who notes that the poor proportional vote counts shows that the LDP's policies are not as popular as one might believe and Abe is merely striking while the iron is hot.

However, there is one other factor that is simmering on the outskirts of analyst observations. That of the 'Japanese Debt Time Bomb', a phrase recently highlighted by Hedge Fund manager Kyle Bass in financial blog ZeroHedge. The Texas based manager highlights that Japanese debt is around 24 times central government tax revenue and that 25% of said revenue is spent on interest. Whilst pinpointing the end of a 70-year debt super cycle to the day is naïve, Bass sees it coming in the next few years. His comments hint that Abenomics may be a final throw of the dice by the authorities before the inevitable occurs. However, it should be noted that it's said that cemeteries are full of the careers of traders who thought that Japan was on the verge of collapse over the past couple of decades.

CHINA – THE IMPORTANCE OF MANAGING EXPECTATIONS

Meanwhile in China, despite a decade of unbelievable growth and development, the leadership transition in November came about at a time of relative economic instability, where the main question being asked is if



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China will have either a hard or soft landing from the dizzy heights of its recent achievements.

The Chinese economy has seen consistent out performance on its annual targets over the past ten years, averaging close to 11% growth despite the 2008-09 financial crisis. However, more recent growth targets have fallen as low as 7.5% last March. To offer some perspective as to the difficulties facing the Communist Party leadership, former President Hu once famously remarked to former US President Bush that his greatest concern was how to create 25 million jobs a year, just to sustain growth.

Despite GDP growth rates that stuttering European economies

could only dream of, the reality on the ground in Beijing is far from the black and white understanding that many westerners subscribe to. A social contract exists between the Communist Party and the Chinese people that translates in layman's terms as, "let us rule, and we will make your lives better". The past decade has seen such unbelievable progress that expectations have grown, and the high-water mark is proving more difficult to consistently match.

Further, the relationship between the Communist Party and the people is not as simple as many would believe. For every charge that China suppresses human rights, there is an opposing call claiming that the Government is too soft and needs to be more aggressive

both domestically and internationally. Nationalism is an especially powerful force in China and the explosion of anti Japanese protests across the country last year will have served as a stark reminder to the Politburo what they may expect if they fail to manage expectations. China's future looks bright, but the flags waved by passionate citizens will not necessarily be red.

The rise of China has seen a number of border disputes and concerns raised by its neighbours. However, perhaps an alternative view could be that after a long period of colonisation and rebuilding, the Chinese dragon has awoken and is stretching its wings. Rather than viewing the Communist Party as having an inherently aggressive foreign policy in the stereotypical

Soviet mould, we may be best served considering that the party may be doing the bare minimum to meet demand and placate domestic fervour without sparking major international

incidents. After all, this is the same Communist Party that realised that China was falling behind the rest of Asia and pro-actively instigated economic reforms. A look to North Korea offers a sober reminder of what a dogmatic embrace of communism results in.

A number of analysts believe that

demanded, the process may be more of a natural development rather than a sudden event. In this sense, talk of a 'hard or soft' landing might not be as suitable for Chinese economics as it is for Chinese politics. Perhaps the most appropriate question is whether the Communist Party can make the smooth transition to becoming more open and democratic, or will it collapse and lead to the chaos seen following the fall of the Soviet Union.

However, when looking at the nationalist drum beat sounding from Beijing, a further element to consider may be the question of official corruption in China. While there may have been a certain level of tolerance of Communist Party behaviour in the past, the dawn of



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the days are numbered for the Communist Party. However, expectations of a collapse are far from imminent, but with the rate of reform and development being

the internet and social media specifically in recent years has forced an unwelcome air of transparency upon the ruling elite. The internet is heavily censored domestically,



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but with increasing numbers of students studying and working abroad, 'Chinese walls' are being torn down. Further, a generation of increasingly innovative developers is able to stay one step ahead of state censors in a perpetual game of cat and mouse.

