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Research Report

The US-Japan trade deal: Narrow scope, wider implications

Kiel Policy Brief, No. 131

Provided in Cooperation with:

Kiel Institute for the World Economy – Leibniz Center for Research on Global Economic Challenges

Suggested Citation: Chowdhry, Sonali; Felbermayr, Gabriel; Okubo, Toshihiro (2019) : The US-Japan trade deal: Narrow scope, wider implications, Kiel Policy Brief, No. 131, Kiel Institute for the World Economy (IfW), Kiel

This Version is available at:

<https://hdl.handle.net/10419/210648>

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KIEL POLICY BRIEF

Sonali Chowdhry, Gabriel Felbermayr, and Toshihiro Okubo

The US–Japan Trade Deal: Narrow Scope, Wider Implications

No. 131 December 2019

- The US–Japan Trade Agreement is unlikely to meet the ‘substantially all the trade’ criterion of GATT Article XXIV since the scope of tariff liberalization is very narrow. The US and Japan have agreed to liberalize just 3.4% and 10% of tariff lines with positive MFN duties, respectively.
- Key sectors for US exports to Japan such as machinery and instruments are not liberalized under the agreement. Though the market access offered to specific US agri-food products is similar to Japan’s commitments under the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), Japan has not ‘rolled over’ the entire CPTPP schedule for the US.
- Tariff concessions are asymmetric and indicate the relative disadvantage with which Japan entered into bilateral negotiations with the US.
- Overall, the market access gained by Japan from this deal is highly circumscribed in comparison to the recently implemented EU–Japan Economic Partnership Agreement.

OVERVIEW/ ÜBERBLICK

- The US–Japan Trade Agreement is unlikely to meet the ‘substantially all the trade’ criterion of GATT Article XXIV since the scope of tariff liberalization is very narrow. The US and Japan have agreed to liberalize just 3.4% and 10% of tariff lines with positive MFN duties, respectively.
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- Tariff concessions are asymmetric and indicate the relative disadvantage with which Japan entered into bilateral negotiations with the US.
- Overall, the market access gained by Japan from this deal is highly circumscribed in comparison to the recently implemented EU–Japan Economic Partnership Agreement.

Keywords: International Trade; US-Japan Relationship; Trade Deal; Tariffs; GATT

- Es ist unwahrscheinlich, dass das Handelsabkommen zwischen den USA und Japan das Kriterium des „im Wesentlichen vollständigen Handels“ des Artikels XXIV des GATT erfüllt, da der Umfang der Zollliberalisierung sehr begrenzt ist. Die USA und Japan haben sich darauf geeinigt, nur 3,4 % bzw. 10 % der Zollpositionen mit positiven MFN-Zöllen zu liberalisieren.
- Schlüsselsektoren für US-Exporte nach Japan, wie Maschinen und Instrumente, werden im Rahmen des Abkommens nicht liberalisiert. Obwohl der angebotene Marktzugang für bestimmte US-amerikanische Agrarerzeugnisse den Verpflichtungen Japans im Rahmen des „umfassenden und progressiven Abkommens über die Trans-Pazifische Partnerschaft“ (CPTPP) ähnelt, hat Japan nicht den gesamten CPTPP-Plan auf die USA übertragen.
- Die Zollzugeständnisse sind asymmetrisch und spiegeln die vergleichsweise schwache Position wider, aus der Japan die bilateralen Verhandlungen mit den USA aufgenommen hat.
- Insgesamt ist der Marktzugang, den die USA Japan auf Grundlage dieses Abkommens gewähren, im Vergleich zum kürzlich umgesetzten Partnerschaftsabkommen EU-Japan stark begrenzt.

Schlüsselwörter: Internationaler Handel; Beziehungen USA und Japan; Handelsabkommen; Zölle; GATT

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THE US–JAPAN TRADE DEAL: NARROW SCOPE, WIDER IMPLICATIONS

Sonali Chowdhry, Gabriel Felbermayr, and Toshihiro Okubo

On 25th September 2019, the US and Japan announced an ‘early harvest’ trade agreement, easing tensions between these two economies that currently account for nearly 30% of global GDP. The two-part deal consists of the US–Japan Trade Agreement and the US–Japan Digital Trade Agreement. Both have now been approved by the lower and upper houses of the Japanese National Diet where the ruling coalition led by the Liberal Democratic Party holds majorities. On the US side, the Trump Administration intends to use the Trade Promotion Authority (TPA) legislation to enact the commitments, without formal involvement of the Congress. Given this state of play, the agreements could enter into force in January 2020 and are expected to pave the path towards a more comprehensive FTA in the future.

The deal sends an important signal that Japan is willing to accommodate requests by the US in order to avoid a protracted trade conflict. Moreover, it comes at point in time when the Sino-American trade war is still largely unresolved and Japan finds itself in a severe trade tussle with neighboring South Korea. However, the very narrow scope of this agreement has raised pressing questions on whether it is consistent with GATT Article XXIV that carves out an exception to the WTO’s ‘Most-Favored Nation’ principle. This article enables countries to enter into regional trade agreements but requires them to eliminate duties and other restrictive regulations on commerce for ‘substantially all the trade’ among constituent members. It does allow countries to sign an interim agreement on tariffs, provided that they have a ‘plan and schedule’ for concluding a final deal. Does the US–Japan trade agreement meet these criteria? To address this policy question, in Chapter 1 we characterize the structure of US–Japan trade and investment ties. In Chapter 2 we undertake a careful analysis of tariff-related commitments. Finally, in Chapter 3 we reflect on the implications of such ‘mini deals’ for the EU’s external trade strategy going forward.

