

Formation of Economic Partnership Agreements –The Last Chance for Japan to Become a Regional Leader in East Asia –

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Rapidly Changing Economic Environment Surrounding Japan

In the late 1980s, when Japan's economy was growing rapidly, many observers anticipated that the 21st century would be Japan's century. Indeed, policy makers, business people and researchers in the recession-ridden United States attempted to learn from Japan's economic success, in order to achieve an economic recovery and not to be overtaken in economic terms by a dynamic Japan. In developing East Asia, Japanese companies, which were financially backed by good business performance in Japan, actively undertook foreign direct investment (FDI), contributing substantially to economic growth in the region. Japan's FDI brought not only financial capital to the region but also technology and management skills, which were considered highly efficient. The Japanese government contributed to economic growth in developing East Asia by distributing ample official development assistance (ODA). It may not be an overstatement to say that Japan played a leading role in making East Asia one of the most dynamic regions of the world in economic terms in the 1980s.

The situation changed dramatically in the 1990s. The bubble, which bloated the Japanese economy far beyond its actual size, burst in the early 1990s, resulting in a sharp decline in its growth rate. Mainly because of mismanagement of economic policy in dealing with the bursting of the bubble, Japanese economy has been in a long recession since then without a sign of recovery. By contrast, the U.S. economy registered a record-long economic boom from the early 1990s through the beginning of the 21st century, after successfully recovering from a recession. However, the U.S. economy slowed down in 2001 mainly because of the

collapse of the information technology (IT) bubble and terrorist attacks. Developing East Asian economies also performed superbly until they were suddenly struck by the financial crisis of the late 1990s. Despite some variations, many developing East Asian economies recovered from the crisis, but they have not yet recovered fully to regain their pre-crisis growth momentum. In the midst of rapidly changing developments, China has achieved steady and rapid growth since the early 1990s. Indeed, China has become a potential economic giant in Asia and in the world, overshadowing Japan's economic presence.

Recognizing the declining importance of Japan in East Asia and in the world in recent years, this article attempts to examine ways for Japan to reverse this trend and contribute to economic growth in East Asia.

Declining Importance of the Japanese Economy in the World and East Asia

The recent declining importance of the Japanese economy in the world and East Asian economies may be observed from various indicators. In terms of gross domestic product (GDP), Japan's share of world GDP declined from the peak of 18.2% in 1994 to 15.4% in 2000. The declining importance of Japan in East Asia is somewhat more striking, as Japan's share of East Asia's GDP declined from the peak of 78.3% in 1988 to 68.1% in 2000. The decline in Japan's share of East Asia's GDP reflects rapid expansion of GDP by developing East Asian economies. In particular, China (including Hong Kong) increased its share of East Asia's GDP from 9.6% in 1988 to 17.5% in 2000. A similar declining trend is observed in terms of foreign trade. Specifically, Japan's share of world

exports declined from a peak of 9.2% in 1986 to 6.8% in 2000, while its share of East Asia's exports declined from a peak of 59.6% in 1980 to 30.2% in 2000.

Reflecting the relative decline in its position in East Asia's GDP and trade, Japan became a less important trading partner for developing East Asian economies. Specifically, the share of imports from Japan in developing East Asia's overall imports declined from 22.1% in 1990 to 16.5% in 2001, and the share of exports to Japan in developing East Asia's overall exports also declined from 14.8% to 12.1% during the same period. By contrast, the corresponding shares of East Asia's imports from and exports to China increased from 8.1% and 5.5% to 9.8% and 9.2%, respectively, reflecting the rapid expansion of China's economy and trade.

Contrary to the declining importance of Japan for developing East Asia as a trading partner, developing East Asia has become an increasingly more important trading partner for Japan. Indeed, the share of exports to developing East Asia in Japan's overall exports increased from 29.8% in 1990 to 39.2% in 2001, and the corresponding share for Japan's overall imports also increased sharply from 29.8% to 42.3% during the same period. These findings indicate the increasing importance of sustainable economic growth in developing East Asia for achieving economic growth for Japan.

