THE NATIONAL BUREAU *of* ASIAN RESEARCH

NBR SPECIAL REPORT #75 | FEBRUARY 2019

CHARTING A PATH FOR A STRONGER U.S.-JAPAN ECONOMIC PARTNERSHIP

By Saori N. Katada, Junji Nakagawa, and Ulrike Schaede

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FOREWORD

When the United States withdrew from the Trans-Pacific Partnership (TPP) in January 2017, it abruptly shifted U.S. economic and foreign policy strategy in the region and introduced uncertainty in the U.S.-Japan economic relationship. Two years later, the business and policy communities in the United States and Japan are still grappling with this change in course and asking where they go from here. This report brings together three of the top experts on U.S.-Japan economic relations to answer that question.

The strong U.S.-Japan partnership has been a stabilizing force in the Asia-Pacific for decades, and now the two nations are entering a new era in their trade relationship. Japan has stepped up its leadership in the region by spearheading the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) as a high-standard alternative to the TPP without the United States. Meanwhile, the United States has moved away from multilateral deals and is pursuing a narrower bilateral trade agreement with Japan.

In light of these changing dynamics, the National Bureau of Asian Research (NBR), in collaboration with the Ministry of Foreign Affairs of Japan, convened a workshop in Seattle in September 2018 with two-dozen experts to explore how the United States and Japan can strengthen their economic relationship post-TPP. This report is a result of those discussions and includes original, independent research and analysis.

In the first essay, Saori Katada examines the use of economic statecraft by China, Japan, and the United States to project power and shape the region according to their interests. Although Japan had preferred to work with the United States to establish high-standard trade rules for the region, Katada argues that uncertainty over the U.S. commitment to multilateral trade frameworks has prompted Japan to increase its role in maintaining the liberal regional order while engaging in a hedging strategy with China. At the same time, China is aggressively pushing an agenda to cement its own sphere of influence, and norms of regional order for the last 50 years are being contested.

Ulrike Schaede's essay delves into the implications of the U.S.-China trade war for Japan. Schaede analyzes Japan's past and present economic relations with the rest of Asia and the United States and demonstrates that Japan has diversified its trade relationships away from the United States to countries across Asia. China is now Japan's largest trade partner. As a result, U.S. actions such as withdrawing from the TPP, imposing tariffs on Japanese steel, threatening tariffs on automobiles, and engaging in a trade war with China risk moving Japan closer toward China and other trade partners in Asia and the European Union.

In the final essay, Junji Nakagawa considers what a U.S.-Japan bilateral trade agreement could look like and ultimately argues that such an agreement will be too narrow to truly address both the U.S. and Japanese interests in the region. He argues that the United States returning to the TPP or joining CPTPP would be the preferable response to China's push for the lower-standard Regional Comprehensive Economic Partnership (RCEP) to establish the economic framework for the region.

Taken together, these essays suggest that it is in the United States' immediate and long-term interest to prioritize its economic relationship with Japan and continue to promote a rules-based, liberal economic order for the Asia-Pacific. With China actively pushing its own values and rules through RCEP, its Belt and Road Initiative, and other initiatives such as the Asian Infrastructure

Investment Bank, the U.S. response must be comprehensive and strengthen coalitions of regional partners. The United States has taken a step in this direction with its new Indo-Pacific economic vision, and in 2019 attention to economic strategy in this region must rise to the highest levels of foreign policy priorities.

I would like to thank Japan's Ministry of Foreign Affairs and the Consulate General of Japan in Seattle, including Consul General Yoichiro Yamada, Ayako Tsuyada, and Takeshi Murazawa, which made the September discussion possible. I also extend special thanks to the workshop panelists Charles Boustany, Saori Katada, Junji Nakagawa, Ulrike Schaede, Kenneth Pyle, Takashi Terada, and Toshiya Tsugami. Finally, I am grateful to my NBR colleague Meagan Araki for helping the workshop run smoothly and to NBR's publications team for their skillful editing of this report.

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U.S. and Japanese Economic Statecraft toward China: The Reshaping of the Asia-Pacific Economic Order

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EXECUTIVE SUMMARY

This essay analyzes how the regional economic order in the Asia-Pacific is shaped by the economic statecraft and posturing of China, the U.S., and Japan.

MAIN ARGUMENT

The use of economic statecraft by China, the U.S., and Japan to reshape the regional economic order in the Asia-Pacific has been characterized by a mix of competition and cooperation. Competitive and cooperative dynamics are at play not only in bilateral exchanges such as trade disputes but also in efforts to set new standards and build institutions. Amid intensifying leadership competition between the U.S. and China, a series of economic initiatives from the Trans-Pacific Partnership (TPP) to the Belt and Road Initiative and Asian Infrastructure Investment Bank have emerged. In this context, the Japanese government has simultaneously engaged in a strategy of hedging between the two powers while also taking the lead in keeping the TPP alive after the U.S. withdrew in January 2017 under the Trump administration. All these actions and strategies exhibit the ambitions on the part of these three major powers to use economic statecraft to reshape the regional economic order in their respective favor without destroying the connectivity and interdependence that is the foundation of the region's prosperity. Economic statecraft is thus a vital instrument of competition that allows one major power to prevail over another without necessarily undermining the economic system on which they rely.

POLICY IMPLICATIONS

- Given its existing power over the regional economic order, the U.S. should continue to support this order and work to shape the economic rules to its advantage.
- Clearly realizing both its geoeconomic advantage and uncertainty, Japan should adopt a flexible economic strategy. Taking a lead in rule- and standard-setting continues to be its forte with or without U.S. cooperation.
- All parties should keep in mind that Chinese leadership is aware that in the long run a stable economic order is important for China's continued prosperity. As such, the U.S. and Japan should try to actively shape such an environment through cooperation.

Given the increasing economic interdependence in the Asia-Pacific and with the regional order in flux, the use of economic statecraft by the major powers has gained importance. "Economic statecraft" refers to the use of economic means to pursue foreign policy goals, with instruments that include foreign aid, trade, policies governing the international flow of capital, and sanctions.[1] More recently, the concept of economic statecraft has been broadened to mean "war by other means," whereby commercial actors are incentivized to act in a way that supports the security goals of the state.[2] When a major power wants to shift the power balance in its favor through nonviolent means and without creating major disruptions in economic exchanges, which are the sources of prosperity and political stability, economic statecraft becomes the foreign policy tool of choice. In the Asia-Pacific, economic statecraft has become an essential instrument for countries to reshape the rapidly changing regional economic order in their favor. To this end, the major powers engage in competition and cooperation, first, by developing a hedging strategy and, second, by setting particular economic standards and rules to shape the regional institutions and economic order.

The importance of economic statecraft has increased since 2013 due to competitive and cooperative dynamics among China, the United States, and Japan. After having clearly "risen," but still facing the challenges of a declining economic growth rate and troublesome excess capacity, China under President Xi Jinping has diversified its economic focus from intense domestic investment to consumption, innovation, and regional and global expansion. To compete with existing global governance institutions, Chinese leaders have launched new initiatives such as the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank, as well as the ambitious Belt and Road Initiative (BRI) to improve regional connectivity. Concomitantly in Japan, after regaining political power in December 2012, Prime Minister Shinzo Abe launched his so-called Abenomics plan, which emphasizes economic revitalization through aggressive monetary and fiscal policies as well as important economic structural reforms. Under this strategy, he managed, against intense opposition from the agricultural sector, to bring Japan into the ongoing Trans-Pacific Partnership (TPP) negotiations in July 2013. With Japan's participation in the TPP as its twelfth and last negotiating member, the United States hoped to set the rules for trade and investment in the Asia-Pacific in the 21st century. The TPP was an integral component of President Barack Obama's strategy of "rebalancing" to Asia.[3] Meanwhile, the U.S. government saw China's expansion of its influence in the Asia-Pacific through BRI with wariness and opposed China's AIIB proposal. Although Japan has not joined the AIIB, many U.S. allies, including Australia, South Korea, and the United Kingdom, signed on as founding members despite U.S. opposition.

