

**RIETI-JETRO Symposium**  
**Global Governance in Trade and Investment Regime**  
**- For Protecting Free Trade -**  
Reference

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Jeffrey Joseph SCHOTT  
Senior Fellow,  
Peterson Institute for International Economics  
(PIIE)

June 7, 2012

Research Institute of Economy, Trade and Industry (RIETI)  
<http://www.rieti.go.jp/en/index.html>

## THE TRANS-PACIFIC PARTNERSHIP AND JAPAN

Jeffrey J. Schott

Peterson Institute for International Economics<sup>1</sup>

With the Doha Round of multilateral trade negotiations at an impasse, the Trans-Pacific Partnership (TPP) has now taken center stage as the most significant trade initiative of the 21st century. To the casual observer, the commercial payoff from the TPP in the near-term seems modest: the nine countries participating in the TPP negotiations together only account for a small share of world trade and output.<sup>2</sup>

Yet, the relatively small grouping belies its regional scope and importance, in two respects. First, the TPP is a central pathway for region-wide economic integration efforts that envisage a broad Free Trade Area of the Asia Pacific (FTAAP), possibly within a decade, and provide a feasible “Plan B” to the faltering global trade talks. Second, the value of the TPP goes well beyond its impetus to trade and investment. Perhaps even more important is its strategic value in reinforcing economic and political relationships among the Asia-Pacific countries.

In this short note, I describe the countries currently participating or seeking to join the TPP talks and summarize what they are trying to achieve. I then examine Japanese interests and objectives in joining the trade initiative and the US position on Japanese participation.

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<sup>1</sup> © Peterson Institute for International Economics, 2012.

<sup>2</sup> As of June 2012, the countries negotiating the TPP are Australia, Brunei, Chile, Malaysia, New Zealand, Peru, Singapore, the United States, and Vietnam.

### **TPP Participants: How Alike? How Like-Minded?<sup>3</sup>**

To understand the TPP, it is important to know the players. The original initiative started with the so-called P-4 agreement between Brunei, Chile, New Zealand, and Singapore. Those countries thought that if they could craft a high quality accord, their deal could form the core of a broader trading arrangement covering other Asia-Pacific countries—and Australia, Peru, and the United States subsequently joined the P-4 countries in support of that concept in September 2008. Bad timing: the global financial crisis deferred consideration of the TPP for more than a year.

When TPP talks were launched in Australia in March 2010, the seven full participating countries were touted as having a common view on what should be included in the agreement. Working with a small group of “like-minded” countries, TPP trade ministers argued that they could put together a high standard, 21st century trade pact that contrasts sharply to the more limited or hortatory commitments delivered by most trade pacts concluded among APEC countries. Even then, however, the TPP participants had different perspectives and priorities on sensitive issues and product-specific liberalization. Subsequently adding Malaysia and Vietnam to the mix further complicated the negotiating calculus.

The TPP encompasses countries of varying size, level of development, and attitudes towards political rights/civil liberties. Table 1 gives a snapshot of the overall trade of the nine participating countries (the “TPP-9”) and the four countries that could join the talks in the near future (Canada, Japan, Mexico, and South Korea). Table 2 provides economic indicators of the size and level of development of those countries.

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<sup>3</sup> This section draws heavily on analysis in a forthcoming PIIE policy brief, “Understanding the TPP” by Jeffrey Schott, Barbara Kotschwar, and Julia Muir, to be published in late June 2012.

From an economic perspective, the TPP-9 countries are remarkably diverse, with notable differences in the size and composition of their economies and levels of economic development. And while they share a common interest in crafting a high-standard trade agreement, and are working constructively together toward that end, they have different priorities that reflect the predominant economic interests in each country.

Most current TPP participants are high income (Australia, Brunei, New Zealand, Singapore and the United States) or upper middle income (Chile, Malaysia and Peru) in terms of per capita GDP. Vietnam is the outlier in all categories except size of population. Vietnam is the only lower-middle-income country, and its Human Development Index (HDI) and Economic Freedom scores are significantly lower than those of the other countries.

Such diversity will challenge the TPP negotiators to construct a high-quality agreement that all participants can faithfully implement and enforce. I suspect that the TPP will address the issue of different levels of development by including provisions on cooperation to help build capacity with regard to human capital, physical infrastructure, and the administration and enforcement of commitments in areas such as technical standards and intellectual property rights. In addition, the TPP probably will also have to accommodate those differences by allowing asymmetric implementation of the common TPP obligations so that poorer countries can pursue innovative ways to manage the adjustment process as they pursue TPP-mandated reforms over a fixed period of time.

