Mark Manger

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Competition and Bilateralism in Trade Policy: the Case of Japan's Free Trade Agreements

Mark S. Manger
Department of International Relations
London School of Economics

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Why do major economic powers seek more and more free trade agreements (FTAs) with smaller partners? Recently, Japan has joined the bandwagon by signing its first bilateral FTA. The decision, highly contested domestically, represents a sea change in Japanese trade policy and a challenging case for theories of regionalism. This paper lays out a theoretical appraisal for why more and more industrialized countries join FTAs with emerging markets and illustrates the argument with an analysis of the Japanese case.
The paper argues that foreign direct investment (FDI) changes the incentives for states in favour of preferential trade agreements. Increased FDI and shifts in multinational firm strategies increase flows of intermediate goods. As a result, firms lobby their home governments to bolster their competitive position by signing preferential agreements. Yet, FTAs also discriminate against firms from third parties, motivating them to lobby for defensive agreements.
The qualitative case studies show how NAFTA discriminates against Japanese FDI in Mexico. As a result, firms began to lobby the Japanese trade bureaucracy, changing the perception of key policymakers who developed a strategy of pursuing preferential trade agreements in the Asia Pacific region, as shown in a case study of the initiative for an FTA with Thailand.

Keywords: regional economic cooperation; Japan; free trade agreements; multinational corporations; NAFTA; foreign direct investment

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Introduction

During the past ten years, regional and bilateral free trade agreements (FTAs) have proliferated rapidly. The WTO counts more than 250 regional trade arrangements, over half of them signed in the last ten years.[1] Recently, Japan has joined the bandwagon. After adhering to a multilateralist trade policy for over four decades, it concluded its first bilateral free trade agreements (FTAs): the Japan-Singapore Economic Partnership Agreement (JSEPA), signed in January 2003, followed by the Japan-Mexico FTA in September 2004 and a 'basic accord' with the Philippines in November 2004. Negotiations with South Korea, Thailand and Malaysia are underway. The decision to pursue preferential agreements for trade and investment, intensely contested domestically, represents a sea change for Japanese trade policy.

Japan's policy shift is puzzling for several reasons. Scholars have argued that countries seek FTAs to protect export markets when other countries are concluding preferential agreements, especially when multilateral negotiations are stalled (Mansfield and Reinhardt, 2003; Zissimos and Vines, 2000). Yet as markets, countries like Thailand and Mexico are of minor importance, with a respective share of four and one per cent of total Japanese exports.[2] Even if the argument of a stalled WTO holds, these countries cannot supplant the US, EU, China and Taiwan that buy 80 per cent of Japanese merchandise exports.

The small size of partner economies also casts doubt on potential welfare gains, a second argument made to explain the popularity of FTAs (Baier and Bergstrand, 2004). Urata and Kiyota (2003) use a computable general equilibrium model to estimate the effects of a regional FTA encompassing Japan, Korea, China, Taiwan, Hong Kong and ASEAN (excluding Brunei and Myanmar) on national income and trade patterns. Yet even their most optimistic scenario predicts an added GDP growth of only 0.05 per cent for Japan.

Japanese government officials offer a third rationale for FTAs: to boost the liberalization of the protected agricultural sector in Japan.[3] In the two existing agreements, however, agriculture was mostly excluded. Indeed, some observers now acknowledge that agricultural reform is a precondition and not a reason for FTAs (Hatakeyama, 2003a; Yamashita, 2004).

So why did Japan begin to seek bilateral agreements in recent years? This article argues that Japan's pursuit of FTAs is representative of a broad trend in international economic relations: it reflects the growing importance of foreign direct investment (FDI) and the sharing of production across borders. FDI changes the incentives for states regarding preferential trade agreements, motivating them to pursue bilateral options <u>in addition</u> to multilateral negotiations. Yet, with the increasing internationalization of production, bilateral agreements also threaten to discriminate against firms from third parties, motivating them to lobby for defensive agreements. According to the argument advanced in this article, Japanese firms with vertically integrated operations in the host country emerge as key supporters of FTAs, in particular when their profits are under threat from FTAs signed by other countries.

In this sense, the explanation given in this paper also differs from recent accounts of the Japanese FTA policy that attribute most of the initiative to Japanese trade bureaucrats (Krauss, 2003; Ogita, 2003). Trade bureaucrats did matter, I argue, but primarily when responding to pressure from interest groups, especially Japanese firms with overseas investment. The logic of this argument is illustrated with two case studies: the Japan-Mexico FTA, a defensive reaction against NAFTA, and the Japanese initiative for an FTA with Thailand, a proactive measure.

For two reasons, the Japanese FTA initiatives are challenging cases for the argument. First, compared to the US and European countries, Japan lags in the central measure of international production-sharing: vertical intra-industry trade,[4] or trade in similar goods of different levels of capital-intensity, with regional trade partners (Fukao, et al., 2003). Second, Japan has a notoriously strong agricultural lobby (George Mulgan, 1999) that should make bilateral agreements with developing countries particularly difficult to achieve. If it can be shown that despite these counteracting factors, lobbying by these Japanese firms was crucial in motivating Japanese policymakers to pursue FTA, then this offers strong support for the central claim of this study.

The aim is not to provide a fully-fledged alternative to existing theories of regionalism. Governments conclude trade agreements for various political reasons, most importantly to support allies (Gowa and Mansfield, 1993; Gowa, 1995). Any FTA, however, will have distributive effects with implications for domestic interest groups, who either support or oppose such deals. I seek to demonstrate that a theory remains incomplete if it does not take the political interests into account that emerge with the increasing importance of FDI. Other factors, such as slow progress in the GATT/WTO and weak regional institutions may have contributed to a change in Japanese trade policy, as argued by Ravenhill (2003), but since they were as valid in the early 1990s as now, they offer little insight into why Japanese policy changed only recently. To provide evidence for this interpretation, this study analyses the sequence of events through process-tracing, (King, et al., 1994: 85-7, 225-28) based on interviews with policymakers in government and industry, newspaper articles, and secondary sources.

The article is organized as follows. The next section provides a brief overview of Japan's trade policy initiatives in the Asia Pacific since 1989. Section three examines existing theories of regionalism in the field of International Political Economy and finds that they cannot fully account for the Japanese case. An alternative view is offered in section four. Section five analyzes the effects of NAFTA that led Japanese policymakers to consider FTAs; section six the initiative for an FTA with Thailand and the possibility of a competition with China. Section seven concludes.