The transition from the Obama administration to the Trump administration has heightened the flux in the Asia-Pacific and shifted the balance of economic statecraft among China, Japan, and the United States. With his "America first" economic policy and disdain for multilateral institutions, President Donald Trump has disrupted the regional economic order in two

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1 For further discussion of the use of sanctions as the main instrument of economic statecraft, see, for example, Daniel W. Drezner, *The Sanctions Paradox: Economic Statecraft and International Relations* (Cambridge: Cambridge University Press, 1999).

2 Robert D. Blackwill and Jennifer M. Harris, *War by Other Means* (Cambridge: Harvard University Press, 2016); and William J. Norris, *Chinese Economic Statecraft: Commercial Actors, Grand Strategy, and State Control* (Ithaca: Cornell University Press, 2016).

3 Famously, the former U.S. secretary of defense Ash Carter under the Obama administration remarked that the "TPP is as important to me as another aircraft carrier." Ash Carter, "Remark on the Next Phase of the U.S. Rebalance to the Asia-Pacific" (speech at the McCain Institute, Tempe, April 6, 2015), https://dod.defense.gov/News/Speeches/Speech-View/Article/606660/remarks-on-the-next-phase-of-the-us-rebalance-to-the-asia-pacific-mccain-instit.

major ways. First, the United States withdrew from the TPP on Trump's first few days in office in January 2017 through an executive order. At that point, the TPP was very close to going into effect, having been signed by the twelve member states in February 2016. With its withdrawal from the agreement, the United States walked away from an important tool of economic statecraft that would have increased U.S. and Japanese leverage in the competition with China for leadership of the regional order in the 21st century. Second, the Trump administration began prioritizing bilateral economic engagement through renegotiating many existing free trade agreements (FTAs) such as the Korea-U.S. FTA and the North American Free Trade Agreement (NAFTA). It also imposed tariffs on many foreign goods, including exports from U.S. allies. In the case of China, the imposition of tariffs on a wide range of Chinese products exported to the United States has escalated into a trade war between the two countries. By using such blatant protectionist tactics, the Trump administration aims to balance the deficit with many of its trade partners and to bring investment and jobs back to the United States. This constitutes a new turn in economic statecraft in the Asia-Pacific, one that threatens to undermine the open liberal economic order that has prevailed in the region since World War II.

This essay first discusses Japan's economic statecraft after joining the TPP negotiations and as it continued to insist on the TPP-11 after the U.S. withdrawal. The second section focuses on China's geoeconomic grand strategy through BRI and the reaction by the United States and Japan. Finally, the last section turns its attention to the impact of the Trump administration's America-first strategy on regional dynamics. The essay concludes by considering the implications of such evolving economic statecraft and geoeconomics for the regional economic order in the Asia Pacific.

Japan's Economic Statecraft through the TPP and TPP-11

Before 2017, competition between mega economic initiatives led by the United States and China gave Japan geoeconomic leverage. Had things gone according to plan, Japan could have simultaneously helped position the TPP to serve as a robust framework for the rule-based trade and investment order in the region, while directly contributing to improving the quality of AIIB investments by scrutinizing this new institution and cooperating through other multilateral development banks. With the U.S. withdrawal from the TPP and Trump's America-first stance, however, Japan's role in the economic order in the Asia-Pacific has become more complex but still vital. Given the country's large investments and significant supply chains spread all across the region, Japanese economic prosperity depends considerably on the stability of the regional trade and investment order. As the shifting geoeconomic balance facing the Trump administration introduces greater uncertainty, the need for the Japanese government to carry the leadership torch to maintain and strengthen the liberal economic order in the Asia-Pacific has intensified. Japan must work to ensure that the region prospers regardless of changes in U.S. policy or the upswing in China's geopolitical ambitions. Japanese economic statecraft takes two major approaches to achieving this goal.

First, Japan has hedged against uncertainty by actively engaging China in building the regional economic order. The Japanese government has often adopted such a hedging strategy, but this strategy has gained even more salience under the Trump administration. Japan has managed its relations with China in the manner of "cooperative competition," whereby it proactively engages in regional projects that include China, such as the Regional Comprehensive Economic

Partnership (RCEP).[4] Prime Minister Abe has even entertained the idea of Japan participating in BRI. During the first Belt and Road Forum in May 2017, the Japanese government sent a political heavyweight, Party General Secretary Toshihiro Nikai. Japan also continues to show an interest in collaborating with the AIIB by indirectly supporting it through co-financing projects with the AIIB and the Asian Development Bank (ADB). Moreover, Deputy Prime Minister and Finance Minister Taro Aso has repeatedly expressed interest in Japan joining the AIIB. The ADB is conventionally headed by a Japanese official, and its current president, the former Ministry of Finance official Takehiko Nakao, has actively worked with Jin Liqun, the first president of the AIIB, on project formulation and co-financing. The Japanese government has moved to increase its own credibility in support of these regional projects by providing economic expertise drawn from Japan's experience as a major provider of foreign aid for infrastructure investment throughout Asia since the 1970s. Although the high costs and risk averseness of Japanese firms weakened Japan's presence in this area in recent years, the skills and technology they have developed have much to contribute to the region's connectivity and development.

The second approach is to emphasize Japan's role in building institutions and setting rules to support the regional economic order. For the last few decades, the Japanese government has turned to rules-based institutions such as the World Trade Organization (WTO) to settle trade disputes, while relying on formal treaties such as bilateral investment treaties to make rules for regional investment.[5] The Japanese government ratified the TPP in 2016 before any other members, and following the United States' withdrawal from the agreement in 2017, it led efforts among the remaining eleven countries to negotiate the TPP-11. The negotiation of the TPP-11 was not easy, as some smaller countries such as Vietnam and Malaysia were wary of joining an agreement that did not provide access to the large U.S. market, while others like Canada insisted on more progressive rules and separate protections. After a difficult but relatively short process, the eleven remaining TPP members concluded negotiation of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) in January 2018. The member governments signed the agreement in March 2018, and it went into effect on December 30, 2018. Although the new arrangement is not as large as the original TPP, which would have covered 40% of global GDP, the eleven CPTPP signatories represent nearly 500 million people and 13.5% of global GDP (about $10 trillion). One authoritative analysis has estimated that the CPTPP will generate an additional $147 billion in global income.[6] In addition, several countries, such as Thailand and Colombia, have shown interest in joining the group. The CPTPP promotes standards and norms for regional engagement and integration, providing more protections for investments and intellectual property and demanding more transparency from state-owned enterprises.

The Japanese government continues to hope that the United States will someday rejoin the TPP and has worked to preserve the agreement in a form close to what was negotiated in 2015 as a way to make it easy for the United States to do so. In fact, the CPTPP suspended, but did not eliminate, twenty substantive items from the original TPP agreement in a very strategic manner. These suspended provisions are all items that the U.S. government had insisted on during the earlier negotiations, ranging from the mechanism for investor-state dispute settlement to biologics to

4 Michael Auslin, "China vs. Japan: Asia's Other Great Game," *National Interest*, October 2017, 20.

5 Saadia M. Pekkanen, *Japan's Aggressive Legalism: Law and Foreign Trade Politics beyond the WTO* (Stanford: Stanford University Press, 2008).

6 "CPTPP: A Victory for Reason in Trade," *Japan Times*, March 13, 2018, https://www.japantimes.co.jp/opinion/2018/03/13/editorials/cptpp-victory-reason-trade/#.WvDADdMvxTY.

copyright provisions and financial services.[7] In addition, eminent trade diversion, arising from the United States' exclusion from the CPTPP's preferential market access, will have an impact on U.S. farmers, as the CPTPP only opens the Japanese agricultural market extensively to the agreement's members. Other U.S. producers are also feeling pressure from trade and investment diversion as the United States engages in a tariff war with China.

