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Changing commercial policy in Japan during 1985 - 2010

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**Changing Commercial Policy in Japan
During 1985–2010**

Masahiro Kawai and
Shujiro Urata

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Abstract

In this paper we examine the changing nature of Japan's commercial policy over the last 25 years while reviewing Japan's changing structure of trade, FDI and economy that underlay policy changes. We argue that until the late 1990s Japan adopted a two-track approach of relying on multilateral liberalization under the GATT/WTO and open regionalism under Asia-Pacific Economic Cooperation (APEC) on the one hand and on the bilateral trade relationship with the US on the other. Although the Japan-US bilateralism sometimes resulted in "managed trade" and encountered negative perceptions of the US approach in Japan, overall, it had a positive impact on the Japanese economy in opening domestic markets through various reforms and deregulation measures. Japan's more recent commercial policy focuses on bilateral and plurilateral economic partnership agreements particularly with—but not limited to—East Asian economies. We argue that agricultural sector liberalization is key to the further integration of Japan with the Asian and global economies.

JEL Classification: F13, F14, F50

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1. INTRODUCTION

Japan is the first country in post-World War II (WW II) East Asia that significantly benefited from the open multilateral trading regime and achieved rapid industrialization and economic growth through trade expansion. Since its accession to the General Agreement on Tariffs and Trade (GATT) in 1955, Japan began to liberalize cross-border trade restrictions through reductions of quantitative restrictions, tariffs, and other non-tariff barriers mainly in manufactured goods trade. But its economic success created a series of trade frictions with other industrialized economies, particularly the United States (US), between the 1960s and the 1990s due to Japan's explosive export growth and large trade surpluses.

Starting in the 1980s and continuing through most of the 1990s, Japan's trade policy was centered on how to handle the US demands to curb Japan's explosive growth in exports of manufactured products, such as color televisions, industrial machinery, automobiles and other machinery products, and to open its "closed" markets to US imports such as semiconductors, automobiles, beef, agricultural products and financial services. The US often applied pressure on Japan by using the threat of protectionist measures such as Section 301 of the Trade Act of 1974 (Super 301), and Japan had to respond through "voluntary export restraints" and/or "voluntary import expansions."¹

Japan's economic structure began to change significantly after the sharp, rapid yen appreciation following the Plaza Accord of 1985.² Japanese firms, through foreign direct investment (FDI), began to locate their production sites to more cost effective Asian emerging economies, initially in the newly industrialized economies (NIEs)—i.e., Hong Kong, China; Republic of Korea (hereafter Korea); Singapore; and Taipei, China—then to middle-income Association of Southeast Asian Nations (ASEAN) countries and, more recently, to the People's Republic of China (PRC). This contributed to the formation of production networks and supply chains throughout East Asia. Japan began to trade more with these East Asian economies than with the US, by using these economies as a production platform to manufacture goods for Japan's and other advanced countries' markets.

Such a fundamental change in Japan's trade and associated economic structures, together with the establishment of the World Trade Organization (WTO) in 1995, significantly reduced trade frictions with the US. Japan's trade surplus, both overall and with the US, persisted but the US trade deficit began to balloon to high levels, making Japan no longer the most important surplus country for the US. The WTO's enhanced dispute settlement mechanism allowed Japan to bring the bilateral trade issues with the US to the dispute settlement panel. Japan's commercial policy began to pay increasing attention to forging institutional ties with East Asian economies, which became the most important trade partner for Japan.

At the turn of the century, Japan started to shift the focus of commercial policy towards pursuing trade and investment liberalization and deepening economic relationships with its trade partners, particularly its East Asian neighbors, through economic partnership agreements (EPAs), which are more comprehensive than free trade agreements (FTAs). The Japan-Singapore Economic Partnership Agreement in 2002 was the first EPA ever implemented by Japan. The *White Paper on International Trade 2003* published by Japan's Ministry of International Trade and Industry (presently Ministry of Economy, Trade, and Industry) argued the need for pursuing a multi-track approach to trade policy, centered on

¹ Voluntary export restraints (VERs) and voluntary import expansions (VIEs) are forms of "managed" trade. VERs typically establish a quantitative limit on a country's exports to its trading partner(s) and, thus, implicitly set up a quantitative limit on the imports from a trading partner. VIEs often establish a minimum target for the share of a country's market to be supplied by imports or foreign producers. Tyson (1993) claimed that VERs restrict trade and competition, while VIEs can promote trade and competition in economies where policies or structural factors limit access for foreign suppliers.

² The yen had started to appreciate in the spring of 1985, but it was after September that the yen began to appreciate significantly due to policy support.

the WTO and bilateral and plurilateral EPAs. As it recognized the useful role of EPAs as an option for achieving trade liberalization, the Japanese government expected EPAs to play a positive role for promoting Japan's economic growth—through providing business opportunities for Japanese firms in EPA partner countries, strengthening economic ties and cooperation with EPA partners, and facilitating domestic policy reforms such as agricultural and labor market reforms in Japan.

This chapter examines the changing nature of Japan's commercial policy over the last 25 years. Section II reviews Japan's changing structure of trade, FDI and economy that underlay policy changes. Section III focuses on Japan's commercial policy between 1985 and 1999 when policymakers adopted a two-track approach of relying on multilateral liberalization under the GATT/WTO and open regionalism under Asia-Pacific Economic Cooperation (APEC) on the one hand and on the bilateral trade relationship with the US on the other. Section IV examines Japan's more recent commercial policy since the turn of the century as the country increasingly began to rely on bilateral and plurilateral EPAs particularly with—but not limited to—East Asian economies. We argue that agricultural sector liberalization is key to the further integration of Japan with the Asian and global economies. Section V concludes the paper.

2. JAPAN'S CHANGING TRADE AND ECONOMIC STRUCTURE

It is well known that Japan's post-WW II economic reconstruction and industrialization was aided by the liberal international trading regime. With its accession to GATT in 1955, Japan began to liberalize international trade by reducing quantitative restrictions, tariffs and other non-tariff barriers on manufactured imports. In 1964, Japan became an International Monetary Fund (IMF) Article VIII member and eliminated exchange controls on current account transactions. In the same year, it joined the Organisation for Economic Co-operation and Development (OECD) and began to liberalize the policies and rules on international capital flows, particularly for FDI. Japan's trade started to expand in the 1960s and its outward FDI became active in the 1970s.

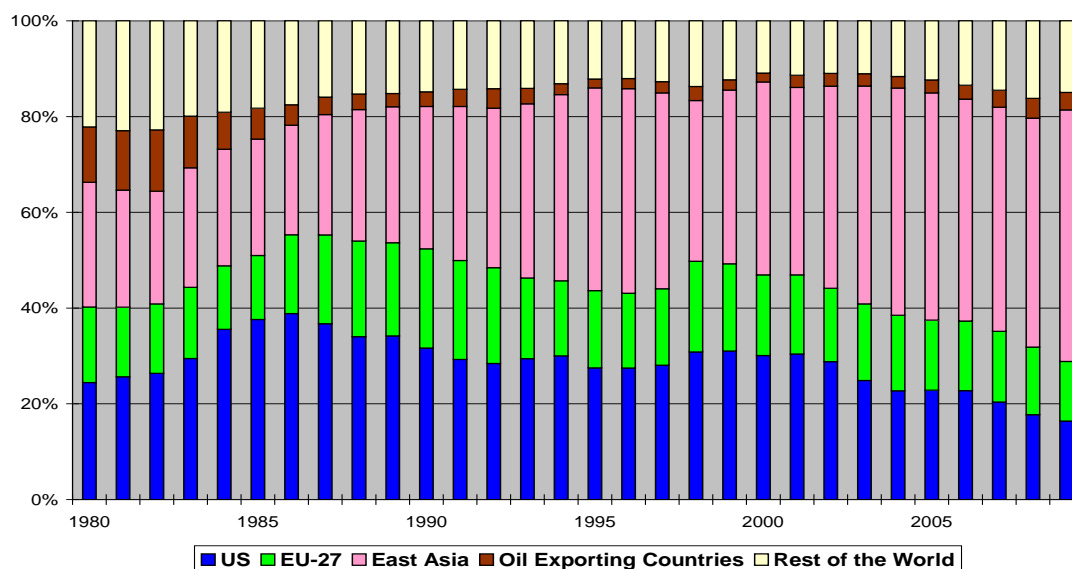
Over time, the structure of Japan's exports shifted sequentially from labor-intensive products such as clothing and textiles, to capital-intensive products such as electrical appliances, iron and steel, and automobiles, and then to technology-intensive products such as machine tools and semiconductors. The shift in the structure of exports reflected the changing patterns of Japan's comparative advantages. But it was in the mid-1980s when Japan's trade and FDI structures underwent a significant transformation.

