

FTAs and Japan

By *Kimura Fukunari*

The Full-Scale Proliferation of FTAs

The forging of free trade agreements (FTAs) has finally been initiated in East Asia, which, in this respect, had been lagging far behind Europe and Central and South America. Japan completed its first FTA (Japan-Singapore Economic Partnership Agreement: JSEPA) in January 2002 (effective November 2002). The negotiations with Mexico stagnated for a while before an agreement was finally reached in March 2004. Negotiations with South Korea commenced in December 2003, and the concept of an East Asian Community was brought forth at a special Japan-Association of Southeast Asian Nations (ASEAN) commemorative summit. In addition, negotiations were started with the governments of Thailand, the Philippines and Malaysia in January and February 2004. China, Thailand and Singapore have also begun taking proactive steps toward the conclusion of FTAs. The trade policy map of East Asia is being radically redrawn.

Following World War II, Europe provided a model for regional economic integration. But at present, most FTAs being established in areas around the world are vastly different from the European Union (EU) model.

The political agenda tools associated with "Free Trade Areas," as defined by the General Agreement on Tariffs and Trade (GATT), are more easily wielded by government decision makers, compared to the free trade endorsed by the World Trade Organization (WTO) or "customs unions" such as the EU. The first advantage of Free Trade Areas is speed. Provided the participating countries can come to an agreement, they can be concluded without delay. This feature is in contrast with WTO round negotiations, which take time and effort. The second advantage is scope. As long as Free Trade Areas do not violate the

provisions of the GATT and WTO agendas, they can include a wide range of content. Sequential flexibility is the third advantage. Unlike customs unions, countries participating in Free Trade Areas need not standardize their tariffs with respect to those countries not included in the agreements. Accordingly, even if a country already has an existing trade agreement with one country, a second agreement with another country would not necessitate modifications to the first agreement, and the new Free Trade Area can be created on an entirely different time schedule.

Of course, there is a price to be paid for this type of convenience. Free Trade Areas differ from multilateral liberalization and are discriminatory. And, unlike customs unions, the rule of origin is made ever more complex (known as the "spaghetti bowl" phenomenon; more on that later) with the increase in Free Trade Areas. These come into play and translate into costs. But because they are easily employed, regional integration in many parts of the world, with the exception of the EU, has taken the form of Free Trade Areas.

Motivation to Finalize FTAs

Unlike the past European model, many FTAs established after 1990 pair developed countries with developing countries. Moreover, in many agreements, it is the developing country that bears a heavier burden of duties. At a glance, this arrangement appears unilateral, so why then do developing countries aggressively seek FTAs?

The main reason, until now, was securing access to the markets of developed countries. But unlike the era of pre-World War II block economies, the abolition of tariffs by developed countries is rather advanced under GATT Round negotiations. Trade barriers vital to developing countries against agricultural goods, textile products and the like

undoubtedly remain, and relaxing and abolishing them is also important. However, this eradication carries the likely possibility that the effects will be only static, and a dramatic effect on the growth track of developing countries cannot be anticipated.

What developing countries are seeking, above all, is direct investment from developed countries. If the FTA can facilitate inward direct investment, a tremendous dynamic economic effect can be achieved. For example, let's say the forging of an FTA results in annual inward direct investment growth of just 2% of a developing country's GDP. If we were to consider the direct investment simply as capital inflow and assume an incremental capital output ratio (ICOR) of 4, the economic growth rate of that developing country could be accelerated by 0.5% annually. Of course, whether direct investment impedes or triggers domestic investment is a subject of ongoing debate. However, if we were to think of direct investment as the key to obtaining technology, management know-how and access to foreign markets all at once, we could expect a substantial dynamic economic effect in excess of the estimate presented above.

When FTAs are formed with complexities akin to a finely knotted net, it is believed that non-participants will pay dearly as a result of their exclusion. In this case, it is not the changed flow of goods, but rather the modified patterns of direct investment that are important. At present, developing countries are engaged in competition to be geographically superior so they can invite direct investment. Establishing many FTAs and becoming an FTA hub enhances a country's chances of gaining direct investment. Developing countries perceive a sense of urgency and are hastily trying to conclude FTAs in an effort to avoid being left behind in the surge toward globalization.

Whenever a developed country is left out of economic integration, there arises the threat that processes ranging from production through distribution will be transferred overseas and a domestic hollowing effect will result. The formation of FTAs to aid companies' international expansion while retaining what should remain in the country, is what developed countries should consider in the way of FTA strategies.

Dimensions and Development Strategies of the East Asian Economy

As far as integration is concerned, East Asia is lagging in terms of a political agenda, but as far as integration of the actual economy is concerned, it is, in fact, advanced. It is especially notable with regard to the post-1990 building of international production and distribution networks.