The Abe administration's commitment to the early implementation of the CPTPP is an important part of Japan's economic statecraft in several ways. First, it hopes that the high-standard CPTPP becomes a model for other multilateral trade agreements and strengthens Japan's hand in RCEP negotiations. After proposing the Free Trade Area of the Asia-Pacific (FTAAP) as the host of the 2014 APEC summit, China has focused on the RCEP as a proper route to the FTAAP. Hence, it has become even more essential for Japan to use the higher standards and rules established by the TPP as a template for the regional order. The rules-based economic order created by the CPTPP helps Japanese businesses expand their investment and market access in the Asia-Pacific. Second, it also protects the region from falling prey to a power struggle between the two regional superpowers and promotes an environment for open trade. In this way, Japan can also enhance its reputation as a provider of regional public goods. Finally, and as will be discussed further below, the Japanese government expects the CPTPP to act as a bulwark against the Trump administration's campaign for bilateral America-first FTAs.[8] The U.S. and Japanese governments have started bilateral negotiations toward a "trade agreement on goods" in 2019, and the Abe administration hopes to use the CPTPP as leverage.

China's BRI and AIIB and Japan's Response

During the same period, President Xi Jinping has advanced a geoeconomic and geopolitical grand strategy to restore China to its central place in the international order (a part of the "China dream") through BRI and the AIIB. Under BRI, China has promised to spend $1 trillion on infrastructure development along the belt (extending from China to Central Asia and Europe) and the road (spanning from Southeast and South Asia to the Middle East and Africa).[9] With a commitment of $100 billion in initial funding for infrastructure investment, the AIIB was inaugurated in 2016 with 57 founding members, including most countries from Asia and Europe, but notably without the United States and Japan.[10] Although the AIIB emphasizes its aim to be "lean, clean, and green," China has an overwhelmingly large voting share, as the bank gives higher voting weight to the Asian members. The AIIB has imposed competitive pressure on the policies of existing development banks such as the World Bank and the ADB, which have traditionally been dominated by the United States and Japan, especially in the case of the ADB. Furthermore, in May 2017 the first Belt and Road Forum was held in Beijing, with 29 heads of state in attendance and over 130 countries represented.[11]

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7 Martin Khor, "Without U.S., Why Does CPTPP Still Resemble the Old TPP?" *Strait Times*, February 27, 2018, https://www.straitstimes.com/asia/se-asia/without-us-why-does-cptpp-still-resemble-the-old-tpp-the-star-columnist.

8 Aurelia George Mulgan, "CPTPP a Boost for Japan's Regional Trade Leadership," East Asia Forum, February 27, 2018, http://www.eastasiaforum.org/2018/02/27/cptpp-a-boost-for-japans-regional-trade-leadership.

9 Jane Perlez and Yufan Huang, "Behind China's $1 Trillion Plan to Shake Up the Economic Order," *New York Times*, May 13, 2017.

10 After the second membership expansion in 2017, the AIIB included 87 member at the beginning of 2019.

11 Shannon Tiezzi, "Who Is Actually Attending China's Belt and Road Forum," *Diplomat*, May 12, 2017, https://thediplomat.com/2017/05/who-is-actually-attending-chinas-belt-and-road-forum.

In response to these two Chinese-led initiatives, the Japanese government unveiled its own plan to address the need for large investments in infrastructure in Asia. This plan, called the Partnership for Quality Infrastructure, was announced by Prime Minister Abe at the 21st International Conference on the Future of Asia in May 2015 and pledged to boost Japanese economic cooperation, including an increase in infrastructure support in Asia by 25%.[12] In November 2015 the Japanese government issued follow-up measures to establish a "quality infrastructure partnership" with Asia that includes (1) the acceleration of yen-loan approval procedures, (2) the establishment of dollar-denominated foreign aid loans, (3) the possible exemption of recipient government funding guarantees on a case-by-case basis, and (4) the development of relevant international standards for quality infrastructure investment.[13] Along with these institutional changes, the "all Japan" approach to infrastructure investment and export, which utilizes a team of public and private entities from Japan, has intensified since 2015. In August 2015, the Japan International Cooperation Agency (JICA) extended 240 billion yen (almost $2 billion) in official development assistance loans to the Philippines for railroad and highway projects by providing the fund in one tranche rather than in multiple tranches. In December of that same year, India awarded Japan a high-speed rail project between Ahmedabad and Mumbai costing 1 trillion yen ($8 billion). As part of its dialogue with Southeast Asian governments, the Japanese government has also lobbied to change the contract-bidding procedures to take into consideration not only low prices but also the quality of infrastructure.[14]

The Japanese government has attempted to increase its own credibility in support of these regional projects in two ways. The first way is by leveraging Japan's economic expertise and commitment to quality. This strategy capitalizes on the country's postwar history as a major provider of foreign aid to the region in support of infrastructure development, while highlighting the skills and technology that Japan can contribute to increasing regional connectivity. The second way that Japan can contribute is by engaging with the region to calm concerns among smaller nations about China's attempt to further its geopolitical ambition through regional initiatives. Such a strategy is effective because many Southeast Asian countries view Japan as a less threatening counterweight to China.[15]

New Realignment? Trade Wars, Japan-China Rapprochement, and the New U.S. Strategy

As the trade war between the United States and China intensified throughout 2018, Beijing has counterbalanced the U.S. pressures in a few ways. First, on the trade and investment front, it is seeking a breakthrough in RCEP negotiations with the ASEAN +6 (the ten members of the Association of Southeast Asian Nations plus China, Japan, South Korea, Australia, New Zealand,

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12 The four pillars of the Partnership for Quality Infrastructure are (1) expansion and acceleration of assistance through the full mobilization of Japan's economic cooperation tools, (2) collaboration between Japan and the ADB, (3) doubling of the supply of funding for projects with relatively high-risk profiles through the Japan Bank for International Cooperation, and (4) promotion of quality infrastructure investment as an international standard. See Ministry of Economy, Trade and Industry (Japan), "Announcement of Partnership for Quality Infrastructure," May 21, 2015, http://www.meti.go.jp/english/press/2015/0521_01.html.

13 "Follow-up Measures of 'the Partnership for Quality Infrastructure,'" Ministry of Foreign Affairs (Japan), November 21, 2015, http://www.mofa.go.jp/mofaj/gaiko/oda/about/doukou/page23_000754.html.

14 Author's interview with a foreign aid specialist in Japan, January 2016.

15 Chien-peng Chung, "Japan's Involvement in Asia-Centered Regional Forums in the Context of Relations with China and the United States," *Asian Survey* 5, no. 3 (2011): 407–28.

and India).[16] Facing this formidable challenge from the Trump administration, the Chinese leadership has also engaged in a hedging strategy by seeking rapprochement with Japan. After meeting President Xi at Vladivostok during the Eastern Economic Forum in September 2018, Prime Minister Abe visited Beijing in late October. The leaders reiterated the importance of improved bilateral relations between China and Japan, especially in the area of economic cooperation. Toward this end, the two governments signed over five hundred business deals and agreed to cooperate on infrastructure funding in third countries. One prerequisite for such enhanced bilateral cooperation was the renewed interest on the part of Prime Minister Abe in collaborating with China on BRI.