2.1 Trade and Investment Expansion

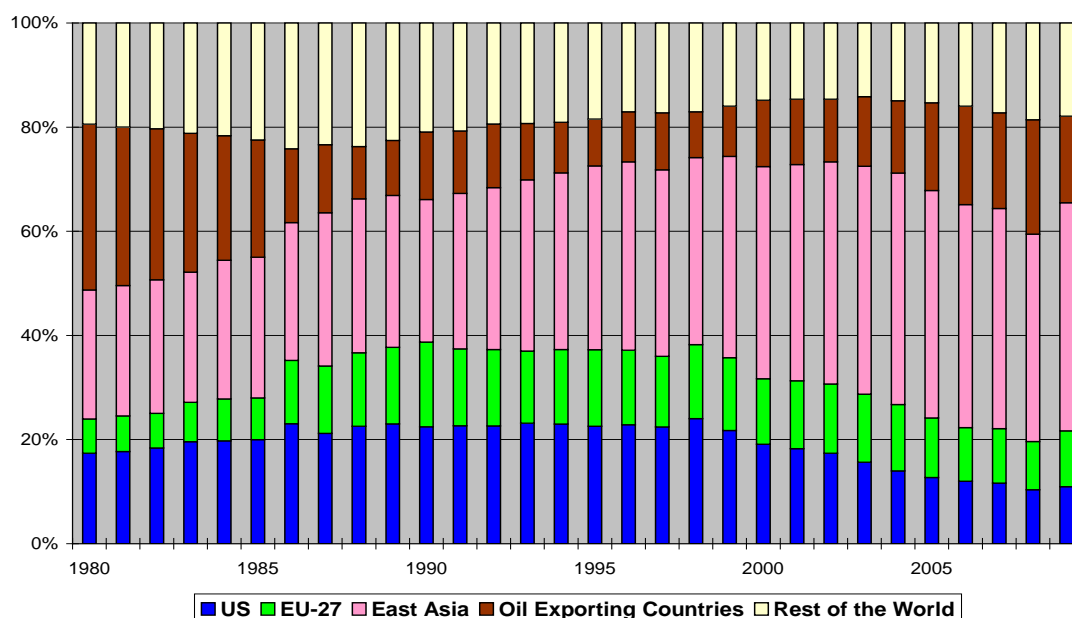
Until the mid-1980s, Japan's major trading partners were the US, Europe, East Asia and oil producing countries. Although the share of trade with East Asia was comparable to the share of trade with the US in 1980, the US was a prime, expanding market for Japan's producers. The share of exports to the US rose in the 1980s, fueling Japan's trade frictions with the US, as will be discussed in the next subsection. The importance of East Asia as a trading partner for Japan began to rise in the second half of the 1980s (see Figure 1).

Figure 1: The Shares of Trade with Japan’s Major Trading Partners from 1980–2009

1A. Japan’s Exports



1B. Japan’s Imports



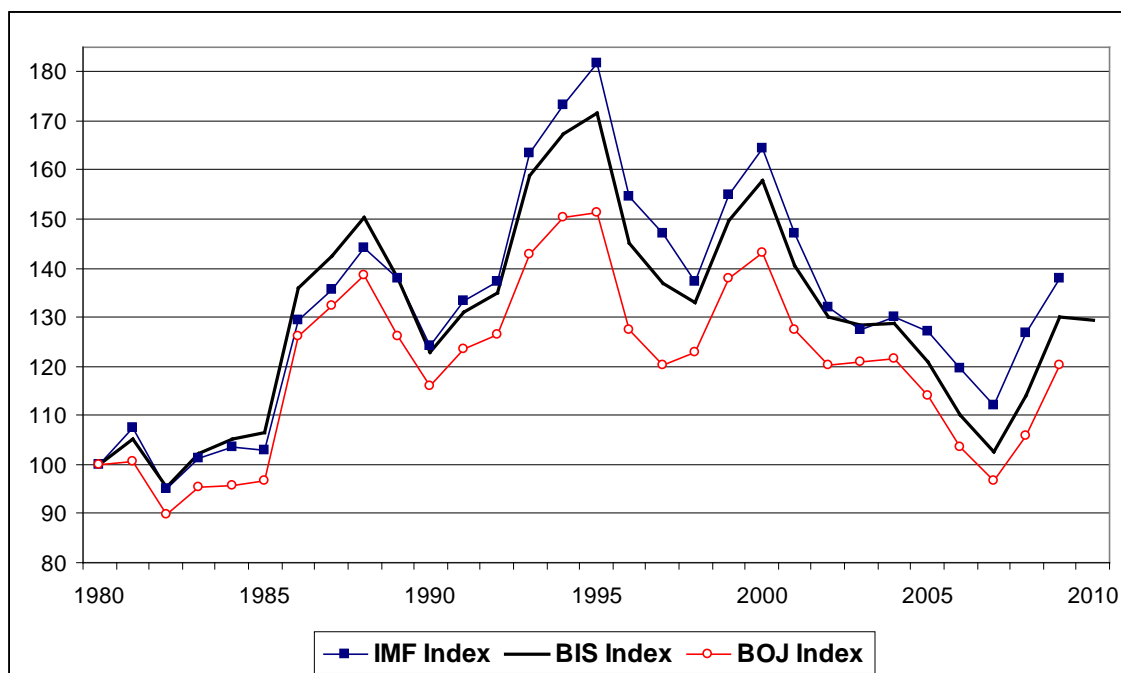
Source: IMF, Direction of Trade Statistics, CD-ROM.

The substantial rise in the yen’s value following the Plaza Agreement of 1985 (see Figure 2) provided a strong impetus for the change in patterns of Japan’s trade and FDI. Facing the rising cost of domestic production, Japanese manufacturing firms decided to move to cost effective emerging East Asia, in order to cope with the declining international price competitiveness of the products manufactured domestically.³ In the 1980s, several emerging East Asian economies—starting with the NIEs and middle-income ASEAN countries such as Malaysia, Thailand, Indonesia and the Philippines—adopted outward-oriented policies of liberalizing trade and FDI regimes and deregulating domestic economic activities. Such policy changes were designed to alter the incentives in the economy from import substitution to export promotion and raise the attractiveness of these economies to

³ As part of the policy of recycling Japan’s current account surplus, Japanese firms were generally encouraged to invest abroad, but without explicit policy support such as subsidies and/or favorable tax treatments.

foreign investors, thereby promoting economic growth. A combination of higher costs of production in Japan due to the sharp yen appreciation and outward-oriented economic reforms in emerging Asia motivated Japanese firms to invest in these economies.

**Figure 2: Alternative Measures of the Real Effective Exchange Rate of the Yen
(1980=100)**



Notes: (1) The IMF index is based on unit labor costs, the BIS index on consumer price indexes, and the BOJ index on producer price indexes.

(2) A rise in the index means appreciation of the yen, and vice versa.

Source: IMF, International Financial Statistics, CD-ROM; Bank for International Settlements (BIS) and Bank of Japan (BOJ) websites.

In the second half of the 1980s and throughout the 1990s, Japanese manufacturing FDI expanded in emerging East Asia, initially to the NIEs, then middle-income ASEAN countries, and more recently PRC. Japanese multinational corporations (MNCs) began to form supply chains and production networks in East Asia, in industries such as electronics, automobiles, and other machinery products. Essentially they fragmented the entire production process into several subprocesses, located these subprocesses throughout East Asia by taking into account each economy's comparative advantage—represented by its factor proportions and technological capabilities—and linked these subprocesses through trade across East Asia as if each economy were a factory.⁴ In this way, Japanese MNCs developed vertical, inter-subprocess division of labor and intra-industry trade in East Asia, between their home country parents and foreign affiliates, or between the foreign affiliates. Such activities were supported by: industrial infrastructure development such as power, telecommunications, and transport; a rapid reduction of information and communications costs due to the recent information and communication technology (ICT) revolution; and a reduction of the logistics cost due to greater liberalization of business services that enabled different production subprocesses to be linked more easily. Intra-firm trade began to account for a substantial share of trade for these MNCs, particularly their Asian affiliates in their total trade with Japan.

Initially led by the Japanese MNCs and later joined by US and European MNCs and, more recently, by emerging Asian firms, East Asia has been transformed into a large

⁴ See, for example, Kawai and Urata (1996, 1998), Athukorala (2005), Kimura and Ando (2005), and ADB (2008).

manufacturing base that serves the global market. This “factory Asia” has seen a persistent rise of intra-regional trade in industrial materials, parts and components, and capital goods for the production of finished manufacturing goods. Factory Asia has been built on the strong nexus between trade and investment. For example, Kawai and Urata (1998) presented some evidence that Japan’s trade and FDI were largely complementary, that is, FDI created trade and trade induced further FDI.

The Asian financial crisis of 1997-1998 had a significant economic and financial impact on many East Asian economies, but had only a temporary negative impact on the region’s trade and FDI. In fact, the recovery of the East Asian economies from the crisis was supported by a mutually reinforcing process of intra-regional trade expansion as the global economy began to grow in 1999 and created demand for East Asian exports. The post-Asian financial crisis period saw a rapid rise of the role of PRC in “factory Asia.” PRC emerged as one of the most active assemblers of Asian manufacturing products, importing technology-intensive parts and components from such neighboring economies as Japan; Korea; and Taipei,China. PRC’s trade began to expand rapidly and became the most important trading partner for many East Asian economies, including Japan.

