

Free Trade Agreements: A Catalyst for Japan's Economic Revitalization

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I. Introduction

Japan enacted its first free trade agreement (FTA) in November 2002 with Singapore. The formal name of the agreement is the Agreement between Japan and the Republic of Singapore for a New-Age Economic Partnership, or Japan-Singapore Economic Partnership Agreement (JSEPA). JSEPA is a comprehensive economic partnership agreement (EPA), which includes not only removal of tariff and non-tariff barriers, or traditional elements of FTA, but also liberalization of foreign direct investment (FDI), trade and FDI facilitation, economic and technical cooperation in a wide range of areas including development of human resources, information and communications technology (ICT), small and medium enterprises (SMEs), tourism and others. Both Japan and Singapore realize the importance of broad-ranging comprehensive agreement, in order to have significant impacts on economic activities in the emerging international economic environment where not only goods but also people, funds, and information cross borders freely. Japan is currently negotiating FTAs with Mexico, Korea, Malaysia, Thailand, and the Philippines with a focus on East Asian countries. These FTAs that Japan is negotiating are EPAs, as they are comprehensive to include more or less the same contents as JSEPA with the philosophy that broad ranging agreements are needed to promote economic growth of the countries involved. Indeed, the Japanese government has negotiating FTAs by referring to JSETA as a model.

Japan had pursued trade liberalization under the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) until the late 1990s, and therefore, recent pursuit of FTAs by Japan is a reflection of the change in its trade policy from single track approach based on the GATT/WTO multilateral trade liberalization to a multi-track approach including bilateral and plurilateral liberalization. The white paper on international trade 2003 published by Japan's Ministry of Trade and Industry argued the need for pursuing a multi-track approach. Several reasons can be identified for the emerging interest in FTAs by Japanese government. One important reason is new developments in global trade scenes, where multilateral trade negotiation under the WTO is making little progress and regional trade agreements such as FTAs

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are rapidly increasing. Faced with the situation, Japanese government recognized FTAs as an option for achieving trade liberalization. To put it differently, Japanese government expected FTAs to play a role for promoting Japan's economic growth through providing business opportunities for Japanese firms in FTA member countries and promoting domestic policy reforms such as agricultural reform, which are necessary for revitalizing the stagnant Japanese economy. Another reason is the expectation that FTAs can play effective roles for the promotion of economic integration in East Asia, in order to contribute to the achievement of economic growth, and political and social stability.

This paper examines the possible role that FTAs may play for the revitalization of the Japanese economy and promoting economic integration with fast growing East Asia. It then identifies the obstacles to the formation of FTAs. Based on these analyses the paper proposes the ways to overcome these obstacles to establish FTAs.

The paper argues that FTAs, especially comprehensive FTAs (EPAs) would contribute to economic growth for Japan and FTA partners through various channels. FTAs establish not only freer trade and FDI environment to increase trade and FDI between FTA partners but also a competitive environment conducive for achieving economic growth by catalyzing structural reforms. For Japan, competitive sectors such as machinery sectors expand FDI and exports, while non-competitive sectors such as agriculture are pressured to restructure. Such structural adjustment would result in economic growth by improving resource allocation. Faced with a serious problem of labor shortage because of low population growth and rapidly aging population, Japan can utilize foreign workers as FTAs have a program on labor mobility. For FTA partners in East Asia, they can expand exports and send workers to Japan, to result in earning much needed foreign exchange. In addition, they can obtain technology and other items necessary for economic growth through economic and technical cooperation with Japan.

To successfully conclude FTAs Japan and its FTA partners are required to deal with structural adjustment, which would be necessitated by trade and FDI liberalization. Specifically, for Japan liberalization in agricultural trade and importation of medical care givers such as nurses are major challenges, which have to be overcome to establish FTAs with East Asian countries. The paper proposes income compensation and provision of technical assistance to those negatively affected by FTAs as a way to overcome these challenges.

Having argued the need for Japan to promote FTAs, especially East Asia wide FTA, the paper emphasizes the importance of successful multilateral trade liberalization under the WTO in order to promote global economic growth. Indeed, FTAs and trade

liberalization under the WTO should play complementary roles. FTAs that could be concluded quickly can become building blocs to WTO liberalization and FTAs that could provide rules in various areas such as FDI and labor mobility, which are not covered by the WTO rules.

The structure of the remainder of the paper is as follows. Section II gives a brief review of recent developments in FTAs in East Asia and the world, in order to set the stage for the analysis of Japanese FTA strategy. Section III examines Japan's FTA strategy, while section IV discusses the motives and importance of FTAs for Japan. Section V analyzes the possible impacts of FTAs by referring to the results of simulation analysis. Section VI identifies the obstacles for establishing FTAs. The final section, section VII, proposes some ways to overcome the obstacles to establish FTAs.

II. Recent FTA Developments in the World and in East Asia

In the past Japan mainly liberalized its trade regime under the GATT/WTO multilateral framework, but recently it started to regard FTA as one of its trade policy options. Japan changed its trade policy paradigm, partly because many countries started looking at FTA with a new perspective. FTA had been traditionally regarded as an exclusionary measure that would go against worldwide trade liberalization. However, recently many governments started to recognize FTA as an option that would complement the WTO and promote world trade. This section reviews recent developments in FTAs in the world with an emphasis in East Asia, in order to set the stage for the following analysis.

The number of regional trade agreements (RTAs) began to increase notably in the 1990s.² The cumulative number of RTAs reported to the GATT from 1948 to 1990 was 30. The number increased notably to 79 in the next five years in 1995, when the WTO was established. The pace of the increase quickened after the establishment of the WTO and the number reached 155 in 2000 and stood at 208 as of May 1, 2004. Recognizing that RTAs, which violate the most-favored-nations treatment among the GATT/WTO members, one of the principles of the GATT/WTO system, the quick

² RTAs include FTAs and customs unions. Under FTA FTA members remove tariff and non-tariff barriers on trade among the members while they maintain their own tariff and non-tariff barriers on trade with non-members. Under the customs union the members establish common tariff and non-tariff policies on their trade with non-members, in addition to free trade among the members. Since FTAs are dominant among RTAs and a relatively small number of RTAs are customs unions and since most if not all RTAs involving East Asian countries including Japan are FTAs, in this paper "FTAs" are used to mean RTAs unless otherwise stated.

spread of FTAs after the establishment of WTO, which was set up to improve the world trading system under the GATT, is ironic and also reflects difficult problems facing the newly established WTO.

Toward the end of the 1990s when Japan and other East Asian countries became interested in FTAs, Japan, China, Korea and Taiwan were four major economies that did not have any FTAs. As we will argue later, these economies began to be interested in FTAs, as they realized the need to deal with disadvantageous situations caused by the non-member status for any FTAs and also to gain potential benefits from the establishment of FTAs.

Several reasons can be identified behind rapid expansion of FTAs in recent years in the world. First, an increasingly large number of countries have become unsatisfied with the WTO mainly because of the two reasons. One is slow progress in multilateral trade liberalization and the other is limited coverage of WTO rules. Let us briefly discuss these points in turn.

Many countries realize the benefits of trade liberalization as it has brought them economic growth³. Indeed, one of the important factors that led to rapid economic growth for many countries in the post WWII period was substantial trade liberalization carried out under the auspices of the GATT. However, multilateral trade liberalization has become increasingly difficult to be carried out because of disagreement about the WTO process among the GATT/WTO members, which have increased to exceed 140.

The Uruguay Round, which was the last multilateral trade negotiation under the GATT, started in 1986 and was scheduled to reach agreement within four years. However, it took twice as long as the initial schedule (eight years) to complete the round. After the WTO had been established in 1995, developed countries proposed launching a new round, but the opposition from developing countries, which were not satisfied with the outcome of the Uruguay round prevented the WTO from starting a new round. It was the end of 2001 when they actually agreed to start a new round (Doha Development Agenda). Although the Doha Development Agenda started, the progress on negotiation has been very slow. As was indicated earlier, increasingly large number of the WTO members has made it difficult to pursue negotiations, as the decision making in the WTO negotiations requires consensus. One of the contentious issues concerning Japan and preventing the negotiations from making progress is liberalization in agricultural trade. Japan and nine other countries such as Korea, Switzerland and Norway formed a group to resist liberalization in agricultural trade, which has been promoted by

³ See, for example, World Bank (1993).

pro-liberalization countries including the US and the Cairns group consisting of 17 countries including Australia, Brazil, Thailand, Indonesia, the Philippines.