Meanwhile, despite the withdrawal of the United States from the TPP and its disinterest in multilateral cooperation in Asia, the Trump administration still seeks to prevent China from dominating the region through BRI and the AIIB or allowing Japan to play China against the United States (or vice versa). The United States has begun to create a counter-coalition against China and entice Japan through a U.S.-Japan bilateral trade agreement. In its National Security Strategy released in December 2017, the Trump administration formulated a "free and open Indo-Pacific" strategy to counter Chinese initiatives in the region.[17] This strategy pursues the geostrategic goals of containing China's ability to dominate Asia and bolstering partnerships with major democratic countries like Australia, India, and Japan.[18] Following up on a speech by Secretary of State Mike Pompeo in late July 2018 that emphasized the importance of U.S. business engagement in the Indo-Pacific, the U.S. government announced $113.5 million in new initiatives that will support funding for infrastructure, the digital economy, and energy as well as regional institutions such as ASEAN. In addition, the recently concluded U.S.-Mexico-Canada Agreement (USMCA) added crucial conditions for Mexico and Canada absent from the original NAFTA agreement that went into effect in 1994. In addition to stricter rules on local content requirements and higher wage standards for workers, Article 32.10 was introduced to prevent treaty members from engaging in FTA negotiations with "non-market economies," which likely targets China.

Bilaterally, the U.S. government has placed significant pressure on the Abe government to start negotiating a U.S.-Japan free trade agreement. Advocating for a "free, fair, and reciprocal trade deal," the United States is working to ensure that U.S. farmers and manufacturers will have the same market access in Japan as the TPP-11 members. Yet it was important both domestically and regionally for the Japanese government to resist entering talks for as long as possible. On the domestic front, Japanese farmers and the general public are wary of U.S. pressure, having experienced an exhausting series of trade conflicts with the United States in the 1980s and the 1990s.[19] The fear on the part of Japan is that, due to the continuing trade imbalance in Japan's favor, the U.S. negotiators will push harder for agricultural opening through bilateral negotiations. Japanese farmers, in particular, are opposed to the further opening of the country's market beyond what has been agreed to via the CPTPP template. Moreover, having led the CPTPP process and still hoping to convince the United States to rejoin the TPP or a TPP-type regional

[16] Liu Zhen, "U.S. Trade War and Japan Push Raise Prospects for China-Backed Asia Free-Trade Deal," *South China Morning Post*, September 2, 2018, https://www.scmp.com/news/china/diplomacy/article/2162395/japans-relations-china-back-normal-track-says-shinzo-abe.

[17] White House, *National Security Strategy of the United States of America* (Washington, D.C., 2017), 46.

[18] This strategic concept emerged in the early 2010s among the defense strategists of Australia. Prime Minister Abe also used this language during his first term as prime minister in 2007. Japan has a very developed definition of a free and open Indo-Pacific in terms of free markets and freedom of navigation. For further discussion, see Ashish Kumar Sen, "A Free and Open Indo-Pacific," Atlantic Council, July 31, 2018, http://www.atlanticcouncil.org/blogs/new-atlanticist/a-free-and-open-indo-pacific.

[19] Saori N. Katada, "Amerika no TPP seisaku to Nihon" [The American TPP Policy and Japan], *Kokusai Mondai*, September 2015.

FTA, the Abe administration believes that keeping the trade-diversion pressure on the United States is crucial for the region. As the largest economy in the CPTPP, Japan did not want to betray the trust of other regional countries by taking the bilateral route. However, the continued imposition of U.S. tariffs on Japanese iron and steel and the threat of 25% tariffs on automobiles made it impossible for the Abe administration to put off the U.S. demand to negotiate a bilateral FTA further into the future. As a result, following Prime Minister Abe's meeting with President Trump on the sidelines of the UN General Assembly in September, they announced that the U.S. and Japanese governments would start negotiating what Japan calls a trade agreement on goods at the beginning of 2019.

Conclusion

Several twists and turns in Japanese economic statecraft in the last five years have revealed Japan's position between the United States and China, which is on the one hand ambivalent but on the other strategic. Multilateral rule-making in the area of trade and investment through the TPP and CPTPP has been a relatively comfortable role for Japan. In such efforts, the Japanese government did not have to overtly confront China's rising influence and yet still managed to set rules to help check China's expansion. Furthermore, Japan shared the United States' concern over the rise of the Chinese-led BRI and AIIB initiatives. The dynamics of this power game shifted, however, with the inauguration of President Trump in January 2017, when the multilateral and institutional means to shape the regional economic order lost their most powerful advocate, the United States. Now, the Japanese government is left to carry the torch for the liberal economic order in the Asia-Pacific through the CPTPP agreement without the United States.

Since the Trump administration's America-first policies have intensified the uncertainty in the regional economy through the use of bilateral tactics, including the imposition of tariffs, both Japan and China have started to engage in hedging strategies. Leaving aside their historical rivalry and tension, the leaders of the two countries have demonstrated that they can work together, or at least appear to do so, for the prosperity of Asia by cooperating on infrastructure investment and regional rule-making through the RCEP. At the same time, the United States continues to engage in its own economic statecraft through the push for cooperation on its free and open Indo-Pacific strategy and the negotiation of a bilateral trade agreement with Japan.

All these strategies and tools of economic statecraft exhibit the ambitions of these three major powers to shape the regional economic order in their respective favor without destroying the connectivity and interdependence that is the foundation of the Asia-Pacific's prosperity. For over 70 years, the post-1945 liberal order has set the norms for economic exchange in the region. Now it seems that these norms will be contested and negotiated among the major powers.

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NBR SPECIAL REPORT #75 | FEBRUARY 2019

U.S.-Japan Business Relations and the Trade War with Asia

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EXECUTIVE SUMMARY

This essay analyzes the current U.S.-Japan trade relationship and assesses the consequences of the U.S. trade war for bilateral relations.

MAIN ARGUMENT

The Trump administration's protectionist trade policies will affect U.S.-Japan relations at multiple levels. Japan's economic structure has changed fundamentally over the past two decades, and the country is now the technology anchor of many Asian supply chains. For Japan, China is a much more important trading partner than the U.S. Regarding bilateral U.S.-Japan trade negotiations, it is important to weigh the potential short-term gains from higher tariffs against deep-rooted technology dependencies and long-standing business collaboration, including Japan's funding of U.S. innovation and ownership of large companies and plants in the U.S. In the pan-Asian context, in the long run, both the U.S. and Japan may benefit from a diversification of trading partners in Asia, and the trade war is already having this effect. But in the short term, the Trump administration's approach will increase uncertainties and may stall regional economies. Recent initiatives to increase economic collaboration between Japan and China raise the risk that the U.S. could be marginalized in Asia.

POLICY IMPLICATIONS

- Due to the globalization of supply chains, U.S. tariffs on Chinese and Japanese goods are bound to affect all Asian economies. China's role in the production chain cannot be replaced overnight. Even if a diversification of production sites in Asia will benefit the region in the long run, this transition will take time.
- Japan is much more critical to the U.S. economy than the bilateral trade statistics indicate. The Japanese economy has fundamentally changed since the 1990s, with Japan becoming one of the U.S.'s most important technology collaborators and investors in the private sector. Japan can no longer be taken for granted, and U.S. trade policies that alienate this critical ally may prove costly.
- Japan has become the technology anchor of trade in Asia. While the U.S. continues to be important for Japan, Japanese trade with China and within Asia is now much larger. The new trade war thus risks pushing Japan toward China.