The global economy, trade, and investment grew briskly during the period 2002-2007 until the global financial crisis erupted in 2008. The crisis had significant contractionary effects on international trade and investment globally; international trade shrank by 23% in 2009 from 2008. Japan’s exports and output were severely affected by the crisis. Its exports collapsed in late 2008 and early 2009, and real gross domestic product (GDP) fell sharply.

Japan’s exports declined significantly for two reasons (Kawai and Takagi 2009). First, Japan’s exports of consumer durables to the US and Europe collapsed because of the sharp demand contraction there. Second, its exports of industrial supplies and capital goods to emerging Asia also collapsed because emerging Asia saw a decline in exports of manufactured products to the US and Europe and, thus, reduced their import of industrial supplies and capital goods which were necessary to produce their exports. By the second half of the 2000s, over 90% of Japanese exports consisted of highly income-elastic industrial supplies, capital goods, and consumer durables. Hence once the US and European economies collapsed rapidly, this exerted a severe negative influence on Japanese exports directly and indirectly through emerging East Asia.⁵

2.2 Changing Industrial Structure in Japan

The industrial structure of Japan has undergone significant transformations over time in the post-WW II period. In particular, the composition of the manufacturing sector has changed. In the 1950s and 1960s, high levels of investment in plant and equipment and imports of advanced technologies helped establish heavy industries, such as iron and steel, shipbuilding, machinery and chemicals. The oil price shock of 1973 forced the Japanese industries to adopt energy efficient technologies and develop higher value added products, such as automobiles, electronics, electric machinery, communication equipment and apparatus, and machinery with electronic controls. The industrial structure has changed since 1985 when the real effective exchange rate of the yen began to appreciate significantly (see again Figure 2). The yen’s real effective appreciation continued for ten years as a trend; it peaked in 1995 when the level was some 80% higher than in 1980, and then began to decline as a trend until 2007, except for the brief 1999-2001 period when the value rose temporarily.

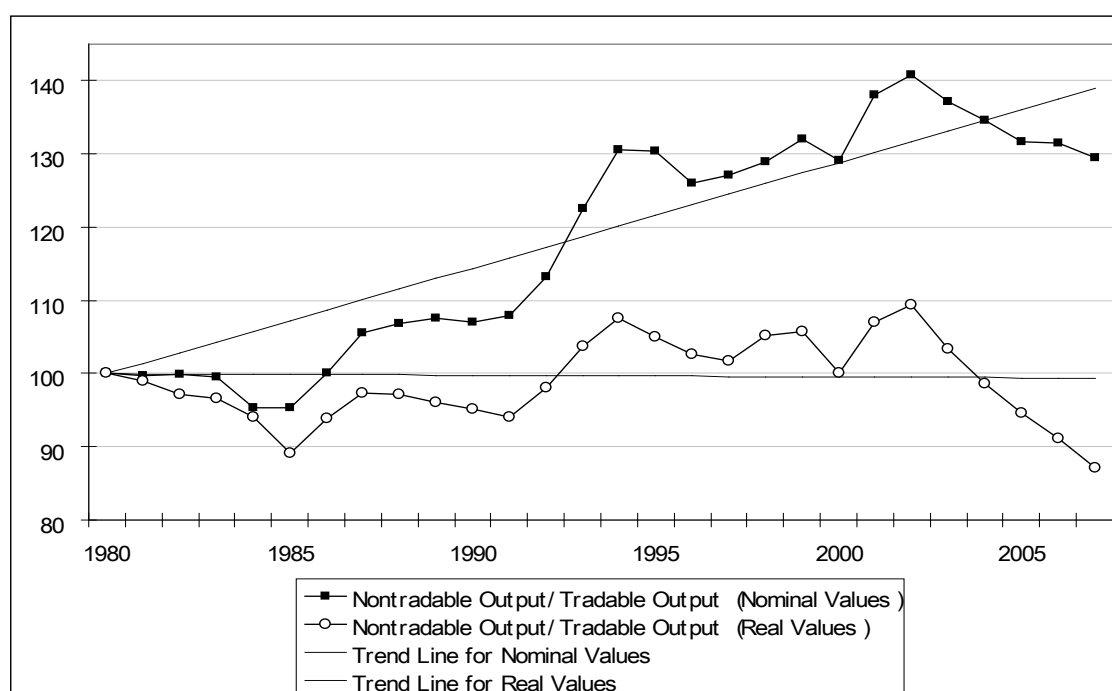
From a theoretical perspective, a high real value of the yen raises the price of nontradable goods relative to the price of tradable goods and, thus, encourages the production of

⁵ Asia’s production networks created a significant amount of intraregional trade in parts and components and, thus, involved double counting in the trade data in terms of value added. This may have exaggerated the volume of trade prior to the global financial crisis and the drop of trade during the crisis.

nontradable goods relative to tradable goods; resources therefore should shift away from the tradable goods sector towards the nontradable goods sector. As this relative price change reduces the international price competitiveness of manufacturing firms that produce tradable goods, it encourages them to shift their production activities abroad through FDI. Indeed, this is what we observed.

Figure 3 depicts the production of nontradable goods relative to tradable goods between 1980 and 2007 in terms of both nominal and real outputs. The two solid lines represent the respective trend lines.⁶ The figure clearly indicates that the relative size of nontradable goods output rose steadily over this period in terms of nominal value, although the relative size of nontradable goods output was virtually flat when measured in terms of real values, reflecting the relatively more rapid growth of nontradable goods prices than tradable goods prices. An important point is that, during the period of trend yen appreciation, i.e., 1986-1995, the relative size of the nontradable goods sector rose. Even though the yen rate began trend depreciation in 1996, the size of nontradable goods output remained above the trend line—regardless of whether it is measured in nominal or real values—until 2002 because the real effective exchange rate, though declining, was still high.

**Figure 3: Production of Nontradable Goods Relative to Tradable Goods
(1980=100)**



Notes: (1) Nontradable sectors include: construction, electricity, gas and water, wholesale and retail services, finance and insurance, real estate, transport and communications, and other services.

(2) Nominal and real values are aggregated GDP component values of sectors.

Source: Kawai and Takagi (2009). Compiled from National Income Account, Cabinet Office.

It is interesting to note that when the real effective yen showed a clear sign of weakening, the size of nontradable goods output relative to tradable goods output began to decline from a peak achieved in 2002. This was matched by Japan's recovery from the "lost decade." When Japan began slowly to emerge out of the prolonged stagnation, it relied on the export sector as an engine of growth as the yen fell in real effective terms. As a result, not only did

⁶ Here, the nontradable goods sectors include construction, electricity, gas, water, wholesale and retail trade, banking and insurance, real estate, transportation, telecommunication, and services. The tradable goods sector includes manufacturing.

the GDP share of exports increase, but also Japan’s overall openness rose throughout the 2000s until the country was hit by the global financial crisis. For instance, Japan’s exports to GDP ratio, which was only 11% in 2000, rose to over 17% in 2008. Over the same period, trade openness, measured by the sum of exports and imports as a percentage of GDP, increased from about 20% of GDP to almost 35%.

