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4 Japan: a new move toward bilateral trade agreements

T.J. Pempel and Shujiro Urata

1 Introduction

On October 31 2002, an exchange of diplomatic notes took place between Japanese Ambassador Extraordinary and Plenipotentiary to Singapore Kunihiko Makita and Singapore's Minister for Foreign Affairs S. Jayakumar. The notes provided for the two countries to enter into the Japan–Singapore Economic Partnership Agreement (JSEPA). This FTA represents a comprehensive economic partnership agreement (EPA) aimed at liberalizing and facilitating trade and investments, and promoting bilateral cooperation in a wide range of areas, including financial services, information and communications technology (ICT), human resources development, small and medium enterprises (SMEs), and tourism. Its wide coverage makes JSEPA more than a traditional FTA that normally focuses solely on the elimination of trade barriers among signatories.

JSEPA itself came into force on November 30, 2002 and for Japan, it represented the country's first comprehensive bilateral free trade agreement. Currently the Japanese government is also negotiating FTAs with Mexico, Korea, Malaysia, the Philippines, and Thailand, while it is studying FTAs with various other economies including Indonesia, ASEAN, and Australia. In this sense, JSEPA represents a striking break with Japan's past approach to trade, which had relied heavily on global or universal trade agreements, most notably those reached through the GATT/WTO process. JSEPA and Japan's open negotiation of additional FTAs reflects the growing acknowledgment that as people, goods, money, and information move actively across borders, easing international economic interaction requires vastly more than the liberalization of rules concerning merchandise trade.

From another perspective, however, the apparent break was somewhat less striking. Starting from at least 1974, the Japanese government had entered into a number of bilateral trade agreements, most frequently with the United States, Japan's most important trade partner. Unlike JSEPA, however, such earlier agreements were far from comprehensive.

The vast majority of agreements involved single products, or a limited number of industrial sectors, and were designed to solve specific and politically sensitive bilateral trade problems. From this perspective, JSEPA represented a break with Japan's past trade policies in three important dimensions. First, it was a pact that did not involve the US. Second, it was comprehensive, rather than sector-specific. Third, as many Japanese officials suggested, JSEPA was seen as the beginning of a new dimension in Japanese trade policy that would open the way to a series of bilateral FTAs. In all three ways, JSEPA represented an important break with Japan's past political economy.

The remaining portion of this chapter is divided into four sections. Section 2 discusses the changes in Japan's trade policies from a multilateral single-track approach based on GATT/WTO to a multilateral, regional and bilateral approach. It also shifted from a US orientation to one that focused more on East Asia. Sections 3 and 4 examine Japan's FTAs from economic and political perspectives, respectively. Section 5 analyzes the developments and issues related to Japan's bilateral FTAs. Section 6 presents concluding remarks.

2 Trade policy overview and bilateral trade agreements

Japan long held that FTAs had a discriminatory effect against nonmembers and hence it had long refused to participate. Instead, the country relied largely on global trade agreements such as GATT/WTO and, when multilateralism failed to alleviate bilateral trade pressures, on the kinds of side deals with the US noted above. But throughout these processes, protection of politically powerful domestic sectors remained a driving force in Japan's trade policies. Thus, the Uruguay Round had been problematic and subsequent global arrangements had been slow to materialize. Moreover, regional arrangements for free trade stalled on important points. APEC's Bogor Declaration (1994) had promised trade liberalization in the region by 2010 for the developed, and 2020 for the developing countries.[1] "Free trader nations" such as the US and Canada strongly pushed for the Early Voluntary Sector Liberalization (EVSL) at the APEC forum's 1997 Vancouver meetings to force speedier implementation in selected sectors of the Bogor Declaration. But EVSL fell apart primarily due to Japanese opposition to a package deal that would bundle together nine distinct sectors. Because Japan refused to participate in the tariff and non-tariff portions of two sectors, forestry and fishing, the result was APEC's most intense conflict and most public "failure" in the trade arena.[2]

Despite such difficulties at the global and transregional level, or perhaps because of them, there was a substantial increase of FTAs in the 1990s. As of October 1, 2002, of the 30 top economies in the world, only five were not members of FTAs—Japan, China, South Korea, Taiwan, and

Hong Kong. Many in Japan contended that if Japan did not participate in the rapid rise of FTAs Japanese exporting companies would face economic isolation.

Japan thus came to recognize FTAs as potentially valuable in dealing with changes in global trade. Several factors contributed to this shift in Japan's trade policy. Greater access to foreign markets was one of the most important motives: as noted earlier, Japan was one of the few countries that did not have any regional trade arrangements. Facing a world market that contained many discriminatory trading arrangements, Japan felt the need to secure market access for Japanese firms by setting up FTAs. FTAs would eliminate trade barriers among Japan's FTA partners, enabling Japanese companies to enjoy greater business opportunities. This recognition created more positive perspectives within Japan about FTAs. For internationally competitive Japanese firms, this could mean enhanced business opportunities when competing with foreign companies. For example, the Japan–Singapore EPA encourages Japanese firms to expand their business activities in Singapore. As Singapore is ASEAN's most important member, some Japanese firms will then use Singapore as a "hub" to expand their business activities throughout the entire ASEAN area. Market access clearly played an important role for Japan in pursing an FTA with Mexico. As the EU and the US already have FTAs with Mexico, many Japanese firms felt that they are at a disadvantage when facing European and US firms in Mexico. These Japanese companies argue that a Japan–Mexico FTA will reverse this disadvantageous environment in the Mexican market by allowing them to compete more effectively with EU and US firms within Mexico.