From APEC to Economic Partnership Agreements

During most of the 1990s, Japan's regional trade policy initiatives were limited to the Asia Pacific Economic Cooperation (APEC), an intergovernmental forum intended to liberalize trade and investment around the Pacific Rim. Originating in an initiative of the Ministry of International Trade and Industry,[5] Australia put forth the official proposal (Berger, 1999; Ravenhill, 1998). While the forum received considerable political and scholarly attention (Beeson and Jayasuriya, 1998; English, 1999; Gallant and Stubbs, 1997; Ravenhill, 2000; Terada, 1998), its weak legalization (Kahler, 2000) and lack of credible commitment mechanisms made trade and investment liberalization difficult to achieve. Although the 1994 APEC summit in Bogor declared the goals of free trade in the region by 2010 for developed and 2020 for developing countries, the proposed unilateral liberalization skirted domestically sensitive sectors. In consequence, the 1994 'Individual Action Plans' and the 1997 initiative for an 'early voluntary sector liberalization' (EVSL) foundered on a divergence of interests: under domestic pressure, the Japanese government was unable to commit to an opening of its agricultural market, while the US insisted on reciprocal concessions (Ravenhill, 2000).

As the 'altruistic liberalization'[6] within APEC failed, other countries around the Pacific Rim began to sign formal free trade agreements. In response, by 1998, both the Ministry of Foreign Affairs (MOFA) and MITI began to study regional trade agreements as a serious policy option. Surprisingly, the first proposal for an FTA with Japan did not come from an Asian neighbour, but from Mexico. However, Singapore became the partner in the first actual agreement, for domestic political and tactical reasons outlined below. So far, all Japanese FTA initiatives have followed a similar pattern: first a study by a bilateral, tri-sectoral commission of governments, academics and business, then working level dialogues, followed by actual negotiations at the level of Ministries. As of 2005, Japan is seeking FTAs with Thailand, Malaysia, South Korea and the Philippines. In all cases, a fierce political struggle has ensued, allowing for a comparison of the merits of theories of regionalism in the light of the Japanese case.

Current Explanations of Regionalism

In recent theoretical debates, IPE scholars attribute the popularity of regional agreements to two main causes: the slowing of multilateral liberalization efforts, and domestic politics, often revolving around multinational firms and imperfect competition. Mansfield and Reinhardt (2003) argue that regional agreements function as an insurance policy against trade disputes and a stalled WTO. Preferential trade agreements spread when multilateral rounds are underway, or countries become embroiled in commercial disputes that threaten access to export markets. These arguments are echoed by Japanese trade bureaucrats and some observers of Japanese trade policy (Dent, 2003: 10-1, 5; Krauss, 2003; Urata, 2002: 11-20).

Yet as countered by Haggard (1997), if the WTO is stalled, then the central issue is the convergence or divergence of state interests. Agricultural liberalization remains the perennial problem of WTO rounds. Japan’s resistance to open its market further, though, creates one of the main obstacles to progress. At the same time, Japan is among the most vocal demandeurs for the incorporation of new issues like rules for FDI. It seems that multilateral rounds are too slow for some Japanese constituents - whose views tend to be articulated by METI - and too quick for the protected agricultural sector. Possibly, FTAs can be negotiated faster because with weak WTO disciplines on FTAs, they allow the exclusion of sensitive sectors (Bhagwati, et al., 1996: 687; Ravenhill, 2003: 307-9). This shifts the focus to domestic politics and the constituency in favour of FTAs.

Milner (1997) proposes that firms in industries characterized by economies of scale will support regional agreements. If firms can expand their market, they can move down the cost curve enough to increase profits, even though the price of their product falls. Milner hypothesizes that increasing returns to scale (IRS) determine an optimal market size, which may be regional but not global (85). Moreover, firms that become more efficient regionally will also be more competitive when exporting beyond the FTA market. This theory explains well why competitive firms with unrealized economies of scale in small markets will support regional liberalization efforts with bigger countries. But it offers less insight into the motivations of big countries: why would they allow competitors to enter their home market, when they gain only a small market in return? Likewise, it omits the possibility that production may be relocated. If IRS are firm-specific, then these companies should prefer to export rather than invest. In practice, however, FTAs tend to coincide with considerable increases in FDI.

Chase (2003) addresses these problems and extends the theory in two directions. First, he points out that IRS matter at the level of the plant rather than the firm. If firms have unrealized IRS that would increase rapidly with growing plant size, these firms will be interested in market expansion through FTAs. Second, regional agreements help solve commitment problems when firms move labour-intensive stages of production abroad. Firms make highly specific investments, exposing them to a higher risk of disruptions in the production process. FTAs safeguard such international production-sharing. Finally, if production-sharing requires a restructuring of existing operations, then differential tariff-phasing in FTAs can be used to temporarily extend protection to incumbent firms (Chase, 2004).

By themselves, however, these arguments are insufficient to explain Japan's FTA policy. Production-sharing takes place even without FTAs. Firms can import their products into home markets because developed country tariffs are usually very low - often zero in the case of Japan. Offshore processing, the tariff-free import of parts and re-export after labour-intensive stages of production, is regularly obtainable in developing countries (Feenstra, et al., 2000; McIntyre, et al., 1996; Warr, 1990). When will firms see FTAs as necessary to achieve the same ends?

I propose that they do so in reaction to other countries' policies. Various scholars have argued that countries join preferential trade agreements (PTAs) as a result of strategic interaction (de Melo and Panagariya, 1993: 5-6; Oye, 1992; Perroni and Whalley, 1996). Empirical tests have offered limited support of this hypothesis (Mansfield, 1998). If trade diversion and loss of export markets are the central concern, however, PTAs should expand and possibly grow into economic blocs centred on major powers, as hypothesized by Baldwin (1996). But with the exception of the enlarged EU, as much a political as an economic phenomenon, regional agreements do not appear to expand or emerge into competing blocs. Rather, we observe a dense network of bilateral FTAs. A focus on the role of foreign direct investment and the vertical integration of production modifies the argument and solves these puzzles: FTAs are important commercial policy instruments that confer advantages to firms when undertaking FDI and production-sharing across borders. Yet if one developed country supports its industry with a bilateral agreement, it becomes imperative for other countries to counter. Japan's bilateral initiatives are strategic moves to preserve the competitiveness of Japanese multinational firm operations when other countries are actively seeking FTAs. The next section outlines this framework.