One can also argue that the increasing opposition to globalization by many groups including environmentalists has made it difficult to pursue trade and liberalization under the WTO. Globalization has allegedly affected some groups negatively in the forms of reduction in employment opportunities, deterioration in environmental problems, and others. Indeed, in 1999 in Seattle, WTO ministerial meeting, whose aim was to form consensus to start a new round, was unsuccessful partly because of aggressive anti-WTO demonstrations by environmentalist groups, labor unions and NGOs.

The coverage of international economic activities expanded under the WTO from the GATT, where the coverage was limited to goods trade. The WTO expanded to include trade in services, investment, intellectual property rights, which have become important in international economic activities. Although the expansion of the coverage is a major achievement, there are still various areas which are not covered under the WTO. Some of them include environment, labor standard, movement of natural persons and e-commerce. As for the new areas, Japan is particularly interested in establishing comprehensive rule on FDI, which go beyond the WTO rules, by including rules such as national treatment of foreign firms. Japan's position on movement of natural persons is ambivalent. Japan wants to attract engineers in the information technology (IT) areas, which are in short supply, from foreign countries as a part of FTA, but Japan is resisting to requests from the Philippines and Thailand to allow the "importation" of medical care givers such as nurses because of strong opposition from labor unions of medical care givers.

Many WTO members that are not satisfied with the slow progress in multilateral trade negotiations and/or limited coverage of the WTO have opted for bilateral and plurilateral FTAs with like-minded countries. Indeed, many FTA negotiations have been concluded in short time period because of the small number of participants. For example, Japan-Singapore FTA negotiations practically took approximately ten months. To deal with the limited coverage of the WTO, many FTAs have included areas such as labor and environment. As indicated earlier, Japan has included many new areas including FDI liberalization, trade and FDI facilitation, and economic and technical cooperation in its FTA negotiations not only with Singapore but also with other countries.

So far we have discussed recent FTA developments and their causes in the

world. Let us now turn our discussions to the developments in East Asia (Table 1)⁴. East Asia was not active in the formation of FTAs until recently⁵. Indeed, ASEAN Free Trade Area (AFTA) was the only major FTA until Japan and Singapore FTA was enacted in November 2002.

AFTA was established in 1992 with six ASEAN member countries, Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Brunei. New ASEAN members, Vietnam, Myanmar, Cambodia, and Laos joined AFTA in the latter half of the 1990s, and currently AFTA has 10 member countries. AFTA was completed in 2002 after 10 years from its launch. The targets for tariff reduction to 5 percent have not been achieved for many members except for Singapore, although substantial tariff reduction has been achieved for all the members⁶. Despite substantial progress on tariff reduction, AFTA has not been very successful in promoting intra-regional trade. The following figures on intra-regional trade attest to this observation. The share of intra-regional trade for the AFTA members in world trade increased only slightly from 1.40 percent in 1995 to 1.44 percent in 2003. During the same period the share of intra-regional exports to total AFTA exports declined slightly from 23.0 to 22.0 percent, while the share of intra-regional imports to total AFTA imports increased notably from 22.0 to 27.2 percent⁷. One of the problems of AFTA is difficulty in using the AFTA scheme or preferential tariffs. For example, it takes time to have necessary documents processed because of cumbersome procedures. Another problem is a lack of unified definition of rules of origin. Furthermore, presence of non-tariff barriers such as lack of harmonized system of technical standards discourages intra-regional trade.

Besides AFTA, ASEAN as a group as well as its members have become active in FTA discussions with other countries. One of the FTAs involving ASEAN that has received most attention recently is that with China, which will be discussed below. ASEAN is also discussing the possibility of FTAs with Japan and Korea. Among

⁴ Lincoln (2004) presents detailed discussions on economic regionalism in East Asia. He views the progress on regional institution building in East Asia so far slow and shallow despite a lot of talks.

⁵ Urata (2004) discusses recent developments on FTAs in East Asia.

⁶ AFTA was reported to the GATT as an FTA under the enabling clause rather than GATT Article XXIV because AFTA members are developing countries. FTAs under the enabling clause are treated preferentially in that many exceptions are permitted, whereas FTAs involving developed countries are subject to stricter conditions under GATT Article XXIV for trade in goods and GATS Article V for trade in services. Discussions on these conditions will be presented later in the main text.

⁷ The figures are computed from the trade data base prepared by Japan External Trade Organization (JETRO).

ASEAN members, Singapore and Thailand are very active in establishing FTAs. It was Singapore that first strongly promoted FTAs, but in recent years Thailand has become a very active promoter of FTAs under the Thaksin government.

Compared to ASEAN countries in Southeast Asia, the countries in Northeast Asia including China, Japan, and Korea had not been active in FTAs until recently. Despite increasingly strong interest in FTAs by Northeast Asian countries, so far only three FTAs have been enacted, one each for Japan (with Singapore in 2002), Korea (with Chile in 2004), and China (with Hong Kong in 2004). As noted above, Japan is currently negotiating with five countries and studying possible FTAs with several countries including ASEAN as a group. We will discuss Japan's FTA strategy in detail in the next section.

Korea started having an interest in FTAs before Japan. Korea started negotiations with Chile in 1999, and it took three long years to reach conclusion in October 2002. Even after signing the agreement, it took more than a year to ratify it in the Korean National Assembly because of strong opposition from farmers, who are concerned with the negative impacts. Korea is currently negotiating FTAs with Japan and Singapore.

China's active FTA strategy has received a lot of attention. China joined the WTO in 2001 and established an access to the world market, and it started to pursue regional strategies by using FTAs. China signed a framework agreement on comprehensive economic cooperation with ASEAN in November 2002. The agreement, which was proposed strongly by China, has not only trade liberalization but also cooperation in the areas of FDI and economic development. China and ASEAN started negotiations on FTA January 2003 with a target for its conclusion by June 2004. China has offered various schemes attractive to ASEAN and particularly to its new members such as economic cooperation for the new ASEAN members and advanced trade liberalization (early harvest) in agricultural products. In addition to ASEAN, China, specifically Premier Zhu Rongji, informally proposed the leaders of Japan and Korea to establish a trilateral FTA including these three countries at the leaders meeting in 2002. Japan did not accept China's proposal by indicating that Japan would like to make sure that China, a new WTO member, abides by the WTO commitments and rules before discussing FTA. At least two reasons could be postulated for Japan's rejection. One is its possible negative impacts on non-competitive sectors such as agriculture and labor-intensive apparel industries, and the other is its rivalry vis-à-vis China. We will take up these issues more in detail later again.

Several factors may be considered behind China's active FTA policy. Hai and

Li (2003) pointed out two economic factors. One is to maintain and expand export markets and the other is reduced adjustment costs for trade liberalization as a result of substantial trade liberalization committed before its entry to the WTO. China started to have a concern about its export market because of the increase in FTAs and increase in protectionist measures against Chinese exports, particularly in the form of antidumping charges. Faced with these obstacles to the expansion of its exports, China considered FTAs as possible solution. China's positive attitude toward FTAs was attributable to the realization that China may not have to incur much additional adjustment costs from FTAs because it had already committed to substantial trade liberalization under the WTO. Besides these economic motives, it is commonly perceived that China uses FTAs as regional policy to increase its economic and non-economic positions in East Asia.

An idea of FTA covering East Asian countries has emerged. At the Leaders' summit meeting of ASEAN+3 (China, Japan, and Korea) in 1998 the leaders decided to set up East Asia Vision Group to study long term vision for economic cooperation. The group has presented the leaders with recommendations including the establishment of East Asia FTA. Despite the recommendation from the Vision Group, East Asia FTA has not yet become a concrete agenda at the leaders meeting. Obviously agreeing on East Asian FTA at this time is politically very difficult mainly because of strong opposition from non-competitive sectors. However, activities of the East Asia Vision Group have been followed up by establishing the forum 'Network of East Asian Think-tanks (NEAT)' in 2003, which is supported by the governments of ASEAN+3 countries, to continue dialogue and deepen mutual understanding.