The combined GDP of the TPP-9 countries is about \$17 trillion. However, more than 85 percent of that total is accounted for by the United States. The other eight economies are relatively small. The United States also accounts for more than 60 percent of the total merchandise trade of TPP participants (and an even larger share of total services trade). Couple

the US economic dominance with more diversified range of scores on Human Development Indicators (HDI) or Economic Freedom, and one can see how TPP negotiators face key challenges in crafting a new trade rulebook in areas such as transparency, dispute settlement, labor and the environment, among other issues.

Japan would make the TPP a big deal. Its GDP is more than 2.5 times larger than the combined total of the non-US participants. In terms of volume of trade, Japan's merchandise trade, exports and imports, is about the same as the other eight countries combined. So from a US perspective, adding Japan more than doubles the size of the trading arrangement covered by the prospective TPP accord.

### **The TPP: Scope and Coverage**

The TPP participants are committed to crafting a comprehensive agreement that dismantles barriers to trade in goods and services, breaks new ground on issues like labor, environment, investment, competition policy, and state-owned enterprises, and seeks to develop a more coherent approach across sectors with regard to regulatory policies that affect flows of trade and investment. The goal is to create a trade regime that is "state of the art." To get an idea of the basic parameters of the prospective TPP accord, I would commend looking at the newly-minted Korea-United States FTA which is considered the "gold standard" of FTAs in terms of content and coverage and provides important precedents for the ongoing negotiations.

While the TPP negotiators face a daunting challenge in crafting a comprehensive regional trade integration pact, they are not starting from scratch. There already is an extensive network of bilateral and regional free trade agreements in place among core and candidate countries that

includes a large stock of liberalization commitments. Some of the free trade agreements (FTAs) among TPP members are high standard agreements that cover goods, services and extensive obligations on domestic policies and regulations that can distort trade and investment. Most, however, merely make reference to existing WTO obligations in those rulemaking areas and do not include significant commitments in key areas like investment, services, transparency, movement of labor, etc.

At their meeting in Honolulu in November 2011, TPP leaders issued a framework for the TPP accord and urged their negotiators to finish the deal in 2012. Talks have accelerated. To date, twelve negotiating rounds have made remarkable progress in compiling draft text on more than 20 chapters. But there is still a lot of work to do and a long list of contested issues that need to be resolved. Creating a “high standard” agreement in terms of both trade liberalization and trading rules inevitably runs up against political pressures to maintain support for import-sensitive products. Questions also arise regarding what is the appropriate standard for rules covering trade-related aspects of issues such as intellectual property, investment and capital controls. All of these issues have been vetted in prior FTA negotiations, and current TPP participants have different approaches for dealing with them.

The 2012 target date is clearly over-ambitious. The short list of sticking points in the TPP talks is too long. Negotiators are still grappling with the scope and depth of rulemaking obligations in areas such as intellectual property rights, disciplines on state-owned enterprises, investor-state dispute settlement provisions as well as liberalization of long entrenched border and regulatory barriers distorting trade and investment in agriculture, manufactures, and services. As a result, the negotiations will likely extend well into 2013 before an initial deal can be cut.

## Japan's Cautious TPP Overtures

In 2010, former Prime Minister Kan sought to accelerate Japan's decision on whether to join the TPP talks, and began to develop strategies for garnering support and muting opposition from agricultural and other key domestic constituencies. Sadly, the Tohoku earthquake, tsunami, and nuclear disaster of March 2011 necessarily set back the timeline for Japan's decision so that the government could focus its efforts on a rebuilding strategy. Despite this, the Japanese government continues to discuss the matter of membership, and is pursuing new economic strategies that could facilitate Japanese participation in the TPP negotiations in the near future.

The Japanese government's Interim Report on Strategies to Revitalize Japan (August 2011) recognized these problems and recommended reforms over the next five years "to enhance the competitiveness and soundness of Japan's agriculture, forestry, and fisheries" including "introducing more efficient distribution systems."<sup>4</sup> Some Japanese observers wonder whether it would be better to provide income support to farmers in lieu of trade protection. With the exception of rice, the cost of such transfers could be accommodated in the budget without too much difficulty...especially if current tax proposals succeed in generating additional revenues.

Japan has already begun to implement reforms. In June 2011 the government enacted tax reform provisions that incentivize employment, environmental investment and a reduction in the effective corporate tax rate by roughly 5 percent.