Economic incentives aside, however, FTAs are also one quick and less painful way to force vigorous structural reforms at home. Such changes are increasingly recognized as necessary to revitalize the currently stagnant economy. FTAs expose companies in both participating countries to direct foreign competition, the result of which is likely to be either structural reform through peer pressure or else ongoing loss of market share and eventual industrial restructuring. For much of the period since World War II Japanese structural reformers made use of international frameworks (e.g. GATT and OECD) and external pressures (especially, pressures from the US) to reform Japan's domestic structures. However, in the latter half of the 1990s, trade liberalization had become more difficult under the WTO framework. In addition, since the US was enjoying an economic boom while Japan's economy was mired in deflation, American politicians found no necessity to put much pressure on Japan to open its domestic market. Such developments meant that Japan's reformers were not able to depend on external pressure to push domestic structural reform. In such a situation, FTAs gained attractiveness as a policy option that might promote structural reform. Japanese leaders became increasingly interested in the ways in which the EU and NAFTA had used FTAs to promote domestic structural reforms.

At the same time, Japanese politicians have been no quicker to embrace liberalization through FTAs than they have been to support it through unilateral Japanese deregulation or WTO or APEC multilateral agreements. This point was driven home most dramatically with regard to ASEAN trade. At the ASEAN Plus Three (APT) meeting in Brunei in 2001, China dramatically proposed an ASEAN–China FTA to be put into place within ten years. Challenged to do the same, and to demonstrate a continued Japanese capability to "lead" within East Asia, the best that Japan could muster was a promise to consider freer trade with its Southeast Asian neighbors.

Japan's interest in East Asia is due to the realization that East Asia has become an important economic partner for Japan and for its companies operating there. For example, in terms of foreign trade, the share of East Asia in Japan's overall exports and imports increased from 34 and 32 percent in 1990 to 39 and 43 percent in 2001 (see Figure 4.1). It should be noted that the share of East Asia in Japan's exports declined notably in 1998 because of the financial crisis, but it started to rise again with East Asia's quick recovery. East Asia is projected to grow significantly faster than a mature Japanese economy; therefore, it is only natural for Japanese policy makers and business people to be interested in using FTAs to increase their country's ties with the fastest growing parts of East Asia. Furthermore, Japan was eager to see a decline or removal of import protection in East Asia, where the level of protection remains quite high. Japan considered its ties with ASEAN, where a large amount of Japan's economic aid and foreign direct investment had been provided, very important to maintaining its influence in East Asia not only in economic activities but also in international relations.

Prior to JSEPA, as was noted above, Japan deeply resisted any consideration of FTAs as a trade negotiation strategy. Its national approach had been based on GATT/WTO global agreements, tempered with periodic bilateral arrangements with the US that aimed at reducing tensions when specific sectors created problems for trade relations between the two.

Japan is well recognized as a significant exporter of many globally dominant manufactured products. But much of Japan's approach to trade has been one-sided. What Japan exported was quite different from what it imported. Japan's old regime of "embedded mercantilism"[3] insulated large segments of the domestic economy from foreign trade and investment while encouraging the development of globally competitive firms in increasingly sophisticated sectors. Government policies ensured that Japan bought few foreign-made consumer or manufacturing goods; instead, its foreign purchases were heavily concentrated in raw materials and other inputs to Japanese manufacturing, giving Japan one of the most skewed import–export balances in the industrial world. Japan imported vastly smaller portions of manufactured goods than other large democracies.

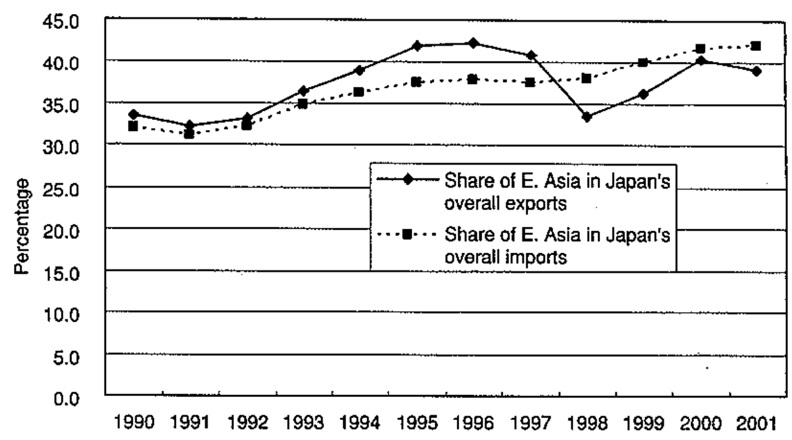

Figure 4.1 Increasing importance of East Asia for Japan's trade.

Similarly, Japan's capital market was long buffered from world capital markets. Capital insulation and Japan's distinctive trade pattern were further bolstered by the country's exceptionally limited incoming foreign direct investment (FDI). As late as the mid-1990s, even though FDI per capita ranged from $1500 to $3500 in the US, Germany, France, and the UK, the figure for Japan was a miniscule $46 per capita.