3. JAPAN’S COMMERCIAL POLICY IN THE 1980S AND 1990S

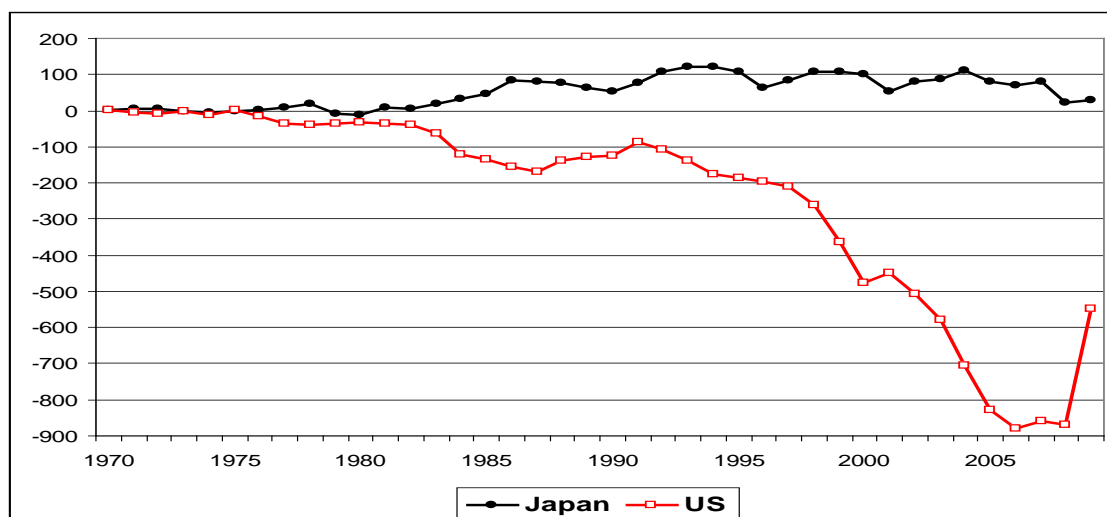
3.1 Japan-US Trade Frictions

Japan experienced various types of trade frictions with advanced economies, particularly the US, due to its explosive export growth. Trade frictions between Japan and the US go back to the 1950s and spread from Japanese exports of clothing and textiles, electrical appliances, and iron and steel, to the exports and imports of automobiles and high-technology products—such as machine tools and semiconductors—and the imports of agricultural products in the 1980s.⁷ Facing a surge of imports of certain products from Japan, the US government occasionally requested the Japanese government to voluntarily restrain exports of these products. Textiles and steel were primary examples. Some Japanese industries that encountered trade threats in the US, such as the textile, color television, and iron and steel industries, were persuaded to adopt “voluntary export restraints.” Other firms started to invest in assembly or production plants in the US, for example, in the electrical appliance and automotive industries, to avoid protectionist trade measures. Some Japanese firms shifted their production plants to East Asia to avoid discriminatory trade measures imposed by the US authorities on Japanese products.

Bilateral trade frictions

In the early 1980s when the Reagan administration adopted a mix of tight monetary policy and lax fiscal policy, US imports surged and Japan’s exports to the US expanded, reflecting the rising demand in the US and the real appreciation of the US dollar. As a result, not only did both Japan’s trade surpluses and the US trade deficits rise (see Figure 4) but also the Japan-US bilateral trade imbalance expanded, which led to a new stage of Japan-US trade frictions focusing on economy-wide structural issues, going beyond sectoral trade frictions.

Figure 4: Trade Imbalances of Japan and the US, 1970-2009 (Billion US\$)



Source: IMF, International Financial Statistics, CD ROM.

⁷ See Komiya and Itoh (1988) for a review of Japan’s commercial policy during 1955 and 1984.

The US government took the view that Japan's distorted market structure, closed to foreign products and conducive to creating trade surpluses,⁸ was the fundamental cause of both Japan's trade surplus and the US deficits. The Japanese market was closed because of high import barriers to foreign products due not only to border restrictions—such as tariffs and quantitative restrictions—but also due to “behind-the-border” regulations and market practices. So the US government argued that if the Japanese market had been opened by reducing such import barriers, US exports to Japan would have risen and the US-Japan bilateral trade imbalance and the overall US deficit would have declined. Therefore, Japan should open up its economy to foreign competition by eliminating import unfriendly restrictions and practices.

In contrast, the Japanese side took the view that the large trade imbalance reflected the large savings and investment imbalances in the US and Japan (Komiya and Itoh 1988). Unless these domestic imbalances were corrected, the trade imbalance would persist. To reduce the trade deficit, the US was advised to reduce the budget deficit and increase household savings. To reduce the trade surplus, Japan would stimulate domestic demand through structural reforms and deregulation of various restrictions. The “Maekawa Report” (Economic Structural Adjustment for International Coordination) produced in 1986 urged the Japanese government to implement such a policy.

In the “Structural Impediments Initiative” (1989-1990), the US addressed squarely the need to deregulate Japan's “closed” markets for automobiles, color film, retail distribution services and insurance services and demanded that the Japanese government dismantle undue restrictions and cease interventions that would limit imports from abroad. The US side pointed out that exclusive transactions practices among Japanese firms, the Large-scale Retail Store Law, and other measures restricted imports of foreign products. Exclusive transactions practices, based on the “*keiretsu* system,” were considered to put foreign competitors at a disadvantage because they were outsiders of the group.⁹ The Large-scale Retail Store Law, which limited the operations of large-scale stores, was considered to inhibit the import of goods to Japan through American style large-scale retail stores. The US argued that such unjust public interventions should be lifted so as not to impede imports of foreign products.

Case of semiconductor disputes

The case of semiconductor disputes was an interesting one as it resulted in “voluntary import expansion” on the part of Japanese firms. Japanese semiconductor producers had been expanding their market share for semiconductors globally, including in the US and Japan. The Semiconductor Industry Association of the United States argued that US producers were disadvantaged because of (i) the Japanese government's public support for Japanese firms and (ii) the exclusive *keiretsu* relationships among Japanese firms in Japan, despite the fact that Japanese firms could freely compete against US firms in the US market.¹⁰ The

⁸ Lawrence (1987) attempted to demonstrate that the Japanese economy was different and relatively closed in comparison to other advanced economies by using a gravity model. However, Saxonhouse (1993) showed that Japan's market was not necessarily “closed” once its factor endowments and resource availabilities were taken into account.

⁹ Based on surveys on the purchasing behavior of Japanese, US and European subsidiaries in Australia, Kreinin (1988) found that Japanese firms abroad had an unusually strong preference to buy from Japanese rather than other foreign suppliers. Specifically, according to his results, Japanese subsidiaries were more tightly controlled by the respective parent company, procured more of their equipment from the home country, and owned and operated more machinery produced in the home country than their US and European counterparts. He concluded that Japan's industrial structure and buyers' preferences played an important role. Using econometric models, Lawrence (1991) demonstrated that *keiretsu* links were barriers to foreign sales in Japanese markets. That is, he showed that the larger the share of industrial output produced by firms that were *keiretsu* members, the smaller the import penetration in that industry. See papers in Krugman (1991) for a comprehensive treatment of the economic, industrial and financial structure of Japan that were perceived as a source of the “closed” nature of the Japanese economy.

¹⁰ See Wolf, Gadbow, Howell, and Richards (1985).

US took the position that as the import barriers in Japan distorted the country's resource allocation, it would be desirable for the government to intervene in order to correct such distortions by raising the share of foreign products in the market. The US pressured Japan to accept such market opening measures with a threat of using Section 301 of the Trade Act of 1974 (Super 301).¹¹ Given that the activation of Super 301 would severely restrict Japan's exports to US markets, the Japanese government yielded to the US demand. The two sides reached the semiconductor trade agreement (SCTA) in 1986 to increase the share of foreign-produced semiconductors to 20% in the Japanese semiconductor market on the assumption that the Japanese government could manage market shares of the private semiconductor industry.¹²

Itoh and Shimoi (2009) argued that the Japan-US bilateral semiconductor agreement was trade distorting. First, there was no convincing evidence of the presence of import barriers. Even if such barriers had existed, an appropriate policy would have been to directly address such barriers themselves rather than agreeing on a certain numerical target. Second, the US intention was to increase the share of US-produced, rather than foreign-produced, semiconductors in Japan's market. That is, the "voluntary import expansion" was not designed to increase overall imports of foreign semiconductors from abroad but to secure a certain market share of foreign (largely US) products. To the extent that this type of "managed trade" did not expand overall import value or did not reduce semiconductor prices, it likely distorted the market and did not necessarily serve the interest of consumers.

In contrast, Tyson (1993) argued that the major impediments to the Japanese semiconductor market were rooted in the unique character of Japanese business organizations and their distinctive relationships with one another and with the Japanese government. She contended that voluntary import expansions were inferior to the first-best approach of unimpeded market competition, but that they could sometimes prove more useful than doing nothing when such competition was constrained by structural impediments and foreign trading practices. Hence, the SCTA was useful in stimulating competition in the Japanese market where competition was effectively hampered.

Essentially, the US government used the threat of severely restricting imports of major products from Japan, and this aggressive US policy towards Japan generated resentment in Japan. Nonetheless, to the extent that the Japanese government addressed many "behind-the-border" regulations, there is no doubt that the policy had a positive impact on Japanese market openness, efficiency and transparency, and improved the economic welfare of Japanese consumers.

3.2 Japan-Europe Trade Frictions

Japan also had some trade frictions with Europe, although they did not become as contentious as the Japan-US trade frictions. As was the case for Japan-US trade frictions, expansion of Japan's trade surplus with Europe precipitated Japan-Europe trade frictions. Japan-Europe trade frictions in the post-WW II period began in the late 1960s, when the European Community (EC) imposed import restrictions on rapidly increasing Japanese exports of color televisions. Trade frictions continued into the 1970s and 1980s as products that caused problems expanded to include electronic machinery, automobiles and machine tools. During the 1970s, Japanese producers of automobiles, videocassette recorders, machine tools, microwave ovens, semiconductors and other products responded to trade

¹¹ "Super 301" is an enhanced version, introduced in 1988, of Section 301 of the 1974 US Trade Act. This allowed the US government to impose sanctions against countries which it deemed as engaging in unfair trade practices and erecting trade barriers against US products and services.