Production and distribution networks span many industries, but the machine industry, including the general, electrical, transportation and precision machineries, is foremost. Nowadays, machinery constitutes over half of all products exported from East Asian countries, and machine parts and intermediate goods make up approximately one-third. The production and distribution networks of East Asia are unprecedented in terms of economic value in the countries of their respective areas, participation by countries of varying income levels and sophistication of transactions, both within companies and between companies. Similar networks exist between the United States and Mexico, as well as among Germany, the Czech Republic and Hungary, but neither of these networks is of the same scale as the networks of East Asia.

The establishment of international production and distribution networks is playing a role in forming the concept of "East Asia" as an economic integration



The concept of an East Asian Community was discussed at a special Japan-ASEAN commemorative summit

unit. The economic integration of the ASEAN Plus Three is being furthered without the explicit coordination of the countries within the area. However, the ultimate goal of integrating the overall area is implicitly understood by all of the area's countries. This is particularly gratifying in light of East Asia's historical background. Since the Asian currency crisis, the United States has also become tolerant of activities on the part of East Asia to promote integration.

In general, the motivation for developing countries to conclude FTAs is, above all, the prospect of direct investment, but East Asian developing countries have been particularly aggressive in their response to direct investment. The key task will be to revise development

strategies in order to make direct investment more effective by linking it to economic development.

The countries of East Asia have adopted dual-track development strategies to concurrently cultivate their import-substitution industries and export-oriented industries. Since the late 1980s, East Asian countries have focused on export-oriented industries to reduce the service-link costs associated with dispersal locations, and have promoted the accumulation of industry. But now the protection costs involved with import-substitution industries have become widely recognized. Furthermore, the countries of Southeast Asia, which are competing for geographic desirability with China, need to boost the advantages distin-

Photo: Kyodo News



Japan and Mexico agreed in March 2004 to conclude an FTA in principle: (from left) Agriculture Minister Kamei Yoshiyuki, Foreign Minister Kawaguchi Yoriko and Minister of Economy, Trade and Industry Nakagawa Shoichi

guishing their locations in the interest of attracting direct investment.

One issue is the reorganization of import-substitution industries. Although import substitution, which includes trade protection, has been attempted in the automobile, electrical appliance, and iron and steel sectors with additional aid in the form of foreign capital, efforts will be made to rearrange industries across borders to take advantage of the tariff abolishment prompted by FTAs.

The other issue is the intensified activation of international production and distribution networks. Here, the abolition of tariffs is insufficient. There is a need to insert dedicated East Asian agenda items, such as trade and investment facilitation, institutional building and conflict resolution, into the FTA.

■ Impact on the Japanese Economy

The forging of an East Asian FTA is likely to have a profound impact on the Japanese economy.

Throughout the past 40 years, East Asia has continued to be one of the world's growth centers. A decrease in Japan's potential growth rate may be inevitable given the country's already high level of income, but Japan must also create a vital economic society, while tapping into East Asia's dynamic energy. The improvement of East Asia's

business environment is imperative for this reason.

FTAs establish mutual rights and obligations on the basis of international agreements, and are substantially more binding than the Organization for Economic Cooperation and Development (OECD) and Asia-Pacific Economic Cooperation (APEC)-grounded agreements. Moreover, it is possible to insert various features besides the abolition of tariffs and even to have a commitment to changes in the domestic policy of a partner country. As a developed country, Japan must recognize its role in the strict discipline of the economic and social policies of East Asian countries.

The JSEPA concluded with Singapore covers a considerably wide scope of topics, and when establishing FTAs with other Southeast Asian countries, further enhancement of its contents will be necessary. Though the FTAs recently forged by the United States with Singapore and Chile can also serve as references, additional contents that reflect the characteristics of the East Asian economy are needed.

Specifically, over and above the free trade in goods and services, FTAs should emulate the JSEPA by including investment agreements to assure transparency in investment-related policies, and the principle of non-discrimination. Fundamental principles must be

enforced, even if exceptions are allowed with respect to equal national treatment prior to investment and certain performance requirements.

System building for both certification in various standards and intellectual property rights, which were deficient in the JSEPA, should be included by all means. This is absolutely essential in light of the possibility of future FTA negotiations with China. In some cases, cooperation aimed at capacity building for the purpose of enforcement will be necessary.

Additionally, although it may not be possible to incorporate all the items into the FTA mainframe, issues pertaining to trade and investment facilitation can be remedied, and systems of resolution can be included for problems arising between companies and nations.

Unlike other developing areas, local companies are undergoing rapid growth in East Asia. This trend is particularly discernible in China. Providing international public property, namely a favorable business environment, while the technical superiority of Japanese companies is clearly evident, should be highly profitable for companies both within and outside of the area. It should also result in improved welfare for the people of East Asia.

■ Opening of the Japanese Market

It is said that agricultural problems are hurdles that must be overcome in order for Japan to establish FTAs. This problem should be divided into three parts for the purpose of discussion.