One can think of various factors that have led to an emerging interest in FTAs among the countries in East Asia in addition to the factors that were discussed above to explain rapid expansion of FTAs in the world. The financial crisis in East Asia increased the awareness among East Asian countries of the need for regional cooperation such as FTAs to avoid another crisis and to promote regional economic growth. Indeed, because of the immediate concern about possible financial problems, regional cooperation in financial dimension has made greater progress than FTAs. Specifically, bilateral currency swap arrangements to deal with the shortage in foreign exchange under the name of Chiang-Mai Initiative were set up in 2000⁸. Furthermore, ASEAN+3 countries are developing Asian Bond Market, in order to develop efficient and liquid bond markets in East Asia, enabling better utilization of East Asian savings for East Asian

⁸ As of August 29, 2004, among ASEAN+3 countries, eight countries (Indonesia, Malaysia, Philippines, Singapore, Thailand, China, Japan, and Korea) are participating in the scheme.

investments. It is also expected to contribute to the mitigation of currency and maturity mismatches in financing.

Rivalry in the region has also been a factor contributing to an increased interest in FTAs. Specifically, both China and Japan, which are competing to become a 'leader' in the region, are keen on using FTAs to strengthen the relationships with ASEAN and the Newly Industrializing Economies (NIEs). Indeed, in November 2002 Japan proposed an economic partnership framework to ASEAN one day after China agreed to start FTA negotiations with ASEAN. It should also be noted that ASEAN and the NIEs also consider FTAs as a means to maintain and increase their influence in East Asia.

Before closing this section on FTA developments in East Asia, let us note one special feature of FTAs more or less common to many FTAs which have been enacted, negotiated and studied in East Asia. Many FTAs in East Asia are comprehensive in their contents as they include not only traditional features of liberalization in goods and services trade but also FDI liberalization and trade and FDI facilitation⁹. Furthermore, many FTAs include economic and technical cooperation such as human resource development and development of small and medium-sized enterprises (SMEs). Economic and technical cooperation is regarded as an important feature of FTAs in East Asia, because many countries in the region are developing countries, which need economic and technical cooperation in order to promote economic growth via trade and FDI liberalization. Indeed, the inclusion of economic and technical cooperation in FTAs may be attributable to a view that the trading arrangement such as the WTO that has only trade liberalization cannot be effective in promoting trade liberalization or promoting economic growth because it does not deal with the problems faced by developing countries effectively.

III. Japan's FTA Strategy

Japan had been a passive participant in FTA discussions until November 2002 when Japan proposed possible FTA with ASEAN. Prime Minister Go of Singapore proposed FTA to Prime Minister Obuchi of Japan in December 1999. They decided to set up a study group consisting of government officials, business people, and academics to investigate the contents of possible FTA and its impacts on their economies. The study group after a series of discussions recommended the prime ministers to start FTA

⁹ Trade facilitation is defined as the simplification and harmonization of international trade procedures such as import and export procedures (e.g. customs or licensing procedures); transport formalities; and payments, insurance, and other financial requirements

negotiations in October 2000. Responding to the recommendation by the study group, two prime ministers asked their government officials to start FTA negotiations. Negotiations began in January 2001 and reached an agreement in October 2001. After the agreement was signed by Prime Ministers Go and Koizumi of Japan in January 2002, Japan-Singapore FTA (JSEPA) went into effect in November 2002. Negotiations appeared to have moved rather smoothly because contentious issues such as liberalization in agricultural trade were limited for both countries.

JSEPA has both strengths and weaknesses. One of the strength is its comprehensiveness, as mentioned several times so far. Another strength is symbolic nature as JSEPA sent a message to the world Japan's strong interest in FTAs. One of weaknesses is limited coverage of trade liberalization on Japan side. Singapore removed tariffs on all imports from Japan, while Japan removed tariffs on 94 percent of imports from Singapore. It should be noted that those imports from Singapore that were not liberalized include not only agricultural products but also selected manufactured products including some petrochemical products and leather goods.

Mexico was the first country that approached Japan for a possible FTA. In November 1998 President Zedillo of Mexico proposed FTA to Japan. Following the proposition by the Mexican president, the committee on Japan-Mexico Closer Economic Relation was set up by Japan External Trade Organization (JETRO) and Mexico's SECOFI. In April 2000, JETRO and SECOFI released a joint report on possible Japan-Mexico FTA. Since the report concluded that Japan-Mexico FTA would give significant favorable effects on both nations, Japanese prime minister and Mexican president agreed to establish a business-government-academics study group to examine a possible approach for strengthening mutual economic ties, including FTA. The study group was established in September 2001 and examined the contents of possible FTA. The group presented its recommendation to their national leaders in summer 2002, to start FTA negotiations. The negotiations started in October 2002 with an aim of reaching an agreement in one year. However, the negotiations took much longer than expected and the two countries reached an agreement in September 2004.

The most serious obstacle in the negotiations was Japan's strong resistance on liberalization in agricultural products, specifically pork, beef, and chicken products, oranges and orange juice. After strong request from Mexican government, Japan opened up these markets by increasing import quotas, not removing tariffs as it should under FTAs. Mexico agreed to liberalize steel and automobile markets within 10 and 7 years, responding to Japan's strong request. As a result, Mexico agreed to open its market to all imports from Japan, while Japan agreed to open its market to only 84 percent of its

imports from Mexico. Japan-Mexico FTA was strongly recommended by Japanese business sector, which felt that their business is suffering from loss of business opportunity because it does not have FTA with Mexico. Specifically, the cost in the form of lost business is estimated at 400 billion yen in 1999, amounting close to Japan's exports to Mexico¹⁰. Mexico on the other hand was interested in exporting its agricultural products to Japan, as Mexican government was under pressure from Mexican farmers, who were unhappy with the negative impacts of the NAFTA. As can be seen from the results of the negotiations noted above, Japan gained substantially and did not give in much on agricultural liberalization. Although it may be a victory for trade negotiators, it certainly is a defeat for those keenly interested in structural reform.

As for FTA with South Korea, President Kim took a lead in suggesting a closer economic partnership between South Korea and Japan in October 1998. In November 1998 at the Japan-Korea Ministerial Meeting the issue of possible Japan-Korea FTA was taken up. Following the meeting, private institutions jointly carried on research activities and released their report in May 2000. The Japanese prime minister and Korean president agreed to establish "Japan-Korea FTA Business Forum" in the September 2000 summit meeting. In March 2001, this business forum was established, having both nations' business leaders as core members. In January 2002, after adopting their joint declaration calling for concluding Japan-Korea FTA as soon as possible, this forum submitted a report to the Japanese prime minister and Korean president. Based on this report's recommendation, Japan and Korea agreed to establish a joint study group consisting of government officials, business leaders, and academics. The study group made recommendations to the leaders to start negotiations. FTA negotiations between Japan and Korea started in December 2003 with an aim of concluding the negotiations in two years. Japan proposed to finish negotiations in one year, but Korea insisted on two years. Although Korea expects an increase in FDI from Japan from the FTA, Korea is concerned with possible negative impacts on its manufacturing industries except for some electronics products such as semi-conductors because of their lack of competitiveness vis-à-vis Japanese counterparts. In particular, small and medium-sized enterprises (SMEs) strongly oppose Japan-Korea FTA, as they fear serious impacts from increased imports from Japan. These possible negative impacts have made the Korean government concerned with worsening bilateral trade balance and increasing dependence on Japan, although these views cannot be justified from the economic ground. Both Japan and Korea generally oppose to liberalization of trade in agricultural

¹⁰ Keidanren (2003)

products, as has been demonstrated in the WTO negotiations as well as their respective FTA negotiations so far. However, liberalization of agricultural products has not been a serious issue in the negotiations. This may be due to the observation that both sides feel their agriculture will not be affected much because of similar levels of competitiveness and/or that they can exclude agricultural products from liberalization for their own interests.

Japan proposed ASEAN an economic partnership agreement (EPA) including FTA in November 2002 only one day after China and ASEAN signed an agreement on closer economic partnership. Compared with the sensational impact that China-ASEAN Closer Economic Agreement had, Japan-ASEAN EPA did not attract much attention, as it did not have any concrete actions. In November 2003 Japan and ASEAN agreed on the framework for comprehensive economic partnership and agreed to start consultations in 2004¹¹. As for the actual start of negotiations, they came out short of specifying the exact date by stating that they make maximum efforts to commence negotiations in 2005. While Japan continues to have discussions with ASEAN, some members of ASEAN and Japan started negotiations on bilateral FTA. So far, Thailand, the Philippines, and Malaysia started negotiations with Japan. Despite the realization of the need to establish Japan-ASEAN EPA, Japan has decided to establish FTAs bilaterally with selected members of ASEAN because Japan felt that it cannot establish speedily an ASEAN wide FTA, because of the wide differences in economic and non-economic conditions among ASEAN members. Some argue that bilateral FTAs with selected members of ASEAN by not including others would create divisiveness among ASEAN members. Since this is certainly a possibility, Japan should work hard to start negotiations with ASEAN as early as possible.