In October 2011, the US-Japan Business Council released a white paper supporting Japan's participation in the TPP, emphasizing the positive benefits it would have on Japan's economic growth by stimulating economic reforms in key areas that will "make the economy

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<sup>4</sup> "Interim Report on Strategies to Revitalize Japan." National Policy Unit, Government of Japan. August 5, 2011. Available at [www.npu.go.jp](http://www.npu.go.jp).

more dynamic and competitive, and a more attractive place to invest and operate.” The paper also emphasized the importance of a realistic reform plan and timeframe. Two months later, Prime Minister Noda announced at the APEC Summit in Honolulu that Japan would enter into consultations with current TPP participants to explore the possibility of joining the negotiations.

### **Japanese Interests and Objectives in the TPP**

In pursuing bilateral and regional trade pacts, major trading nations almost always have a combination of economic and strategic objectives. In the case of the TPP, the major strategic interest is in strengthening the bilateral alliance with the United States while commercial benefits accrue from deeper trade and investment ties with all the member countries.

**Strengthen the US-Japan Strategic Alliance.** From a strategic or political/security perspective, the TPP would reinforce the US-Japan alliance, which is especially important given the rise of China and provocations from North Korea and our joint efforts to deflect Iran’s quest for nuclear weapons. Japan is working closely with the United States on economic sanctions aimed at forcing Iran to forego its weapons program. In recognition of its support, President Obama exempted Japan in late March 2012 from the harsh US sanctions due to be implemented at the end of June that would bar those continuing to pursue “business as usual” with regard to purchases of Iranian crude oil from access to US financial markets.

In addition to the sanctions waiver, the United States needs to work with Japan to ensure that reliable and diversified supplies of energy are available to fuel renewed economic growth in Japan at a time when the aftershocks of the terrible tragedies of 3/11 severely constrain power



generation in the country. It can do so in several ways. One approach is to encourage additional production from other Middle East producers, especially Saudi Arabia whose heavy crude is comparable to the Iranian exports covered by the sanctions. Another possible action would be to plan to export liquefied natural gas (LNG) to Japan in the future, now that the recent boom in US gas production has created exportable surpluses. Under US law, FTA partners are exempted from export licensing requirements for energy shipments, so TPP participation would facilitate future US exports of LNG to Japan. More immediately, the US government should expedite regulatory and environmental reviews required under US law so that infrastructure investments can go forward on an export-oriented distribution network. Doing so would provide Japan a very tangible payoff for its decision to join the TPP talks and undertake the trade liberalization and regulatory reforms that will be required of each signatory.

**Reinforce efforts to reform domestic economic policies.** The most important economic reason for Japan to participate in the TPP is that it would complement efforts to boost the efficiency and productivity of the Japanese economy. TPP obligations should work hand in glove with ongoing Japanese policy reforms to that end. Arguments in favor of Japanese membership highlight the complimentary goals of the TPP agreement and Japan's strategy to reorient domestic policies towards a more outward looking trade and investment strategy. Funabashi (2010) emphasizes the need for Japan to "establish a trade and investment strategy that will further connect it both to the Asia-Pacific region and the world."<sup>5</sup> In light of the reconstruction needs after the tragic 3/11 events, increased trade and investment should be an

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<sup>5</sup> Funabashi, Yoichi. 2010. "Japan must support liberal international order," East Asian Forum, November 8.

integral part of Japan's economic recovery plans and participation in the TPP can help strengthen commercial relations with key markets in the Asia-Pacific region.

**Upgrade and expand bilateral and regional trade arrangements.** Participation in the TPP would provide Japan an opportunity to upgrade the stock of relatively lower quality Economic Partnership Agreements (EPAs) already concluded with some TPP participants and harmonize them with new accords with other TPP countries (United States, New Zealand, Australia, Canada). Call it an EPA modernization program!

Japan already has an extensive network of trade agreements among the countries participating in the TPP talks and those seeking to do so. EPAs are in place, under negotiation, or in preparation with all of the countries with the notable exception of the United States. EPAs with Chile, Peru, and Singapore are comprehensive compared to most trade pacts concluded in Asia, the pact with ASEAN – covering TPP participants Brunei, Malaysia and Vietnam -- much less so. None are on a par with the Korea-US FTA that is likely to provide precedents for many TPP chapters.

Moreover, Japan's talks with Australia are stalled, those with Canada just announced and with New Zealand still in the pre-natal stage, and negotiations with South Korea have been suspended since December 2004. Prospects in all these talks are clouded by problems in agriculture and none of the prospective bilateral deals alone is sufficiently important in economic terms to spur the needed changes in Japanese farm policies. The TPP could be different for two reasons: it adds the US-Japan dimension and it cumulates the prospective trade gains from the

other countries where agriculture impedes the negotiating process. Simply put, Japan could substantially multiply the trade concessions it gets for farm trade reforms in the TPP.