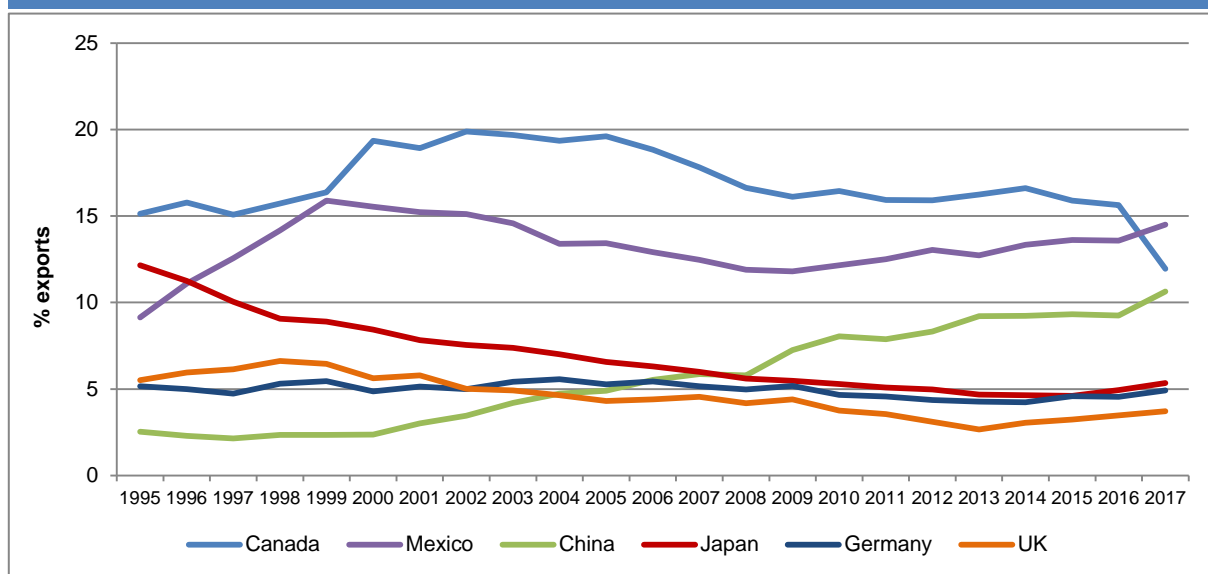
1 US–JAPAN TRADE AND INVESTMENT: DESCRIPTIVE EVIDENCE

1.1 EXPORT SHARES

Japan’s share in US goods exports has declined steadily from 12.2% in 1995 to 5.3% in 2017. One major factor underlying this trend is the rising importance of China. Over the same period, China’s share in US goods exports grew from 2.5% to 10.6%. In 2018, China was the third-largest export destination and the largest source of imports for the US. On the Japanese

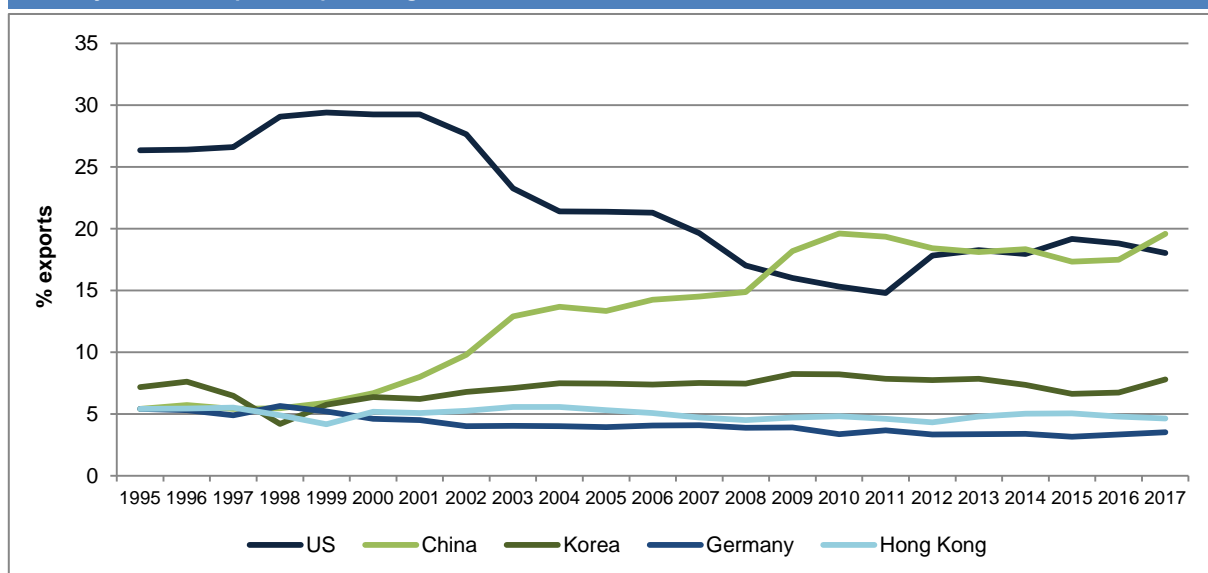
side, the share of US in Japan's goods exports has declined from 26.4% to 18%, coupled with an increase in China's share from 5.4% to 19.6%. Given the combined market size of the US and Japan's economies, this downward trajectory of shares in export baskets might reflect unfulfilled trade potential and should be of bilateral concern (Figures 1–2).

Figure 1:
Country shares in US exports of goods, 1995–2017



Source: BACI Database; authors' own calculations.

Figure 2:
Country shares in Japan's exports of goods, 1995–2017

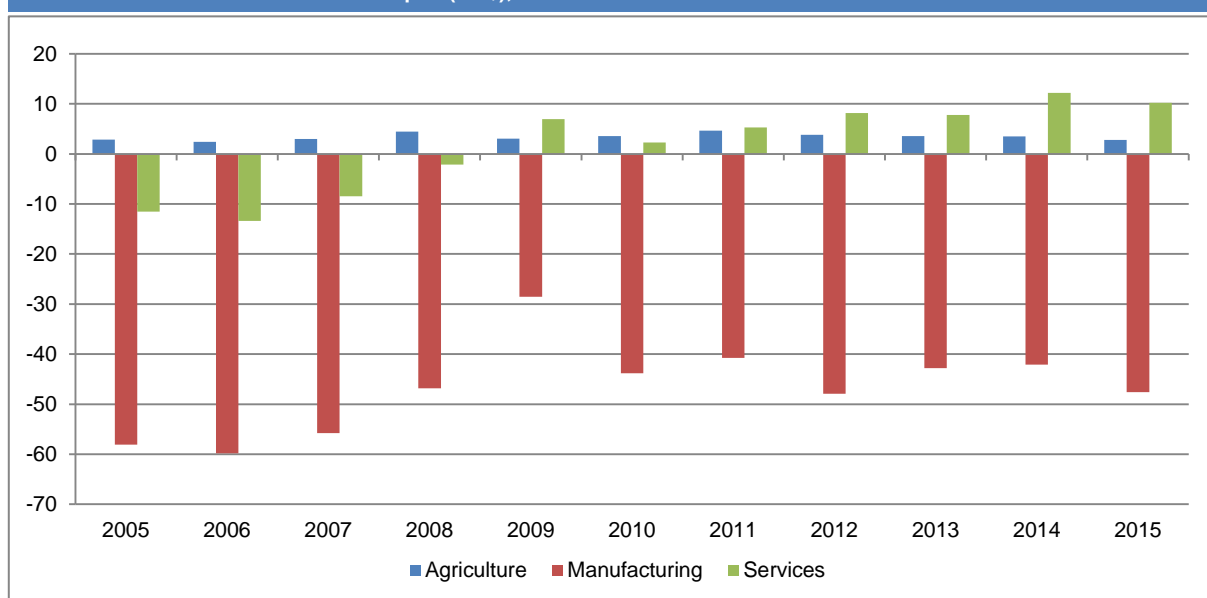


Source: BACI Database; authors' own calculations.

