Japan and Asia-Pacific Economic Integration: Looking beyond TPP

William W. Grimes

A little over a year ago, on July 23, 2013, Japan formally joined the negotiations to create the Trans-Pacific Partnership (TPP), one of the most ambitious trade negotiations ever. After a number of years of domestic debate and attempts by two previous prime ministers to persuade their coalitions to support it, the new Shinzo Abe administration had resolutely chosen a path toward all-out liberalization of trade and investment that could transform the Japanese economy. TPP had the potential to promote both Asia-Pacific economic integration and domestic reform. Today, however, the TPP process is in limbo and Japan’s commitment to comprehensive liberalization is in question. What does this mean for Japan’s economy going forward?

Japan in the Asia-Pacific Economy

Despite the old shibboleth that Japan’s economic miracle was due to “export-led growth,” Japan has in fact been a rather closed economy by many measures. This pattern began to change in the late 1980s, after the rapid appreciation of the yen that began with the 1985 Plaza Agreement. Japanese firms began to source more of their intermediate goods and components from other Asian economies; over time, these practices contributed to the development of extensive regional production networks (RPNs) for the manufacture of consumer electronics, information technology hardware, and (to a lesser extent) automobiles. RPNs allowed for a regional division of labor based on comparative advantage, creating opportunities for developing and middle-income countries up and down the supply chain.

Today, RPNs drive the bulk of East Asian intra-regional trade, with final production being exported globally. This is not simply about regional sourcing, as Japanese foreign direct investment and services trade have generally followed goods trade. Japanese banks, trading companies, and shipping companies have also built regional and global operations that support the needs and activities of manufacturers. To be sure, Japan and Japanese firms are no longer at the center of the regional economy; moreover, RPNs have contributed to the deindustrialization of Japan, creating considerable angst. Nevertheless, it is evident that Japan’s economic future lies in further integration into a regional Asia-Pacific economy.

Further integration of Japan into the regional economy will be the result of private-sector decisions and actions, as firms and banks make decisions about how best to serve existing markets and prioritize new ones. Still, government policies are important in shaping incentives.

TPP in Theory and Practice

The concept of the TPP is to create a high-quality, “21st century” trade agreement that will be comprehensive in scope and promote deep integration among its members. It goes beyond existing regional trade agreements by reaching inside borders to address nearly every type of policy that has cross-border implications. The proposed reach of TPP includes rules that govern trade in goods and services, investment, competition policy, government procurement, e-commerce, agricultural policy, financial regulation, intellectual property rights, the activities of state-owned enterprises, labor, and environment. At

1 Japan’s trade-GDP ratio is by far the lowest of any of the major East Asian economies; among industrialized countries, only the United States ranks lower on that measure (http://data.worldbank.org/indicator/TG.VAL.TOTL.GD.ZS). Inward foreign direct investment (FDI) has also been unusually low—with a cumulative inward FDI stock of $205 billion (3.4% of GDP), it is lower in absolute terms than FDI stock in Poland and by far the lowest relative to GDP among OECD countries (at 3.4%, far behind the next lowest OECD member, South Korea, at 12.8%) (http://www.oecd.org/investment/FDI%20in%20figures.pdf.) Among indicators of economic globalization, Japan punches in its weight class only in terms of outward FDI.
least some of these disciplines would be enforced through an investor-state dispute resolution mechanism that would allow foreign investors to challenge domestic laws, further reducing the policymaking discretion of member states.

Thus, TPP is more than just a trade agreement. If the maximalist positions in each of its disciplines are adopted, it would have a transformative effect on the economies of many of the participating states, including Japan. For Japan, TPP addresses a number of Prime Minister Abe’s “third arrow” priorities, while also providing a backdoor means to a U.S.-Japan free trade agreement (FTA), which had long been considered politically infeasible. Externally, TPP would create new opportunities for Japanese firms to enter and do business on a level playing field with locals in the 11 other TPP countries. Internally, it could provide a bludgeon with which to advance the cause of structural reform: forcing Japanese farmers to improve efficiency and cost competitiveness, increasing competition into protected sectors like health care and legal services, and eliminating preferences for partially privatized institutions like Japan Post and NTT.