Joining the TPP is also a natural complement to Japan's strategy of promoting economic integration in the Asia-Pacific region, and could meld with Japan's proposal for an "ASEAN + 6" to advance progress toward the APEC goal of a FTAAP. Participating in the TPP, just as joining with China and South Korea in a Northeast Asia pact, can be pursued as complementary approaches to the broader and longer term goal of Asia-Pacific economic integration.

**Avoid discrimination from other trade pacts.** Japanese exporters currently face a double whammy: a strong yen that adversely affects their price competitiveness, and discrimination generated by other trade pacts that grant preferences to Japanese competitors in foreign markets. In that regard, Korea's recent FTAs with the European Union and the United States are the most significant. The TPP would level the playing field for Japanese firms and help them keep pace with Korea in major industrial markets.

### **US Concerns about Japan's Readiness to Join the TPP**

US officials strongly favor Japanese participation in the TPP talks. Japanese participation would raise the economic profile of the deal and the size of the potential benefits for all the TPP countries, and would further reinforce the robust US-Japan strategic relationship. On a more practical level, Japan would be a constructive partner of the United States in crafting new TPP disciplines on investment and intellectual property issues, among others.

However, US Trade Representative Ron Kirk has emphasized that Japan “must be prepared to meet the TPP’s high standards for liberalization of trade and to address specific issues of concern to the United States regarding barriers to agriculture, services, and manufacturing trade, including non-tariff barriers.” The most frequent complaints involve restrictions on access to Japan’s auto market, the new advantages accorded Japan Post in recent legislation passed by the Diet, and import restrictions on farm products like dairy and beef. The following is a short list of US concerns about Japanese participation in the TPP talks that have arisen in US public debate over the past year or so:

Is there sufficient political support in Japan to sustain the commitment to economic reform?

Given the volatility of Japanese politics in recent years, the frequent leadership changes, and vigorous intra-party and inter-party debate on the TPP, questions arise about the durability of Japan’s interest in participating in the TPP talks and undertaking TPP-mandated trade liberalization. The strategic and commercial advantages of Japanese participation cited in the previous section appear decisive; the TPP would provide substantial benefits overall for the Japanese economy. But politicians focus closely on the distribution of those gains and thus have to develop domestic programs to manage the adjustment of constituents that will face more competition as a result of the new trade pact. US officials face the same challenge and are working closely with congressional leaders who have been very supportive of the TPP.

Will Japan create problems in developing new trade rules in areas such as disciplines on state-owned enterprises (SOEs) among others?

While Japan would likely support US efforts to craft high-quality rules on investment and other issues, there are concerns about US-Japan differences over disciplines on SOEs. In that regard, the recent passage by the Diet of a bill to reverse crucial postal reforms may have intensified rather than ameliorated US concerns about discrimination against foreign providers of insurance products and financial services in the Japanese market.<sup>6</sup> The new law repeals the mandate for Japan Post Insurance and Japan Post Bank to be fully privatized. The mandate was replaced with a “best efforts” requirement, which will essentially allow Japan Post to maintain indefinitely its network of post offices that allow it to sell its own “over-the-counter” insurance policies to postal customers in preference to carrying private-sector products. US officials undoubtedly will want Japan to implement reforms to level the playing field between Japan Post and private providers as part of a TPP deal. In the interim, a standstill on the placement of new products that receive preferential regulatory treatment under the new law should be considered.

Will Japan ask for wide-ranging exceptions for agricultural products or sectors that would conflict with the commitment of TPP countries to achieve comprehensive trade coverage?

Agriculture presents the most intractable political and economic challenge. As in most countries, agricultural districts are over-represented in the Diet and lobby fiercely for the maintenance of domestic programs that support farm income and trade barriers that limit import competition. Rice is the most prominent concern. In this case, Japanese officials regard the exemption of rice from liberalization in the KORUS FTA as an appropriate precedent for the TPP as well. But Japanese tariffs on dairy products and other sensitive farm products also are in

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<sup>6</sup> For an analysis of these concerns, see Gary Hufbauer and Julia Muir, “Japan Post: Anti-Reform Law Clouds Japan’s Entry to the Trans-Pacific Partnership”, Policy Brief 12-12, Peterson Institute for International Economics, Washington, May 2012.

the stratosphere, often coupled with non-tariff measures that impede access to or distribution within the Japanese market. Such policies provide comfort for those who value local production but come at a high cost to the overall economy – and to Japanese consumers in particular -- because of the large diversion of resources into relatively less productive activities.

Will longstanding concerns of US industry about Japanese market access barriers, particularly non-tariff measures (NTMs), be adequately addressed?