¹² Tyson (1993) documented that in a confidential side letter to the SCTA, the Japanese government "would make efforts to assist foreign companies in reaching their goal of a 20 percent market share within five years." When the SCTA was renewed in 1991, an explicit target of the 20 percent market share was mentioned, to be realized by the end of 1992.

frictions mainly through voluntary export restraints. However, the EC began to use anti-dumping litigation and duties to limit Japanese exports of ball bearings, copying machines, printers, microwave ovens, and semiconductors. The European governments attempted to protect and promote European producers, particularly those in electronics industries, by limiting imports of Japanese products. Responding to these measures, Japanese firms actively set up production bases in the EC by undertaking FDI.

One noted case of Europe's import restrictions against Japanese products took place in Poitiers, an inland city in France, between October 1982 and April 1983. In the so-called "Battle of Poitiers," the French Government limited the customs processing of all Japanese videocassette recorders to a small customs house in Poitiers.¹³ As a result of this import restricting measure, as many as 60,000 Japanese videocassette recorders were piled up in the warehouse one month after the implementation of the measure.¹⁴ At that time no French electronic producers were manufacturing videocassette recorders, thus French government's accusation claiming that the imports of Japanese videocassette recorders brought injury to French electronic producers was unfounded.

During the 1980s Japan's trade surplus against Europe expanded and its magnitude was even larger than Europe's total exports to Japan. Irritated by this huge trade imbalance, European governments and the EC criticized Japan for having a closed market. Furthermore, emotional reactions, such as accusing Japanese people of being workaholics living in rabbit hutches, erupted in Europe.¹⁵ Nonetheless, the Japan-Europe trade frictions did not go as deep as the Japan-US trade conflicts in the sense of urging Japan to address the structurally "closed" nature of the economy and market. Japan-EC trade frictions dissipated in the 1990s mainly because of the yen appreciation, rise of Japanese FDI in Europe and the resulting expansion of local production, and less aggressive export behavior of Japanese firms.

3.3 The Role of the WTO and APEC

Uruguay Round under GATT

The Uruguay Round of multilateral trade negotiations under the auspices of GATT started in 1986 and was concluded in 1994. Although the negotiations lasted eight long years, the Uruguay Round made substantial progress towards liberalizing trade and FDI. The achievements included: a reduction in tariff rates; framework agreements on trade in services, on intellectual property rights, and on trade-related investment measures; a timetable for phasing out all quantitative restrictions on trade; first steps towards bringing agricultural trade more firmly under a multilateral discipline; a stronger dispute settlement mechanism; and the establishment of the WTO.

Japan did not play a critical role in the Uruguay Round because it could not offer sufficient concessions on agricultural liberalization. In the negotiations, Japan argued that agricultural goods trade should be treated differently from manufactured goods trade because of the multi-functional role of agriculture—such as protecting the environment and preserving nature. But due to the lack of international support, Japan could neither lead nor exercise influence over the negotiations. Domestically, agricultural interests strongly advocated the continuation of protection, while non-agricultural interests did not present a sufficiently compelling case for opening the agricultural goods market.

Nonetheless the Uruguay Round agreement had significant impacts on Japan's commercial policy. First, partial liberalization of agricultural trade, including rice imports, was achieved. Japanese trade negotiators were persuaded that the country could no longer maintain the

¹³ See Kimura (2005) for more detailed discussions.

¹⁴ Iwaki (2007) provides a concise overview of Japan-EU Economic relationship with a focus on trade issues.

¹⁵ See Kimura (2005) for more detailed discussions.

policy of protecting the agricultural sector while enjoying the benefit of liberalization of manufacturing trade. Although their original position stated that “no grain of rice would be allowed to come to the Japanese market,” in the end they had to accept the “minimum access” approach to rice imports. Essentially, Japan abandoned its policy of prohibiting the import of rice and began to allow a certain amount of rice imports, equivalent of 4-8% of domestic consumption. Soon after this, Japan shifted to tariffication of rice imports by setting a prohibitively high tariff rate of 778% on rice imports.

To deal with the trade adjustment in agriculture, necessitated by the partial liberalization of rice imports, the Japanese government provided to the domestic agricultural industry as much as six trillion yen. Although the intention could be justified, the program was not successful in facilitating meaningful adjustment, because a large part of the funds were not spent for upgrading skills of impacted workers, enhancing labor productivity, or concentrating farm land in the hands of large-scale productive farmers, but for different purposes such as drilling for hot springs or paving country roads.

Second, the way Japan handled the bilateral trade frictions with the US changed in a fundamental way. Before the establishment of the WTO, Japan tended to respond to the US pressure to reduce its exports to the US and open its market to US products by agreeing to “voluntary export restraints” and “voluntary import expansion,” respectively. With the establishment of the WTO, Japan began to use its enhanced dispute settlement mechanism.¹⁶

The Japanese government essentially found three reasons for bringing the bilateral issues to the multilateral mechanism of WTO dispute settlement. First, the multilateral forum would deliver decisions based on objective trading rules and norms, rather than the asymmetric bargaining power between disputing parties. Second, even if Japan lost the case, it would be easier for the government to convince the domestic stakeholders to accept the WTO decisions and to make the appropriate national policy responses, such as adjustment policies. Third, such policy responses would take the form of addressing the fundamental problem, such as changing domestic regulations, rules and procedures, rather than putting in place “managed trade” measures such as numerical targets.

Japan indeed took the case of color film dispute to the WTO panel. Eastman Kodak argued that Japan’s film market was unduly controlled by Fuji Film and, as a result, closed to foreign products, such as Kodak film, and in 1995 presented the case for sanctioning Japan to the US Trade Representative. The Japanese government argued against Eastman Kodak and brought the case to the WTO. The WTO panel delivered its decision in support of Japan in 1998.

Since this incident, there has been no major Japan-US bilateral trade dispute. Six factors could explain this. First, the availability of the WTO’s dispute settlement mechanism may well have deterred the US authorities from resorting to bilateral negotiations with trade sanction threats. Second, Japan undertook a number of policy reforms such as those in the financial system and corporate governance, the areas that were the main focus of US concerns over the structure of the Japanese economy. Third, Japanese firms began to expand production in the US through FDI and, thus, created a local constituency that sometimes opposed US government’s policymaking that could have limited imports from Japan. Fourth, Japan’s trade surplus was no longer the most important source of the US trade deficit, as the US deficit began to balloon in the second half of the 1990s. The trade and economic structure of Japan had changed in a way not to run a large bilateral trade imbalance with the US. Fifth, the stagnation of the Japanese economy after the bursting of the asset market bubble may have reduced the US perception of the Japan threat. Finally,

¹⁶ One innovation under the WTO was the introduction of the negative consensus approach to dispute settlement. That is, a case could now be heard unless there was the unanimous objection of the panel members.

rising competition from, and expanding trade deficits with, emerging East Asian economies began to divert US attention away from Japan towards these economies, such as PRC.

APEC

A voluntary and unilateral approach under APEC has also contributed to the liberalization and facilitation of trade and FDI for Japan as well as emerging East Asian economies. Established in 1989, APEC began with 12 members and has grown into a trans-regional cooperation organization with 21 members.¹⁷ This forum's membership includes some with great influence in the world economy, such as the US, Japan, PRC, and Russia. APEC has been the only international economic forum in which the US and East Asian economies hold policy dialogue on a wide range of economic issues and pursue trade and investment liberalization outside of the GATT/WTO.

APEC's aim has been to promote free and open regional trade and investment and contribute to economic growth in the Asia-Pacific region and the world. The means employed to attain this end have been the liberalization and facilitation of trade and investment and engaging in economic and technical cooperation. Decisions to act are left to the discretion of each member without including legally binding negotiations, treaties, and conventions, such as those imposed by the WTO. In addition, APEC liberalization measures are also applied to non-members, thereby enforcing most-favored-nation (MFN) treatment without discrimination. Thus, its approach has been termed as "open regionalism."

Japan has played an important role in APEC. On the occasion of the organization's birth, it joined with Australia in performing the role of midwife, and subsequently it has made major contributions in many areas, including organization building and cooperative activities. In Bogor, Indonesia, APEC in 1994 agreed on what was considered to be its primary goal: the achievement of free and open trade and investment by no later than 2010 in the case of developed economies and no later than 2020 in the case of developing economies. But it was in Osaka, Japan, that APEC in 1995 adopted an action plan for achieving this goal, the Osaka Action Agenda. This agenda specified principles, frameworks, and actions in the three areas of trade and investment liberalization, trade and investment facilitation, and economic and technical cooperation. Among the general principles for liberalization and facilitation were comprehensiveness, WTO consistency, comparability, and nondiscrimination. The economic and technical cooperation was to be implemented by the APEC members as soon as they were ready, making use of action, forums, and other means. For Japan—and other developed economies in the APEC region—2010 is both the deadline to meet the Bogor goal and also the year in which it hosts the annual APEC summit. Strictly interpreted, the Bogor goal is unlikely to be met, but there is no question that APEC has facilitated significant trade and investment liberalization in the Asia-Pacific.