Foreign Direct Investment and Competitive Liberalization

FDI plays a central role in research into the incentives for developing countries to enter preferential trade agreements. Both Latin American and Southeast Asian developing countries have opted for FTAs with developed countries as part of liberalizing policies. The benefits are twofold. First, they serve to lock-in international commitments to liberalization, often against the interests of domestic groups (Fernández and Portes, 1998; Rodrik, 1989, 1991). Second, developing countries secure tariff-free access to markets like the US or Japan to compete as 'export platforms' among themselves (Ethier, 1998). Building on these studies, the following argument rests on the assumption that developing countries (henceforth host countries) seek FTAs to attract foreign direct investment.

But what about the developed country in the bilateral partnership? I argue that they respond to demands by multinational firms. Firms support FTAs because they offer competitive advantages when using a developing country as an export platform. I develop the argument in two stages, first clarifying firm preferences, then outlining when and why they are likely to prevail in the political arena.

Three assumptions underpin the argument. First, following recent work in economics on the vertical integration of production (Fukao, et al., 2003; Martín and Orts, 2001), I assume that multinational firms invest in developing countries to benefit from different factor endowments. Relatively low wages, the same reason why these countries are only minor export markets, may make them highly attractive locations for investment, given the right political conditions. Second, as in Chase's (2003) framework, such production will be characterized by economies of scale at the plant level, requiring exports to home and other developed country markets. Finally, multinationals compete mainly with firms from other developed countries.

One immediate benefit of bilateral agreements is that they allow multinational firms to import parts and machinery from the home into the host country at reduced tariff rates. Often, developing host countries still charge higher most-favoured-nation (MFN) tariffs than developed countries. Reducing this tariff becomes crucial when firms integrate production vertically, whereby the most capital-intensive intermediate goods are further processed in the export-platform country.

In addition, bilateral trade agreements offer firms a specific benefit over multilateral liberalization: they can generate economic rents. As developing countries liberalize, firms can move labour-intensive stages of production into developing countries, allowing them to produce more efficiently and re-export to the home market. But since other firms will likewise invest in these countries, competition will rapidly diminish any profits made possible by greater efficiency. Bilateral agreements, however, can be used to restrict access to this benefit of location, if host countries impose a sufficiently high tariff on imports from non-members.

To this end, firms from the home country will try to harness the remaining MFN tariff. They will lobby for strict rules of origin to ensure that goods imported from the developing country mainly originate in the FTA (Anson, et al., 2003; Chase, 2003: 166-68; Suominen, 2004). Although firms from non-member countries can invest in the developing country, their intermediate goods imports incur higher tariffs. Likewise, home country firms will try to ban host countries from rebating MFN tariffs on components and machinery for non-members. Strict rules of origin thus interact with the preferential margin, the difference between the MFN tariff applied by host countries and the tariff-free exchange within the FTA, so that competition in the home market can be restricted to home country firms. This holds until the host country unilaterally reduces its MFN tariffs. In sum, to generate economic rents, FTAs have to incorporate clauses that discriminate against outsiders. FTAs thus become commercial policy instruments to further the competitiveness of multinational firms.

How will this play out in the political arena? Seen through the lens of a political economy framework inspired by Grossman and Helpman (1994), political leaders mainly care about getting re-elected. Trade liberalization affects consumer surplus, producer profits, and tariff revenues. In practical terms, tariff revenues are negligible for developed countries. Lower tariffs benefit consumers by allowing cheaper imports. With the relocation of production to the FTA partner, import prices tend to fall somewhat, because production is more efficient. This benefits the consumer. But because competition is restricted, producer surplus also rises. Bilateral agreements offer a compromise between consumer and producer surplus that appeals to political leaders.

It could be countered in the tradition of the developmental state literature (Aoki, et al., 1996; Hall, 1986; Johnson, 1982; Wade, 1990; Woo-Cumings, 1999) that in Japan, trade policy is made by bureaucrats, not elected politicians. Sheltered from pressure, bureaucrats have a longer time horizon. But under the assumptions made here, Japanese bureaucrats care primarily for their constituents. For METI bureaucrats, this means manufacturing firms. After all, firms can offer rewards: lucrative positions after retirement from public service, a practice known as amakudari or ‘descent from heaven’

(Curtis, 1999: 233-4). These bureaucrats should therefore become key supporters of bilateral trade agreements.

All liberalization, however, threatens import-competing sectors. Since the partners are developing countries, these sectors will likely be agricultural producers and labour. At first glance, labour should uniformly resist relocation of production (Rodrik, 1997). Yet vertical integration tends to divide labour along firm lines: firms that produce intermediate goods for overseas production benefit from FTAs (Chase, 2003: 184). If labour is organized in firms and only weakly centralized, as in Japan, we should expect little resistance.

Agricultural producers will mount the strongest resistance to bilateral liberalization. FTAs, however, leave much room for the exclusion of sensitive sectors, given the weak WTO disciplines on preferential agreements. According to Article 24 of the GATT, they should liberalize “substantially all trade,” which in practice allows the exclusion of ten per cent of trade or more. If the partner country produces only a few agricultural goods, a deal will indeed be easier to reach than in a multilateral round. FTAs with major agricultural producers, however, should be rare for a country like Japan, and difficult even with small developing countries.

When will the demands of multilateral firms outweigh those of protectionist forces? Most likely only when the competitive pressures warrant great lobbying efforts. This should be the case when existing FTAs by other countries impose costs on firms with FDI overseas, or when such FTAs are announced and potentially threaten multinational firms’ operations in developing countries. The rents generated by FTAs imply a competitive disadvantage for investor firms from third parties. Competing firms will press their respective governments to counter with FTAs. Although these FTAs cannot eliminate rules-of-origin requirements, they weaken their protectionist force by lowering the tariffs on imported parts. Consequently, bilateral agreements trigger counter-agreements by affected third parties. North-South FTAs therefore fall into two categories: ‘proactive FTAs’ that exclude outsiders, and ‘defensive FTAs’ that level the playing field again. A closer look at the Japanese FTA initiatives illustrates the elements of the argument above. While the initial reaction was defensive in the form of the Japan-Mexico-FTA, the more recent initiative for an FTA with Thailand has a decidedly proactive character.