The Causes of the Decline in Japan's Competitiveness

The declining importance of the Japanese economy in East Asia and the rest of the world in recent years is attributable to various factors. A study conducted by the Japan Center for Economic Research examined the changes in the international competi-

Table Changing Competitiveness of the Japanese Economy

	1980	1990	2000
Overall	4	3	16
Internationalization	11	11	17
Financial sector	3	3	21
Corporate sector	2	3	13
Education	10	17	21
Government	10	4	7
Infrastructure	12	12	10
Science & technology	2	2	2
Information technology	—	—	14

Note: The figures indicate Japan's ranking among 31 countries.

Source: Japan Center for Economic Research

tiveness of 31 countries, Organization for Economic Cooperation and Development (OECD) countries and East Asian countries, by focusing on eight areas – science and technology, the corporate sector, the financial sector, the government sector, infrastructure, education, internationalization and IT. The analysis was conducted for 1980, 1990 and 2000. Japan's overall competitiveness declined dramatically from the fourth and third places in 1980 and 1990 respectively to 16th place in 2000. (cf. Table) Singapore was ranked first in 1980 and 1990, while Hong Kong was ranked first in 2000. The United States was ranked second in 1980 and 1990, and third in 2000.

Among the areas under study Japan performed very well in science and technology. Japan's private sector is active and competitive in research and development (R&D). By contrast, Japan's competitiveness is very low in education (21st), the financial sector (21st), and internationalization (17th). It should also be noted that the rankings in these categories dropped significantly in the 1990s, as Japan's rankings in education, the financial sector, and internationalization were higher in 1990 at 17th, 3rd and 11th, respectively.

An examination of the educational

attainments among developed countries reveals that the enrollment ratio in higher education is low in Japan. In particular, the enrollment ratio in graduate school is very low. Another important finding from the international comparison is that the number of students specializing in engineering and the natural sciences is low in Japan when compared to such countries as South Korea, China, Hong Kong and the United Kingdom. These findings indicate that the good educational system with an emphasis in engineering and the natural sciences that contributed to the creation of the competitive Japanese economy has become mediocre in recent years. The English proficiency of the Japanese is very poor. In terms of average Test of English as a Foreign Language (TOEFL) scores, Japan has one of the lowest rankings in the world. In a rapidly globalizing world, where English is used as the world language, English proficiency is critical in obtaining useful information for the promotion of economic growth. Recognizing that it does not take long for the quality of education to deteriorate while it takes a long time to rebuild a good educational system, Japan cannot lose any time to start rebuilding its educational

system.

We do not need to explain much about the lack of competitiveness of the Japanese financial sector, which is largely attributable to the worsening of the non-performing loan (NPL) problem. The problem of NPLs is rooted in excessive lending by banks during the bubble economy period based on an expectation that the value of land, which is used as collateral for lending, would continue to rise in the future. A collapse of the bubble in the early 1990s made it difficult for the borrowers to make payments. Commercial banks with a weak asset position due to an increasing amount of NPLs have been hesitant in making new loans. Realizing that an adequate supply of funds from the financial sector is necessary to support economic activities, a speedy resolution of the financial problem is necessary for the Japanese economy to get back on a sustainable economic growth path. It should be emphasized that the resolution of financial problems requires refurbishing not only of the financial sector, or the lenders, but also the corporate sector, or the borrowers.

Japan's ranking in internationalization dropped in the 1990s. Internationalization may be looked at from two perspectives – external and internal. External perspectives refer to outgoing activities by the Japanese, while internal perspectives refer to incoming activities by foreigners. Specifically, exports and outflow of FDI are examples of internationalization from external perspectives, while imports and inflow of FDI are examples of internationalization from internal perspectives. Looking at internationalization from these two perspectives, Japan is particularly lagging behind in internationalization from internal perspectives.

As a result of a series of multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT) in the post World War II period, import restrictions in Japan have been reduced substantially. Indeed, the average import tariff rate for Japan is one of the lowest in the world. Formal barriers to FDI inflows have been

reduced as well, as a result of international commitment to the OECD and also as a result of strong pressure from foreign countries, especially from the United States. Despite a substantial reduction in trade and FDI barriers, there still remain various barriers to imports and FDI inflows to Japan. Some of them include non-tariff barriers (NTBs) such as regulations on product quality and safety and exclusive business practices such as tacit collusion behavior. One should realize that a lack of competitiveness in education and in the financial sector, which were discussed above, has much to do with the fact that these areas are closed to foreign competition.