As for FTA with other countries, Chile, Australia, New Zealand, Canada, Taiwan among others have approached Japan for possible FTAs. However, there have been no significant activities at official level for any of these pairings. A lack of progress on FTA discussions for these countries except for Taiwan is essentially attributable to two reasons. One is the importance of agricultural trade in Japan's trade with these countries, making it difficult to negotiate on trade liberalization. The other reason is limited geopolitical importance of these countries, as they are not located in East Asia, an region of Japan's utmost interest, as will be discussed more later. Lack of progress on FTA discussions with Taiwan is due to its political sensitivity in Japan's relationship with China..

¹¹ Ministry of Foreign Affairs,
<http://www.mofa.go.jp/region/asia-paci/asean/pmv0310/framework.html>

As can be seen from the discussions above, Japan's FTA strategy emphasizes East Asia as a region for establishing FTAs¹². Several reasons can be identified for this policy. According to Japan's Ministry of Foreign Affairs, East Asia is given high priority mainly because of economic and political reasons. Japan has been expanding its economic and political relations with East Asia, but regional institutional frameworks to cover East Asia with Japan's leadership have not been established. This contrasts with the situations in Western Europe or North America. East Asia has a high potential for economic growth, but Japanese firms have not been able to benefit fully from its economic relations with East Asia largely because of high protection in East Asia. Specifically, Japanese firms have invested significantly, but they cannot operate efficiently because of high protection, which makes it difficult for Japanese firms not only procure parts from foreign countries but also sell their products to foreign countries efficiently. Japan thinks that FTAs would contribute substantially to remedy these situations.

East Asian countries would also gain benefits from FTAs with Japan, as they can not only enjoy greater access to Japanese market but also receive various factors such as FDI and economic assistance to promote economic growth under EPA. Indeed, Japan is interested in establishing EPA rather than FTA to promote economic growth in East Asia by taking JSEPA as a model. East Asia's economic growth would contribute Japan's economic growth as well as stability in political and social environment in East Asia. In order to achieve economic growth and political and social stability in East Asia, it is important to establish East Asia FTA by including all East Asian countries. In this regard, all East Asian countries get together to discuss the ways to establish East Asia FTA.

As was noted above, Japanese government set up a study group consisting of private sector representatives, government officials, and academics to examine possible FTAs before entering negotiations. The idea of study group was quite useful in formulating the contents of FTAs because in many cases pro-liberalization voices of business and academics rather than pro-protection views of government officials were adopted. Officials of Ministry of Agriculture, Fishery and Forestry and representatives from agriculture associations oppose any import liberalization of agricultural products by arguing the need for food security and multi-functionality of agriculture. In other words, they argue that maintenance of agriculture would contribute to conservation of

¹² The Ministry of Foreign Affairs of the Japanese government released a document entitled "Japan's FTA Strategy" in November 2002.
http://www.mofa.go.jp/mofaj/gaiko/fta/senryaku_05.html

environment, preservation of rural life, and others. By contrast, business representatives, academics, and in some cases officials of Ministry of Economy, Trade, and Industry and Ministry of Foreign Affairs present arguments for liberalization.

IV. Motives for Japan's FTA Strategy

As already mentioned earlier, Japan came to recognize FTA as one of its trade policy options. Several factors contributed to this shift in Japan's trade policy. This section investigates these factors.

First, a greater access to foreign market was one of the important motives that aroused Japan's interest in FTAs. Japan was one of few countries that did not have any regional trade arrangements such as FTAs in the world, where an increasingly greater number of FTAs had become established. Facing the world market with many discriminatory trading arrangements, Japan felt its need to secure a market for Japanese firms by setting up FTAs. As FTA would eliminate trade barriers in FTA partners, Japanese companies are surely able to enjoy more business opportunities. This kind of thinking also led to positive perspectives on FTA, especially when multinational trade negotiations under the WTO were making little progress.

For internationally competitive Japanese firms, it is very important to have more business opportunities when competing with foreign companies. For example, FTA with East Asian countries including Korea, Thailand, Malaysia and the Philippines would increase Japan's exports to these countries, which are presently protected with high tariff and non-tariff barriers (Table 2) In addition Japanese firms could expand their business in FTA member countries via FDI as FTA includes not only trade but FDI liberalization.

The market access motive clearly played an important role for Japan in pursuing FTA with Mexico. Thanks to the NAFTA and EU-Mexico FTA, EU and US firms can export their products to Mexico without tariffs. Japanese firms have to pay high tariffs to export their products to Mexico, whose market is protected by high tariffs. Indeed, a simple mean tariff rate for Mexico was at 16.2 percent in 2001¹³. Among the manufacturing sectors, automobile and steel industries are very eager to have FTA with Mexico. Automobile industry is interested in expanding exports of finished cars to Mexico, while steel industry is interested in exporting steel products, which are used for production of electronics, household electrical appliances, general machineries, and automobiles by Japanese assembly firms operating in Mexico. Besides, Mexican

¹³ World Bank, World Development Indicators 2003, publication.

government only allows FTA members to participate in government procurement. Mexico can impose such restriction on government procurement because it is not a signatory to WTO's government procurement code. Faced with these market access problems in Mexico because of its non-FTA member status, Japanese business has pushed rigorously Japanese government to have FTA with Mexico.

Another motive for Japan to pursue FTAs is to stimulate structural reforms that are essential to revitalize the currently stagnant Japanese economy. Since the collapse of a bubble economy in the early 1990s, the Japanese economy has been in a long recession. Indeed, the 1990s was characterized as the "lost decade" for Japan. Although Japan's post-war systems contributed to high economic growth in the past, recently they became ineffective. This is one of the reasons why Japan fails to recover from such long recession. Many observers agree that the structural reform is necessary for refurbishing the ineffective systems. As for the specific sectors related to FTA negotiations, we can identify the following sectors for the need of structural reforms, agriculture and fishery and some service sectors such as medical and education services. Medical and education services are related to FTA negotiations as they are subject to mutual recognition agreements on professional licenses and mobility of natural persons. Currently medical and educational services are heavily in the forms of issuance of visas, which are only granted to qualified persons. We will come back to this issue when we discuss the obstacles to FTAs.

In the post World War II period Japan had made use of international frameworks (e.g., GATT and OECD) and external pressures (especially, pressures from the United States) to reform its domestic structures through trade liberalization. Indeed, structural reform contributed significantly to improve competitiveness of Japanese manufacturing sector. However, in the latter half of the 1990s, liberalization was getting more difficult under the WTO framework. Several reasons are found for slow progress under the WTO. First, as a result of substantial trade liberalization under the GATT, there remain only difficult areas for further liberalization, slowing down further liberalization. Second, the number of WTO members increased significantly over time to reach 148 (as of August 2004), making it difficult for the WTO to make decision on trade liberalization, because decision making at the WTO is based on consensus. One seriously contentious issue is liberalization of agricultural products, because of different views on this issue between the US and the EU and because of strong opposition from a group of ten countries protecting agricultural sector including Japan and Korea, as noted earlier.

The US pressure on trade related issues weakened after the establishment of the

WTO. This is because the US, Japan and other WTO member countries became to use strengthened dispute settlement mechanism under the WTO for settling trade related issues. It should also be noted that Japan undertook a number of policy reforms such as those in financial system, and corporate governance system, which were main causes of US concerns over macroeconomic performance of Japanese economy.

Faced with a lack of external pressures, especially from the WTO's multilateral trade negotiations, Japan became interested in FTA as one of the policy options to promote structural reform. Japan came to look at FTA in a positive perspective, because it found that the EU and NAFTA promoted structural reforms in member countries.

Finally, Japan expects to contribute to the strengthening of the world trading system under the WTO. Some argue that FTAs would have harmful impacts on the world trading system because of their discriminatory nature. Having acknowledged such harmful effect, one could argue that harmful effect can be more than offset by favorable effects from FTAs, as will be discussed in the next section. Indeed, FTAs may bring positive impacts on fostering the WTO, if FTAs address the issues that are not covered by the existing WTO framework. Japan may contribute to the strengthening of the WTO system if Japan can successfully form EPAs (like Japan-Singapore EPA) that have arrangements on the issues not covered in the existing WTO framework. For example, while GATT/WTO do not have specific rules on competition policies or investments, Japan-Singapore EPA (JSEPA) does cover these fields. Japan has been trying to include these new features in all EAPs including those under negotiations.