Among others, US auto companies have complained about obstacles to effective market access in Japan. Their concerns echo charges leveled at Korean companies during the KORUS FTA negotiations, including NTMs embedded in emissions and safety standards and differential taxes based on engine displacement. Clearly, these companies would like Japan to accept, at a minimum, the policies and transition measures that Korea accorded US exporters in the supplemental agreement concluded in December 2010.<sup>7</sup> More oddly, these companies also claim that Japan is manipulating its exchange rate to protect Japanese auto production. But with the yen/\$ rate at 79, this critique is not credible. Indeed, due in part to the strong yen, a large majority of Japanese-brand cars sold in the United States are produced in North America.

In addition, Senator Max Baucus (Chairman of the powerful Senate Finance Committee) and others continue to complain about Japanese restrictions on the imports of US beef in effect since the BSE outbreak in late 2003. Japan initially banned imports of American beef and the US market share was ceded to Australia and New Zealand, the only major beef exporters that had access to the Japanese market. Japan subsequently reopened its market to US supplies.

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<sup>7</sup> For the details of that pact, see Jeffrey Schott, "KORUS 2.0: Assessing the Changes", Policy Brief 10-28, Peterson Institute for International Economics, Washington, December 2010.

However, unlike South Korea and many other countries, Japan only allows imports of US cattle less than 21 months old in contrast to the 30-month age limit applied by other countries. US officials argue that since the World Organization for Animal Health certified the United States as a “controlled risk” supplier, the limits should no longer be applied. The matter is currently under review by Japan’s Food Safety Commission, and I am hopeful that those deliberations will help clarify the issue and mitigate the differences.

All of the above concerns can and should be resolved in the current bilateral consultations in which both countries seek the same end result, namely Japanese participation in the TPP talks. I am optimistic that Japan will be able to join the negotiations in the near future and will be a full partner at the negotiating table when the final deal is struck.

**Table 1. TPP: Economic Indicators (US\$ billions)**

	<b>GDP</b>	<b>Exports</b>	<b>Imports</b>
	<b>2010</b>	<b>2011</b>	
United States	14,587	1,481	2,265
Other TPP countries	2,193	1,187	1,065
Japan	5,459	823	854
Subtotal	22,239	3,491	4,184
World total	63,257	18,217	18,381

Sources: World Development Indicators 2012 and WTO Statistics Database, 2012.

**Table 2. Development Indicators**

	Population (millions)	GDP (billions US\$) <sup>1</sup>	Per capita GDP (US\$) <sup>1</sup>	2011 HDI Index <sup>2</sup>	2009 Economic freedom in the world index <sup>3</sup>
Australia	22	1,132	50,748	0.929	7.98
Brunei	0.4	11	27,390	0.838	n.a.
Chile	17	213	12,431	0.805	7.77
New Zealand	4	127	29,352	0.907	8.27
Malaysia	28	238	8,373	0.761	6.68
Peru	30	157	5,401	0.725	7.39
Singapore	5	209	41,120	0.866	8.68
United States	310	14,587	47,153	0.910	7.60
Viet Nam	88	106	1,224	0.593	6.48
<b>Subtotal: TPP - core</b>	<b>505</b>	<b>16,780</b>			
<b>Average: TPP core</b>			<b>24,799</b>	<b>0.815</b>	<b>7.61</b>
Canada	34	1577	46,212	0.908	7.81
Japan	127	5459	42,831	0.901	7.44
Korea	49	1014	20,757	0.897	7.32
Mexico	109	1036	9,133	0.770	6.74
<b>Subtotal: TPP - candidates</b>	<b>210</b>	<b>8,050</b>			
<b>Average: TPP - candidates</b>			<b>29,733</b>	<b>0.869</b>	<b>7.33</b>

<sup>1</sup> Figures for Brunei and New Zealand are from 2009. All others are 2010 data

<sup>2</sup> The Human Development Index (HDI) is published by the United Nations Development Program. The index comprises six indicators: life expectancy at birth, mean years of schooling, expected years of schooling, per capita GNI, GNI rank and non-income HDI value. The index is on a scale of 0 to 1; where 0 is the lowest and 1 indicates the highest level of human development.

<sup>3</sup> The index measures the degree to which the policies and institutions of countries are supportive of economic freedom. The index comprises 42 data points to measure the degree of economic freedom in five broad areas. These include: size of government, legal structure and security of property rights, access to sound money, free to trade internationally and regulation of credit, labor and business. Countries are ranked on a scale of 0 to 10, with 10 representing the more economic freedom.

Sources: World Bank Development Indicators 2012, UNDP, Fraser Institute.