NAFTA and the Defensive FTA Strategy

Japan’s policy shift originated in a defensive reaction triggered by the effects of NAFTA. Over the last 15 years, Japanese firms have made considerable investments in Mexico. Due to their traditional competitive advantages, most Japanese FDI in Mexico is concentrated in sectors such as automobiles, auto parts, consumer electronics and electronic components.

A particular feature of the Mexican economy is the maquiladora (in-bond manufacturing) sector. Under this programme, dating back to 1965, foreign investors could set up factories in the region south of the US border to profit from low Mexican wages. Products could be imported into Mexico from the US, processed, and re-exported. Upon entering the US, tariffs were only levied on the value added abroad. This system attracted considerable investment from Japan in consumer electronics and electronics parts: Well-known manufacturers like Sharp and Sony used their US subsidiaries to create affiliated companies in Mexico.

Initially, most Japanese FDI sought efficiency gains made by employing low-cost Mexican labour. Geographic proximity and preferential access guaranteed under the maquiladora factory system facilitated serving the US market (Nikkei Sangyou Shimbun, 31 July 1991), but also other countries in the region (Nihon Keizai Shimbun, 2 March 1999). Japanese investors primarily saw Mexico as an export platform rather than a market in its own right.

The conclusion of NAFTA, however, put these Japanese investors at a disadvantage vis-à-vis their US competitors. Under pressure from US automobile companies, NAFTA negotiators agreed that in order to qualify as a 'North American' product, 62.5 per cent of a car would have to originate from within NAFTA (Robert, 2000: 152-63). After witnessing that Honda transplant factories in Canada used considerable foreign content under a 50 per cent rule-of-origin, US automakers wanted to prevent Mexico from becoming another export platform to threaten their home market (Cameron and Tomlin, 2000: 90-3, 132-36). Similar rules-of-origin were put in place for a variety of other products, usually with a 50 per cent threshold on a net cost basis.[7] At the same time, the auto decrees were being phased out over a period of ten years.

Second, in accordance with NAFTA Art. 303, the maquiladora system was fundamentally transformed. In the negotiations with the US, Mexico agreed to allow duty free temporary inputs from outside of NAFTA only if a) the finished good complies with the rule-of-origin when exported to another NAFTA country, or b) the final product is exported to a non-NAFTA country. As a result, considerable Japanese investment in

Mexico aimed at serving the US market was affected by the difference between Mexico's applied MFN and NAFTA tariffs. Japanese companies paid 5-16 per cent tariff when sourcing important intermediate goods such as machinery or parts, e.g. cathode tubes for TV sets (United States Trade Representative, 2000: 284; Nihon Keizai Shimbun, 12 December 2002). A sectoral promotion scheme called PROSEC offered tariff relief for individual firms, but was perceived as unpredictable and insufficient by Japanese firms (Japan Machinery Center for Trade and Investment, 2001). Vertically integrated Japanese manufacturing investment in Mexico proved vulnerable to disruption by NAFTA.

NAFTA's discriminatory effect on FDI from non-members did not go unnoticed by Japanese industry representatives for long. In a 1991 interview, the regional managers of several Japanese firms in Mexico referred to NAFTA as an 'assault on Japanese firms' (Nikkei Sangyou Shimbun, 30 July 1991). Already in 1994, the Federation of Japanese Industry (Keidanren) noted the 'regionalistic' aspect of NAFTA in a comment on the GATT review of the FTA.[8] Over the course of the next years, Japanese lobby groups began to press the Japanese and Mexican governments for relief. By 1996, electronics firms were under pressure to meet the rules-of-origin requirements of NAFTA when exporting to the US. Despite efforts to procure more parts from within Mexico, it became obvious that the Mexican supply industry could not supplant imports within the timeframe of five years until the abolishment of the maquiladora benefits. In a first, but unsuccessful effort, Japanese firms under the umbrella of the Japan Maquiladora Association (JMA) began to lobby the Mexican government directly for tariff reductions (Nihon Keizai Shimbun, 5 January 1996). The Japanese Institute for Overseas Investment (1997) referred to the problems in an assessment of the Mexican investment environment and specifically emphasized the resulting difficulties for the export of machinery from Japan.

However, given the declared strategy of Mexican government to negotiate FTAs with all major trade partners, it showed little interest in a further reduction of its MFN tariff. Rather, the Mexican government prodded Japan to consider a bilateral agreement. Herminio Blanco, then Mexican Minister for Foreign Trade and Industry, and President Zedillo used various occasions to remind Japanese companies of pending changes in the maquiladora system (Nihon Keizai Shimbun, 7 October 1998), the advantages of investment treaties (Nihon Keizai Shimbun, 5 November 1998), and the benefits of an FTA with Mexico for foreign investors (Nihon Keizai Shimbun, 2 March 1999).

Since the discriminatory effect of NAFTA depended on the tariffs applied by the host country, Japanese firms exhausted all possibilities to press the Mexican government for a reduction of these tariffs. At the same time, Japanese firms were most likely aware that a bilateral deal with Mexico was unprecedented and difficult, given the protectionist agricultural sector that had restricted Japan's APEC policy. This strengthens the view of Japan as a challenging case for the argument advanced here and explains why an FTA was only considered much later. For an FTA to become a viable policy, the coalition in favour of trade agreements had to be broadened and advocates in the trade bureaucracy had to be found.

The Conversion of the Japanese Trade Bureaucracy

Despite institutional reforms in Japan, bureaucratic politics remain at the heart of Japanese trade policy. Ministries conduct trade policy at the behest of their constituencies, while politicians of the ruling Liberal--Democratic Party (LDP) occasionally veto initiatives that endanger rural interests. As a result, Japanese bureaucrats nurture close relations with their constituent interest groups. Likewise, Japanese trade policy has no equivalent of hearings before the US Senate in which concerned parties voice their views. Consequently, while lobbying leaves even less of a paper trail than in other countries, it is evident that ministries regularly consult with interest groups, leading to a transmission of firm interests through the bureaucracy. In the case of METI, multinational firms in the manufacturing sector are among the most important constituencies.