One of the most significant achievements was to help both PRC and Taipei,China to join the WTO in December 2001 and January 2002, respectively. However, the effectiveness of APEC has been challenged recently due to its limited role played at the time of the 1997-1998 Asian financial crisis and the slow progress of unilateral, voluntary liberalization since the early 2000s.

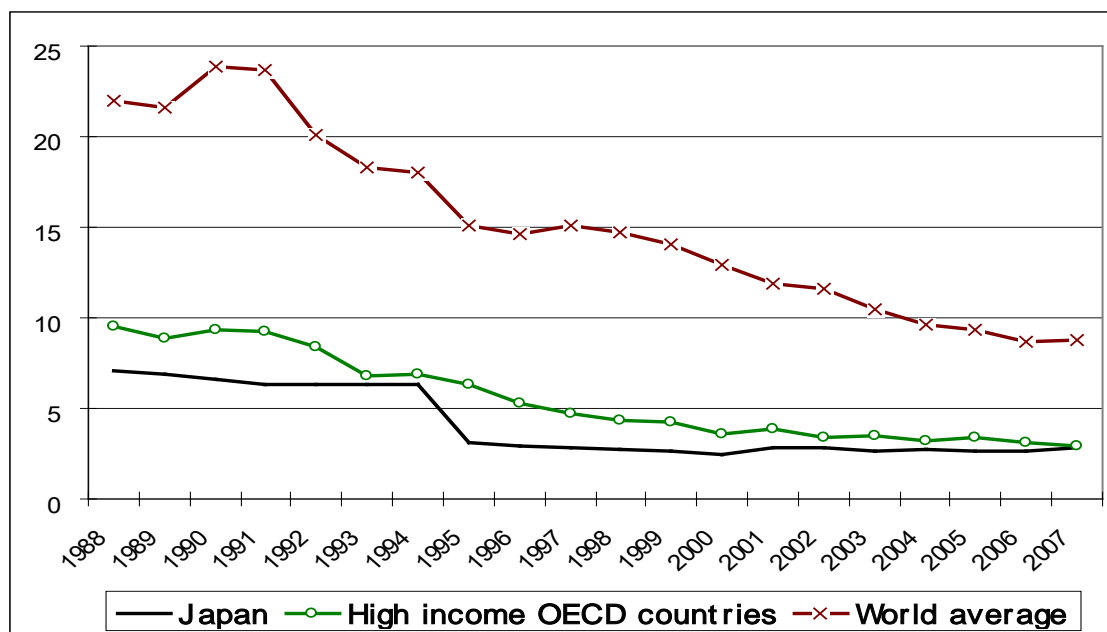
Japan's slow tariff reduction

Since its accession to the GATT, Japan has been liberalizing trade by cutting tariff rates, reducing quantitative restrictions, and addressing other non-tariff barriers. Figure 5 demonstrates how Japan has been reducing the average tariff rates over the past 20 years. Japan saw a significant tariff reduction in 1995 as a result of the conclusion of the Uruguay Round, but the tariff reduction since then has been very slow. This is in sharp contrast with

¹⁷ Starting with 12 members (Australia, Canada, Japan, New Zealand, Korea, US, and the six members of ASEAN: Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore, and Thailand), 9 additional economies have subsequently joined APEC, including Chile; PRC; Hong Kong, China; Mexico; Papua New Guinea; Peru; Taipei,China; Viet Nam; and Russia.

other high income OECD countries and the world as a whole. Although Japan's average tariff rates are much lower than the world average and marginally lower than the high income OECD country average, the rest of the world has been reducing tariffs since 1996, while Japan has not. This implies that if the Doha Development Round negotiations should become stalled, Japan needs to find another way to further reduce the tariff rates.

Figure 5: Trends in Japan's Average Applied Tariff Rates, 1988–2007
(Unweighted in %)



Notes: (1) All tariff rates are based on unweighted averages for all goods in ad valorem rates, or applied rates, or most-favored-nation (MFN) rates whichever data are available in a longer period.

(2) Tariff data are primarily based on United Nations Conference on Trade and Development (UNCTAD) Trade Analysis Information System (TRAINS) database and then used WTO IDB data for gap filling.

(3) High income OECD countries include: Australia, Canada, European Union, Iceland, Japan, Korea, New Zealand, Norway, Switzerland, and the US.

Source: Various sources from UNCTAD TRAINS database, WTO IDB database, World Bank, OECD, and IMF.

4. JAPAN'S COMMERCIAL POLICY IN THE 2000S

4.1 Adoption of EPA Initiatives

At the turn of the century, Japan began to adopt the policy of promoting trade and investment liberalization through bilateral and plurilateral trade arrangements. Notably, since November 2002, Japan has implemented 10 bilateral EPAs with 7 ASEAN members, Mexico, Chile and Switzerland and one plurilateral EPA with ASEAN, while pursuing official negotiations with five trading partners (see Table 1 for a summary of Japan's EPA initiatives). Japan's move to use EPAs as commercial policy tool has spawned FTA moves by other East Asian economies, particularly PRC, Korea and ASEAN countries. In response to the Japan-Singapore EPA negotiations that began in January 2001, PRC and ASEAN began official negotiations on closer economic partnership, which were concluded in November 2002. Then, Japan completed a series of bilateral EPAs with Malaysia, Thailand, Indonesia, Brunei Darussalam, the Philippines, and Viet Nam, while implementing an EPA with ASEAN as a group. Japan, PRC and ASEAN have been joined by Korea, India, Australia and New Zealand in active FTA moves. In this sense, there have been domino and bandwagon effects among these and other economies in their drive for FTAs/EPAs.

Table 1: Japan's EPAs Implemented or Under Official Negotiations

	Partner Country/Region	Date Negotiation Begun	Date Signed	Date Implemented
Implemented	Singapore	January 2001	January 2002	November 2002
	Mexico	November 2002	September 2004	April 2005
	Malaysia	January 2004	December 2005	July 2006
	Chile	February 2006	March 2007	September 2007
	Thailand	February 2004	April 2007	November 2007
	Indonesia	July 2005	August 2007	July 2008
	Brunei Darussalam	June 2006	June 2007	July 2008
	Philippines	February 2004	September 2006	December 2008
	ASEAN	April 2005	April 2008	December 2008
	Switzerland	May 2007	February 2009	September 2009
	Viet Nam	January 2007	December 2008	October 2009
Under Official Negotiation	Korea ⁽¹⁾	December 2003		
	GCC ⁽²⁾	September 2006		
	India	January 2007		
	Australia	April 2007		
	Peru	May 2009		

Notes: (1) Japan's EPA negotiations with Korea began in December 2003 but were suspended in November 2004.

(2) GCC stands for Cooperation Council for Arab States of the Gulf.

Source: Ministry of Foreign Affairs.

Mexico was the first country that approached Japan for a possible EPA. Following the Mexican President's proposal to establish a possible Japan-Mexico EPA in November 1998, think tanks in both countries conducted a study on a possible bilateral EPA and an official study group was set up in September 2001 to examine the details of a possible EPA. Official negotiations began in November 2002, followed by an agreement in September 2004. The Japan-Mexico EPA was enacted in April 2005. The most serious obstacle in the negotiations was Japan's strong resistance to liberalization of trade in agricultural products, specifically pork, beef, and chicken products, oranges, and orange juice. In the end, Japan agreed to open up these markets by increasing import quotas—not by removing tariffs as it should under FTAs that are consistent with the WTO rules—in exchange for Mexico's agreement to liberalize steel and automobile markets within ten and seven years, respectively. Mexico opened its market to all imports from Japan, while Japan opened its market to only 84% of its imports from Mexico. The Japan-Mexico EPA was strongly supported by the Japanese business sector, which felt that their business was suffering from the loss of market access and business opportunities, including government procurement, in the absence of an EPA with Mexico.

Japan's approach has been to establish an EPA, rather than simply an FTA, by covering wider issues of WTO-plus elements. WTO-plus elements include the four Singapore issues (trade facilitation, investment, government procurement, and competition policy) and other provisions such as intellectual property rights, labor standards and mobility, environmental, information technology and small- and medium-sized enterprise cooperation. The four Singapore issues were conditionally included in the work program for the Doha Round in November 2001 but were subsequently dropped at the WTO Ministerial Conference in Cancun in 2004. Japan's EPAs with Indonesia and the Philippines include provisions on the movement of natural persons in the area of nursing and old-age care. Intellectual property rights are included in all the EPAs that Japan has concluded.

Motives behind Japan's EPA strategy

Japan came to recognize EPAs as one of its trade policy options, in addition to the multilateral framework under the WTO.¹⁸ Several factors contributed to this shift in Japan's trade policy.

