

# Japan's FTA Strategy at Crossroads: Toward Functionalism or Diplomacy?

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## ■ Back to APEC?

After the unprecedented financial crisis in 1997, regionalism emerged rapidly in East Asia trying to secure growth potential by tapping into the regional market, independently from the United States. Free trade agreement (FTA) negotiations have become a fashionable core of “real” regionalism, going well beyond the Asia-Pacific Economic Cooperation (APEC) forum, which was characterized by “openness” and “voluntarism.” However, the piling-up process of each negotiation has started to show an interesting inclusion of these familiar characteristics of APEC: At the beginning, there seemed to be a consensus to build the blocks into an “ASEAN+3 (Japan, China and South Korea)” framework.

However, after moves toward FTAs between ASEAN and each of Japan, China and South Korea, it lost centripetal force to shape “ASEAN+3” when South Korea, Thailand and Malaysia opted to talk with the United States. Japan, who had initiated “ASEAN+3” through financial cooperation at the time of the crisis, shifted her focus to India and Australia. Despite the high level of liberalization commitment in the ASEAN-China Free Trade Area (ACFTA), the reciprocity principle about sensitive and highly sensitive items can actually postpone a real opening to each other. And despite the commitment for the “high-level FTA” with broader coverage and explicitness, Japan’s protectionism in the agriculture sector remains, including a variety of tariff quotas. “Openness” and “voluntarism” are still haunting East Asian regionalism no matter what rosy picture of an “East Asian Community” is advocated.

One major reason for harking back to APEC may be the force coming from the United States with its enormous market power, and the regional

worries about true integration among Japan, China and South Korea that open the way to maintain American leverage. As the three countries negotiate, major interests for their FTAs have started to diverge; Japan’s interest has narrowly concentrated on securing a business environment for multinational firms, focusing more on investor protection and deregulation in the service sector much more than tariff reduction. Japan’s FTA tends to include or to be combined with a Bilateral Investment Treaty (BIT). While developing countries are trying to accept such treaties and other measures to attract Foreign Direct Investment (FDI), the problem of sovereignty still exists. On the other hand, China has relatively more room for tariff reduction while trying to maintain control over FDI, being less interested in investor protection. In addition, China has a major interest in acquiring recognition of market economy status by FTA partners to achieve a better environment for trade remedies. Almost all Chinese FTAs require this recognition, which many mature economies find difficult in coordinating competition policy. South Korea’s FTA has sought to allow a generous rule of origin on products made in the Kaesong industrial park in North Korea by South Korean firms, which makes FTA negotiations politically sensitive, especially for Japan and China. The three engines of the regional economy embrace different focuses on integration, which means the need for intensive efforts for coordination.

In fact, Japan has been most concerned about the diversion of FTAs, for the presence of Japanese multinationals is the largest in the region with highly developed intra- and inter-firm trading networks. Complication of rules of origin (ROOs) and trade procedures following the rules has been pointed out as typical potential problems imposing additional costs on trade, despite liber-

alization. So far the other countries have been less worried, setting up a more generous ROO in ACFTA, and it is Japan herself, as well as Australia and the United States, that tends to complicate the ROO to prevent detour-route imports using cheaper tariffs. As FTAs with different levels of explicitness, varied coverage and diverted ROOs emerged in East Asia, how to achieve convergence among FTAs has become a significant question, especially for Japan. To enhance regional integration beyond the APEC level, Japan may have to find her own answer on how to graduate from “voluntarism” by increasing commitment to more market opening. To depart from “openness,” Japan needs better accounting for the choice of FTA partners, particularly about choosing Australia before China, and more seriously about the question whether to seek any kind of negotiation with the United States before China.

## ■ Basic Features of Japan's FTA

At the beginning, there were still certain principles floated about Japan’s FTA, typically confirmed in the paper “Basic Principles on Further Enhancement of Economic Partnership Agreement (EPA)” at the end of 2004 by the Cabinet. The paper made a clear priority for East Asia, and took a rather defensive position to minimize the cost of going without FTAs/EPAs rather than maximizing the potential. At the same time, the paper also stressed the economic feasibility of FTAs/EPAs, including promotion of structural reform even in agriculture, food security and contribution of foreign labor in a globalizing Japanese economy.