After years of promoting trade expansion and the globalization of supply chains, the U.S. government in 2018 moved toward protectionism in an effort to prioritize domestic interests. The key target in this policy shift was China, which accounted for 30% of U.S. trade volume and 46% of the U.S. trade deficit in goods in 2017.[1] In that same year, Mexico and Canada accounted for about 53% of total U.S. trade and 10% of the goods deficit, followed by Japan with 9% of trade and 8.5% of the deficit. To address this trade imbalance, in 2018 the Trump administration levied tariffs on China and renegotiated the North American Free Trade Agreement (NAFTA) into the U.S.-Mexico-Canada Agreement (USMCA), which contains higher local content rules and caps on free exports by product category.[2] The United States also threatened Japan with tariffs and trade restrictions, in particular on automobiles. This occurred even though Japan remains a strong U.S. treaty ally and is "the cornerstone of U.S. security interests in Asia and…fundamental to regional stability and prosperity."[3]

Despite Japan's salient role in U.S. policy toward Asia, fairly little is known about the details of U.S.-Japan trade as of December 2018, mostly because China has attracted most of the attention. The U.S. trade representative (USTR) leading the negotiations, appointed in May 2017, was Robert E. Lighthizer, who had also served in the office of the USTR under President Ronald Reagan from 1983 to 1985, when the first U.S.-Japan trade war began. However, as this essay will show, since then, Japan's industrial architecture, global business strategies, and investment goals have fundamentally changed, and Japanese companies have repositioned themselves in global supply chains as purveyors of pivotal input technologies.

There were two main sources of tension in U.S.-Japan trade in 2018. The first was the United States' direct threat to impose bilateral trade restrictions on Japan. In September 2018 the two sides began negotiations regarding a rise in tariffs on automobiles and agriculture. Given the high mutual dependencies and direct investments and strategic business alliances between the countries, this raised great concerns about the viability of current business tie-ups and the outlook of long-term relations. The second challenge was the indirect effect that U.S. trade restrictions on China would have on the entire region. Japan is a huge part of Asian trade, and due to the globalization of supply chains, a "new Cold War" would be felt throughout Asia. China, in fact, has become a much more important trade partner than the United States for Japan, and there is a nontrivial risk that the United States could find itself marginalized in the Asia-Pacific.

This essay analyzes Japan's trade situation in 2018 to assess the consequences of the Trump administration's protectionist trade policies for U.S.-Japan business relations. The first section analyzes U.S.-Japan trade data between the 1980s and 2017, while the subsequent section highlights how Japan's economy has changed over the past two decades. Section three then explains the new realities of the Asian supply chain, as well as the size and reach of Japan's trade interactions in Asia. The essay concludes by considering positive and negative scenarios as to what the trade war may mean for U.S.-Japan relations. While it is possible that Japan could benefit from the U.S. effort

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1 This section is based on the U.S. Census Bureau, "U.S. International Trade in Goods and Services," https://www.census.gov/foreign-trade/Press-Release/current_press_release/index.html; and Kimberly Amadeo, "U.S. Trade Deficit by Country, with Current Statistics and Issues," *Balance*, November 21, 2018, https://www.thebalance.com/trade-deficit-by-county-3306264.

2 The United States had already formally withdrawn from the Trans-Pacific Partnership (TPP) in January 2017. In February 2016, twelve countries, including the United States, had signed an agreement to greatly lower tariffs and non-tariff barriers, contingent on later ratification. Even though there was disagreement regarding the net trade benefits for the United States, many saw the TPP as an important geopolitical mechanism to reduce the signatories' dependence on China and strengthen the U.S. role in the Pacific Rim. After the United States withdrew, the remaining eleven countries signed a modified agreement in March 2018, which became effective in December 2018.

3 U.S. Department of State, "U.S. Relations with Japan," Bureau of East Asian and Pacific Affairs, Fact Sheet, July 17, 2018, http://www.state.gov/r/pa/ei/bgn/4142.htm.

to diversify the Asian supply chain away from China in the long run, it would be dangerous for the United States to take Japan for granted.

The Bilateral Relationship: U.S.-Japan Trade

In 2017 the United States was the world's largest trading nation and recorded the world's largest trade deficit in goods and services, totaling $566 billion (total exports were $2.33 trillion, while imports were $2.89 trillion). The focus of the 2018 trade war was on manufacturing, and therefore the remainder of this essay will look only at the trade deficit in goods. In this category, the U.S. deficit was even larger, totaling $810 billion (with exports of $1.55 trillion and imports of $2.36 trillion).[4] By product, the four largest categories of the U.S. trade deficit in 2017 were automobiles (including engines and parts), consumer electronics, electrical equipment, and clothing. Meanwhile, the United States was earning a surplus in civilian aircraft and engines, soybeans, and chemicals.

China accounted for $375 billion (46%) of this $810 billion trade deficit. (How the structure of the Asian supply chain ballooned this deficit will be discussed further below.) The second-largest deficit for a single country was the $71 billion differential with Mexico, mostly as a result of trade in cars and electronics under NAFTA. The third-largest single-country deficit was with Japan. The total trade between Japan and the United States was $204 billion, with Japanese exports of $136.5 billion and imports of $67.5 billion. The resulting deficit of $69 billion translated into 8.5% of the U.S. deficit in goods.[5] This is a huge reduction from the 1980s, when Japan accounted for 65% of the trade deficit (see **Figure 1**).

Figure 2 graphs the bilateral trade dependence between the United States and Japan over time. In 2017 the United States accounted for 19.3% of total Japanese exports and 11% of all imports, compared with 38.5% and 23%, respectively, in 1986 (graphed in the two top lines). Conversely, for the United States, Japan accounted for 12% of exports and 23% of imports in 1986, but by 2017 these shares had dropped to a fairly small 4.4% and 6%, respectively (graphed in the two bottom lines).[6]

The main reason for this decline in the relevance of the United States for Japanese trade is Japan's long-standing trend of locating production facilities abroad that began in response to the first U.S.-Japan trade war of the 1980s and 1990s. **Figure 3** shows cumulative outward-bound FDI by Japan for the decade of 1989–98 and the two decades after 1998. The United States has long been the dominant destination for Japanese production plants abroad; over the past two decades, Japan's outward-bound FDI totaled $1.6 trillion, of which 30% was invested in the United States.[7]

Returning to products traded between the two countries, **Figure 4** graphs percentage shares of total Japanese exports to the United States over 30 years (upper panel), compared to Japanese imports from the United States (lower panel). Each bar represents a year between 1988 and 2017.

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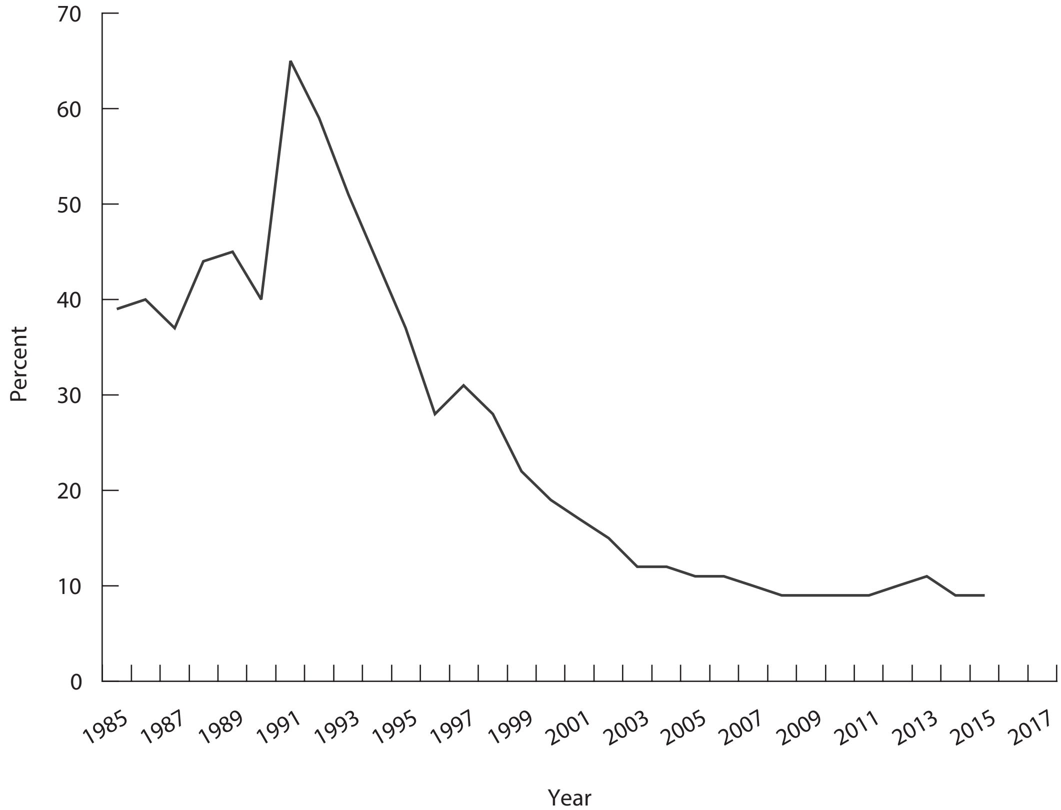
4 U.S. Census Bureau, "U.S. International Trade in Goods and Services," https://www.census.gov/foreign-trade/Press-Release/current_press_release/index.html.