First, greater access to foreign markets was one of the important motives that aroused Japan's interest in EPAs. Japan was one of the few countries in the world that did not have any bilateral, plurilateral or regional trade arrangement such as FTAs until the early 21st century, despite the fact that an increasing number of FTAs had become established globally. Facing the world market, which had many discriminatory trading arrangements, in particular those in Europe and North America, Japan felt an urgent need to secure market access for Japanese firms by setting up EPAs. As an EPA eliminates trade barriers in EPA partners, Japanese firms are able to enjoy more business opportunities, especially when multilateral trade negotiations under the Doha Development Agenda 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, EPAs with East Asian countries would increase Japan's exports to these countries, which are presently protected with high tariff and non-tariff barriers.¹⁹ In addition, Japanese firms could expand their business operations in EPA partners via FDI, as an EPA includes FDI liberalization and other measures contributing to creating a business friendly environment.²⁰ Japan's EPA strategy focuses on East Asia, as establishing EPAs with East Asian countries would contribute to economic prosperity and, hence, political and social stability in the region, which in turn would benefit Japan.

The market access motive clearly played an important role for Japan in pursuing an EPA with Mexico. Thanks to the North American Free Trade Agreement (NAFTA) and the European Union (EU)-Mexico FTA, EU and US firms could export their products to Mexico without tariffs. In order to export their products to Mexico, Japanese firms had to pay high tariffs, an average of 16.2% for all imports in 2001, which protected the Mexican market. Among Japanese manufacturing sectors, the automobile and steel industries were eager for the government to form an EPA with Mexico. Japan's automobile industry was interested in expanding exports of finished cars to Mexico, while its steel industry was interested in exporting steel products, which were used for the production of electronics, household electrical appliances, general machinery, and automobiles by Japanese assembly firms operating in Mexico. In addition, the Mexican government allowed only FTA members to participate in the government procurement market. Mexico could impose such restrictions on government procurement because it was not a signatory to the WTO's government procurement code. Faced with these market access problems in Mexico, the Japanese business community vigorously pushed its government to obtain an EPA with Mexico. Essentially, the Japanese government used EPAs to combat discrimination in foreign markets, like Mexico, which favored Japan's competitors engaged in FTA networks.²¹

Second, stimulating structural reforms, which are required by EPAs, was considered essential to revitalize the Japanese economy. After the collapse of the asset price bubble in the early 1990s, the Japanese economy entered a long stagnation. Indeed, the 1990s was characterized as the "lost decade" for Japan. Although Japan's post-WW II system contributed to high economic growth until the bubble arose, it became ineffective after it burst. To put Japan back on a sustainable growth path, a series of structural reforms are

¹⁸ Pempel and Urata (2006) discussed Japan's EPA policy in conjunction with its bilateral trade agreements with the US in semiconductors and others in the 1970s and 1980s.

¹⁹ In sectors other than electronics whose MFN tariffs are already low.

²⁰ See Solis and Urata (2007) for the discussion of Japan's activist foreign economic policy.

²¹ See Urata (2009) for this observation.

needed, including those addressing the rapid demographic change associated with a population that is aging and declining in number. From this perspective, EPAs can trigger a series of structural reforms in Japan, such as labor market and agricultural reforms.

Third, Japan expects to contribute to the strengthening of the world trade system under the WTO, as FTAs/EPAs could have harmful impacts on the world trade system because of their discriminatory nature. While acknowledging the possibility of such a harmful effect, it would be possible to maximize the favorable effects from EPAs to more than offset the harmful effect. For example, Japan could contribute to the WTO system by successfully forming EPAs that include many “WTO-plus” elements.

4.2 Japan’s Approach to Regional Economic Integration

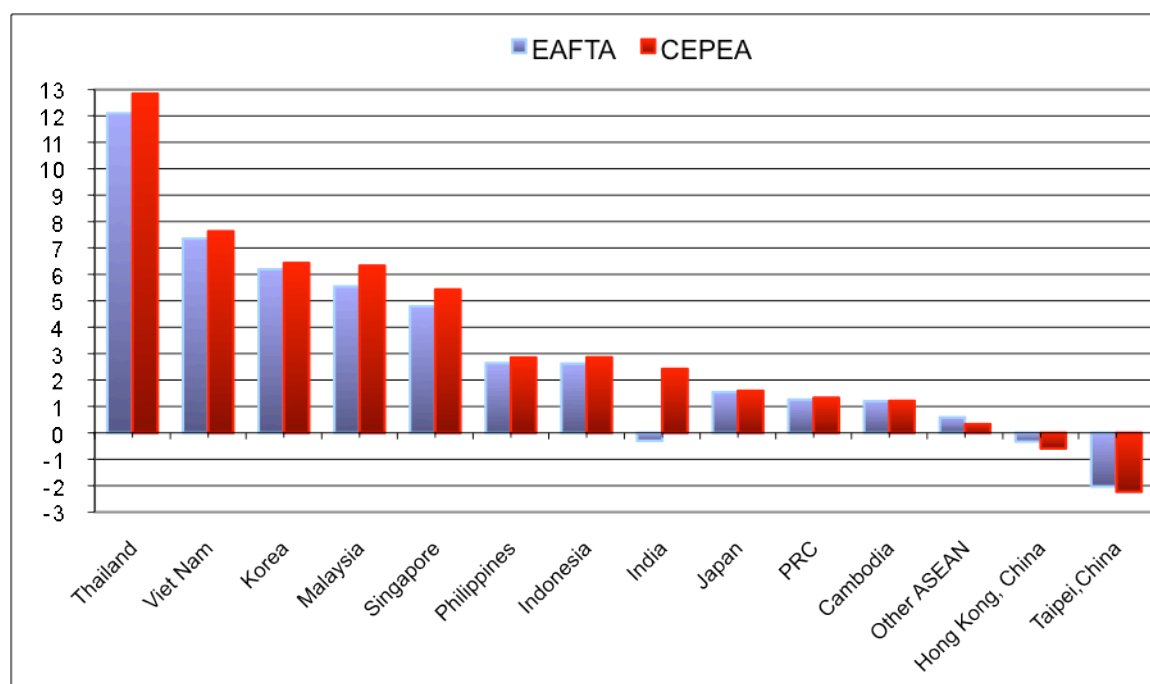
Forming a region-wide EPA

There is increasing recognition in Japan of the merits in forming a region-wide EPA as a means to consolidate the “noodle bowl,” a plethora of bilateral and plurilateral agreements in East Asia. Such a large EPA would confer various economic benefits: (i) increase market access to goods, services, skills, and technology; (ii) increase market size to permit specialization and realization of economies of scale; (iii) facilitate the FDI activities and technology transfer of MNCs; and (iv) permit simplification of tariff schedules, rules, and standards.

With key ASEAN+1 agreements—such as the ASEAN-Japan EPA, ASEAN-PRC FTA, ASEAN-Korea FTA, ASEAN-India FTA and ASEAN-Australia and New Zealand FTA—implemented, the policy discussion in Asia is focusing on competing region-wide agreement proposals. They are an East Asia Free Trade Area (EAFTA) among ASEAN+3 countries (ASEAN, PRC, Japan, and Korea) and a Comprehensive Economic Partnership for East Asia (CEPEA) among ASEAN+6 countries (ASEAN+3, India, Australia, and New Zealand). Japan takes the view that the region should create a CEPEA while PRC advocates the EAFTA. An important challenge is to identify which of the two, an EAFTA or a CEPEA, is more beneficial in terms of economic welfare for the regional and global economy.

Figure 6 presents the results of a computable general equilibrium (CGE) analysis for economies in Asia reported in Kawai and Wignaraja (2010). Three overall results can be highlighted from the CGE exercise in terms of change from 2017 baseline income projections: (i) a region-wide FTA, whether an EAFTA or CEPEA, offers larger gains to world income than the current wave of bilateral and plurilateral FTAs; (ii) the CEPEA scenario, which is broader in terms of country coverage, offers larger gains to the world as a whole in terms of income than the EAFTA scenario; and (iii) third parties outside either an EAFTA or CEPEA lose little from being excluded from a region-wide agreement. The benefit to Japan as a result of an EAFTA or a CEPEA is around 1.5% of baseline GDP, which is smaller than the benefits to many other economies, but sizable for a large economy like Japan.

**Figure 6: Income Effects of Alternative Scenarios Compared to 2017 Baseline
(% Change in GDP by Economy)**



Notes: ASEAN = Association of Southeast Asian Nations; CEPEA = Comprehensive Economic Partnership for East Asia; EAFTA = East Asia Free Trade Area; PRC = People's Republic of China.

Source: Kawai and Wignaraja (2010).

Thus, the CGE analysis demonstrates that a region-wide agreement in East Asia—particularly a CEPEA—would provide welfare gains over the present wave of ASEAN+1 FTAs. The gains to members of such an agreement are notable, while losses to non-members are relatively small. Accordingly, arguments for, and moves towards, a CEPEA are supported by economic modeling.