The WTO and other international organizations may establish specific rules applicable to competition policies and investment in the future by using JSEPA as a model. Japan is able to contribute to forming international framework through forming FTA and EPA with other countries. However, so far, Japan has not been successful in including rules on FDI and competition policy as agenda under the Doha Development Agenda because of strong opposition from developing countries.

V. The Impacts of FTAs on the Japanese Economy

Japan will make use of FTA as one of its important trade policy options. Then, what kind of economic impacts will FTA give on Japan, its FTA partners and non-FTA partners? This section briefly discusses FTA's economic effects and also examines how much FTA will give impacts on Japan and East Asia based on simulation analysis. One can classify the economic impacts of FTA into two groups: static effects and dynamic

effects¹⁴. Static effects include “trade creation effect,” “trade diversion effect” and “terms of trade effect,” while the dynamic effects are “market expansion effect” and “competition promotion effect.” “Trade creation effect” means that FTA eliminates trade barriers on trade among FTA members and, therefore, creates trade among them. “Trade diversion effect” means that FTA would replace imports of highly efficient non-member countries by imports from less efficient FTA members. “Terms of trade effect” represents that FTA would expand trade volume among its parties, strengthen the parties’ influence on non-members and, then improve their terms of trade. “Market expansion effect” represents that trade barrier elimination among members would expand market size to achieve efficient production/distribution by realizing economies of scale. “Competition promotion effect” means that market integration would make oligopolistic industries more competitive and achieve higher productivity by introducing competitive pressures.

From the viewpoint of FTA members, the “trade creation effect,” “terms of trade effect,” “market expansion effect,” and “competition promotion effect” will give positive impacts. However, “trade diversion effect” would have adverse effects on them under certain circumstances. On the other hand, from the viewpoint of non-member states, the trade diversion effect and terms of trade effect will give negative impacts, while other effects tend to have positive impacts on them. If FTA expands market size, promotes competition, and encourages economic growth in member countries, its positive effects will spread out to non-member states as well. FTA option is recently gaining popularity, because governments expect FTAs to realize positive dynamic effects. However, if a country gives preferential treatment only to certain trade partners, other countries might form exclusive economic blocs in order to countervail “trade diversion effects” created by such preferential treatment. In this case, the world economy will suffer from significant adverse effects like what happened during the Inter-War era.

Recognizing the negative impacts of trade diversion and of excluding non-members, one argues that FTA should cover a lot of countries and include some highly competitive countries because such FTA will be able to minimize possible negative impacts from the trade diversion effect¹⁵. This observation indicates the important of successful multilateral trade negotiations under the WTO. Indeed, it is the optimal outcome. However, under the circumstance that WTO process has faced

¹⁴ For the impacts of RTAs, see, for example, Winters(1991).

¹⁵ See Schiff and Winters (2003) for useful discussions on the dos and don'ts of regional trade agreements.

problems, despite its second or third-best nature, FTAs can be a viable option. Besides, FTAs have some favorable impacts that cannot be achieved through the WTO process.

In addition to the impacts on trade, FTA also affects foreign direct investment (FDI). As FTA eliminates regional trade barriers and expands the market size, FDI will flow into the regional market, hoping for selling more products. In addition, if FTA enables firms to conduct efficient production in the region, foreign firms will undertake investments in the region to take advantage of favorable production environment, in order to export their products. This is called FTA's investment creation effect. Investment may be undertaken in member countries at the expense of investment in non-member countries because of increased attractiveness of member countries for investment. This is FTA's investment diversion effect.

Many empirical studies have been conducted on the economic impacts of FTAs. In these studies the EU and NAFTA have attracted most attention¹⁶. Although these analyses draw different conclusions to a certain extent, they generally show that FTA basically expanded regional trade/investment, encouraged competitions within the region and brought some other positive effects to the members. On the other hand, as some analyses show that FTA diverted trade and investment, FTA might have given some negative effects on non-member countries. According to the estimation by Japan's Ministry of Economy, Trade and Industry, trade diversion caused by the NAFTA incurred a loss of Japanese exports amounting to 395 billion yen in 1999¹⁷. Investment diversion was also reported as the NAFTA attracted FDI inflows in electronics and apparel industries to Mexico, which would have flowed in East Asia.

We are able to measure FTA's overall economic impacts for the world as a whole by comparing FTA members' benefits and non-members' costs. As a lot of research projects prove that the former exceeded the later, FTA would generally bring positive impacts on net basis. Because existing empirical analyses tend to ignore FTA's dynamic effects, they are likely to underestimate FTA's positive impacts. If FTA has large dynamic effects, it will surely bring more positive impacts on the member countries as well as on non-member countries.

Let us examine the impacts of FTA on Japan, which are obtained from a simulation analysis based on computable general equilibrium (CGE) model, specifically GTAP model version 5, which was carried out by Tsutsumi (2003). The study was

¹⁶ METI (2001) also provides detailed analysis on economic impacts of EU and NAFTA.

¹⁷ METI, an internal document.

conducted as a part of the research project organized by Japan Center for Economic Research to examine the issues on regional economic integration and cooperation between China, Japan, and Korea. In the simulation analysis the base case was established for the growth paths of the countries by making assumptions on growth rates of population, labor inputs and the rate of technological progress for the 1997-2010 period. Simulation results that assume removal of barriers on trade among FTA members are compared with the base case to measure the impacts of FTAs. The base case assumes the presence of Japan-Singapore FTA and the NAFTA.

The results of simulation are shown in Tables 3 and 4. In Table 3 the impacts of FTAs on GDP are shown, and according to the results, establishment of FTAs would have positive impacts on GDP, or economic growth, for FTA members. The results also show that the larger the number of FTA members the greater the benefits from joining FTA. For example, Japan can expect its GDP to increase only by 0.009 percentage point annually, if Japan establishes FTA with Korea. The impacts get larger as other countries join this FTA. Specifically, Japan's GDP would increase by 0.038 and 0.061 percentage points annually, respectively, as ASEAN and China (including Hong Kong) join Japan-Korea FTA¹⁸. Indeed, East Asian countries should aim to establish East Asia FTA, as it brings the largest gain in GDP for the members.

It should be noted that the results are likely to underestimate the true impacts, because the simulation analysis only incorporates static effects but not dynamic effects nor the impacts on FDI due to difficulty in introducing these features in the model. Indeed, many observers emphasize the importance of dynamic effects from the formation of FTAs.

The impacts of FTA would be large for countries with high trade dependence. For example, Japan-Korea FTA would increase Korea's GDP by 0.2 percentage point annually. The impacts would be larger at 0.37 percentage point, if ASEAN+3 FTA is established. ASEAN countries can expect their economic growth rate to increase by 1.2-3.6 percentage points, depending on the countries. Large impacts on Thailand (3.6 percentage point) and Vietnam (2.4 percentage point) are due to high trade-GDP ratios

¹⁸ Several studies have examined the impacts of FTAs using the same GTAP model and GTAP database. Therefore, their results are basically similar. Many studies estimated the impacts on consumers' welfare not on GDP, as is done in this paper. For example, Scollay and Gilbert (2001) reports an increase of welfare of consumers in Japan from ASEAN+3 to be 0.34 percent of GDP. The figure rises to 0.98 percent if global trade liberalization is achieved, indicating large benefits from WTO liberalization. We did not use consumers' welfare as an indicator for the impacts of FTAs and used GDP because FTAs do have impacts on producers and governments as well.

and high protection.

Simulation results indicate that FTAs in East Asia would increase world GDP. However, they yield negative impacts on non-FTA members in terms of decline in their GDP growth rates. For example, Japan's GDP would decline by 0.006 percentage point annually, if China, Korea and ASEAN establish an FTA without Japan. US GDP would decline slightly if ASEAN+3 FTA is formed. These results imply the possibility of competitive (beggar-thy-neighbor) FTAs, similar to the development during the Inter-World War period, when many countries set up closed trade blocs with countries with special relationships such as colonies to maintain their export markets. Such development would be detrimental to growth of world trade and world economy, as manifested by the fact that closed trade blocs was an important factor leading to World War II as closed trade blocs resulted in remarkable reduction in world trade and world GDP. In order to avoid possible negative impacts of FTAs, Japan and other countries have to try hard to promote not only FTAs but also global trade liberalization under the WTO.