The result was that many Japanese products manufactured by indigenously owned firms in areas from cameras to cars, from steam irons to ships, and from electrical machinery to machine tools, eventually gained global competitiveness in the postwar climate of global trade liberalization. Rarely, however, did these companies face serious foreign pressures in the Japanese home market.

A large and different segment of the Japanese economy, meanwhile, experienced neither overseas expansion nor domestic competition. Sectors such as construction, distribution, financial services, agriculture, and power were profitable by relying on the home market and were insulated from any incentives for "creative destruction". Again, protectionist measures kept them free from foreign pressures in the Japanese market.

Japan's individual consumers, of course, bore the high costs of such insulation.[4] Oligopoly and cartelization meant higher domestic price levels that responded sluggishly if at all to market pressures. As Samuels (1989) has argued, in Japan the consumer existed for the benefit of the manufacturer, rather than the other way around.

Meanwhile, the US provided unchallenged market access for Japan's exports while demanding relatively little return access to the Japanese market. For virtually the entire postwar period, the US was far and away Japan's major export market, absorbing roughly 30 percent of Japan's annual exports. Japan's number two market—often South Korea or (West) Germany—typically took less than 5 percent. The result was a skewing of Japan's exports that eventually left it quite vulnerable to pressures by the US to enter into bilateral trade talks on various politically sensitive products.

From the 1970s into the early 1990s, the US began hammering for changes in a variety of Japanese institutions and policies on the grounds that these tilted the international economic playing field unfairly in Japan's favor. As numerous American corporations began losing market share to Japanese imports, and as the cumulative bilateral trade balance between Japan and the US shifted dramatically in Japan's favor, political pressures built for a redress.

Pressures from the US initially focused on using GATT to bring about Japanese reductions of tariffs, import quotas, and various non-tariff barriers. When such global measures failed to reduce the bilateral US–Japan trade deficits, however, US pressures became increasingly bilateral and sector-specific (e.g. Destler, Sato and Fukui, 1976). For some sectors, most notably steel, machine tools, televisions, automobiles, and later computer chips, the US demanded so-called "voluntary export restraints" (VERs) of Japanese exports to the US market.[5] American policy eventually moved toward opening the Japanese market to foreign products. At times this involved pressures on behalf of specific US companies or regions—cell phones for Motorola; supercomputers for Cray; tobacco, auto, and medical technology efforts for entire sectors; the Florida citrus industry;[6] Washington apple growers; and New York wine merchants, among others.[7] At other times, the governments engaged in formal negotiations such as the 1986 MOSS (market-oriented, sector-specific) agreement[8] the 1990 Structural Impediments Initiative (SII) and the bilateral Semiconductor Trade Agreement which spelled out specific "targets" or "quotas"—depending on each country's interpretation—for US companies' share of the Japanese semiconductor market. This last represented a shift in US policy to what Tyson (1996) called "managed trade as a second-best alternative".

Such bilateral agreements formed an important, if reluctantly accepted, part of Japan's trade policies. Still, they were predominantly complements to the country's broader reliance on multilateral and global trade arrangements such as the various GATT rounds. From the Japanese perspective, bilateral arrangements with the US represented little more than side payments that lubricated broader ties with its most valuable strategic partner and its largest export market. They did little to

undercut or replace Japan's broader commitment to the GATT principles and to multilateral negotiations on the various trade rounds.

3 Economic analysis of bilateral trade agreements

If Japan succeeds in making use of FTAs as an important trade policy option, what will be the economic impacts on Japan, its FTA partners and non-FTA partners? This section uses a simulation analysis to discuss the economic effects of FTAs on Japan and East Asia. One can classify the economic impacts of FTAs into two groups: static effects and dynamic effects[9]. Static effects include "trade creation effects", "trade diversion effects", and "terms of trade effects" while the dynamic effects are "market expansion effects" and "competition promotion effects". "Trade creation effects" result from the elimination of trade barriers among FTA members and, therefore, the new trade created among them. "Trade diversion effects" address the ways that FTAs replace highly efficient products of non-member countries by imports from less efficient FTA members. "Terms of trade effects" represents expanded trade volume among the parties, the strengthening of the parties' influence on nonmembers, and improvement in their terms of trade. "Market expansion effects" involves expanded market size needed to achieve efficient production/distribution and economies of scale. "Competition promotion effects" are those that result from market integration in ways that would make regionally oligopolistic industries more competitive, thus achieving higher productivity through the introduction of competitive pressures.

From the viewpoint of FTA members, trade creation effects, terms of trade effects, market expansion effects, and competition promotion effects all have certain positive impacts. However, trade diversion effects could be adverse under certain circumstances. On the other hand, from the viewpoint of nonmember states, the trade diversion effects and terms of trade effects are negative, while other effects tend to be positive. If a particular FTA expands market size, promotes competition, and encourages economic growth in member countries, its positive effects will spread out to nonmember states as well. The FTA option has recently been gaining popularity because governments expect them to generate positive dynamic effects. However, if a country gives preferential treatment only to certain trade partners, other countries might form exclusive economic blocs to counterbalance the trade diversion effects created by such preferential treatment. In this case, all the countries in the world economy, including FTA members, would suffer from significant adverse effects similar to those of the interwar era. Recognizing these negative impacts on nonmembers, FTAs should ideally cover a lot of countries and include some highly competitive countries because such FTAs will minimize the possible negative impacts from trade diversion.