1.2 TRADE BALANCES

In 2018, the US exported \$75.9 billion in goods and \$45.2 billion in services to Japan. On the import side, the US purchased nearly \$144.4 billion in goods and \$34.7 billion in services from Japan¹. The implied total trade deficit of nearly \$58 billion in gross terms has been a source of trade tensions between the countries. However, these gross estimates don't fully capture the role of cross-border trade in intermediate goods. We therefore examine the US trade deficit in value added terms using the OECD's Trade in Value Added (TiVA) database that provides statistics from 2005 to 2015. In 2015, the value added trade deficit of US with Japan amounted to \$33.3 billion, higher than the gross deficit of \$26.4 billion. Breaking down by sector, the value added deficit is consistently driven by the manufacturing industry since high shares of US imports from Japan are in transportation (44%) and machine goods (32%). Besides Japan, the current US administration has also targeted trade deficits with other major partners such as Canada, Mexico, China and the EU under its 'America First' strategy. Comparing value added deficits with these partners over time, we observe that the US deficit with Japan approximately halved from 2005 to 2015, in contrast to China and the EU with whom the deficits have steadily widened since 2009. The declining deficit with Japan may be the result of strategic choices made by many Japanese firms, partly due to pressure exerted by Washington over decades, to move production to the US and benefit from NAFTA preferences (Figures 3–4).

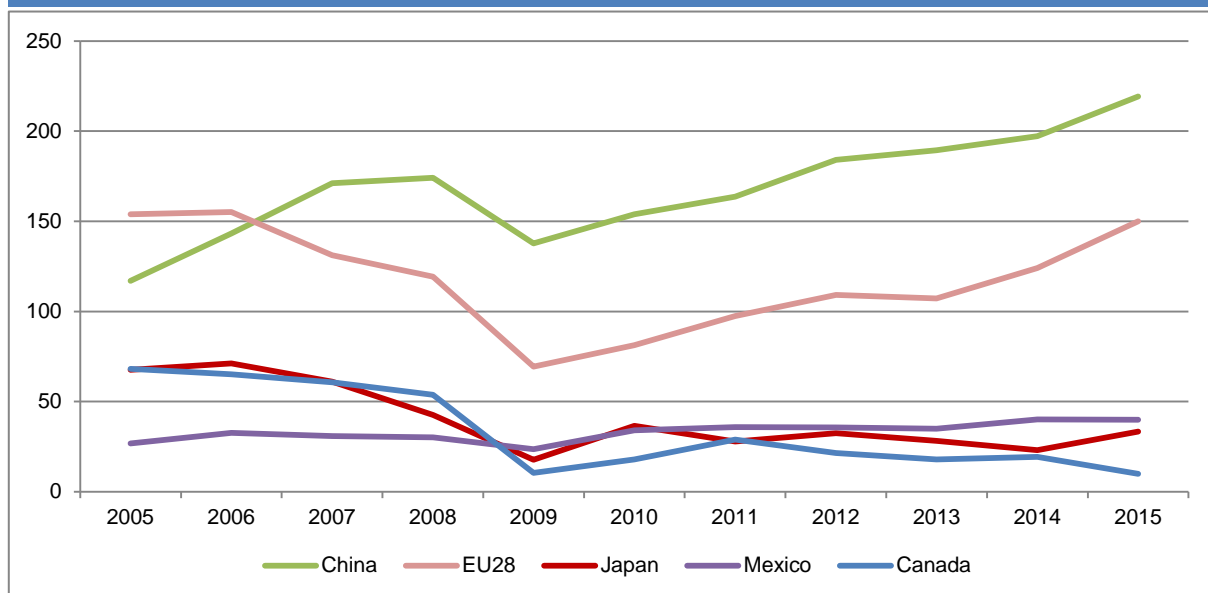
Figure 3:
US value added trade balance with Japan (bn \$), 2005–2015



Source: OECD Trade in Value Added Database; authors' own illustration.

¹ Statistics from the Japan Factsheet published by the US Bureau of Economic Analysis.

Figure 4:
US value added trade deficits (bn \$), 2005–2015

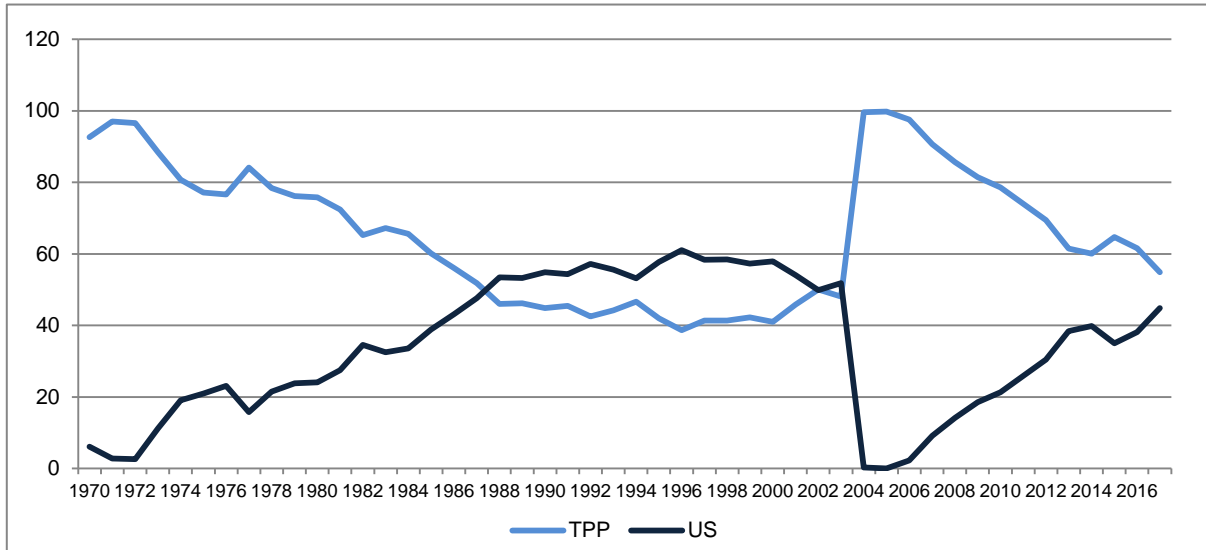


Source: OECD Trade in Value Added Database; authors' own illustration.