Consultations with firms about NAFTA's discriminatory effect on Japanese direct investment in Mexico changed the perceptions of key policymakers in Japan's trade bureaucracy. Both ministries realized that US and European FTAs endangered the competitiveness of Japanese production abroad.[9] MITI/METI emerged as the driving force behind the shift towards a 'multi-layered' trade policy (Munakata, 2001). Ministry of Foreign Affairs (MOFA) bureaucrats appeared more interested in balancing the various interests, but also provided important policy leadership in deciding that selective bilateral rather than broader regional options would be pursued in the near term, since a Japan-ASEAN-FTA would be difficult to bring into compliance with GATT Art. 24.[10]

By 1998, the increasingly concerned voices of Japanese multinationals with subsidiaries abroad convinced two key policymakers of the need to pursue bilateral options: Tanaka Hitoshi,[11] Director General of the Economic Affairs Bureau of MOFA, and former MITI Vice-Minister Hatakeyama Noboru, then Chairman of JETRO. In early summer of 1998, Hatakeyama met with his Mexican colleague Blanco in Tokyo, who informed him of the framework agreement with the EU that would eventually lead to an FTA. Hatakeyama suggested to then-MITI Minister Yosano Kaoru to pursue an active FTA strategy to counter a further deterioration of the competitive position of Japanese companies in Mexico. (Hatakeyama, 2003b: 24).[12] While a report was prepared under the guidance of Konno Hidehiro, at the time Director General of MITI's International Trade Policy Bureau, various bureaus expressed concern that an extra-regional FTA initiative would send the wrong diplomatic signal for future agreements: The first Japanese FTA ought to be concluded with an Asian neighbour.[13]

At the same time, discussions began in MOFA's Economic Affairs Bureau, again set off by consultations with affected Japanese firms. Under Director General Tanaka, a policy paper was prepared that would eventually provide the roadmap for MOFA's pursuit of FTAs.[14] However, there was considerable opposition to bilateral agreements within the Ministry: Multilateralism had served Japan (and the careers of officials trained in international law) well for four decades.[15] After a lengthy process of consensus-building, MOFA's new stance was documented by publication of an article by Tanaka (2000) in the monthly magazine Chuuoo Kouron.

In cooperation, METI and MOFA then pursued a strategy that would tackle the ideological and material opposition to FTAs one at a time. To this end, Singapore was selected as the partner for the first bilateral agreement on the grounds that it exported virtually no agricultural products.[16] The first FTA thus had limited political or economic relevance, but provided a template for future negotiations.

Lobbying Around the New Trade Policy

Following the policy shift of MOFA and METI, but facing the still unresolved problem in Mexico, Toyota decided to push for trade liberalization in anticipation of future FDI, although it did not have significant operations in Mexico at the time,[17] (Nikkan Kougyou Shimbun, 23 September 2002). Canon even closed a plant in May 2002, citing lack of progress in concluding a bilateral trade deal.[18] Nissan, an incumbent since 1961, partly benefited from NAFTA's rules-of-origin because it achieved a relatively high Mexican content quota (Nikkei Sangyou Shimbun, 30 July 1991). Over time, however, the position of Nissan began to approximate that of Toyota. The initial incumbency benefits became problematic when the 1994 Mexican currency crisis depressed domestic demand, forcing Nissan to export more of its production to the US (Walzer, 1995; Nikkan Kougyou Shimbun, 7 June 2001). The company thus moved from a passive stance to become an active supporter of a bilateral trade agreement. METI officials gave Nissan's views considerable weight, "since the 20,000 or so cars that Japan exports to Mexico pale in comparison to the hundred thousands Nissan can produce there and sell in the US," which in turn would generate business for Japanese suppliers and machine tools producers.[19]

Concurrently, the Mexican branch of the Japanese Chamber of Commerce and Industry lobbied METI to conclude an FTA (Nihon Keizai Shimbun, 31 July 2003). Keidanren called for the speedy conclusion of a Japan-Mexico FTA in policy paper in 1999 and 2000, specifically stressing the need to shorten lead-times of production by initially importing parts from Japan, as well as emphasizing the increasing difficulties of Japanese upstream producers of steel, chemicals and plant equipment in the Mexican market.[20] Similar lobbying efforts were made by the Japan Business Council for Trade and Investment Facilitation (boueki toushi enkatsu kyougikai) and the Japan Machinery Centre for Trade and Investment (JMCTI), which called for an FTA as a result of a survey on problems relating to trade and investment in the Asian and Pacific Countries.[21]

The emergent coalition in support of an FTA matches the predictions made earlier. The most vocal supporters were firms using Mexico as an export-platform, and their suppliers of intermediate and capital goods. There is less evidence of calls for an FTA by exporters of finished goods. Apparently, the Mexican export market by itself did not warrant such lobbying efforts.

In June of 2001, a joint Japanese-Mexican tripartite study group was convened to provide an assessment of the potential effects of an FTA between the two countries. The group eventually published a report that underlined the need for an agreement to counter the effects of NAFTA. At the October 2002 APEC meeting in Los Cabos, President Fox and Prime Minister Koizumi agreed to launch official negotiations in November (Nihon Keizai Shimbun, 27 October 2002). Unlike Singapore, however, Mexico is a major supplier of agricultural products: 19 per cent of its exports to Japan are pork meat. This prompted an immediate reaction from LDP constituents in rural areas, including two visits by the President of the Japanese association of agricultural cooperatives Zenchu to the office of Cabinet Secretary Fukuda in November of 2002, and the distribution of policy papers to LDP parliamentarians in April 2003 (Nihon Keizai Shimbun, 12 December 2002; Nikkei Weekly, 19 May 19 2003). While the conclusion of the Japan-Mexico Economic Partnership Agreement was scheduled for Presidents Fox's visit to Tokyo in October 2003, a delay of several months was necessary due to disagreements over the degree of agricultural liberalization. The key to striking a deal, as predicted, was to carve out the 'sensitive' pork imports into Japan. Using a complex formula, Japan not only limits imports to a quota, but also applies a tariff that brings up the price of Mexican pork to the Japanese 'gate price' guaranteed to domestic farmers.[22] The exclusion of most agricultural trade shows that Japanese farmers and their representation of interests through the Ministry of Agriculture, Forests, and Fishery (MAFF) is still strong enough to stall METI initiatives for liberalization. Japan's FTA policy is therefore not the result of diminished influence of import-competing sectors or the ministries that represent their interests. More likely, FTAs allow agricultural protectionism to persist when it would difficult to maintain in the WTO.