In addition to its impacts on trade, an FTA also affects FDI. As the FTA eliminates regional trade barriers and expands market size, FDI should flow into the regional market with the expectation of selling more products. This is an FTA's investment creation effect. Investment may also be undertaken in member countries at the expense of investment in nonmember countries because of member countries' increased attractiveness for investment. This is an investment diversion effect of FTAs. These observations indicate that FTAs would promote economic growth of FTA members by enabling them to attract FDI, which would bring the members various factors needed to achieve economic growth, such as funds for fixed investment, technology, and management know-how.

Many empirical studies have been conducted on the economic impacts of FTAs. In these studies the EU and NAFTA have attracted the most attention[10]. Although these analyses draw different conclusions, they generally show that FTAs basically expand regional trade and investments, encourage competition within the region, and bring about other positive effects. On the other hand, as some analyses show that FTAs divert trade and investment, FTAs might have some negative effects on nonmember countries. For example, it is said that NAFTA prevented FDI flows to East Asia and diverted it to Mexico in industries such as electronics and apparel.

We are able to measure the overall economic impacts of FTAs for the world as a whole by comparing FTA members' benefits and nonmembers' costs. Since a number of research projects have shown that the former exceeded the latter, we would expect FTAs to generally bring net positive impacts. Because existing empirical analyses tend to ignore the dynamic effects of FTAs, they are likely to underestimate the positive impacts of FTAs. If an FTA has large dynamic effects, it will surely bring more positive effects for the member countries as well as for nonmember countries.

Let us examine the impacts of FTAs on the Japanese economy. Table 4.1 shows the results of a simulation analysis based on the computable general equilibrium (CGE) model carried out by Tsusumi for a project organized by Japan Center for Economic Research.[11]

The study examined the impacts of four types of FTAs with different members: (1) Japan and Korea; (2) Japan, Korea, and ASEAN; (3) Japan, China, Korea, and ASEAN; (4) China, Korea, and ASEAN. In order to examine the impacts of FTAs, a base case scenario for the economies involved in the analysis is constructed by making likely assumptions on population growth and technological progress for these economies for the period between 1997 and 2010. The base scenario incorporates existing FTAs, including the Japan–Singapore EPA, the NAFTA, and the AFTA. The impacts of FTAs are analyzed by comparing the base case with the results of simulations. FTAs in the simulations include not only removal of tariff and nontariff barriers but

Table 4.1 Impacts of East Asian FTAs on GDP (% change).

	FTA member countries			
	Japan Singapore Korea	*Japan Korea ASEAN*	*Japan China Korea ASEAN*	*China Korea ASEAN*
Japan	0.009	0.038	0.061	–0.006
Korea	0.207	0.274	0.366	0.226
China	–0.004	–0.019	0.497	0.213
Hong Kong	–0.000	0.023	0.899	0.657
Taiwan	–0.007	–0.031	–0.094	–0.049
Indonesia	–0.008	1.294	1.319	0.857
Malaysia	–0.009	1.731	1.813	1.063
Philippines	–0.007	1.119	1.152	0.701
Singapore	0.180	0.985	1.176	1.098
Thailand	–0.039	3.409	3.576	1.800
Vietnam	–0.013	2.215	2.403	1.841
US	–0.001	0.003	0.001	–0.000
EU	–0.000	0.006	0.006	0.002
World	0.005	0.070.	0.096	0.035

Source: Tsutsumi (2004).

also improvement in productive efficiency resulting from trade facilitation such as improvement in customs procedures. In order to include possible impacts of trade facilitation, the analysis incorporates elements of a new type of FTA. However, the estimated impacts of FTAs in this analysis are likely to be substantially smaller because the simulation does not include dynamic impacts or FDI impacts, which are discussed above.

The results of the simulations are shown in Tables 4.1 and 4.2. Table 4.1 shows the impacts of FTAs on GDP of the countries in East Asia, the US, the EU and the world.

The results indicate that FTA members would benefit economically by achieving higher economic growth. The results also indicate that the benefits for FTA members tend to get larger as the number of FTA members becomes greater. Specifically, Japan's FTA with Korea would increase Japan's GDP by only 0.009 percent, but Japan's GDP would increase by 0.038 and 0.061 percentage points as ASEAN and China join the Japan–Korea FTA, respectively. These potential GDP gains are not small if one realizes that Japan's potential GDP growth is estimated at around 2 percent. It is important to note that Japan would suffer from a reduction in GDP if Japan were excluded from an East Asian FTA.

Although not shown in the simulation tables, results indicate that the Japanese people would improve their living standard as a result of Japan's joining the FTA. For example, ASEAN Plus Three FTA would

Table 4.2 Impacts of East Asian FTA on Japan's Production (% change).

Agriculture	−0.09	Transportation machinery	0.31
Forestry	−0.30	Other manufacturing	−0.09
Fishery	−0.21	Electricity, water, and gas	0.06
Mining	−0.10	Construction	0.08
Food processing	−0.12	Transportation services	0.03
Textiles and apparel	−0.22	Communication services	0.01
Wood and pulp products	−0.06	Finance and insurance	0.02
Petro-chemical products	0.16	Business services	0.03
Iron and steel	0.27	Individual services	0.05
General machinery	0.31	Other services	0.01
Electric and electronic machinery	−0.35		

Source: Tsutsumi (2003).

increase Japan's national income by 0.276 percentage point, which is translated into an increase in welfare level equivalent to $30 per person.