While frustrations are often felt at the corruption of the lower level local officials, claims in publications such as *The New York Times* and *The Economist*, that former Premier Wen Jiabao's family have amassed billions of dollars in recent years was met with stern, but not complete censorship. Further, in 2012 Bo Xilai, son of one of the Eight Elders of the Chinese

Communist Party and once hotly tipped to become President, became embroiled in a scandal involving the murder of a British businessman and a host of questionable financial arrangements. With both the past and future of the Politburo leadership showing questionable ethical characteristics, it is understandable that questions, no matter how censored, start to circulate. Against such a backdrop, the distraction of nationalistic rabble rousing could be quite appealing.

손바닥으로 하늘을 가리려한다
- *Don't try to cover the whole sky with the palm of your hand*
Korean proverb

SO WHERE ARE WE NOW?

So, elections have passed and transitions have taken place but the drum is still beating. What gives? It could well be the case that once you let the cat out of the bag, it takes careful and delicate negotiation to get it back in. Asian culture is steeped in concepts of honour and pride. After the Chinese Government stoked the mob protests which led to the blockading of Japanese products and the violent targeting of Japanese businesses, exports to China (20% of exports) plunged, thus pushing Japan towards recession and it became politically impossible for an incoming Japanese leader to appear to let the issue lie. Conversely, a new administration has taken over in China and as the new leaders of the world's up-and-coming superpower, they cannot appear to be dictated to by a fading old enemy. They say that pride comes before a fall, and it is not that outlandish to assume that on this issue at least, both Japanese and Chinese tanks are currently running on pride.

Outside factors too are most certainly playing a role. The US and many of its regional allies are keen to prevent Chinese aims of a unipolar Asia. Further, recent US support for Japan on the issue may have irked Beijing but encouraged them to step back. A likely consideration is that the US position is also being made in reaction to China's stance over Syria. Furthermore, there have been reports in German newspaper *Spiegel* that North Korea is taking



its first steps towards economic reform with the assistance of German businesses and economic advisors. No matter how distant and improbable, the prospect of a unified Korea would worry China on the basis that Korea has historical claims to the Manchuria region, is highly developed, extremely militarized and has the backing of the US. Opportunities to show strength to those reading between the lines, on a world stage, nonetheless, do not present themselves often and are duly taken when given.

Continuing with the North Korean wild card theme, reports have circulated in which the hermit kingdom claims to be conducting nuclear missile testing with the aim of being able to launch attacks that can target the US. Considering

that, just days previously, the islands issue looks to have reached an uncomfortable truce, the timing is uncanny. Educated in the West, leader Kim Jong-Un is said to favour economic reform but it is believed that an internal struggle is taking place where the Chinese backed military, fearful of having to justify its dominant role in a freer country, is proving to be an obstacle to further progress. From this perspective, the Senkaku/Diaoyu Islands disputes look to be just one part of a larger and more complex game of chess in the region.

IMPLICATIONS FOR FX?

The reports of peaceful overtures from the Chinese, followed by reciprocal moves from the Japanese, indicate that the status quo will remain for now but short of

ultimate resolution through armed conflict, the issue looks like it will continue to resurface whenever convenient domestically and/or provoked internationally. In terms of what to watch for, it should be noted that on two occasions since 2010, the Chinese government has encouraged mob protests that have targeted Japanese businesses and boycotted Japanese goods. 20% of Japanese exports go to Mainland China and as such, the nation is sensitively exposed in such events.

With Abenomics in full swing, the trigger-happy Aso in place as Finance Minister and a new regime in the BoJ, future tensions could be seen as an opportunity to short JPY on peaks, in anticipation of easing measures following hits to Japanese exports to and businesses in China. Likewise, similar positions in KRW and other regional exporters could be targeted in anticipation of retaliatory measures. As seen of late, aggressive easing by major central banks has left many emerging nations planning to take action themselves. In a tit-for-tat central banking environment where everybody is taking action but nobody is “manipulating” their currency, excuses to print are actively sought after, and four years after the financial crisis of 2008, easy monetary policy and its subsequent trends look to be here to stay, in the medium term at very least.

Gus Farrow