1.3 AGRI-FOOD TRADE

Under the new agreement, the US sought to liberalize Japan's relatively protected agri-food sector which has an average applied MFN rate of 15.7%. This was a pressing policy issue since Japan has already provided preferential market access for agriculture to EU member states (since February 2019) and CPTPP countries (since January 2019). In key products such as bovine meat, pig meat and soybeans, US exporters to Japan face tough competition from these alternate suppliers (as seen in Figures 5–7) and would be at a significant disadvantage in the absence of preferential tariffs.

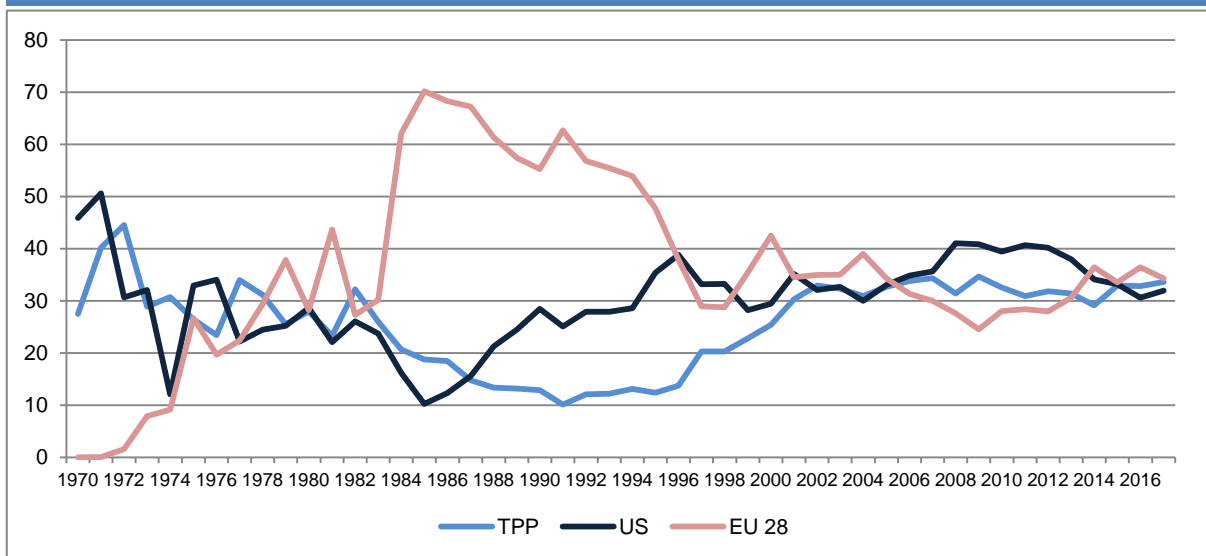
Figure 5:
Share in Japan's bovine meat imports, 1970–2016



Note: The strong movements in bovine meat imports reflect the trade restrictions imposed by Japan on US beef producers in response to the mad cow disease being confirmed in 2003. In May 2019, Japan agreed to remove the longstanding age limit for US beef.

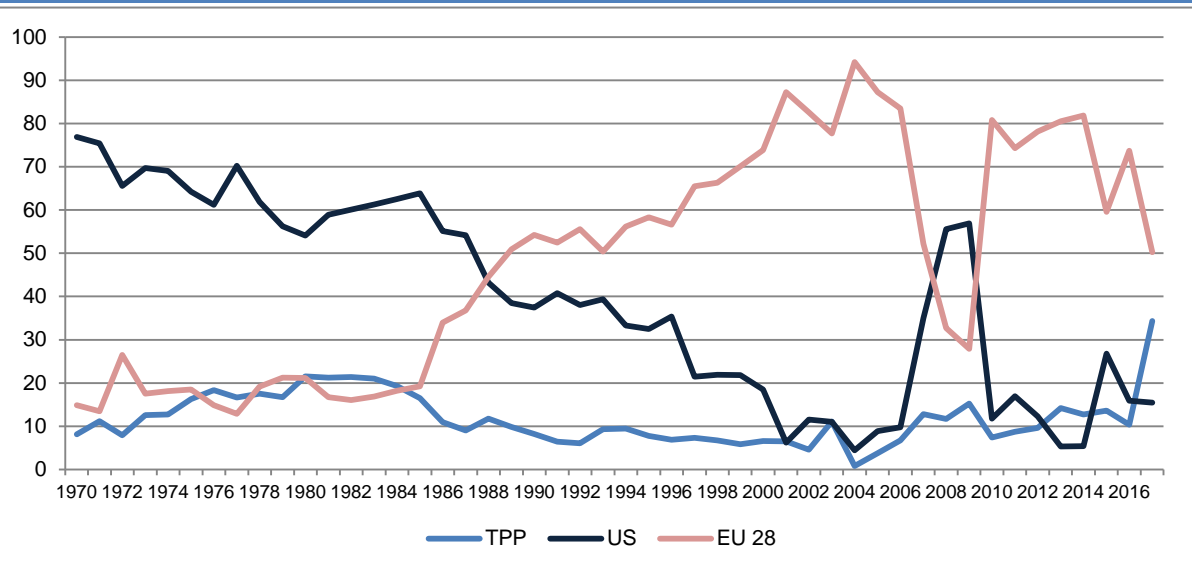
Source: BACI Dataset; authors' own illustration.

Figure 6:
Share in Japan's pig meat imports, 1970–2016



Source: BACI Dataset; authors' own illustration.