5 Amadeo, "U.S. Trade Deficit by Country, with Current Statistics and Issues." The United States reported a trade surplus in services with Japan of $13.4 billion, leaving the total trade differential at $55.4 billion, or 9.8%, of the total U.S. trade deficit in 2017.

6 Based on U.S. Census Bureau, "U.S. Trade in Goods by Country," https://www.census.gov/foreign-trade/balance/index.html#J; U.S. Census Bureau, "Trade in Goods with Japan," https://www.census.gov/foreign-trade/balance/c5880.html#2017; and Ministry of Finance (Japan), "Trade Statistics of Japan," http://www.customs.go.jp/toukei/suii/html/time_e.htm.

7 Detailed data can be found at Japan External Trade Organization (JETRO), "Japan's International Trade in Goods (Monthly)," https://www.jetro.go.jp/en/reports/statistics.html.

FIGURE 1 Japan's share of the U.S. trade deficit, 1985–2017



SOURCE: U.S. Census Bureau, "U.S. Trade in Goods by Country," https://www.census.gov/foreign-trade/balance/index.html#J.

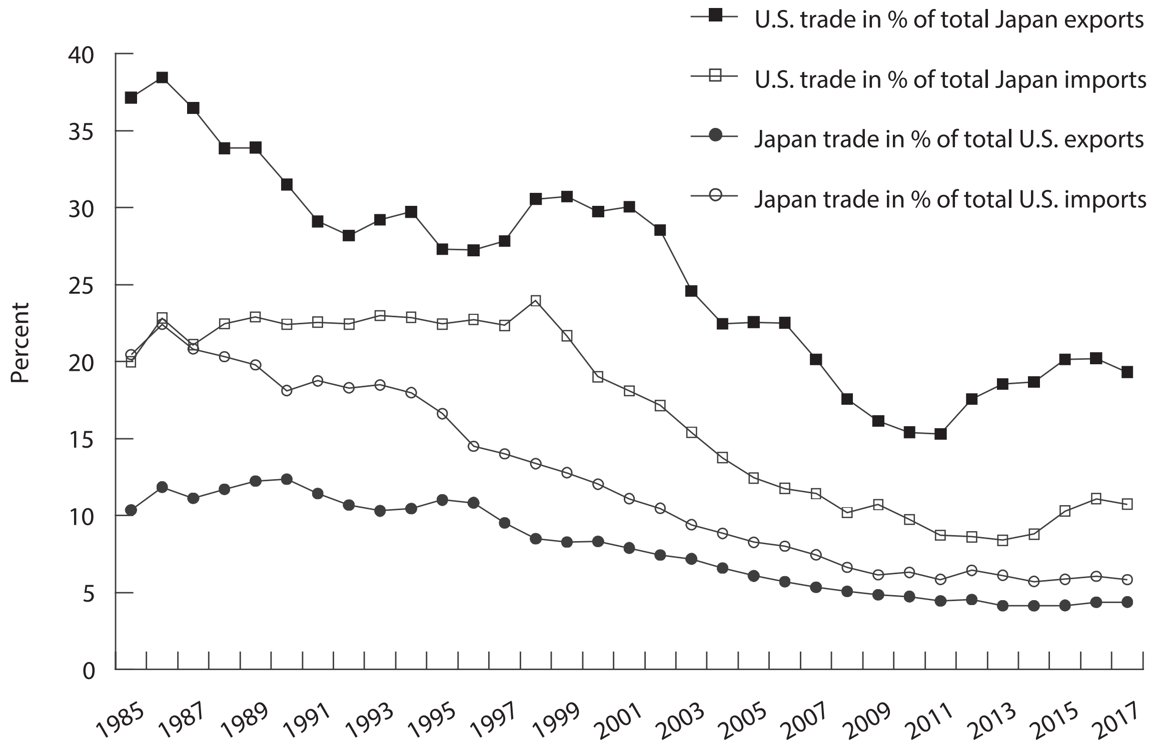
Throughout the four decades, cars and car parts increasingly accounted for the majority of Japanese exports, followed by machinery and electronics (though their share has been declining). Meanwhile, Japanese imports from the United States were dominated by agriculture ($12 billion in 2017, making Japan the fourth-largest agricultural export market for the United States, especially in corn, beef, pork, and soybeans, followed by machinery, optical and medical instruments, aircraft, and mineral fuels).[8]

It is no surprise, then, that the motor vehicle industry was at the center of the 2018 U.S.-Japan tariff negotiations, and it illustrates nicely how trade and FDI are intertwined. According to the Japan Automobile Manufacturers Association, worldwide car production in 2017 totaled 97.3 million vehicles.[9] By location, roughly 22% of automobiles (22.2 million) were produced in Europe, 13% in North America, and 10% in Japan. Roughly half of the ten million cars manufactured in Japan were exported, of which one-third went to the United States. If one had to describe the U.S. trade deficit with Japan in only one word, it would be "Prius": Japanese automakers held a combined market share of over 60% of hybrid cars sold in the United States, and all of these cars

8 See Office of the U.S. Trade Representative, "U.S.-Japan Trade Facts," https://ustr.gov/countries-regions/japan-korea-apec/japan.

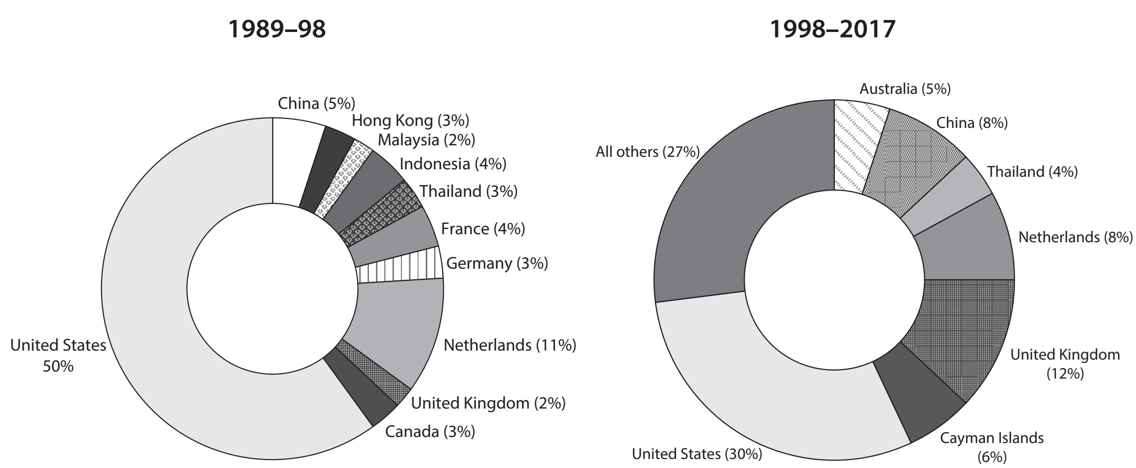
9 The following is based on Japan Automobile Manufacturers Association, "The Motor Industry of Japan 2018," May 2018, http://www.jama-english.jp/publications/MIJ2018.pdf.