FTAs have different impacts on different sectors. Table 4.2 shows the impacts of ASEAN Plus Three FTA on production for different sectors in Japan. Poorly endowed with natural resources and unskilled workers, Japan does not have a comparative advantage in products requiring natural resources such as agricultural products or products requiring unskilled labor such as textiles and apparel. By contrast, being richly endowed with skilled workers (human capital) and physical capital, Japan has a comparative advantage in the production of skilled labor and capital-intensive products such as machinery products.

The establishment of FTAs is expected to expand production of products with a comparative advantage and reduce production of products without a comparative advantage, as FTAs would promote the functioning of the market mechanism. The results of the simulation show estimated expected impacts. Specifically, an ASEAN Plus Three FTA would increase production of transportation, general machinery, and iron and steel, whereas it would reduce production of agricultural products, textiles, and apparel.

The results of simulation analysis indicate that FTAs would enable Japan to promote economic growth by shifting resources from uncompetitive sectors (sectors without a comparative advantage) to competitive sectors (sectors with a comparative advantage). However, they also show that FTAs force uncompetitive sectors to face difficult structural adjustment. Indeed, this need for structural adjustment is a source of opposition to FTAs by uncompetitive sectors, which will be discussed in the next section.

4 Political analysis of bilateral trade agreements

Despite the obvious economic benefits of increased FTAs for Japan as a whole, there has been serious opposition to most proposed agreements.

To understand why, it is necessary to appreciate the dual nature of Japan's domestic economy. As was noted in Section 1, Japan's economy has long been a mixture of highly competitive globally-oriented firms and others that were less internationally competitive but achieved profitability in the domestic market largely because of the absence of foreign competition. The former was found in sectors such as automobiles, cameras, machine tools, electronic equipment, and the like. The latter included construction, food distribution, most retail, agriculture, and (somewhat ironically) finance and insurance. Due largely to the country's continuing levels of high economic growth (which in turn relied heavily on protection of the domestic market) the long-ruling Liberal Democratic Party (LDP) for most of its history played an important bridging role by representing the interests of both segments.

Tensions in this dual economy had become quite acute by the middle of the 1980s and their competing interests were brought clashingly into focus by the rapid rise in the value of the Japanese yen following the Plaza Accord of 1985. Many individual corporations consequently concluded that it was economically suicidal not to invest abroad. Continuing to manufacture at home became ever more costly in terms of foreign currency, while the rest of the world's prices for land, labor, and entire corporations were slashed to fire sale levels in yen terms.

Capital flowed out of Japan into overseas manufacturing operations, portfolio investments, and real estate.[12] Internationally competitive companies were expanding beyond purely national production networks and into more advanced global operations. Nonetheless, their moves had acute consequences for the domestic Japanese economy.

First, it contributed to a general hollowing-out of manufacturing at home. As large firms moved abroad, many were joined by their smaller and medium-sized suppliers, meaning that the manufacturing base of Japanese-owned companies was no longer restricted, as it had been, to the four main islands. By 1995, Japanese-owned firms were manufacturing more overseas (¥41.2 trillion) than they were exporting from the home islands (¥39.6 trillion).[13] Numerous Japanese firms expanded their manufacturing and banking investments around the world. In 1989, 5.7 percent of the manufacturing capacity of Japanese-owned companies took place outside of Japan; by 2000 that number had jumped to 14.5 percent. The figures were vastly higher in key sectors such as electronics (33 percent) and autos (25 percent).[14]

Such moves abroad further exposed the large numbers of Japan's internationally uncompetitive sectors. As many companies in machinery, autos, and electronics diversified production by moving abroad and continued to be relatively successful, far more firms in traditional industries such as cement and construction remained at home, deeply dependent on domestic public works projects tied to the patronage-generating capabilities of Japanese politicians. Similarly, certain subcontractors of Japan's larger

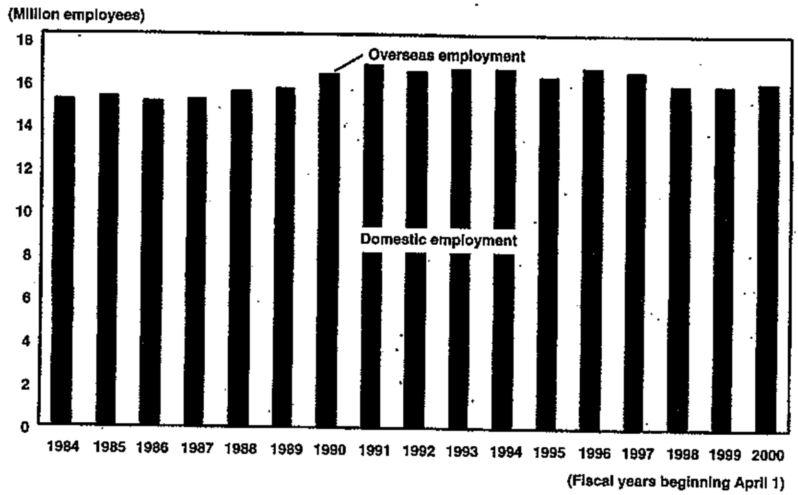

Figure 4.2 Domestic and overseas employment by Japanese manufacturers.