VI. Obstacles to Promoting FTAs for Japan

We saw in the previous sections that Japan can expect economic and non-economic benefits from FTAs. Recognizing the benefits from FTAs, Japan has become active in establishing FTAs. However, Japan faces various obstacles in its pursuance of FTAs. This section examines such obstacles for Japan, with a particular focus on obstacles for establishing FTAs with East Asian countries.

One can identify economic and non-economic obstacles. Let us begin with economic obstacles and then turn to non-economic obstacles. Although FTAs are likely to bring economic benefits to Japan as a whole as shown by the simulation result reported in the previous section, the benefits would not accrue to all the sectors/people. Some sectors or groups are likely to suffer from negative consequences. Specifically, competitive sectors are likely to gain benefits as FTAs would bring them business opportunities in overseas market, while non-competitive sectors are likely to lose because competitive foreign companies put competitive pressures on them. These mixed impacts are expected from any types of trade liberalization, either multilateral liberalization under the WTO or FTAs.

According to the results of simulation analysis shown in Table 4, for Japan production of primary sectors (agriculture, forestry, fishery, and mining) and food processing, textiles and apparel, electric machinery, and other manufacturing is estimated to decline as a result of East Asia FTA, while production of other

manufactured products such as general and transportation machinery is estimated to increase. Judging from these results, we would expect strong opposition to FTAs from primary sectors, food processing, and textiles and apparel sectors¹⁹. These negatively impacted sectors have been successful in generating political support for their appeal for protection and against FTAs because of their strong campaign. It should be noted here that the levels of protection shown in Table 2 mask some very high protection because of averaging the levels of protection for aggregated sector such as agriculture and food products. Some of the items with very high tariff include kongnyaku potatoes (990%), peanuts (500%), rice (490%), butter (330%) and sugar (270%). Among these highly protected items, rice is by far the most difficult item to be liberalized largely because of political factor.

The impacts of FTAs on production discussed above reflect Japan's pattern of comparative advantage. Being richly endowed with skilled labor and capital but poorly endowed with natural resources and unskilled labor, Japan has a comparative advantage in the production of skilled labor and capital intensive products such as general and transportation machinery while it does not have a comparative advantage in the production of natural resource and unskilled labor intensive products such as primary products and apparel.

China and ASEAN, which are lagging behind Japan in terms of economic development, are richly endowed with natural resources and unskilled labor, while they are poorly endowed with capital and skilled labor. Because of these patterns of factor endowments, China and ASEAN have a comparative advantage in the production of primary products and textiles and apparel, while they do not have a comparative advantage in sophisticated products or hi-tech products such as machinery. One would expect mixed impacts, that is, positive and negative impacts, on production among different sectors in China, ASEAN and other East Asian countries, as was the case for Japan. However, we find mostly positive impacts on many or all sectors for China and ASEAN. This is due to large overall positive impacts from East Asia FTA for these countries.

It should be noted that the discussions above on the pattern of comparative advantage is admittedly rather simple. Indeed, in reality the pattern of comparative advantage is more complicated. Take a case of machinery products such as computers, whose production requires many parts and processes. If the entire production process is

¹⁹ Below we discuss possible reasons for the somewhat unexpected decline in the production of electric machinery and then argue that we do not expect much opposition to FTAs from that sector.

undertaken in one country, one can argue that a certain country has a comparative advantage in the production of computers. However, through active FDI by multinational corporations, the production process of computers is fragmented into various sub-processes and they are located in different countries where certain sub-process can be undertaken more efficiently. For example, production of semi-conductors for computers is done in a country such as Japan where high-skilled labor is abundantly available, while assembling of computers by using semi-conductors produced in Japan is conducted in unskilled labor abundant country such as China. China is seen to have a comparative advantage in the production of computers, hi-tech products, as assembled computers are exported from China. But, in reality China has a comparative advantage in labor-intensive process of hi-tech products. These discussions indicate difficulty in discerning the pattern of comparative, and this point should be kept in mind when reading the results of the simulation. Indeed, somewhat unexpected result showing a decline in the production of electric products for Japan may be due to the fragmentation of production process discussed above. Specifically, Japan has a comparative advantage in the production of skill labor-intensive parts and components, while it does not have a comparative advantage in unskilled-labor intensive assembling process of finished electronics products such as computers. As such, production of electric products is estimated to decline in Japan, while it is estimated to increase in China and ASEAN countries.

FTAs between Japan and East Asian countries, which have quite different patterns of comparative advantage because of their differences in the levels of economic development as seen above, would lead to reallocation of resources on a large scale. Such FTAs would theoretically result in large economic benefits, but opposition from potentially impacted groups from non-competitive sectors is very strong. In contrast to the case in East Asia, it is often argued that reallocation of resources is much limited for FTAs or economic integration in the case of Europe, and thus opposition on economic integration is rather weak. The levels of economic development for European countries are much similar leading to a trade pattern where intra-industry trade rather than inter-industry trade is significant, unlike the case in East Asia. Since economic integration in Europe tends to increase intra-industry trade rather than inter-industry trade, requiring less transition costs in the form of reallocation of resources, compared with Japan's FTA with East Asian countries.

On the impacts on FTAs on economic growth, it is important for policy makers to realize that reallocation of resources such as labor and capital inputs from non-competitive to competitive sectors, which can be expected from FTA, is a source of

economic growth. However, such reallocation is not easy because the owners of these resources, namely workers and firms, try hard to resist such reallocation as it incurs them cost in the form of unemployment.

One would also expect opposition from other non-competitive sectors, which are not analyzed in the simulation analysis because of a lack of data and difficulty in including in the GTAP model. For example, as was noted above Japan is opposing to mobility of labor as a part of FTAs, while Thailand and the Philippines are keenly interested in “exporting” medical care givers such as nurses and massage therapists. As aging of Japanese population is projected to accelerate in the future, Japan is likely to be short of medical-care givers to old people. In light of such future projections, “importation” of medical-care givers can be justified. However, nurses associations and medical associations place strong opposition because importation of these people will threaten job opportunities for Japanese nurses and other medical-care givers. Mobility of labor was included in JSEPA but its coverage and form is very limited in that temporary stay is permitted only for short-term visitors for commercial purposes, intra-firm transferees, investors, and engineers with high technological knowledge²⁰.

Let us turn to non-economic obstacles. The issue of national security is an obstacle for Japan and other East Asian countries to form FTAs in East Asia. Japan and Korea have strong security alliance with the United States, while China is not an ally to the US. ASEAN countries regard the US forces as a security balancer in the region. Because of these differences in the stance on national security, truly regional integration based on mutual trust is not likely in the near future. Specifically, Taiwan issue highlights possible conflict between China and US allies. Somewhat related to the national security issue, differences in political systems, namely democratic states like Japan, and many other East Asian countries on the one hand and authoritarian states like China and Vietnam on the other hand, prevents East Asian countries from establishing truly trustful relationship, which is a necessary condition to establish a true FTA. Indeed, for Japan mistrust of China in the areas of national security and political system, coupled with increasing presence of China in the areas of economic as well as political and military areas, is a crucial factor preventing the discussions on possible FTA.

In the pursuit of establishing FTAs with China and Korea, Japan faces historic problem as Japan colonized these countries (part of China) during the WWII period. Specifically, a large proportion of people in China and to lesser extent in Korea remember sad experiences under the occupation and thus do not have a good impression

²⁰ Ministry of Foreign Affairs, Japan-Singapore Economic Partnership Agreement, <http://www.mofa.go.jp/mofaj/area/singapore/kyotei/pdfs/f-6.pdf>

of Japan, making cooperative arrangement such as FTAs difficult to be realized. Despite the historic problem, Japan and Korea are successful in starting process toward the establishment of FTA mainly for two reasons. One is mutual reconciliation over historic issues between the political leaders and the other is increased mutual understanding of the needs for closer economic and social ties among people of the two countries. Mutual reconciliation between the political leaders was realized thanks to strong political leadership of Korean President Kim Dea Jung who accepted an apology from Prime Minister Keizo Obuchi for Japan's atrocity done on Korean people in the past. Increasing awareness of the need for closer economic and social relationships by the peoples of two countries appears to result from the change in people's perception of mutual relationship from backward-looking to future-looking stance, which in turn results from successful economic growth. This case shows the importance of political leadership and successful economic growth for establishing FTAs.