By contrast, labour unions were less active in their opposition to the FTA. Although officially critical of the agreement with Mexico,[23] they did not ally against it with agricultural groups. Labour opposition against later FTA initiatives, however, was expressed through the Ministry of Health, Labour and Welfare.

The relevance of the Japan-Mexico FTA goes beyond its immediate economic impact. Mexican negotiators drew frequently on their experiences with NAFTA and the EU-Mexico FTA, forcing METI bureaucrats to become familiar with these agreements.[24]

Most importantly, high METI officials were convinced that to prevent a repetition of the experience of Japanese firms in Mexico in other countries, Japan would have to pursue FTAs proactively. These efforts became urgent because of changes of host country policies in Southeast Asia, partly stimulated by the Asian Financial Crisis. The following section focuses on the case of Japan's FTA initiative with Thailand, a country that is quickly becoming an important export-platform for Japanese firms.

The Proactive Pursuit of FTAs: Supporting Japanese Firms in Thailand

In Southeast Asia, the 'contagion' of the Asian Financial Crisis forced countries to try to attract more FDI rather than volatile portfolio investment. The crisis thus boosted a process of investment liberalization that had come off a slow start in the early 1990s (Yoshimatsu, 1999), and gave further impetus to the development of the ASEAN Free Trade and ASEAN Investment areas (Nihon Keizai Shimbun, 7 October 1998, 10 December 1998). It rapidly altered the environment for Japanese firms with existing operations in Asia that had been set up under restrictive host country policies. The liberalization efforts thus show important parallels to those undertaken by Latin American countries, in particular Mexico. METI and MOFA proactively pursue FTAs with these countries to provide support to Japanese firms, buttressing a reorientation towards exports.

Although Thailand based its economic development to a great extent on FDI, the country originally imposed strict requirements on manufacturing investment. Japanese FDI was oriented towards regional markets rather than exports, with about 60 per cent targeting regional sales (Japan Bank for International Cooperation (JBIC), 2003: 18; METI Overseas Activities of Japanese firms, cited in Kitamura, 2003: 22). In the automobile industry, Japanese investment began in the 1970s under tightly constrained conditions. The host country government mandated ever-higher local content quota (Doner, 1991: 40-63; Humphrey and Oeter, 2000: 59-60), making it difficult to achieve efficient production scales and driving up prices for domestic sales as a result. Consequently, Japanese manufacturers built their regional production networks around host country policies whereby locally produced parts could be sourced tariff-free within ASEAN, provided local content quota were fulfilled (Yoshimatsu, 1999, 2002). In an implicit bargain, these schemes also acted as a barrier to the entry of competitors (Doner, 1997: 112), because the small market size required large, 'commanding' shares to be efficient. As a result, as of 1992, Japanese affiliates accounted for 94 per cent of production in Thailand (Hatch and Yamamura, 1996: 37). Likewise, in Malaysia and Indonesia, combined imports and local assembly by Japanese firms accounted for 70-95 per cent of all auto sales (Mukai, 1997; Noble, 2002; Takeuchi, 1993). Although Japanese firms supported further integration of ASEAN markets to achieve economies of scale (Yoshimatsu, 1999), both Honda and Yamaha at the time expressed the hope that they could forestall further liberalization of external ASEAN tariffs.[25]

In comparison, the electronics sector in Thailand is characterized by a much stronger presence of US firms and production networks. Yet, whereas US firms initially sought local low-cost suppliers to produce for re-export to other advanced markets, much Japanese investment served nascent regional markets (Borrus, 1999: 220).

Until the mid-1990s, Japanese investment was thus primarily tariff-jumping, oriented towards host country markets, and put a low emphasis on exports. Yet in the wake of the Asian Financial Crisis, the conditions for Japanese FDI changed. Slumping demand and trade liberalization begun to affect Japanese production networks, while Korean and Western firms began to make inroads into previously uncontested markets (Noble, 2002). In the ASEAN-Five,[26] non-Japanese firms increased their share of the passenger car market from 5-10 per cent to 25-30 per cent compared to the early 1990s, prompting Ford and GM to make new investments that competed with Japanese incumbents in local markets (Yoshimatsu, 2002).

At the same time, host country governments liberalized the investment environment in order to attract more FDI. Thailand made bold steps towards liberalization of the investment regime, partly as a requirement of the IMF support package,[27] and abolished limits on equity holdings by foreigners in 1998. Likewise, it eliminated the 30 per cent export requirement necessary to qualify for an exemption from import duties on goods used in local manufacturing. (United Nations Conference on Trade and Development, 1998: 342, Nihon Keizai Shimbun, 10 December 1998).

Under these circumstances, Japanese firms could no longer maintain their old business model. Host country liberalization created a stiff wind of competition and eliminated the rents earned in protected markets, while falling currencies diminished purchasing power. At the same time, however, the depreciation of the Thai Baht created the prospect of a highly competitive production for export, with unit costs reaching comparable levels to those in China (Nihon Keizai Shimbun, 17 November 1998).

Japanese automotive firms reacted quickly. Already before the crisis, the expansion of automotive parts production for export to Japan had accelerated. Firms began a rapid process of centralization and restructuring of their operations in Thailand to achieve high capacity utilization rates (Kagaku Kougyou Nippou, 8 September 2003; Nikkei Bijinesu Daily, 12 February 2004). In an unprecedented development, Japanese manufacturers began to ship finished cars to the home market. The striking trend becomes apparent in figure 1. While no separate data on the exports of Japanese auto and auto parts manufacturers from Thailand to Japan is available, it is safe to assume that virtually all are shipments of Japanese-owned producers, given the notorious lack of success of foreign brands in Japan. Exports of parts and complete vehicles grew exponentially within a short time, although it should be noted that the overall volume is still low.