In fact, these principles of regional priority, defensiveness, and stress of economic feasibility with less political calculations have reflected the institutional, structural, and even contingent

factors shaping Japanese regionalism. First, together with other East Asian countries, it was the financial crisis and the shared pains after it that awoke regionalism. Japan committed nearly \$60 billion in assistance at the time, which recognized the significance of a sustainable growth structure within the region.

Second, when Japan turned to regionalism, global society had already been tending toward regional FTAs/EPAs. Japan became serious after the EU-Mexico FTA was established and the negative impact came true through trade diversion effects. The shock underlined the risk of going without FTAs/EPAs, which shaped the defensiveness.

Thirdly, it was more the bureaucratic and administrative side that learned the risk of sticking to old-fashioned multilateralism, considering the enhanced power of the regional groups in international bargaining. On the other hand, naturally, politicians did not have enough incentive to persuade the local/agricultural sector to bend. The bureaucratic leadership influenced many other characteristics such as the lack of political leadership and the lack of positive strategy, in that the bureaucrats do not have to take responsibilities in coordinating groups with vested interests such as the protected agricultural sector, if they have little to lose by failing.

East Asian priority by Japan has been confirmed by the careful approach to combine bilateral FTAs with leading ASEAN members with the whole ASEAN negotiations. This is a unique approach compared to China or South Korea, which both opted to negotiate with the whole of ASEAN only, by covering tariffs exclusively, postponing services and investment. Japan tried to go deeper and more comprehensively with selected ASEAN members. Defensiveness has also become a tradition; Japan started FTA negotiations with Mexico after seeing real negative trade effects from the EU-Mexico FTA. Rapid agreement of ACFTA also stimulated acceleration in Japan's negotiations with ASEAN as it tried not to repeat the Mexican case.

In terms of economic cooperation, while China tried to highlight the

Mekong River development in line with ACFTA, Japan has approached functionally, without such a political symbol, by supporting trade facilitation through assistance for the standardization of tariff code classification among ASEAN, training professionals on custom clearance, or promoting the "ASEAN Single Window" program, enhancing the Electronic Data Interchange (EDI) system.

### ■ Impact of Korea-US FTA

What is going to make East Asian regionalism more complicated may be an agreement on the South Korea-US FTA (KORUS), which was reached in April 2007. KORUS has two unique, independent characters in East Asia's traditional regionalism. First, KORUS is the most political FTA with the purpose of confirming the US-Korea alliance comprehensively in security relations. It was after a series of US-Korea security frictions that the Roh Moo Hyon government suddenly offered FTA negotiations with the United States. South Korea brought in the issue of ROOs on products made in the Kaesong industrial park in North Korea against opposition by the United States when the tension was mounting for North Korea's nuclear weapon problems. The two countries agreed to set up a committee to discuss the issue. In fact, despite the rivalry for leadership in economic integration, both Japan and China have tried to depoliticize each FTA, emphasizing the practical merits and economic profits. While certainly not totally independent from politics, the Mekong River development project linked to ACFTA has emphasized economic cooperation, and Japan's support for trade facilitation has been a part of "functional" cooperation. KORUS may bring a political FTA into the region with the American tradition of having FTAs with Israel and other pro-US Middle East countries.

Second, departing from voluntarism and gradualism, KORUS may have direct and instant trade diversion effects on East Asian trade, depending on the level of concessions agreed. The United States has sought to allow a

grace period of 10 years except beef (15 years) for the opening of the agricultural sector in South Korea, which is much faster than ACFTA's pace and is far more substantial than Japan's FTAs. The *table* (on the next page) shows the impact of KORUS on major East Asian economies calculated by the Korea Institute for International Economic Policy (KIEP) using the computerized general equilibrium (CGE) model. The Seoul government has stressed better market access for South Korean firms against Japanese companies in the US market and it is true that Japan may suffer in terms of certain competing items. But the whole impact remains relatively minor, while Australia, Canada and ASEAN may face minus impact due to the trade diversion of agricultural exports to South Korea substituted by US products. In fact, trade diversion effects that may cause "domino effects" in FTA negotiations, which were commonly observed in the EU, have never become serious in East Asia so far. However, if a certain domino effect really starts, most probably with China's pressure for a China-Korea FTA, Japan may have to reconsider the FTA strategy in Japan-Korea negotiations that have been stalled for years.