The first issue is whether a multilateral policy discipline can be fulfilled. Article XXIV of GATT and the "Understanding on the Interpretation of Article XXIV of GATT 1994," stipulate that tariffs and other restrictive trade laws that apply to "substantially all the trade" in free trade areas and customs unions, should be abolished within a "reasonable length of time (10 years)." The precise definition of "substantially all the trade" does not exist. However, if we were to conform to EU documents,

over 90% of all trade would have to be completely free of restrictions, and the creation of specific areas that are exempt from liberalization would be prohibited.

This 90% rule alone would not be very difficult to adhere to, but for an FTA with Thailand, the negotiations are expected to be problematic, as Japan's agricultural, forest and fishery product import ratios exceed 20%. However, the same import ratios with respect to South Korea, the Philippines and Malaysia are roughly 10%, and several of the products are subject to low tariff rates. Liberalization of those products through political resolve should suffice.

The second topic is whether a counterpart nation can be satisfied with the concessions extended by Japan and negotiations can reach completion. Additionally, whether those terms will be a contentious point in negotiations in other areas is an issue. Because the countries of East Asia are eagerly seeking an FTA with Japan, the talks are not likely to be stalled, as was the case with the Mexico. However, there are concerns over how effectively Japan can obtain concessions without exposing its weaknesses.

The third topic is Japan's ability to aggressively promote its own interests and establish an FTA benefiting its domestic structural reform. The ratio of Japan's agriculture, forestry and fisheries industries to GDP has decreased by just over 1%, so agricultural problems have already ceased to be a major issue in view of the overall national economy. However, exceedingly high trade barriers on certain products and the subsequent long-term burden they place on the national economy are by no means desirable. The essential issue that should precede any discussion on the subject of compensation is the presentation of a lucid reform plan.

The Philippines and Thailand are requesting the acceptance of nurses, care persons and masseurs. At present, WTO disciplines do not address the subject of transferring human beings, but the second and third points described above almost directly apply. Considering the

income disparities between East Asian countries, the liberalization of labor movements as in Europe is out of the question for the time being. But accepting foreign labor, with certain limitations on types of businesses and lengths of stay, is worthy of deliberation. Acceptance of foreign labor is also likely to have a positive and encouraging effect on domestic structural reform.

■ Japan's Tasks

It is not an overstatement to say that the basic design of the East Asian FTA has been assigned to Japan.

The first thing that needs to be done is to take the lead in promoting high-quality FTAs. The quality referred to here demands a high degree of liberalization as well as a wide scope. The ASEAN Free Trade Area (AFTA) and the China-ASEAN FTA are pacts binding developing countries, and because they are objects of "enabled clause," a high-level of liberalizing disciplines cannot be expected. The scope must be, for the most part, limited to trade in goods. Japan will take the lead as far as the East Asia FTA's contents are concerned.

Secondly, in the interest of achieving uncomplicated integration of the overall area in the future, the contents should be conscientiously conceived when bilateral FTAs are forged with various countries. The road map leading to an FTA encompassing the overall area has not yet been drawn, but an agreement consisting of a commonly shared format and contents is desirable to the furthest possible extent.

In principle, custom unions, in which member countries standardize their trade barriers with respect to all regions outside the area, can abolish borderlines between the countries within the area and allow for the free transfer of goods. However, in the case of Free Trade Areas, certifications of origin are requisite at all times, even when multiple network FTAs are established, in order to prevent external products from entering through countries with relatively low barriers. If differing rules of origin are

applied to each respective bilateral FTA, an extremely complicated system will administer the trading of goods within the area, and ultimately, there is even the risk that goods will not be able to move freely. This effect is referred to as the "spaghetti bowl" phenomenon. To avoid this, a system for the certification of origins, such as one that incorporates changes in tariff classification and added-value standards, should be integrated wherever possible, and the development of a system for issuing simple certificates of origin is needed. In addition, because generally high trade barriers against the countries outside the area are responsible for these issues, it is important to sustain efforts to achieve multi-based liberalization, as well as integration, that are externally accessible.

Thirdly, in order to realize the most thorough integration possible, Japan should not pursue trade policy independently, but rather, should enhance coordination with other areas of policy, including security, international finance and currency exchange, energy and the environment, and economic cooperation. The reorganization of economic cooperation with East Asia is a particularly urgent task. Support for South Asia and sub-Saharan Africa, and economic cooperation with East Asia, are vastly different in terms of both character and purpose. Economic cooperation with East Asia must be reorganized with the promotion of economic integration as a primary objective, and without regard for the link between income level and concessionarities. Drastic reorganization focusing on the advancement of local small and medium-sized enterprises, capacity building for the integration, and consideration for countries whose entry into ASEAN was delayed, will be necessary.

In terms of economic cooperation in East Asia, the next few years will be crucial. **JS**

Kimura Fukunari is a professor at the Faculty of Economics, Keio University. He specializes in the theory of international trade and development economics.