--- Figure 1 about here ---

Besides taking up the production of passenger cars for the Japanese market, all major manufacturers developed and started to implement plans to use Thailand as an export platform for other markets (Nikkan Jidousha Nyuusu, 22 March 2003). Concurrent with the start of FTA negotiations with Thailand, Japanese firms announced plans for significant investments in the country. Toyota confirmed the production of the "IMV International Multipurpose Vehicle," a light pickup truck for exports to markets in Europe as well as important developing countries (Nikkei Bijinesu Daily, 8 August 2004).

Suppliers closely affiliated with the group such as Aisin Seiki, Aichi Steel, NSK and Denso prepared to quickly increase production (Nikkei Bijinesu Daily, 12 February 2004; Nihon Keizai Shimbun 24 August 2004). Initial plans proved to be too conservative, motivating Toyota to increase production capacity from 140,000 to 260,000 units per year (Nihon Keizai Shimbun, 7 May 2004). Nissan presented plans to expand production capacity in Thailand by over 50 per cent (Nihon Keizai Shimbun, 3 July 2004). Honda considered building a second plant for its small, environmentally friendly car model marketed as "Life" in Japan, because its current factory operated at full capacity (Nihon Keizai Shimbun, 6 December 2004). Even struggling automaker Mitsubishi announced a capacity expansion of 30 per cent because of the rising demand for pickup trucks in Europe (Nihon Keizai Shimbun, 25 August 2004).

Japanese electronics firms, having replicated the production network strategy of the automobile sector, were affected by the same forces when host countries began to liberalize their markets, although many of the new entrants were in fact local companies in Korea, Singapore and Malaysia (Borrus, 1999: 224). Although many firms also produced in China, Japanese multinationals were not willing to abandon Southeast Asia as a production base, likely because operations in the ASEAN countries tend to be more profitable than those in China (JETRO survey, cited in Mainichi Economist, 15 July 2003). In consumer electronics, Thailand's wage and currency advantages attracted investment that in the past would have gone to Malaysia or Singapore (Nikkei Weekly, 3 May 2004). Similar developments affected the upstream component of Japanese investment in the chemical industry (Nikkan Kougyou Shimbun, 26 May 2000).

The changes in the operations of Japanese firms in Thailand were quickly relayed to MITI bureaucrats, who in 1999 began a formal study on how to offer government support for firms in a changed environment (Nikkan Kougyou Shimbun, 22 March 1999). Companies interested in supplying Japanese factories abroad with machinery also expressed their interest in an FTA with Thailand to METI in consultations.[28] Following discussions in the International Trade Policy Bureau as well as the regional bureaus, MITI/METI began to develop plans for an FTA with Thailand.[29] Given the strength of protectionist agricultural groups, however, the success of this policy depends on Japanese firms with investment in Thailand and their chain of suppliers, the central constituency in favour of a free trade agreement.

The Political Struggle over an FTA with Thailand

Just like in the case of the Japan-Mexico FTA, a successful negotiating outcome depends on an accommodation of Japanese agricultural pressure groups. Unlike Mexico, however, Thailand produces rice, the most sensitive product, as well as several other agricultural exports that hurt important lobbies in Japan.

Together with LDP politicians of the infamous nourin zoku, or farm and forestry tribe, MAFF managed to delay negotiations that were scheduled to start in June 2003 after the visit of the Thai Prime Minister to Japan (Nihon Keizai Shimbun, 9 June 2003) by almost seven months. In addition, MAFF officials publicly discussed the possibility of a blanket exclusion for rice as a precondition for an FTA with Thailand (Nihon Keizai Shimbun, 9 June 2003; Nikkei Weekly, 15 December 2003). To still approach close to 90 per cent coverage of trade and comply with WTO Art. 24 requirements, the remaining agricultural trade would have to be completely covered.[30] Boneless chicken, the second major export commodity, therefore became a stumbling block (Nikkei News, 6 August 2004).

To counter the protectionist groups, several industries organized a concerted lobbying effort. Keidanren acted as vanguard of these firms' interests in the public battle, starting with a November 2003 policy statement that requested the pursuit of FTAs with the advanced ASEAN countries.[31] During the following months, the association called for the speedy conclusion of an FTA, warning that US firms were outcompeting Japanese firms in terms of using Thailand as production base because of the better investment conditions afforded to US firms under the US-Thailand Treaty of Commerce and Navigation (Nihon Keizai Shimbun, 18 April; 12 May 2004). Similar demands had been repeatedly raised by the Japan Business Council for Trade and Investment Facilitation in a policy paper submitted to METI (Hideya, 2003). After mentioning the initiative for an FTA as positive step, the paper also addressed the issue of intermediate and capital goods exports to Thailand:

> "[Regarding electronics parts, ball bearings and rubbers] it is requested that a further cut in tariff rates be undertaken (…), keeping in mind the materials that cannot be produced in Thailand. Furthermore, the tariffs on cutting tools ought to be reduced rapidly. (…) On auto parts, the duty ranges from 5 to 42 per cent, necessitating a significant reduction."

As these demands show, using Thailand as an export basis would be greatly facilitated by a reduction of host country tariffs, reflecting the fact that compared to their direct competitors, Japanese electronics firms still source much more inputs from their home country (Arimura, 2002; Guerrieri, 2000), leading to ratios of 85-90 per cent of trade within the firm or with close affiliates (Ernst, 2000: 83).

Concern about the effect of a foundering of FTA negotiations were voiced by representatives of the textile industry (Nihon Keizai Shimbun, 9 June 2003), a sector with significant overseas production in Southeast Asia.[32] Again, manufacturers cited the importance of lowering barriers on intermediate goods (Nikkei Weekly, 15 December 2003). The Japanese Chamber of Commerce in Bangkok warned that Japan would fall behind in its international competitiveness without an FTA with Thailand (Toyo Keizai Weekly, 29 November 2003, 80).

Negotiations began in February 2004 in Bangkok, with initial Japanese proposals focusing on improving the Thai investment environment for Japanese firms by guaranteeing national treatment (Nikkei News Service, 17 February 2004). MAFF indeed sought and obtained an exclusion of rice from the negotiations (Nihon Keizai Shimbun, 10 June 2004, 10 October 2004). Reflecting the interests of Japanese automotive manufacturers, the Japanese negotiating team began pushing for a reduction of tariffs on cars and parts (Nihon Keizai Shimbun, 31 October 2004). This demand was publicly supported by Keidanren Chairman Okuda, also President of Toyota Motors, who toured the ASEAN countries to muster business support for free trade agreements (Nihon Keizai Shimbun, 1 November 2004).