Source: For domestic employment, *Labor Force Survey* (Ministry of Public Management, Home Affairs, Posts and Telecommunications), and for overseas employment, *Survey of Overseas Business Activities* (Ministry of Economy, Trade and Industry).

manufacturers followed them overseas, but far more, particularly the smallest, remained in Japan despite the fact that doing so typically meant a steady dwindling of market shares and profitability.[15] The importance of overseas manufacturing to the total economy is captured in Figure 4.2.

The duality of Japan's economy was further exposed when Japan's five-year asset bubble finally burst in 1990. With major exporters increasingly producing abroad, manufacturing jobs and subcontracting arrangements within the home islands shrank; industrial productivity stagnated; wage growth ceased; and official unemployment rose to the highest levels in two decades, reaching over 5.5 percent by early 2003, well above the 2.5 percent of 1993 which in turn was double the levels of a decade earlier. Globally uncompetitive firms and sectors began to increasingly dominate Japan's domestic economy.

Japan had long faced strong incentives to move away from being a protected, export-oriented economy to one that was far less regulated and far more driven by domestic demand. The bursting of the bubble provided an excellent opportunity for massive economic restructuring of uncompetitive firms. Rather than restructuring or going out of business, as classical economics would have predicted, many of these economic losers were instead protected by political interventions.

The LDP was evicted from power by an internal split in 1993, but it returned to power in 1994 and, since then, the party's most anti-liberal

forces have largely controlled its agenda. Typically, uncompetitive firms and sectors, the potential losers in any grand-scale deregulation or liberalization, have been sufficiently well-networked into the national political and bureaucratic power structure to prevent the imposition of policies that would cause them severe disadvantages. The overall result has been that Japan's economy has resisted sweeping and systematic restructurings for more than a decade, with disastrous macroeconomic consequences.

Politically, there has been a decade-long battle between reformers and resisters, much of it contained within the LDP. Those advocating extensive economic restructuring to eliminate uncompetitive sectors and firms have largely been blocked by resisters anxious to protect economically uncompetitive yet electorally critical constituents.

It is in this context that the move toward bilateral FTAs has taken on particular political importance within Japan. Essentially, bilateral FTAs are now seen by many free trade forces within Japan as devices that would bolster national economic restructuring in ways that would be more palatably gradual than either sweeping domestic reform programs or commitment to comprehensive global free trade measures.

As we saw in the previous section, FTAs tend to have positive impacts on FTA members because they provide larger market opportunities to competitive firms and will also give consumers more opportunities to buy a greater variety of goods and services at lower prices. However, FTAs have severely negative impacts on less competitive firms and their employees since these are exposed to increasingly severe competitive pressures. Accordingly, potential victims oppose FTAs. Not surprisingly, in Japan, automobile, electronics, and other competitive industries support FTAs, but primary sectors (e.g. agriculture, fisheries) and less competitive industries (labor-intensive manufacturing industries, and some service sectors including finance and transportation services) tend to oppose FTAs. Such opposition has been an obstacle for the negotiation of FTAs by the Japanese government because Japan's possible FTA partners are most often interested in opening up Japan's most protected markets for their own exports of agricultural, fisheries, and other primary commodities.

Agriculture is a very small part of the Japanese economy. It generates less than 2 percent of GDP and employs less than 4 percent of the nation's workers. Nevertheless, it exerts strong political power. Indeed, it appears that the smaller a sector gets, the greater its political influence. Certainly this is true if the sector can maintain or strengthen its cohesiveness. In the case of agriculture, its influence comes primarily from the allegedly large number of votes that it generates. Indeed, the agriculture sector is perceived to generate more votes than even construction, which has more employees, because a far larger number of voters are associated with agriculture than construction. Influenced by politicians supported by agriculture votes and agricultural associations, the Ministry of Agriculture, Fishery and Forestry (MAFF) has been resisting any trade openings in agricultural products. In opposition, many ministries—most notably the Ministry of Foreign Affairs (MOFA) and the Ministry of Economy Trade and Industry (METI)—argue for opening up agriculture. Still, the final decision on trade liberalization in agricultural products comes from the Ministry of Agriculture, Fishery and Forestry. It should be noted here that METI does not exert strong pressure on MAFF because it has its own problem in liberalizing markets for labor-intensive products such as textile products.

In addition to this general point, it is worth noting that for FTAs with ASEAN countries, labor groups in certain sectors have been particularly strong opponents. ASEAN countries, particularly the Philippines and Thailand, are eager to export medical care providers such as nurses to Japan. These countries argue that their capable medical care providers can provide the services which are in greatest demand in Japan, given the rapid aging but slow overall growth in Japan's population. Although many observers underscore the shortage of such services in Japan, Japan's Ministry of Welfare and Labor, whose position is strongly influenced by politicians and medical associations, contends that demand for such services will be met by the local supply of labor; they thus oppose any measures to include international labor mobility in FTAs. Indeed, the Ministry of Welfare and Labor's lack of interest in FTAs has been criticized by some MAFF officials. They noted that MAFF, which is regarded as stalling the FTA discussions, has been much less resistant to FTAs than several Ministries including the Ministry of Welfare and Labor. As they see it, MAFF at least participates in FTA discussions, while the Ministry of Welfare and Labor and others do not.[16]

5 Empirical examination of selected bilateral trade agreements

Singapore

Singapore was a logical first choice since it exports few agricultural and fishery products. As a consequence, the agreement forces little direct challenge to protected sectors within Japan. But Singapore does have a few specific agricultural exports (e.g. goldfish) that still led to tough negotiations at home. Successfully including these very limited areas ("pinholes") within a broader FTA led to the establishment of the general principle that in Munakata's phrase "entire sectors of the economy can no longer be placed off limits by domestic interests fundamentally opposed to free trade agreements".[17]

Singapore is thus potentially the first step in a gradual shift by Japanese free traders toward bilateral FTAs that will complement global

and regional agreements. FTAs allow the country, they argue, to open slowly and specifically and in the process to demonstrate that many of the country's special interests, such as retailing and even agriculture, can face competition and go through upgrading and reform in ways that will allow it to meet new competition within the home market.