Political economy considerations of an East Asia-wide EPA

Even though the consolidation of FTAs/EPAs into a region-wide agreement would yield large economic gains to Japan and Asia, the future path seems unclear. An important reason to establish an EAFTA is that production networks have been developed most significantly among the ASEAN+3 countries, and harmonizing rules of origin among these countries can produce a tangible benefit. The logic for a CEPEA is that the production network is beginning to embrace Australia and India. In addition, it would take more time to produce a region-wide EPA including India if that country were slow to liberalize, whereas it would be easier to form a CEPEA if India were to make tangible progress.

To form an East Asia-wide FPA, whether it would be an EAFTA or a CEPEA, it is important to create preconditions—or building blocks—for this. The missing link is an FTA/EPA among the “plus-three countries”—PRC, Japan, and Korea—which would need to coordinate their trade and FDI regimes.

On a possible Japan-PRC EPA, the Japanese government is concerned about the competitiveness of PRC's manufacturing sector and agricultural products. Japan wishes to treat PRC as a non-market economy so that it can safeguard against a surge of Chinese imports into Japanese markets, but the Chinese government insists upon market economy status for itself. Japan also argues that PRC has yet to clearly demonstrate progress towards implementation of WTO entry commitments, with significant issues including clarity of regulations and rules over firms, and protection of intellectual property rights. Japan would like to see improvements in government procurement practices and the elimination of policy bias favoring indigenous innovation by PRC firms. Food safety issues are also a concern for

Japan. The Japanese government has taken the position that an investment treaty should be a first condition before starting an EPA negotiation.²²

Japan's primary concern over a Japan–Korea EPA is the competitiveness of Korea's agriculture and fishery sectors. In contrast, Korea is concerned about Japan's competitiveness in manufactured products (intermediate inputs), Korea's large tariff concessions required due to high MFN tariffs, and the risk of greater bilateral trade deficits with Japan.

Despite these problems, if Japan is able to craft a trilateral EPA with PRC and Korea or separate EPAs with each of them, a strong foundation for a possible EAFTA and a CEPEA could be built. This will require political commitment from the governments of all three countries. Forming a Free Trade Area of the Asia-Pacific (FTAAP) involving APEC members would be more complex than forming a CEPEA. An FTAAP could possibly be established, but only after the East Asian economies conclude an EAFTA or CEPEA.

4.3 Obstacles to Further Liberalization for Japan

Whether pursuing liberalization through the WTO or EPAs, Japan faces various obstacles. This section examines such obstacles for Japan.

Although trade and investment liberalization brings economic benefits to Japan as a whole, the benefits do not accrue to all sectors and individuals equally. Some sectors or groups are likely to suffer from negative consequences. Specifically, competitive sectors are likely to gain large benefits as firms in these sectors can find business opportunities in overseas markets, while uncompetitive sectors are likely to lose because competitive foreign firms would be able to compete successfully with them. These mixed impacts are expected from any type of trade liberalization, whether under the WTO or from a bilateral EPA.

For Japan, agriculture is the most sensitive sector in trade liberalization, regardless of its form, that is, whether a bilateral or regional framework under an EPA, or a multilateral framework under the WTO. Japan has relatively low tariff protection on agricultural products in general, compared to other agricultural product importing countries. What is notable for agricultural protection in Japan is the very high protection given to several products through complicated protection systems, which combine import quotas and high tariffs. For example, the *ad valorem* tariff equivalent for some selected items, such as rice, wheat, sugar, butter, and *konnyaku* potato, are very high. In addition, as a part of the Uruguay Round agreement, Japan introduced a special safeguard system to deal with the damages caused by import surges.

Policies to protect the agricultural sector have been an obstacle in EPA negotiations for Japan. Japan excluded agricultural products from trade liberalization in the Japan-Singapore EPA, even though agricultural production in Singapore was very small. Pork products became a contentious issue in the Japan-Mexico EPA negotiations. Despite a strong demand from Mexico to reduce the level of protection on pork imports, Japan did not give in, and instead increased import quotas on beef, chicken, oranges and orange juice, which were not included in the initial request. Japan's EPA negotiations with other countries have also encountered the problem of import liberalization of agricultural products. EPA negotiations where the import of various agricultural products faced Japan's strong opposition include: the Japan-Philippines EPA (bananas, rice, wheat, starch, dairy products, beef, pork, sugar, canned pineapples), the Japan-Thailand EPA (rice, sugar, boneless chicken, processed chicken), and the Japan-Chile EPA (fish products, pork). In addition to the products listed above, various agricultural products could be identified as possibly sensitive in the FTAAP negotiations, for example, rice (Australia, US, PRC), beef and pork (Australia, US), sugar (Australia), and dairy products (Australia, US).

²² PRC, Japan and Korea embarked on negotiations for a trilateral investment agreement in March 2007.

Among these highly protected items, rice is by far the most difficult item for Japan to liberalize for several reasons. One reason is its importance in agricultural production, with its share amounting to approximately 25% of agricultural production.²³ The second reason is the geography of its production, with rice grown throughout Japan. Finally, farmers have a relatively strong voice in agricultural policy issues due to the disproportionately high electoral powers allocated to rural areas. These factors result in strong political dynamics. In order to make agricultural production more efficient, productive and competitive, it is essential to accelerate reform of the agricultural sector. The government should encourage the concentration of farm land in the hands of large-scale productive farmers, while at the same time assisting those farmers and farm workers forced to leave the agricultural sector in upgrading their skills and knowledge so that they could be employed in other sectors of the economy.

5. CONCLUSION: THE WAY FORWARD

In the post-WW II period Japan made use of global institutions (e.g., GATT, IMF and OECD) and bilateral external pressures (especially, those from the US) to reform its domestic economy through trade liberalization. Structural reforms contributed significantly to improve the competitiveness and productivity of the Japanese manufacturing sector. Indeed, until the 1990s, Japan pursued trade liberalization within the multilateral framework of GATT/WTO and open regionalism of APEC, while undertaking domestic “behind-the-border” liberalization under a series of bilateral negotiations with the US. Although the Japan-US bilateralism sometimes resulted in “managed trade” and encountered resistance to the US approach in Japan, overall, it had a positive impact on the Japanese economy in opening domestic markets through various reforms and deregulation measures.

The US pressure on Japan concerning trade-related issues weakened after the establishment of the WTO in 1995 for various reasons. First, the US, Japan and other WTO member countries began to use the strengthened dispute settlement mechanism of the WTO for settling trade disputes. Second, Japan undertook a number of policy reforms such as those in the financial system and corporate governance, the areas that were the main focus of US concerns over the structure of the Japanese economy. Third, Japan’s trade surplus was no longer the most important source of the US trade deficit, which began to balloon in the second half of the 1990s. The trade and economic structure of Japan had changed, which limited the bilateral trade imbalances against the US. Fourth, the stagnation of the Japanese economy since the bursting of the asset market bubble may have mitigated the US perception of Japan’s threat, in the face of rising competition from, and expanding trade deficits with, emerging East Asian economies, particularly PRC.

At the turn of the century, Japan’s trade policy shifted from a dual-track approach centered on the GATT/WTO and APEC and on US bilateralism to a multi-track approach that would also focus on bilateral and plurilateral EPAs and on regional economic integration in East Asia. Japan made this shift in response to the changing global and regional trading environment. First, trade liberalization under the WTO was stalled due to emerging differences in the views among the WTO members towards trade liberalization, which in turn was attributable to the increasing number of WTO members and to the increasing influence of emerging economies, such as the PRC, India and Brazil, with a more reserved view towards trade liberalization. Second, a rapid expansion of FTAs globally and the successes of European market integration and NAFTA prompted Japanese policymakers to consider EPAs as an important commercial policy tool and to create a series of EPAs with economies inside and outside of Asia. Third, Japan’s trade and FDI activities have shifted away from the

²³ Ministry of Agriculture, Forestry, and Fisheries home page. <http://www.maff.go.jp/hitokuti/top.htm#mokuji1>

US towards East Asia and this has generated growing interest in regional cooperation with East Asian economies. Furthermore, the integration of the Japanese economy with dynamic emerging economies in East Asia is now considered as an important component of Japan's growth strategy.

At its onset, Japan's EPA policy was, however, both passive and defensive in nature, aiming to avoid being discriminated against in foreign markets, which were rapidly captured by FTA networks. Japan's EPA policy became pro-active as Japan found that it could use EPAs to achieve various objectives, including not only increasing market access in EPA partner countries for Japanese firms, but also improving the business environment of partners, strengthening economic cooperation, and increasing economic integration with emerging East Asia. Japan has so far enacted 11 EPAs, mainly with East Asian countries, which account for approximately 17% of Japan's overall trade. Although the Japanese government has made economic cooperation and integration with emerging East Asia through EPAs a high priority policy, the prospect of achieving this goal could be limited due to strong opposition from domestic agricultural interests. If Japan is to effectively pursue EPA policies, it must make agricultural product liberalization a high priority and undertake needed structural reforms in agriculture. Reform of the agricultural sector is also needed to revitalize Japan's economy and to help the WTO resume its practically stalled Doha Development Agenda trade negotiation.

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