FIGURE 2 U.S.-Japan trade: Bilateral share of each country's total trade, 1985–2017



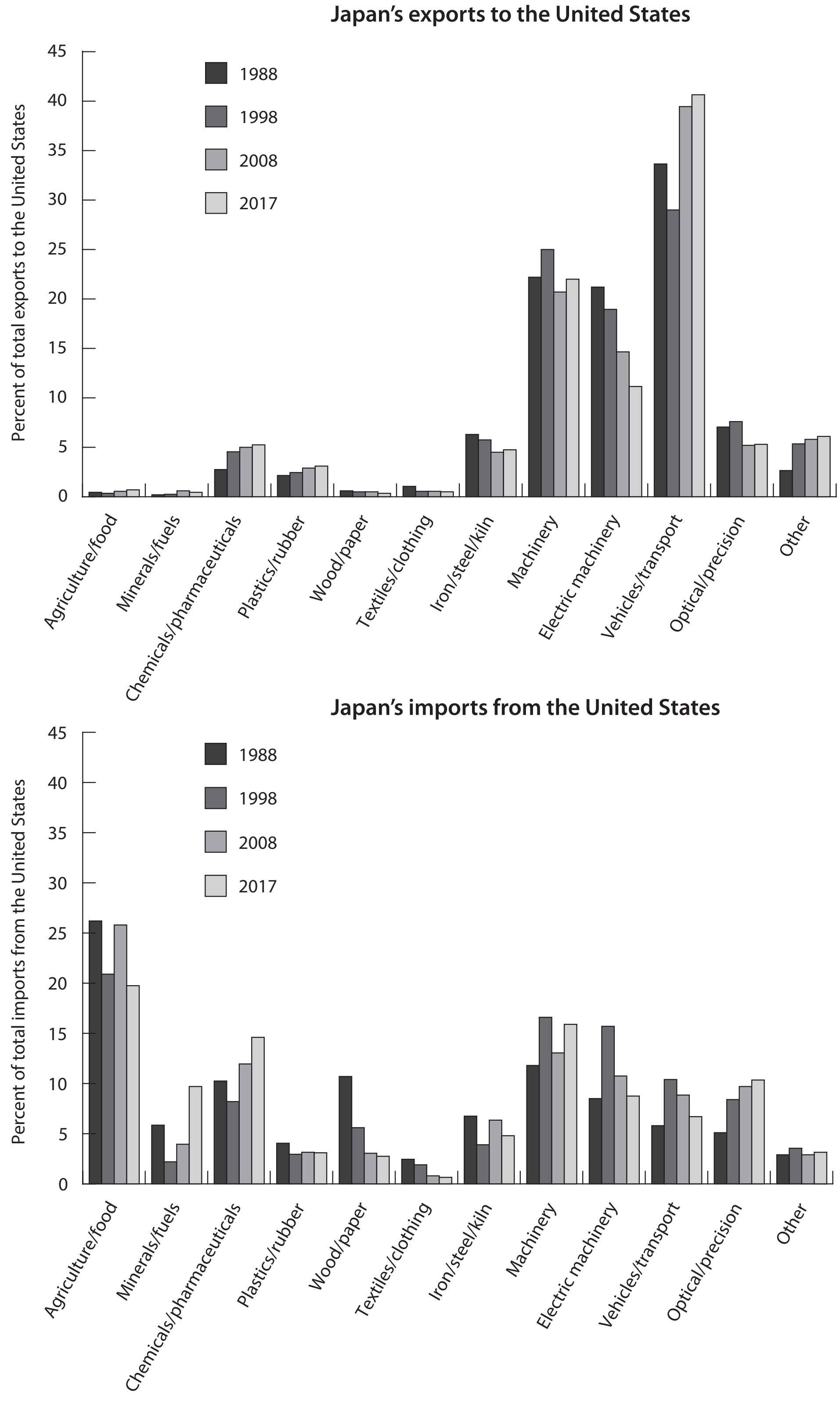
SOURCE: U.S. Census Bureau, "U.S. Trade in Goods by Country," https://www.census.gov/foreign-trade/balance/index.html#J.

FIGURE 3 Cumulative outward-bound FDI from Japan, 1989–98 and 1998–2017



SOURCE: Author's construction of data from the Ministry of Finance (Japan) and JETRO.

FIGURE 4 Composition of U.S.-Japan trade by industry, 1988–2017



SOURCE: Author's construction of data from Japan Customs, http://www.customs.go.jp/toukei/info.

were made in Japan.[10] In 2017, six of the cars on the *Consumer Reports* list of the top-ten cars of the year were made by Japanese companies, including the Prius in the hybrid category.[11]

Viewed by manufacturer, of total world production of 97.3 million vehicles, Japanese companies produced 30% (i.e., about 30 million), and almost 70% of this production was located outside Japan: roughly 50 million were manufactured in Asia, and 4 million were made in the United States. According to one estimate, in 2015 the "Japan 3" (Toyota, Nissan, and Honda) created more than 1.5 million jobs and built more sedan cars (not counting trucks, SUVs, or crossovers) in the United States than the "Detroit 3" (General Motors, Ford, and Chrysler).[12] As a result, U.S. labor advocates demanded to exclude automobiles from the trade talks altogether, even as the U.S. automaker lobby urged the government to push the protectionist agenda.[13]

Further complicating the bilateral trade situation is that a nontrivial portion involved military equipment and aircraft, some of which was classified. In November 2018, the Japanese government unexpectedly announced that it was considering purchasing an additional one hundred military aircraft from the United States above the already negotiated deal—namely the very advanced F-35B stealth fighter jet. At a price tag of around $88 million each, the invoice was to exceed $12 billion. It was no secret that the purpose of the acquisition was not only to strengthen Japan's military defense but also to appease the United States by reducing the bilateral trade deficit.[14] At the same time, Japan committed to paying $2.1 billion for a new U.S. missile defense system.[15] In December 2018, Japan also unveiled a plan to build its first aircraft carrier since World War II as part of a national defense reform to be carried out at "unprecedented speed."[16] Regardless of how such a one-time, point-to-point (or "Prius-to-F-35B") trade could improve the underlying structure of U.S.-Japan trade, it fulfilled the goal of empowering Japan militarily and charting a new course of reducing Japan's military dependence on the United States.

Another critical aspect of U.S.-Japan trade relations is business and technology collaboration within the private sector. In the twentieth century, many strategic alliances and joint ventures had been driven by a Japanese interest in "technological catch-up" and were sometimes viewed in the United States as a threat to U.S. technology leadership, similar to the situation with China today.[17] More recently, the relationship has evolved into one of true collaboration and mutual learning by technology leaders involved in cutting-edge research projects. In 2018, examples of sizable private-sector strategic alliances included a $3 billion joint venture between Qualcomm and TDK

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10 The Prius alone accounted for 49% of total hybrid car sales in the United States between 1999 and 2014. U.S. Department of Energy, Alternative Fuels Data Center, "U.S. HEV Sales by Model," https://afdc.energy.gov/data/10301.

11 Jeff S. Bartlett, "Top 10 Picks of 2017: Best Cars of the Year," *Consumer Reports*, February 28, 2018, https://www.consumerreports.org/cars-best-cars-top-picks-2017.

12 Dan Eaton, "Japan's Big 3 Automakers Built More Cars in U.S. than Detroit 3 Last Year," *Columbus Business First*, June 1, 2016, https://www.bizjournals.com/columbus/news/2016/06/01/japans-big-3-automakers-built-more-cars-in-u-s.html.