Figure 7:
Share in Japan's soybean imports, 1970–2016

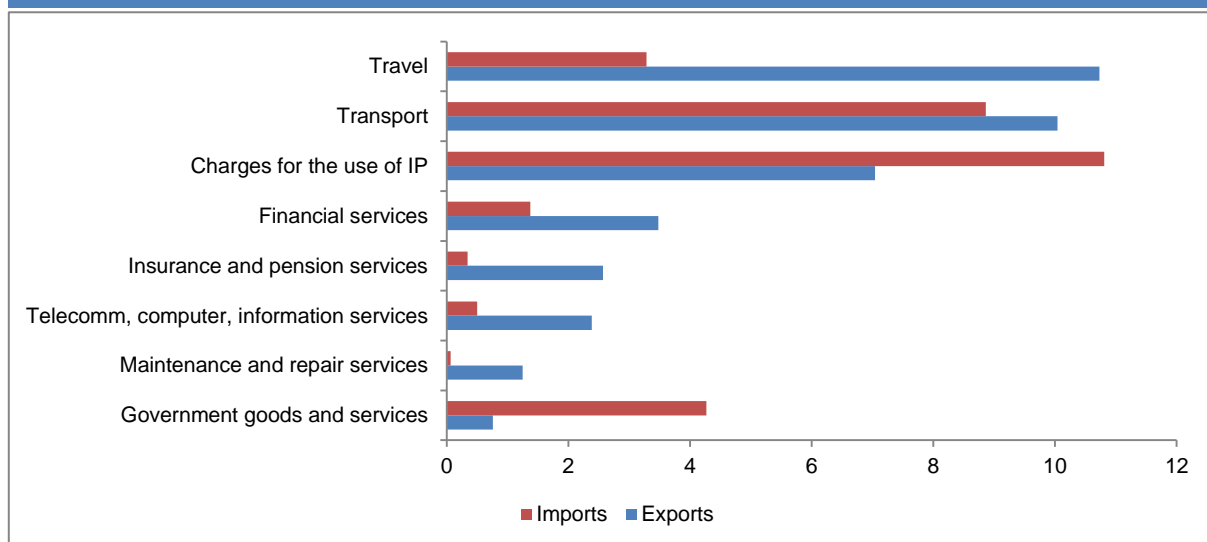


Source: BACI Dataset; authors' own illustration.

1.4 SERVICES TRADE

In 2018, services accounted for 37.5% of US exports to and 19.3% of US imports from Japan. Analyzing the composition, this services trade is led by transport, travel and charges for the use of intellectual property (Figure 8). Data-intensive services such as telecommunications,

Figure 8:
US Services Trade with Japan in 2017 (bn \$)



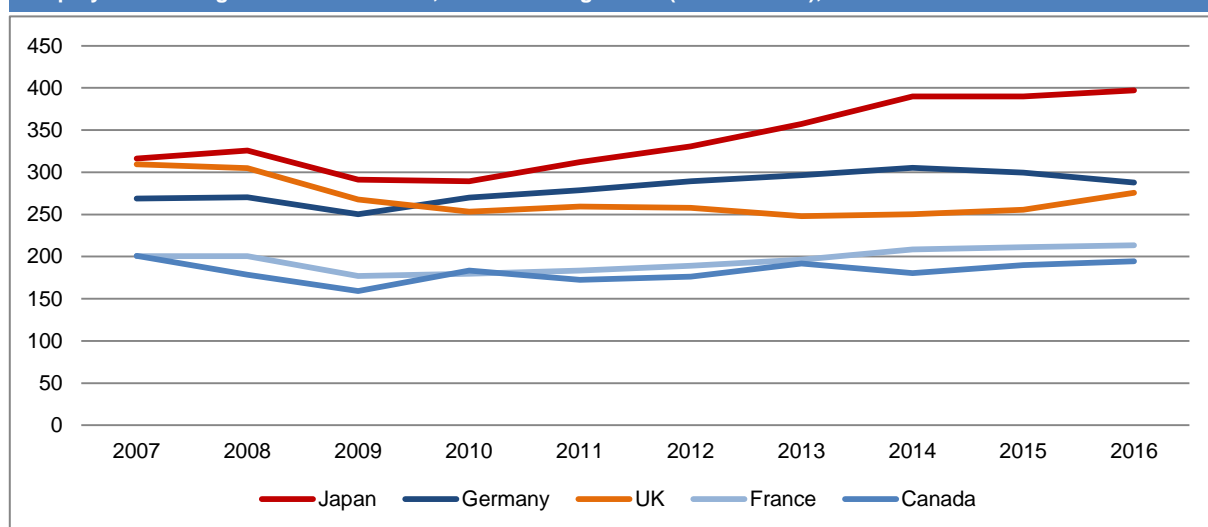
Source: US Census Bureau; authors' own illustration.

computer and financial services have smaller shares. Moreover, Japan is not an important destination for US service providers, despite being an advanced economy with high purchasing power. The EU is by far the most valuable market, where the US exported \$255.9 billion of services in 2018. Hence, the latest provisions on digital trade under this agreement—spanning prohibition of data localization requirements, nondisclosure of source codes and duty-free trade in digital products—may have limited impact in the short run but can promote cross-border flows in digitally intensive services over the medium-long run.

1.5 FOREIGN DIRECT INVESTMENT

Japan has transitioned from an export-led to an investment-driven trade model. It ranks first in global outward FDI flows (UNCTAD 2019) and is the largest investor in the world. Examining the spatial distribution of Japanese FDI, US has been the top investment destination for eight consecutive years and accounted for approximately 30% of Japan's net outward FDI flow in 2017 (JETRO 2018). US-based affiliates of Japanese MNEs also employ high and growing numbers of US workers, particularly in the transport sector (Figure 9). Given Japan's investment portfolio in the US and the deep interlinkages between trade and FDI, the absence of investment-related provisions in the new agreement is of concern. As no Bilateral Investment Treaty (BIT) currently exists between the parties, future negotiations must address broader issues such as national treatment, investment standards and investor protection in order to fully realize the gains from an FTA with Japan. Particularly in the case of automobiles, negotiations on rules of origin (ROO) will matter for Japan's investment and sourcing strategies. Japan may face pressure to meet higher standards for local content, such as for finished vehicles and core parts for which thresholds were raised from 62.5% under NAFTA to 75% under the US-Canada-Mexico Agreement (USMCA).

Figure 9:
Employees of foreign affiliates in the US, manufacturing sector (in thousands), 2007–2016