The JSEPA provided a politically more palatable chance for Japanese free traders to shift the nation's trade policies. Given the reality of expanding FTAs worldwide, as well as the explicit damage increasingly being done to many of Japan's export industries by not participating in them, it has become possible for structural reformers within Japan—most notably within the business community, METI and the Ministry of Foreign Affairs—to press for FTAs as a step-by-step mechanism that will give traction to their reform efforts at home.

Mexico

This has been particularly important in Japanese efforts to negotiate a second FTA after that with Singapore. The chosen target is Mexico, where many major Japanese exporters have actually suffered under Mexican FTAs with other economies. As a consequence of NAFTA, US companies can export goods to Mexico free of tariffs and so can European companies as a result of the EU–Mexico FTA started in July 2000. Japanese companies, however, must still face import tariffs when they export to Mexico as many do. With an average Mexican tariff rate of 16.2 percent, the disadvantages to Japanese companies are significant. Hence the argument in favor of a potential FTA with Mexico is quite apparent and makes for instant allies in Japan's most successful exporting industries. It allows Japanese reformers to argue less about the need to restructure Japan's protected industries and more about the potential—and quite explicit—national economic benefits that would rebound to Japanese companies as a result of a Japanese–Mexico FTA.

At the same time, however, some 20 percent of Mexico's exports are agricultural. Since the WTO stipulates that FTAs have to cover "substantially all trade", it is certain that any Japan–Mexico FTA will include large swaths of products that will challenge agricultural protection within Japan. Since Mexican agricultural goods are more complementary than competitive with Japanese agricultural products, the actual politics of negotiating the FTA and then selling it within Japan appeared to be more manageable than if the products were explicitly competitive. Nevertheless, as of this writing, negotiations were far from smooth, impeded by the power of Japanese protectionist sentiments and political entrenchments. Reports were that the Japanese proposed that both Mexico and Japan open their markets to manufactured goods but that high-tariff imports, such as beef, pork, chicken, all varieties of citrus fruits (such as oranges and pineapples), as well as sugar and a long list of other food items, be "discussed again after a few years". The Mexicans flatly rejected this.

South Korea

Third in line after Singapore and Mexico on Japan's list is South Korea with Thailand, Philippines, Malaysia, and possibly Indonesia also under consideration. In many ways, Korea is a more important goal than Singapore or Mexico in the strategy of moving toward FTAs. Korea provides an ultimately important FTA partner for at least three reasons. First, it is geographically close to Japan. Second, the two economies are more competitive than complementary. Third, Korea has already implemented numerous structural reforms in areas where Japan still lags, including finance and broadband computing, that would be critical to a system-wide transformation of the Japanese economy.

ASEAN

Japan's bilateral FTA negotiations with Malaysia, the Philippines, and Thailand began in early 2004 with a goal of concluding respective negotiations before the end of 2004. As noted above, Japan has a strong interest in establishing FTAs with ASEAN countries bilaterally first and eventually with the ASEAN as one group. Japanese companies that invested actively in ASEAN countries would benefit from a freer trade and investment environment. From an international relations point of view, Japan would like to maintain its influence in the East Asia region by expanding and deepening its relationship with ASEAN in the face of China's growth. Several difficult problems, which include liberalization in agricultural trade and labor mobility, have to be overcome before reaching the agreement.

China and East Asia

The establishment of an East Asian community built upon a single East Asian FTA is allegedly a goal for many East Asian countries including Japan.[18] However, Japan did not accept a proposal by Chinese premier Zhu Rongi in November 2002 to study a possible FTA with China and Korea as a step toward the establishment of an East Asian FTA. An official explanation of this policy stance was that it is too early to enter into an FTA with China, which acceded to the WTO only recently in 2002 and thus one cannot be sure if China abides by WTO commitments and rules. Undoubtedly this is one reason for not accepting the proposal, but there may be other reasons, such as reluctance to face possible large impacts on the Japanese economy requiring massive structural adjustment, security considerations, and others.

It remains to be seen, of course, whether the proposed agreements with Mexico and other countries actually are reached. The forces of resistance to structural reform in Japan remain quite well entrenched. At the same time, the number of FTAs is expanding rapidly in all areas of the globe. Meanwhile, Japan's most sophisticated companies are facing and will continue to face serious and growing barriers if Japan does not expand its use of FTAs. Hence, it seems increasingly likely that the FTA strategy chosen by Japanese reformers may in fact provide an important catalyst for long-term structural changes in a Japanese economy that has for so long successfully resisted them.