Japan's economy will have to be revitalized for the country to regain its regional leadership in East Asia. In this section we have identified several critical problems including weakness in the educational system and financial sector and a closed economic system to foreigners, which have to be resolved in order for the Japanese economy to recover from the long recession and to become competitive again. In order to deal with these problems, deregulation and liberalization of the Japanese domestic market have to be carried out. Specifically, speedy implementation of policy reforms such as restructuring of the financial and corporate sectors, and deregulation in various areas including education, and import liberalization of goods and service markets such as agricultural goods and transportation services will have to be carried out.

Formation of Economic Partnership Agreements: A Key for Japan to Become a Regional Leader

Japan has to contribute to the economic growth and improvement of peoples' lives in East Asia, in order to become a regional leader. To achieve this objective, Japan has to recover from the long recession and regain dynamism. In addition, Japan has to become a country that developing East Asian economies can look up to in many points. Specifically, high living standards have to be achieved not just

in quantitative terms such as high incomes but also in qualitative terms such as an environmentally friendly lifestyle. An efficient and open system has to be constructed in many areas including education, finance, distribution, transportation and communications services. Furthermore, Japan has to contribute to the betterment of the economic situation of its East Asian neighbors not only by providing economic and technical assistance but also by accepting goods, funds, people and information from developing East Asia. Indeed, Japan has to construct two-way relationships, that is give and take relationships, with developing East Asia to obtain mutual benefits.

The formation of economic partnership agreements (EPAs) with developing East Asian economies is a very effective way of achieving these objectives for Japan. EPAs should include not only trade and FDI liberalization and facilitation but also economic and technical assistance. Thus they are beyond free trade agreements (FTAs), which have been concluded by many countries in recent years. Inclusion of economic and technical assistance is very important for deepening economic partnership in East Asia, because the region consists of many developing countries that need such assistance.

One good example of an EPA is the Japan-Singapore Economic Partnership Agreement (JSEPA), which was signed by Japanese Prime Minister Koizumi Jun-ichiro and Singaporean Prime Minister Goh Chok Tong in January 2002, and was enacted in late November of the same year. The main objectives of JSEPA include the promotion of economic growth by expanding trade and investment, and the development of a closer political and social relationship between the two countries. Under JSEPA, Japan and Singapore agreed to liberalize trade in goods and services and liberalize FDI. More specifically, Singapore agreed to remove all tariffs on imports from Japan, while Japan agreed to remove tariffs on all imports from Singapore with a few exceptions, including some agricultural and petrochemical prod-

ucts. JSEPA includes trade facilitation measures to deal with NTBs such as inefficient customs procedures and differences in technical standards. As for service trade, Japan and Singapore agreed to expand the areas of liberalization beyond their commitments made under the General Agreement on Trade in Services (GATS). Concerning FDI liberalization, JSEPA is ambitious in that Japanese and Singaporean firms are granted national treatment or no discrimination in their partner countries. In addition to trade and FDI liberalization and facilitation, many cooperation programs, which would promote economic and social exchanges between the two countries, are being implemented. For example, JSEPA permits the international movement of professionals including medical doctors, and it includes cooperation in various areas such as information technology, science and technology, and human resource development. The coverage of JSEPA is very comprehensive compared to other regional arrangements such as the Association of South-East Asian Nations (ASEAN) Free Trade Area (AFTA). As such, JSEPA can serve as a model for future regional agreements in the region.

We can expect various favorable impacts from EPAs on their members. EPAs with FTAs provide companies with access to the markets of the member countries. Trade and FDI liberalization and facilitation could play a catalytic role in carrying out policy reforms, which are very important for economic recovery but very difficult to carry out by simply relying on internal forces. Inflows of foreign products and foreign firms resulting from trade and FDI liberalization and facilitation improve the efficiency of domestic firms through increased competitive pressures. Trade and FDI liberalization under EPAs is particularly important when multilateral trade negotiations under the World Trade Organization (WTO) are facing difficulty because of its enlarged membership and the emergence of complex issues. Cooperation programs are expected to improve the quality of human resources, technical

capability, and deepen mutual understanding regarding society and culture. In sum, we can expect EPAs to contribute not only to economic growth but also the betterment of social and cultural aspects of our lives.