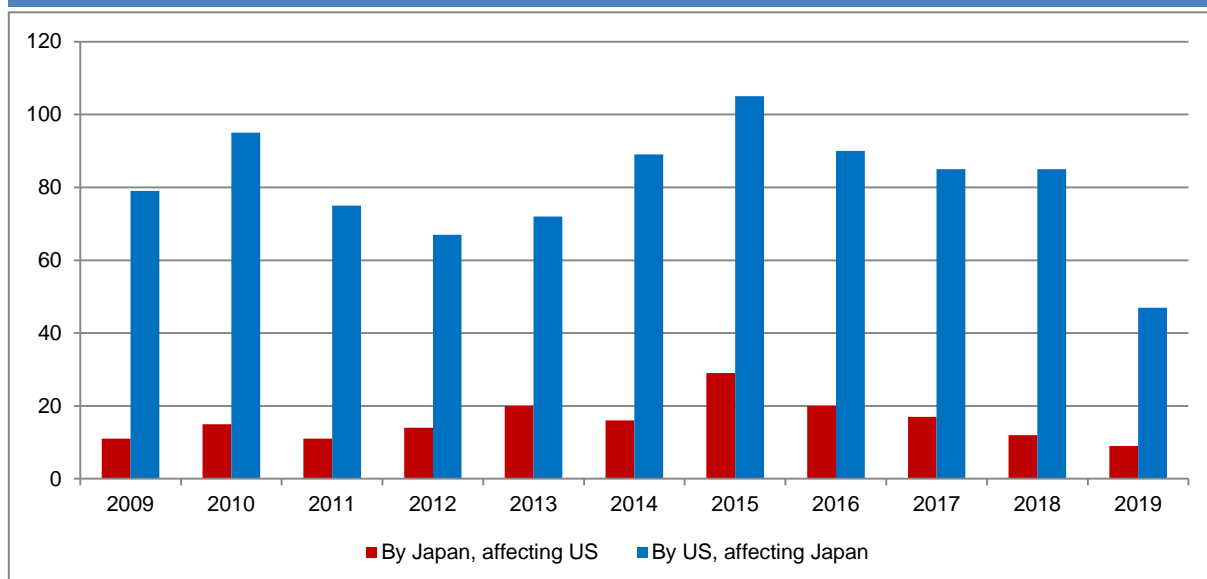


Source: Data from the US Bureau of Economic Analysis (BEA) on majority-owned bank and nonbank US affiliates in the manufacturing sector; authors' own illustration.

1.6 NON-TARIFF BARRIERS

The Japanese market has featured low tariffs but significant formal and informal non-tariff barriers (NTBs). The EUJEPA acted upon this, with multiple provisions to address divergent standards, technical requirements, cumbersome conformity assessment procedures and administrative issues (Chowdhry et al. 2018). These NTB reductions were a core part of EU–Japan negotiations and are expected to drive most of the welfare gains from the EUJEPA. In contrast, the US–Japan trade deal features no such commitments. Furthermore, there is an imbalance in the trading relationship as Japanese exporters to the US are affected by more harmful interventions than US exporters to Japan. Future negotiations should examine this asymmetry as well as the sources of NTBs in order to deliver increased bilateral trade and investment (Figure 10).

Figure 10:
Harmful state interventions (in numbers), 2009–2019



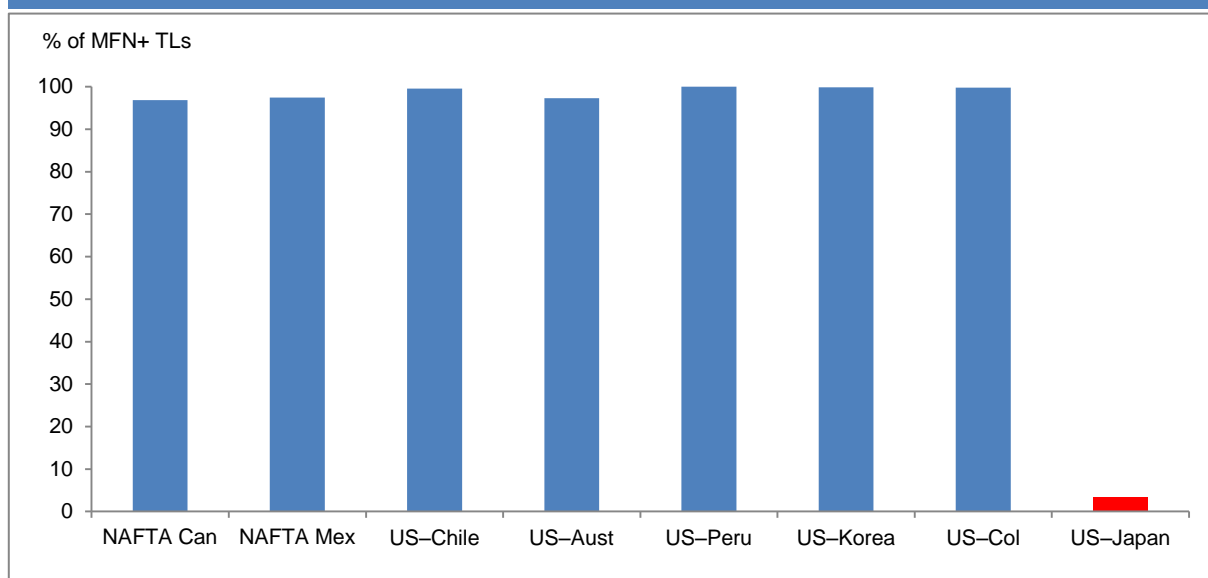
Source: Global Trade Alert Database; authors' own illustration.

2 US–JAPAN TRADE AGREEMENT—SCOPE, DEPTH AND RELEVANCE

The number of tariff lines (TLs) covered under a trade agreement is a simple yet insightful indicator of the scope of liberalization achieved by negotiating parties. By this measure, the US–Japan trade deal is evidently narrow. The US tariff schedule lists 241 TLs for which the US would eliminate or reduce customs duties over the transition period. These constitute just 3.4% of TLs which face positive MFN tariffs (MFN+ TLs) in the US. Furthermore, in approximately 30% of TLs covered, duties will be reduced but not eliminated for Japanese exporters. How do these US commitments compare to its existing trade deals with other

trade partners? Figure 11 below shows the coverage rates of US schedules across various prominent FTAs. These FTAs feature tariff liberalization commitments for nearly all MFN+ TLs. The limited coverage of the US–Japan FTA stands in stark contrast and therefore constitutes an important deviation from the norm for US trade policy.

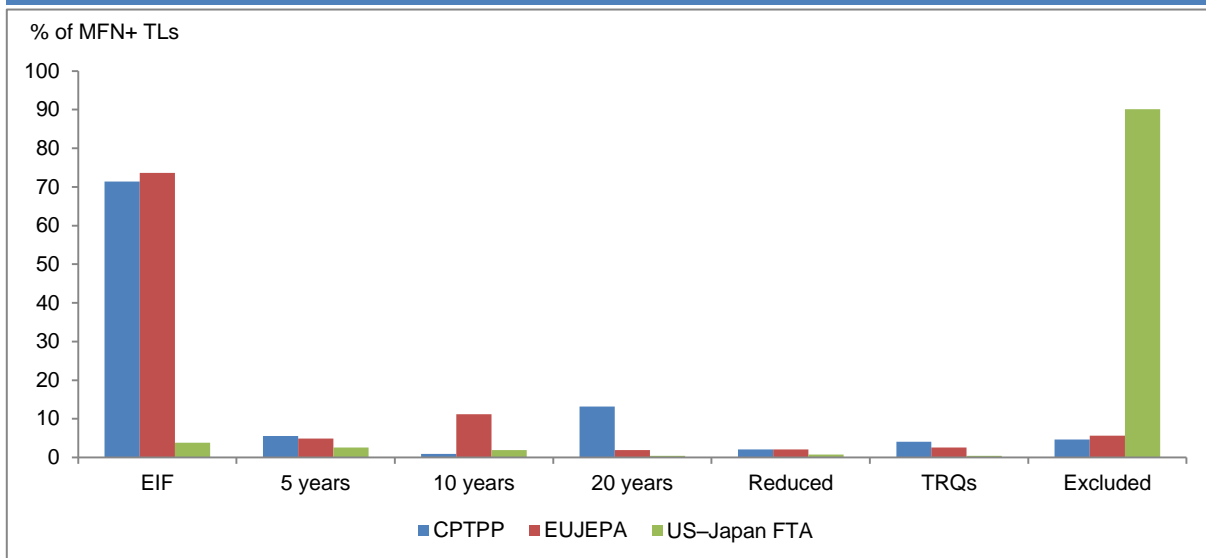
Figure 11:
Coverage of MFN+ tariff lines in US FTAs



Source: Authors' own calculations.