6 Conclusion

FTAs have mushroomed rapidly in recent years. Japan has been slow to explore this tactic as part of its overall trade strategy, despite having engaged in numerous bilateral trade agreements with the US for decades. But the comprehensive yet particular nature of FTAs long appeared to be contradictory to the broader multilateral, GATT/WTO framework within which Japan had long preferred to operate.

In recent years, however, FTAs have gained greater appeal in Japan for three major reasons. First, FTAs have become a major tactic pursued by many other countries. The economic benefits to FTA participants and the detriments to those excluded have become increasingly clear. Japanese firms facing tough conditions in the Mexican market have been among the strongest proponents of negotiating a Mexico–Japan FTA as a means of enhancing their competitiveness in the Mexican market. And as the simulation in this chapter makes clear, the macroeconomic benefits to Japan of FTAs within East Asia are unmistakable.

A second major impetus behind Japan's embrace of the FTA strategy, however, is the assistance they provide in advancing domestic structural reforms in the economy. Japan has been held back economically over the last decade by political and economic forces that have sought to resist internal reorganization aimed at enhancing productivity. Japanese reformers have begun to seize on FTAs as a mechanism to enhance their own internal bargaining power against such forces. Once negotiated, it is assumed, various FTAs will force Japan's most inefficient sectors and firms to adapt to new levels of competition or else to go out of business. The result, it is believed, will clearly enhance national productivity and growth.

A third factor is China, which is actively pursuing an FTA strategy toward ASEAN and other East Asian countries. Japan, which has invested significantly and provided much economic assistance in ASEAN and other East Asian countries, responded to China's move by proposing FTAs with East Asian countries. Indeed, it appears that China and Japan are competing to take a lead in the FTA race in East Asia.

Despite the unmistakable economic benefits that FTAs are likely to generate, however, Japan's political economy remains one in which entrenched powers have strongly resisted rapid economic adjustment. FTAs may prove to be an important lever in moving those forces forward, but the process will be far from problem-free, as current FTA negotiations between Japan and several of its proposed FTA partners is showing.

Finally it has to be emphasized that the Japanese people realize the importance of FTAs in revitalizing the Japanese economy and developing good relations with East Asian countries for the prosperity of Japan and its East Asian neighbors. In this regard strong leadership with a good vision of the future is required.

Notes

1 Aggarwal and Ravenhill (2001).
2 Krauss (2003).
3 Pempel (1998).
4 Sazanami *et al.* (1994).
5 Yoffie (1986) p.66.
6 Kusano (1984).
7 Watanabe (1985) p.258.
8 Lincoln (1990) pp.148–51.
9 For the impacts of RTAs, i.e. customs unions and FTAs, see for example Winters (1991).
10 METI (2001) also provides detailed analysis on economic impacts of EU and NAFTA.
11 Tsutsumi (2004).
12 Urata (1993) discusses Japanese firms' active foreign direct investment in the latter half of 1980s.
13 *Far Eastern Economic Review* July 4 1996 p.45.
14 Pacific Council (2002) p.17.
15 Nakatani (1996).
16 The Ministry of Agriculture, Fishery and Forestry participated in official FTA studies with Mexico, Korea, Thailand, Philippines, and Malaysia as a co-chair along with METI, MOFA, and the Ministry of Finance (MOF). One may argue that MAFF's participation as a co-chair comes from its concern with liberalization in agricultural products rather than their positive attitude toward FTAs. Indeed, MAFF might have learned an important lesson from not participating in the FTA study with Singapore, as MAFF's strong opposition to trade liberalization in agricultural products in JSEPA has been widely publicized and MAFF received a bad image, although liberalization in agricultural products was not so serious issue with Singapore. (Suzuki, 2003)
17 Munakata (2002) p.3.
18 Prime Minister Junichiro Koizumi's speech in January 2002 in Singapore.

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5 US trade arrangements in the Asia-Pacific

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1 Introduction

United States trade policy has undergone a radical shift. The nation that for decades was the foremost advocate of global multilateralism, that for decades was skeptical and sometimes hostile toward regional arrangements as being discriminatory, less efficient and potentially divisive, has now joined the rush toward bilateral and regional trading arrangements.

In its recent pursuit of free trade arrangements (FTAs), the US is playing catch-up with the rest of the world. As the US Trade Representative (USTR) lamented in its 2001 International Trade Legislative Agenda, "There are over 130 preferential trade agreements in the world today—and the US is a party to only two of them".[2] Even President George Bush's lead trade negotiator, USTR Robert Zoellick, bemoaned, "There are 30 free trade agreements in the western hemisphere; the United States belongs to only one".[3]

The US has been a follower in the FTA game. The US has been one of the dominoes, one of the many nations succumbing to the "demonstration effect" of the raft of FTA agreements and has rushed to jump onto the bandwagon.[4] Even for those FTAs that the US has entertained, the initiative has most often come not from the world's remaining superpower but rather from the nominally weaker trading partner.

Still, as the US has engaged in FTA negotiations, it has aggressively pursued a variety of US interests. In justifying publicly—often *ex post*—its FTAs, US government officials have articulated a series of national interests that fall within four categories:

- Creating "asymmetric reciprocity" that advantageously opens markets for US traders and investors;
- Establishing precedents, models, or serving as catalysts for wider trade agreements (competitive liberalization);
- Rewarding and supporting domestic market-oriented reformers;
- Strengthening strategic partnerships.