A lack of strong desire or strong interest in FTAs, particularly East Asia FTA, by politicians and general public is a serious obstacle. For regional integration in Western Europe, which started after WWII, strong political leadership from France and West Germany contributed substantially. In the case of the NAFTA, the US took the initiative. Unlike the cases in the EU or the NAFTA, leadership is missing in East Asia, although Japan and China are expected to play leaders' role. Because of difficult problems lying between Japan and China as discussed above, there is strong possibility that ASEAN-China FTA, and/or ASEAN-Japan FTA be established before Japan-China FTA.

VII. Promotion of FTAs for Japan: Ways to Overcome Obstacles

Japan and many other East Asian countries are currently very active in establishing FTAs with other East Asian countries. Many East Asian countries regard East Asia FTA, which covers the countries in East Asia, as a medium-term goal, which would eventually lead to the establishment of deep regional integration like the EU sometime in the future. Behind such expectation is realization that deep regional integration results in economic prosperity, peace, political and social stability. However, the previous section identified various obstacles for the formation of even bilateral FTAs, let alone East Asia FTA. This section attempts to find the solutions to overcome the obstacles by focusing on the measures that Japan should adopt.

Given the difficulty in pursuing trade liberalization under the WTO at present, FTA would be an effective strategy for trade liberalization, which would bring benefits to both firms and consumers because it will 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. Besides, FTAs would yield additional benefits of liberalizing the areas such as investment that are not covered in the WTO. By contrast to these benefits, FTA will give negative impacts on less competitive firms and their employees since they will be exposed to severer competitive pressures. Accordingly, potential victims tend to oppose FTA. For Japan, while automobile and other competitive industries support FTA, primary sectors (e.g., agriculture, fisheries) and less competitive industries (labor-intensive manufacturing industries, and some service sectors including finance and transportation services) oppose FTA. Theoretically, GATT rules allow exclusion of limited number of sectors from liberalization under FTA, and thus Japan could exclude some agricultural products from liberalization. But this rule is not effective in Japan's FTAs with East Asian countries, because many East Asian countries, with which Japan is trying to set up FTAs, are interested in opening Japan's agricultural market via FTAs. Besides, Japan should liberalize trade in all sectors to gain maxim benefits. On this point, it should be emphasized that Japan's FTAs so far have been failures because they did not result in liberalization of all trade. In the case of Japan-Singapore FTA, Japan liberalized 94 percent of its imports from Singapore²¹, and in the case of Japan-Mexico it is reported that only 86 percent of its imports from Mexico will be liberalized²².

Although FTAs will stimulate structural reforms that are essential for revitalizing the Japanese economy, agriculture sector's strong opposition is a major obstacle for forming FTA. Examining the issue of trade liberalization in agriculture sector or any other sectors, one has to remember costs of protection in various forms such as imposing high prices on consumers and allowing inefficient use of resources such as labor and capital. Indeed, the White Paper on Economy and Public Finance estimates the cost of agricultural protection to consumers to be 10.8 trillion yen, or 2.1 percent of GDP in 2000²³. It should be emphasized that the estimated costs underestimate the true costs, which would be reflected in increasing inefficiency and lower economic growth. Indeed, the cost of protection in the form of misallocation of resources is very high under the present Japanese economic situation, where increase in labor and capital inputs cannot be expected because of rapidly aging society. The preceding discussions point to the importance of overcoming the opposition from

²¹ Japan's Ministry of Foreign Affairs,
<http://www.mofa.go.jp/mofaj/area/singapore/kyotei/kyotei.html>

²² Nihon Keizai Shimbun, March 13, 2004 (in Japanese)

²³ Cabinet Office, Economic and Public Finance White Paper 2004.

agriculture and other non-competitive sectors to establish FTA.

Some argue the importance of protecting agriculture to achieve various objectives such as food security and multi-functionality, i.e. preserving nature, environment, culture, and so on. These objectives may be justified but protection of agriculture is a wrong and inefficient policy. Appropriate policies can be designed to achieve these goals. For example, food security may be achieved by establishing agreements with a number of agricultural exporters to assure stable and sufficient supplies of agricultural products, possibly through FTAs. To achieve preservation of nature and environment, direct subsidy is known to be most efficient. In essence, protection is only a second best or third best policy and not the optimum policy to achieve these goals that protectionists attempt to achieve. Coupled with substantial costs of protection discussed above, the discussions in this section strongly indicate that protection of agriculture should be removed, not only in order to promote FTAs but also to promote Japan's economic growth.

These arguments suggest that liberalizing, rather than protecting, Japan's agricultural sector will help Japan to achieve sustainable economic growth. If this pointed is understood and shared with many Japanese, a major obstacle for FTAs will be removed. Of course, when liberating the agriculture sector, it is necessary to minimize resultant unemployment and adjustment costs. For example, a possible approach will be to liberalize competitive sectors at first and, then, deregulate less competitive sectors after some intervals²⁴. Many FTAs have such schemes of sequential liberalization for different sectors, depending on their competitiveness. However, even in this case, it is necessary to specifically decide the timetable and liberalize the market strictly based on the timetable.

The most difficult problem has to do with displaced workers because of FTAs. Two schemes should be applied. One is income compensation for the duration of unemployment with the ceiling on the length of payment and the other is provision of technical assistance to improve their skills for getting more productive job. With assistance impacted worker should be able to make necessary adjustment. Recognizing that many impacted farmers are too old to find new jobs, income compensation would be a major policy. A more forward-looking, pro-active agriculture policy, specifically rice policy, can be considered by providing subsidy to full-time farmers with large cultivated land.²⁵ With this policy, cultivated land will be integrated so that farmers can improve productivity. As a result, the government can reduce the amount of payments to

²⁴ The GATT/WTO rules allow ten years to complete trade liberalization under FTAs.

²⁵ See Yamashita (2004) for the discussion.

the farmers from the current level that is required to run price support system. Besides, the market will be liberalized and, as a result, not only consumers do not have to bear all the burdens, but also one big obstacle for FTAs will be removed.

To deal with trade adjustment by agricultural sector, which was necessitated by partial liberalization of rice imports as a result of the Uruguay round of trade negotiations under the GATT, Japanese government provided as much as six trillion yen. Although the intension can be justified, the program was not successful in facilitating adjustment, because a large part of the funds were spent not for upgrading skills of impacted workers but for different purposes such as drilling hot springs or paving the country roads. Such mistakes must not be repeated.

Although agriculture matters have been considered a taboo in policy discussions in the past, FTA negotiations with Mexico provided an opportunity to discuss agriculture problems from various perspectives. This is a secondary but desirable effect coming from FTA. Japanese people should have more constructive and intense discussions on liberalizing the agricultural sector in order to promote FTA/EPA, contemplating on what is desirable for the Japanese economy in the future. Similar arguments can be made to deal with opposition from other non-competitive sectors and opening up the labor market in a few areas such as medical care providers.

To promote FTAs by Japan, Japanese people and policy makers, in particular, have to have a sense of urgency concerning Japanese economy and Japan's future. Without such recognition, no meaningful efforts for the promotion of FTAs can be expected²⁶. To promote FTAs with East Asian countries, Japanese people and policy makers have to realize the importance of establishing Japan's strong relationship with East Asia, which would bring economic prosperity, political and social stability in East Asia. Indeed, establishing FTAs is the first step toward achieving these goals.

Various means can be used to increase such awareness on the part of Japanese people as well as people in East Asia for the need of deepening mutual relationship to promote FTAs and eventual regional integration. One effective way is to increase exchange of people of all levels. Among those, non-business people need to increase their exchange with their counterparts in East Asia, since business people have been actively expanding their business in East Asia, where business opportunities abound.

²⁶ In Japan various forums have been established for the promotion of Japan's FTAs mainly involving business and academics. Although such activities are gaining momentum and therefore are likely to increase the awareness of the importance of FTAs among Japanese people, there is still a need for further and greater efforts to make the FTA issue as high-priority agenda.

Leaders should meet at least once a year and they should exchange views frequently through various means such as televised-conferences. Policy makers and government officials have to construct close relationships and maintain them to increase their mutual understanding of the important issues of common interests such as regional economic integration. Indeed, for Japanese policy makers and government officials, the US and Europe have been the central focus. It is high time that Japanese policy makers and government officials to develop strong relationship with Asian countries. In order to promote exchanges by researchers, students, and ordinary people various programs such as joint research projects and exchange programs for researchers, professors and students should be promoted. Indeed, FTAs or EPAs can provide effective frameworks for such programs.