Although the outcome of the negotiations is still open, it is evident that the industry interests supporting the initiative for an FTA with Thailand focus primarily on FDI. The ministries advancing the cause of bilateral free trade, MOFA and in particular METI, receive crucial backing from those industries that have direct stakes in improving the investment environment in Thailand and lowering tariffs on intermediate goods. Taking up demands by Japanese firms, METI bureaucrats advance the FTA policy to strengthen the position of Japanese firms vis-à-vis their competitors from other countries. At the same time, the weak disciplines imposed by the WTO on FTAs allow the continued protection of import-competing agricultural producers.

The China Factor: Strategic Competition?

As argued, Japan's FTA initiatives reflect a global trend towards bilateral trade agreements. Remarkably, China has recently joined this bandwagon by negotiating a regional FTA with the ASEAN countries. Reversing the usual order, a basic agreement was signed in 2002, while negotiations lasted until November 2004. Schedules for liberalization, however, are not to be completed until 2010. To give momentum to the talks, China offered an "early harvest," whereby the tariffs on about 200 agricultural products were eliminated, with only minimal reciprocal liberalization required of Cambodia, Myanmar, Laos and Vietnam (Lim, 2003).

While some authors have argued that FTAs with ASEAN are signs of a competition between Japan and China (Hund, 2003: 411), the above discussion shows that the Japanese policy shift predates the Chinese initiative, first announced in November 2000, by at least two years: At that point, Japan had already entered into negotiations with Singapore. Still, Chinese moves have spurred on Japanese policymakers to match diplomatic initiatives,[33] and may help the pro FTA constituency in Japan overcome domestic resistance.

Conclusion

Japan's new bilateral trade initiatives have to be seen in the context of a global phenomenon: the rapid proliferation of preferential trade agreements, in particular between developed and developing countries. The new 'multilayered' trade policy thus follows the lead of US and European trade policy towards liberalizing developing countries. Yet, as the case study of the Japan-Mexico FTA shows, it is also a defensive reaction to these policies. Japanese policymakers worried about the effect of other countries' FTAs on the competitiveness of Japanese firms. These concerns, however, did not revolve primarily around exports, but focused on the effects of competitors' FTAs on firm operations in developing countries.

The argument in this article can be extended in two directions. First, much FDI from developed to developing countries is in services rather than manufacturing. Such FDI does not create trade in intermediate goods. Nevertheless, if service trade is liberalized preferentially, imperfectly competitive market structures may result in comparable reactions. This issue cannot be addressed based on the Japanese cases, given that Japanese FDI is concentrated in manufacturing, especially in electronics and automobiles. Second, since Japanese multinational firms were latecomers in vertically integrated operations, cases studying the lobbying by EU and US firms for FTAs would offer support for the argument if these firms could be shown to move earlier and make greater lobbying efforts than their Japanese counterparts. Such questions remain to be addressed by future research.

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[1] http://www.wto.org/english/tratop_e/region_e/sem_nov03_e/boonekamp_e.ppt
[2] Calculated based on Statistics Canada (1999) World Trade Analyzer, Ottawa, ON.
[3] See for example Munakata's editorial at http://www.brookings.edu/views/articles/fellows/munakata_20020710.htm, accessed 15 February 2005.
[4] See Fontagné and Freudenberg (1997) for a detailed analysis of vertical versus horizontal trade in similar goods.
[5] MITI was subsequently reorganized and renamed Ministry of Economy, Trade and Industry (METI).
[6] Interview with former senior MITI official, Tokyo, November 2002.
[7] An overview is available provided by the Canadian Legal Information Institute at http://www.canlii.org/ca/regu/sor94-14/
[8] 'Keidanren Views on the GATT Review of NAFTA,' 1994, available at http://www.keidanren.or.jp/english/policy/pol003.html. Accessed September 25, 2003.
[9] Interview with former senior MITI official, Tokyo, November 2002.
[10] See Krauss (2003) for a differing account.
[11] Following Japanese convention, the surname is put first here and in other instances.
[12] Interview with senior METI official, Tokyo, December 2002.
[13] Interview with former senior METI official, Tokyo, December 2002.
[14] Interview with MOFA official, Tokyo, February 2003.
[15] Interview with MOFA official, Tokyo, March 2003.
[16] In the words of one METI official, 'we decided to first throw a screwball.' Interview with senior METI official, Tokyo, November 2003.
[17] Interview with METI official, Tokyo, December 2002.
[18] Interview with METI official, Tokyo, January 2003.
[19] Interview with METI officials, Tokyo, January 2003.
[20] http://www.keidanren.or.jp/japanese/policy/pol226/index.html, http://www.keidanren.or.jp/japanese/policy/2000/016.html accessed Dec 22, 2003.
[21] http://www.jmcti.org/cgibin/list_ind.cgi?Kind=Country&code=351&category=25, accessed December 16, 2003.
[22] See notes 2. b) ii) of the Schedule of Japan. The respective tariff class is 0210.11-.13 (meats of swine).
[23] See for example http://www.jtuc-rengo.or.jp/new/ download/2004-2005/pdf/part2-1-3.pdf.
[24] Interview with METI officials, Tokyo, January 2003.
[25] Interviews with MOFA and METI officials, Tokyo, March 2003.
[26] Indonesia, Malaysia, Thailand, Philippines, Singapore
[27] The respective letters of intent were sent to the IMF by the Thai government on 26 May and 25 August 1998. See http://www.imf.org/external/np/loi/052698.htm and http://www.imf.org/external/np/loi/082598.htm, accessed 15 December 2003.
[28] Interview with representatives of the Japan Machinery Export Association, Tokyo, March 2003.
[29] Interview with METI officials, Tokyo, December 2002.
[30] Interview with MOFA official, Tokyo, March 2003.
[31] http://www.keidanren.or.jp/japanese/policy/2003/114.html

Figure 1: Exports of automotive products from Thailand to Japan, 1988-2003
Source: UN Comtrade Database