Japan's EPA Strategies in East Asia

We argued in the previous section that the formation of EPAs would be an effective policy for Japan and its East Asian neighbors to achieve economic growth, which would in turn contribute to political and social stability in the region. Japan has to take the initiative in formulating and implementing EPAs with developing East Asian economies in order to become a leader in the region. However, Japan will have to overcome various obstacles to achieve this goal.

One of the major obstacles for Japan in forming EPAs is to remove or reduce import protection in sensitive sectors, most notably agriculture. Japan's agricultural sector has been protected for several reasons. Some argue that agriculture serves many useful purposes for the Japanese economy and society such as maintaining the natural environment and traditional culture. Some also argue that domestic agricultural production is necessary for ensuring a stable supply of food, or food security. Import protection may serve these purposes, but it has to be emphasized that import protection is a very costly way of achieving these objectives.

It is also important to point out that import protection may not achieve these objectives. Indeed, contrary to policy makers' expectations, import protection of the agricultural sector has contributed to a loss of dynamism, as a lukewarmly protected environment has discouraged young and ambitious people from engaging in agriculture. This unexpected impact of agricultural protection has contributed to a decline of the agricultural sector. To be sure, there are better policies to achieve these objectives in terms of cost and effectiveness. For example, in the case of food security, diversification of food supply sources is much more effective

than import protection.

Even if there are proper reasons for protecting the agricultural sector in Japan, it is still a huge obstacle to the formation of EPAs involving Japan for at least two reasons. First, the countries that are interested in forming EPAs with Japan are keen on exporting agricultural products to Japan. Accordingly, Japan cannot form EPAs if Japan refuses to liberalize its agricultural markets. Second, GATT Article XXIV stipulates that substantially all trade has to be liberalized under FTAs which are part of EPAs. Exclusion of agricultural trade from EPAs is likely to violate the GATT/WTO rule.

Liberalization of agricultural imports is not the only area of contention. Other sectors that are against liberalization include many service sectors such as finance and transportation. Strong resistance exists against international labor mobility. Specifically, the Philippines is interested in sending nurses to Japan under an EPA, but strong resistance from Japanese nurses makes such an arrangement difficult.

To deal with liberalization issues, we have to realize that in the rapidly globalizing economic environment and in the age of the IT revolution, free international and internal movement of goods, people, money and information is a prerequisite to achieving a competitive and attractive economy. Based on this recognition, we should use EPAs to liberalize Japanese markets and to make the Japanese economy competitive and attractive. To reduce the adjustment costs such as unemployment resulting from liberalization, sensitive sectors may be warranted extra time and economic assistance. Even when extra time is given, it is important to set a timetable and to carry out liberalization on schedule. Finally, it should be emphasized that domestic policy reforms such as the deregulation and restructuring of the financial sector have to be carried out in tandem with liberalization of external policies under EPAs.

In the formation of EPAs, an important agenda for Japanese policy makers is a choice of countries for them. Japan

has already an EPA with Singapore. Japan has officially begun studying the possibility of EPAs with South Korea, and an official study on EPAs with ASEAN is scheduled to begin soon. Japan should conclude EPAs with South Korea and ASEAN countries as quickly as possible, so that Japan's relationships with these countries will deepen to reap mutual benefits. China has proposed an FTA with Japan, but Japan has not responded positively to the proposition. Considering that China has joined the WTO only recently and it has to implement a number of commitments that were made upon WTO entry, it is appropriate for Japan to monitor how China liberalizes its trade regime before discussing the possibility of an EPA with China. Having said this, Japan has to study the possible impacts of an EPA with China, in order to formulate Japan's EPA strategy in East Asia.

Regional economic integration in East Asia, which can contribute significantly to the region's prosperity, cannot be completed before all the economies become members. Having argued the importance of regional economic integration, we should keep in mind the importance of achieving global free trade and an FDI environment to maximize global economic welfare. In this regard, Japan and developing East Asian economies will have to contribute to successful multilateral trade negotiations under the WTO. **UJI**

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* Unless otherwise noted, in this article, developing East Asia is used to mean a group consisting of ASEAN countries, Newly Industrializing Economies (South Korea, Hong Kong and Taiwan) and China, while East Asia is used to mean developing East Asia and Japan.

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