One of the most important factors for the promotion of FTAs is strong political leadership. Recently, China has become very active in pursuing FTA strategy with political leadership, but Japan has been lagging behind China in this respect. It is not that Japan should challenge China in the FTA race, but it is important to lead the FTA discussions in East Asia. More specifically, Japan and China with strong joint leadership should lead the discussion on the ways to establish East Asia FTA with other East Asian countries such as ASEAN countries and the NIEs.

It has to be emphasized that establishing East Asia FTA is not the goal for East Asian countries. East Asia FTA has to be a stepping stone for world wide free trade under the WTO. This is because East Asia FTA would have negative impacts on non-members such as the US and the EU, which may give rise to the establishment of closed trade blocs. In order to avoid such undesirable consequences, worldwide trade liberalization has to be pursued vigorously. In this regard Japan has to contribute by offering trade liberalization schemes for its agricultural sector. Such proposal is not impossible and indeed it is quite possible by pursuing a comprehensive agricultural policy based on income transfer, as discussed above.

As for FTAs, East Asian countries should be active in establishing FTAs with the countries outside of the region to avoid closed FTAs. It should be added that GATT/WTO rules on RTAs (GATT Article XXIV and GATS Article V) need to be improved to make RTAs more transparent and open, in order for RTAs to become a stepping stone to worldwide trade liberalization. On this point Japan should play a constructive role in the discussions on RTAs at the WTO. Specifically, Japan should submit proposals on clarifying ambiguous expressions in GATT Article XXIV such as liberalization in ‘substantially all the trade,’ which is one of the conditions for RTA to satisfy. Furthermore, Japan should address the issue of strengthening the monitoring and

enforcement of the WTO rules on RTAs. Naturally, in order for Japan's actions and proposals to be credible, Japan has to establish model FTAs with removal of tariff and non-tariff barriers on all trade, unlike those established with Singapore or Mexico.

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Table 1 Major FTAs Involving East Asian Economies

In Action	In Negotiation	Under Study
Bangkok Treaty (1976)	Japan-Mexico	Japan-ASEAN
AFTA(1992)	Japan-Korea	Korea-ASEAN
Singapore-New Zealand (2001)	Japan-Malaysia	Korea-Australia
Japan-Singapore (2002)	Japan-Thailand	Korea-New Zealand
Singapore-Australia (2003)	Japan-Philippines	Singapore-Chile
Singapore-EFTA (2003)	Korea-Singapore	Singapore-Taiwan
Singapore-US (2004)	Singapore-Canada	ASEAN-India
Korea-Chile (2004)	Singapore-Mexico	ASEAN-US
China-Hong Kong (2004)	Singapore-India	
	Thailand-India	
	Thailand-US	
	Thailand-Australia	
	Hong Kong-New Zealand	
	China-ASEAN	

Source: Country sources

Table 2 Rate of Protection for East Asian Countries: 1997

Sector	NIEs			ASEAN							
	China	Japan	Korea	Hong Kong	Singapore	Taiwan	Indonesia	Malaysia	Philippines	Thailand	Vietnam
Agriculture	41.3	58.4	110.9	0.0	3.5	6.0	5.2	31.1	15.0	20.3	13.6
Forestry	2.6	0.2	2.0	0.0	0.0	0.4	1.1	0.0	0.5	1.5	3.3
Fishing	14.2	4.9	15.8	0.0	0.0	31.1	7.5	1.4	6.6	44.9	8.9
Mining	0.2	-1.4	3.9	0.0	0.0	4.9	2.8	1.1	1.0	0.3	3.2
Food products and beverages	37.4	50.0	37.7	0.0	4.6	26.1	14.8	14.8	18.7	37.2	36.5
Textiles	25.7	10.7	8.0	0.0	0.0	8.1	15.6	16.1	13.6	26.7	34.0
Pulp, paper and paper products	11.7	2.2	5.3	0.0	0.0	2.9	6.2	9.1	11.4	12.6	19.1
Chemicals	12.6	2.3	7.0	0.0	0.0	3.7	7.1	8.6	6.4	15.3	16.1
Iron, steel and metal products	9.7	1.0	4.9	0.0	0.0	4.0	8.1	6.1	8.1	11.9	8.1
Transportation machinery	18.9	0.0	4.6	0.0	0.0	13.2	25.4	19.7	10.3	31.5	36.9
Electronic equipment	11.9	0.0	8.0	0.0	0.0	2.9	8.1	0.8	3.1	8.8	9.7
General machinery	13.5	0.3	7.8	0.0	0.0	4.9	3.9	5.1	5.5	10.4	6.7
Other manufacturing	16.9	5.5	7.3	0.0	0.0	5.6	9.5	8.2	12.0	13.2	16.9

Note: The rate of protection is defined as (domestic price - international price)/international price. Therefore, it includes both tariff and non-tariff measures.

Source: GTAP Version 5

ariff barrier

Table 3 The Impacts of FTAs on Economic Growth
(percentage point)

	FTA Members			
	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

Notes: The figures indicate percentage point difference in annual average GDP growth rate between the base case and FTA cases.

Source: Tsutumi (2004)

Table 4 The Impacts of East Asia FTA (ASEAN+3) on Production (percentage points)

	Japan	Korea	China	Hong Kong	Taiwan	Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam	US	EU
Agriculture	-0.09	-0.35	0.20	-0.03	0.05	0.17	0.12	0.16	0.17	0.30	0.20	0.02	0.03
Forestry	-0.30	0.07	0.15	0.59	0.28	1.65	1.20	1.03	-1.81	3.39	1.89	0.01	0.01
Fishery	-0.21	0.67	0.17	-0.25	-0.02	0.91	0.83	0.60	0.09	1.61	0.71	-0.05	0.01
Mining	-0.10	-0.11	0.35	0.98	0.15	1.13	1.71	1.86	0.84	3.58	1.49	0.05	0.08
Food processing	-0.12	1.96	-0.03	2.90	-0.04	0.63	1.37	0.13	3.42	0.89	0.21	-0.03	0.00
Textiles, apparel	-0.22	2.02	0.03	0.47	-1.73	1.14	1.00	1.45	-0.40	3.06	9.29	-0.08	-0.22
Wood, pulp	-0.06	0.26	0.09	0.64	0.04	1.71	1.17	0.85	0.46	3.52	1.77	0.00	0.00
Petrochemicals	0.16	0.61	0.14	0.86	-0.27	0.65	0.91	1.13	1.83	2.42	0.82	0.00	-0.02
Iron and steel	0.27	0.19	0.41	0.94	0.20	1.35	1.41	2.47	1.39	4.56	-1.24	-0.01	-0.06
General machinery	0.31	-0.42	0.37	1.01	0.13	3.78	2.48	2.93	1.04	5.41	1.76	-0.02	-0.09
Electric machinery	-0.35	-0.10	0.91	0.99	-0.35	2.00	2.38	2.83	1.60	5.14	1.44	-0.46	-0.38
Transportation machinery	0.31	-0.36	-0.03	-2.75	0.32	-2.06	-1.27	6.42	-1.67	3.75	-3.77	0.02	-0.03
Other manufacturing	-0.09	0.25	0.42	1.57	-0.06	1.34	1.59	1.45	0.72	3.71	2.11	-0.04	-0.05
Electricity, Gas, Water	0.06	0.33	0.30	0.47	-0.18	0.97	1.31	1.12	0.90	3.07	2.35	0.00	0.00
Construction	0.08	0.37	0.68	1.05	-0.18	1.76	1.69	1.32	1.50	3.81	2.74	0.00	0.02
Transportation services	0.03	0.15	0.32	0.50	-0.01	1.21	1.24	1.07	0.42	3.07	1.45	0.02	0.06
Communication services	0.01	0.05	0.39	0.63	-0.05	1.33	1.41	0.91	0.42	3.42	1.28	0.01	0.01
Finance, insurance	0.02	0.18	0.31	0.50	-0.07	1.14	1.35	0.92	0.34	3.22	0.13	0.01	0.03
Business services	0.03	-0.02	0.37	0.51	-0.07	1.17	0.91	0.33	-0.28	3.29	1.56	0.02	0.04
Personal services	0.05	0.41	0.41	0.86	-0.06	1.29	1.33	1.09	0.65	3.26	2.11	0.00	0.00
Other services	0.01	0.01	0.45	0.60	-0.05	1.31	0.70	0.75	0.67	1.93	1.11	0.01	0.01

Notes: The figures indicate percentage point difference in annual average growth rates in production between the base case and FDI case

Source: Tsutumi (2004)