### ■ Changing Options for Japan: Functionalism? Diplomatic Context?

Upon the impact expected from KORUS, there seem to be several options for Japan to change its FTA policy. Probably one is to keep the basics as they were and even to enhance functional cooperation, strategically with China. Most typically, high cost and inefficiency in logistics are the common problems to tackle in East Asia. Hoping to become a "regional hub," South Korea, Thailand, Malaysia and Shanghai all invested heavily in hard infrastructure and the hardware constraints are to be overcome rapidly. However, the improvement of trade facilitation itself has been slower with stagnant standardization among the members and complicated vested interests in each domestic market. Fortunately, Japan has innovated the logistics system intensively during the so-

### Impact of Korea-US FTA on Surrounding Countries

Macroeconomic Impact	China	Japan	ASEAN	Australia	Canada
GDP (%)	-0.14	-0.1	-0.21	-0.14	-0.18
Exports (in millions of \$)	-0.18	-0.06	-0.16	-0.23	-0.16
Imports (in millions of \$)	-0.17	-0.1	-0.16	-0.24	-0.18
Output (in millions of \$)					
Grain	-39.46	21.13	-0.74	-32.59	8.71
Vegetables/Fruits	-24.6	-9.73	-21.23	-18.58	12.39
Other products	-23.85	-15.21	-25.95	-71.74	-12.18
Meat	-14.29	-3.73	-35.39	-73.86	-11.81
Processed food	-119.63	-66.49	-141.8	-128.47	-46.56
Manufacturing	-83.78	-334.52	-459.88	166.58	-585.27
TOTAL	-781.12	-867.36	-1241.7	-1031.71	-1237.45
Exports (change, %)					
Grain	-38.74	-6.41	1.17	-2.52	0.96
Vegetables/Fruits	-0.36	-0.31	-0.1	0.03	0.13
Other products	-8.44	-11.28	-1.98	-6.67	-1.63
Meat	-0.58	-9.45	-2.39	-2.21	-0.68
Processed food	-5.35	-3.6	-1.78	-2.37	-1.12
Manufacturing	0.01	-0.08	-0.12	0.26	-0.24
TOTAL	-0.17	-0.1	-0.16	-0.24	-0.18

Source : Korea Institute for International Economic Policy (KIEP)

called “lost decade” trying to survive under deflationary pressure, and productivity has been rapidly improved. Many logistic firms having close customer relationships with manufacturers started to invest heavily in China and ASEAN to make the production network even more sophisticated. Functional cooperation does not need political consensus, and positive impact can soon be realized. Japan’s option to continue the functionalism may be the one to characterize regional integration further.

A second option is to invite a more comprehensive, diplomatic context in choosing FTA partners. Virtually, the political logic is there already once Japan started to promote FTAs with Persian Gulf countries. However, the choice may be further complicated by initiating negotiations with Australia, potentially embracing the trade diversion effect in politically sensitive items such as Australian beef against US beef. Even before Japan’s first round of talks with Australia, the United States announced the so-called second “Armitage Report,” calling for a further deepened US-Japan alliance partly realized through a Japan-US FTA. Even upon

the traditional principle, as noted before, if KORUS is to have some negative trade impact on Japan in certain items such as digital TVs or LCD screens on which the 5% US tariff is to be abolished for South Korean exporters only, the defense logic may require more explanation in a diplomatic context to persuade the agriculture sector. Then, there may appear another question: whether the FTA should be functionally separated from diplomatic relations, relying simply on economic feasibility?

Ironically, while political relations have been so much complicated between Japan and China, they have shared the common value of keeping the centripetal force within East Asia, and the significance of functional cooperation to boost integration. However, as pointed out, KORUS has a chance to make the first centrifugal and political FTA in East Asia, and Japan and China may have to change their basic principles in responding to KORUS while managing and balancing other considerations. For geopolitical reasons, China is almost certain to increase pressure for a South Korea-China FTA, trying to clinch it earlier than a Japan-South

Korea FTA. In this situation, if Japan still tries to maintain its traditional functionalism, the possible choice may be to shake hands with China for the common value as mentioned before. However, this decision also needs political consensus, including geopolitical strategy against the Korean Peninsula, as well as defining the Japan-US alliance in East Asian regionalism clearly. After all, the time of pure functional approaches in East Asia may be ending, and the time of bureaucratic domination of FTA policy must end in Japan. Japan’s FTA policy has to go through a fundamental review if Japan is not to give up further real integration as the resource of her own growth. **JS**

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