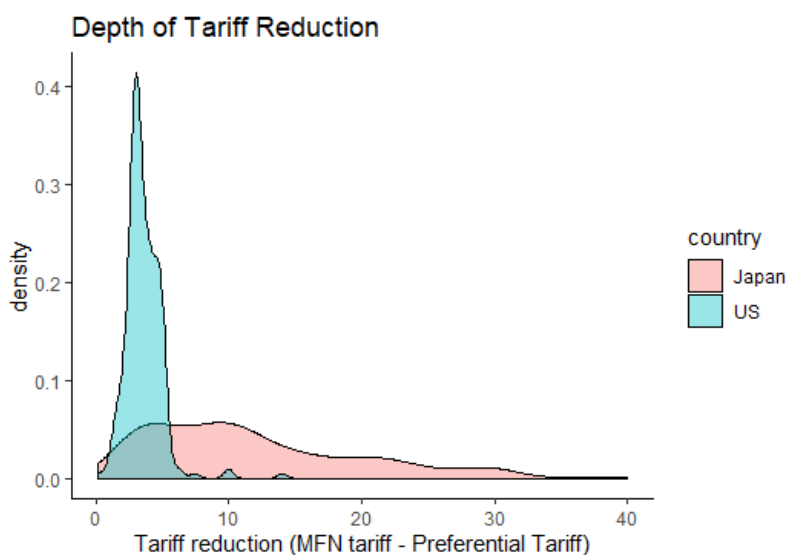
The coverage is similarly limited on the Japanese side (Figure 12). Japan's schedule covers approximately 10% of MFN+ TLs. In comparison, Japan agreed to liberalize 96.2% of MFN+ TLs for EU exporters under the EUJEPa and 97% for CPTPP countries. Though the market access offered to US exporters for specific products such as frozen turkey or pumpkins is similar to Japan's CPTPP commitments, Japan has clearly not 'rolled over' the entire CPTPP schedule for the US under this deal. This raises further questions for the policy rationale underlying the US withdrawal from CPTPP in January 2017.

Figure 12:
Coverage of MFN+ tariff lines in Japan's FTAs



Source: Tariff schedules of respective FTAs: [US-Japan Trade Agreement](#) (Annex 1 and 2), [EUJEPA](#) (Annex 2-A, Part 4) and [CPTPP](#) (Annex 2-D).

Figure 13:
Tariff reductions



Source: Respective tariff schedules are drawn from Annex 1 and Annex 2 of the FTA text published by the Office of the US Trade Representative; authors' own calculations.

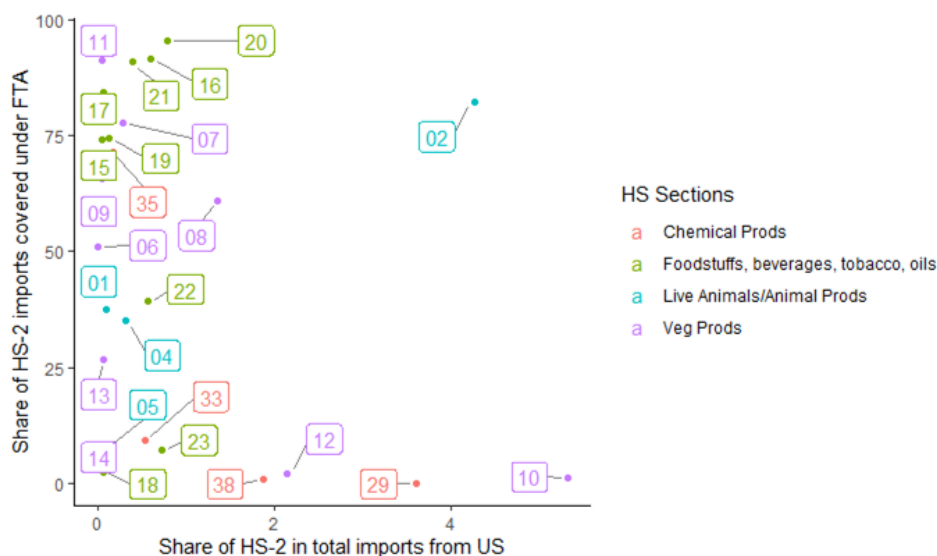
Moving beyond counts of TLs covered, we next examine the depth of liberalization achieved under this agreement. Figure 13 shows the kernel density distributions of tariff reductions² under the US and Japan schedules. It plots the preference margins awarded, pooling together

² Calculated as the difference between the MFN and preferential tariff rates. Excludes products with tariff quotas.

all products in the respective schedules. The Japanese distribution has greater spread and is shifted to the right of the US distribution, indicating an imbalance in the commitments offered. This asymmetry in tariff concessions possibly captures the relative disadvantage with which Japan entered into the bilateral negotiations, as it sought but failed to achieve legal assurances that Japan's automobile sector would be shielded from future tariff hikes under the US Section 232 investigations.

Having analyzed the scope and depth of tariff provisions, we now assess their relevance. Given the composition of US goods exports to Japan, do Japan's commitments liberalize relevant sectors? Figure 14 plots the share of imports under various HS-2 digit sectors covered by Japan's schedule against the share of these sectors in Japan's total imports from the US. We find that many sectors for which a high share of imports is covered under the agreement account for a minimal share in total goods imports of Japan from the US. The outlier in Figure 14 is Chapter 2 (live animals and animal products), which has a relatively high degree of coverage in terms of trade volume under the agreement and accounts for a substantial share of Japan's import basket. Other sectors with high shares of US exports to Japan such as machinery (20%) and instruments (13%) are not liberalized under this agreement.