Theory is not necessarily the same as reality, however. Opposition to TPP runs deep in many participating countries, not only to the “21st century” issues (i.e., the “behind-the-border” issues, e-commerce, supply chain facilitation, intellectual property rights, environment, labor, etc.) but also the “20th century” issues of trade in goods and services. Twentieth century issues are perhaps particularly important between Japan and the United States, which are by far the two largest economies participating in TPP negotiations. According to numerous news reports, U.S.-Japan bilateral negotiations (which are ongoing, even though the formal TPP negotiating rounds are multilateral) have been bogged down by Japan’s unwillingness to fully liberalize agricultural imports. U.S. popular and political opposition to TPP is also strong, especially in the Rust Belt, where fears of competition from the Japanese auto industry run deep. U.S. legislators have shown their hostility to the negotiations by not passing trade promotion authority (TPA, or “fast track”), TPA, which requires Congress to vote up or down on trade agreements without adding amendments, has been an essential tool for passage of trade agreements for decades; without it, it is hard to imagine that the United States’ TPP partners would make their best and final offers or that the negotiations will be successfully completed. While some commentators have blamed Japanese intransigence over agriculture for the apparent slow pace of TPP negotiations since late 2013, it can also be argued that the Japanese government is holding out on making politically unpopular decisions until it can be sure that a deal is imminent—which will not be the case until (or unless) Congress passes TPA. For now, there is simply not enough evidence to make a meaningful judgment about the Abe administration’s intentions.

TPP and Abenomics

The irony is that Japan stands to gain more from TPP than any other participant, at least in absolute terms. The reason is not primarily that Japanese firms will gain a great deal of market access in other TPP economies. Rather, the major gains are expected to result from removal of its own barriers to imports and domestic competition that have made bastions of inefficiencies out of a number of sectors from agriculture to textiles to legal and health services. According to economic logic, exposing these producers to greater competition will either make them more efficient or drive them out of business and shift resources to more competitive sectors.

To put it another way, a trade agreement with TPP countries is less important to Japan’s economic revitalization than large-scale domestic economic reform. The Abe administration shares this assessment of TPP as a domestic policy tool, and indeed several of the items in TPP mirror key elements of Abenomics “third arrow.” However, political resistance to such changes is significant, and there has been limited progress in advancing the structural reform agenda. The result is that the success of Abenomics structural reform has become closely linked with that of the TPP negotiations.

When Prime Minister Abe first came to power, time was on his side. He had a strong majority in the Lower House and was able to appoint accommodative new leadership at the Bank of Japan. After the 2013 Upper House election, he had strong majorities in both houses of the Diet and the prospect of three years without a national election. A year and a half into his administration, with little prospect of TPP being completed before mid-2015 at the earliest, however, the window of opportunity is closing. It appears that Abe can no longer count on TPP to be a silver bullet for structural reform.

What If TPP Continues to Languish?

This raises the question of how Japan should move forward in terms of regional economic integration as well as domestic reform. Fortunately, despite the rhetorical commitment to TPP as a central pillar of both pieces of the economic agenda, there are other options. For the domestic agenda, the Japanese government’s best bet will be to continue with ongoing reforms, although priorities may shift as TPP sits on hold. With or without TPP, serious structural reform will inevitably be a matter of political will, and victory will not be dramatic but rather the result of an accumulation of incremental changes. Certainly, success is not assured. But serious progress is possible if the Abe administration starts acting with greater urgency on the third arrow.

As for trade agreements, the regional picture does not look promising. Not only is TPP in limbo, but negotiations with other major trading partners are either in preliminary stages or stalled. This is true not only of the ASEAN-centered Regional Comprehensive Economic Partnership (RCEP), but also of the Japan-EU, Japan-Korea, and China-Japan-Korea negotiations. While all of these partnerships could have a significant impact on Japanese growth and most would tie the Japanese economy more closely to the dynamism of East Asia, none is a near-term prospect.

Fortunately, regional negotiations do not represent a complete picture of the potential importance of trade agreements. The failure of the Doha Round makes it easy to overlook the successes of multilateral and plurilateral agreements under the World Trade Organization (WTO), including in recent years. Japan can benefit from a variety of recent or upcoming agreements, including the WTO Trade Facilitation Agreement, as well as the International Technology Agreement (ITA), which has succeeded spectacularly in eliminating barriers to much of the component trade that has underlain regional and global production networks in information and communications technology hardware; the Government Procurement Agreement (GPA); the Trade in Services Agreement (TISA); and the Environmental Goods Agreement (EGA). By addressing sectoral barriers to trade among coalitions of the willing, these plurilateral agreements have the potential to move forward Japan’s economic integration with its Asia-Pacific neighbors without the endless negotiations of a TPP or RCEP and the perils of getting stuck in the “noodle bowl” of multiple nonstandardized bilateral FTAs.

Economic Policy beyond TPP

All this is qualified good news for Japan. The TPP strategy had the potential to kill multiple birds—domestic reform, regional integration, and reinforcement of the U.S.-Japan alliance—with one stone. It is not necessary for any of them, however. Given the reality that TPP will not be concluded quickly (or, perhaps, even eventually), the Japanese government would be wise to focus on a combination of domestic reform and rededication to plurilateral initiatives like the ITA, TISA, and EGA. By doing so, it can advance the goals of shaping an integrated Asia-Pacific economy in which Japanese firms are confident and robust players.

William W. Grimes is a professor of international relations and political science in the Pardee School of Global Studies at Boston University.

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