Figure 14:
Coverage of Japan's imports from the US

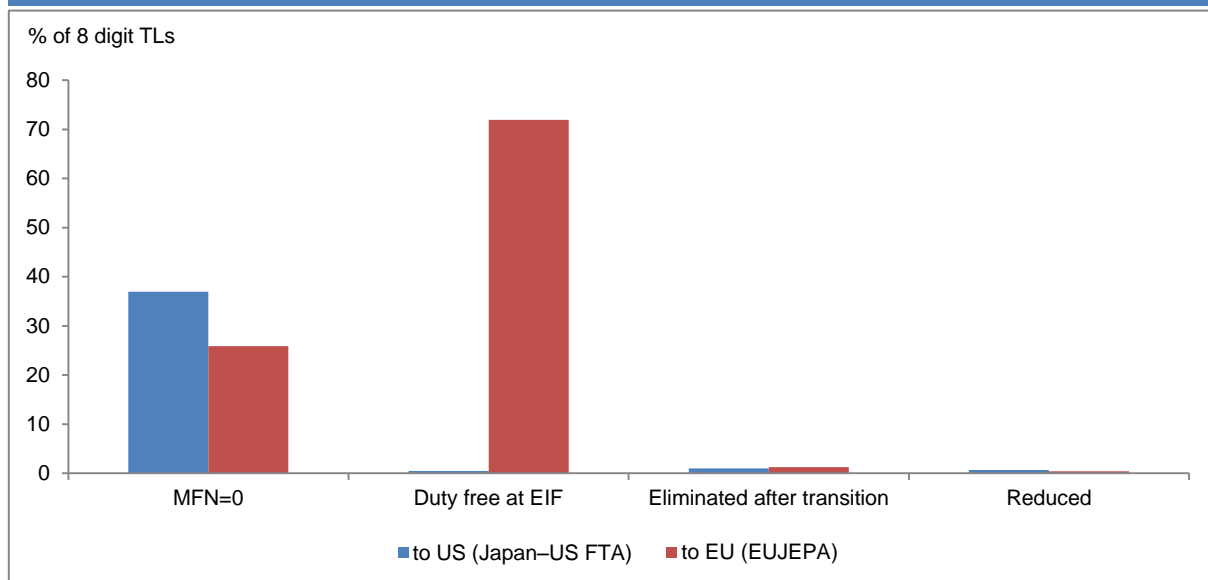


Source: Trade Statistics of Japan for 2018, extracted from [Japan's Customs](#) website. Import values reported in Yen; authors' own illustration.

Overall, the market access gained by Japan from this deal is highly circumscribed in comparison to the recently implemented EU–Japan Economic Partnership Agreement (EPA). Comparing these two agreements, Japan's exports to the EU face considerably lower tariff barriers as 72% of TLs became duty-free on 1st February 2019 when the EPA entered into

force (Figure 15). Moreover, the EU will fully liberalize tariffs on Japan's automobiles over 7 years. The combination of gradual phasing out of tariffs by the EU and potential tariff hikes in the US may lead Japan's automobile sector to reorganize its value chains. This could have long-term implications for US employment, given the large employment of US workers by Japanese MNEs illustrated in Figure 9.

Figure 15:
Tariffs faced by Japan's exports



Source: Tariff schedules of respective FTAs: [US-Japan Trade Agreement](#) (Annex 1 and 2), [EUJEPA](#) (Annex 2-A, Part 4) and [CPTPP](#) (Annex 2-D); authors' own illustration.

3 IMPLICATIONS FOR THE EU

The US and Japan are systemically important players in the global economy. The future of their trading relationship has direct and indirect consequences for third countries. We therefore identify several potential policy issues which emerge from this mini-deal that are relevant for the EU's trade strategy.

First, the mini-deal partially erodes the EU's preferential market access to Japan's agricultural markets under the EUJEPA. As a result, EU producers are likely to face increased competition from US suppliers. This is especially relevant for France, Italy and Spain that are leading exporters of food and feed to Japan. However, the EUJEPA goes further than tariff cuts in promoting EU's agricultural exports. It also ensures protection for nearly 200 EU Geographical Indications in Japan's markets. No such protections are included in the US-Japan deal.

Second, the EU is engaged in its own trade disputes with the US on multiple fronts—including US steel and aluminum tariffs, potential US tariff hikes on cars and car parts as well as the recent WTO ruling on Airbus subsidies which allows the US to impose countermeasures on

\$7.5 billion of EU exports. In order to halt further tariff escalation, the EU and the US have also discussed a limited scope ‘Phase I’ type of agreement. The EU’s negotiating mandate on such a future deal is currently restricted to non-auto industrial goods and conformity assessment. However, the US–Japan FTA clearly reveals the political priorities assigned to the agricultural and digital services sector in the US. The EU should take note of this in defining its final negotiating stance.

Third, the US–Japan Digital Trade Agreement is considered to be the ‘gold standard’ by the US and as such, it may encourage the EU and Japan to discuss further commitments relating to cross-border data flows. The EUJEPa provides a framework for this, since it includes a review clause on the free flow of data whereby both parties would reassess the need for provisions within three years.

Our analysis of tariff reductions under the US–Japan Trade Agreement provides ample evidence that it is unlikely to meet the ‘substantially all the trade’ criterion of GATT Article XXIV, even when liberally interpreted. Though the trade thresholds for this criterion have neither been specifically defined nor been explicitly challenged at the WTO, the Article does hold importance for the functioning of the multilateral trading system. Furthermore, the US and Japan have not yet provided a fully-fledged ‘plan and schedule’ for concluding a comprehensive agreement—their joint statement³ only makes references to a four-month consultation period and negotiations thereafter. Should they become the norm, limited scope agreements can undermine the already strained WTO. Through such arrangements, the US, Japan and the EU also risk sending a conflicting message to other WTO members on their commitment to a rules-based economic order and undercutting their own efforts to initiate wide-ranging reforms in the global governance of trade.

³ The Joint Statement of the US and Japan was issued on 25th September 2019, and can be accessed [here](#).

LIST OF ABBREVIATIONS

BIT	Bilateral Investment Treaty
CPTPP	Comprehensive and Progressive Agreement for Trans-Pacific Partnership
EIF	Entry into force
EU	European Union (EU-28)
EUJEPa	EU–Japan Economic Partnership Agreement
GATT	General Agreement on Tariffs and Trade
MFN	Most-Favored Nation
NAFTA	North American Free Trade Agreement
NTB	Non-tariff barrier
ROO	Rules of origin
TL	Tariff line
TPA	Trade Promotion Authority
USMCA	United States–Mexico–Canada Agreement
WTO	World Trade Organization

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IMPRESSUM

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Value Added Tax Id.-Number:

DE 251899169

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