13 Alex Lawson, "Looming Japan Trade Talks Tee Up Bigger Fight in Auto Sector," Law 360, December 10, 2018, https://www.law360.com/internationaltrade/articles/1109762/looming-japan-trade-talks-tee-up-bitter-fight-in-auto-sector.

14 "F35 sentouki saidai 100-ki tsuika shutoku e: Itchou-en seifu kentou" [The Government Considers Acquiring up to 100 Additional F-35 Fighter Jets for 1 Trillion Yen], *Nikkei Shinbun*, November 27, 2018, https://www.nikkei.com/article/DGXMZO38215250X21C18A1MM0000.

15 Kyodo, "Trump Urges Abe to Balance U.S. Deficit with Japan 'Very Quickly,'" *Japan Times*, December 1, 2018, https://www.japantimes.co.jp/news/2018/12/01/national/politics-diplomacy/trump-urges-abe-balance-u-s-deficit-japan-quickly#.XD9141xKhhE; and "Japan to Order 100 More F-35 Fighters from U.S.," *Nikkei Asian Review*, November 27, 2018.

16 Alastair Gale, "Japan Unveils Plan for First Aircraft Carrier since World War II," *Wall Street Journal*, December 11, 2018, https://www.wsj.com/articles/japan-unveils-plan-for-first-aircraft-carrier-since-world-war-ii-11544524822.

17 See, for example, Robert B. Reich and Eric D. Mankin, "Joint Ventures with Japan Give Away Our Future," *Harvard Business Review*, March 1986, https://hbr.org/1986/03/joint-ventures-with-japan-give-away-our-future; and David C. Mowery and David Teece, "The Changing Place of Japan in the Global Scientific and Technological Enterprise," in *Japan's Growing Technological Capability: Implications for the U.S. Economy,* ed. National Research Council (Washington, D.C.: National Academy Press, 1992).

on radio frequency technologies and a $2.6 billion joint venture between Hitachi and Johnson Controls on air-conditioning technologies. Meanwhile, Japanese banks have become world leaders in so-called project financing of very large-scale installations in the power, transportation, oil and gas, water, mining, and telecommunications industries.[18] These are just a few examples of the deep and broad interconnectedness between Japanese and U.S. business interests.

A final aspect of the U.S.-Japan trade relationship is a growing Japanese role in the U.S. economy through substantial investments as well as mergers and acquisitions. This trend is an expression of Japan's recent successes in restructuring and strategic repositioning; the turnaround of Japan's largest firms has left them cash-rich and eager to broaden their global reach in competitive consolidation, as will be discussed further in the next section. Large Japanese acquisitions of U.S. companies in recent years include Jim Bean (purchased by Suntory in 2014); several large insurance companies, such as Endurance Specialty (Sompo Japan, 2016) and Stancorp Financial (Meiji Yasuda Life, 2016); Ariad Pharma (Takeda, 2017); Reynolds American (Japan Tobacco, 2016); Dell Services (NTT Data, 2016); and Integrated Device Technologies (Renesas, 2018).

Around 2010, many large Japanese companies also began to actively seek foreign corporate venture capital investments under the rubric of "open innovation"—i.e., the outsourcing of ideation from startup companies. According to data collected from CB Insights, between 1996 and 2016, more than two hundred Japanese companies invested in at least 2,970 deals in the United States.[19] In a highly visible continuation of this trend, in 2018 Japan's Softbank, a leading telecommunications company, announced the launch of its $100 billion Vision Fund aimed mostly at Silicon Valley firms.[20] Given the depth of U.S.-Japan technology collaboration and shared concerns about intellectual property protection, such investments were viewed positively as fueling innovation and the growth of startup companies in the United States.

These private investments may now be affected by the U.S.-China trade war as a result of the Foreign Investment Risk Review Modernization Act, which greatly increased U.S. government powers to prohibit foreign investment in critical U.S. infrastructure, technologies, and sensitive data. The new law with its tightened provisions went into effect in November 2018, with the main goal of limiting China's access to U.S. technologies.[21] To be sure, strategies to protect critical U.S. technologies and infrastructure and to control the flow of intellectual property are important to maintan U.S. technology strengths. Insofar as the monitoring process can be efficient and not hold up investments beneficial for the United States, the new law constitutes a cornerstone of protecting U.S. interests. One concern is that it could, perhaps unwittingly, increase uncertainty and stifle technological collaboration with partner countries such as Japan.

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18 See Thomson Reuters, "Global Project Finance Review: Managing Underwriters," 2018, http://www.pfie.com/Journals/2018/04/25/e/v/u/PFI-Financial-League-Tables-Q1-2018.pdf.

19 Masato Sasaki and Ulrike Schaede, "Corporate Venture Capital Investments by Japanese Firms," University of California–San Diego, School of Global Policy and Strategy, unpublished manuscript.

20 Sarah McBride, Selina Wang, and Peter Elstrom, "SoftBank's $100 Billion Vision Fund Is Run by These 10 Men," *Bloomberg Businessweek*, September 26, 2018, https://www.bloomberg.com/news/articles/2018-09-27/softbank-s-100-billion-vision-fund-is-run-by-these-10-men.

21 Morrison Forester, "CFIUS Reform Enacted: Immediate Impact and Extended Uncertainty," September 17, 2018, https://www.mofo.com/resources/publications/180815-cfius-reform-enacted.html; and Alan Rappeport, "In New Slap at China, U.S. Expands Power to Block Foreign Investments," *New York Times*, October 10, 2018, https://www.nytimes.com/2018/10/10/business/us-china-investment-cfius.html.

Japan's Industrial Transformation

In the mid-1990s, the unexpected rise of China coincided with Japan's sudden decline, especially in the highly visible consumer electronics industries. Japan's "bubble economy" collapsed in 1990, which triggered a banking crisis that remained unaddressed until 2003.[22] The wait-and-see approach was blamed as causing the so-called lost decade of the 1990s and, in the eyes of some, a second lost decade in the early 2000s. However, the deeper reason for the country's exit from consumer electronics was a fundamental shift in its industrial architecture, and what was labeled a "lost decade" was in fact a period of economic transformation. Over a period of twenty years, reforms and piecemeal change coalesced into a comprehensive business reorganization that repositioned Japanese industry as a critical provider of high-technology inputs and components in the Asian supply chain.[23]

The "old Japan" that Americans knew from the 1980s was a juggernaut in mass-producing very high-quality consumer end products, especially electronics and cars. Japanese cars arrived in the United States after the two oil crises of 1973 and 1979, when highly fuel-efficient sedans from Japan trumped U.S. gas guzzlers. American consumers fell in love with these cars that also were more reliable and cheaper to maintain, and then they embraced Japanese-made cameras, televisions, stereo systems, office equipment, and many other popular products.

Japan's success in commercializing technologies was anchored in very large firms that competed ferociously on the basis of size, as measured by sales. Substantial corporate cross-shareholdings and in-house boards of directors reduced the need to heed profitability concerns. Over 30 years of fast growth, this resulted in a business system dominated by large, highly diversified companies that worked with the government to execute policies that promoted exports and protected domestic industries. Because there was no pressure on profits, Japan's export machine could roam foreign markets at super-low margins: every sale was a good sale, and every point of market share gained was celebrated. Faced with this new competition, the U.S. electronics industry faltered, while Detroit went searching for new production processes.[24]

Japan's expansion ended in the early 1990s. The trade war with the United States that erupted in the 1980s led to deregulation, the opening of markets, and the phasing out of domestic industry protection. Domestically, the collapse of Japan's bubble economy caused a severe financial crisis that forced banks to foreclose on loans and companies to sell off nonperforming pieces of their conglomerates. Foreign investors bought up a large number of these assets, which significantly altered the composition and motivation of shareholders in Japan's largest companies. By 2010, the majority of shares traded on the Tokyo Stock Exchange had transitioned into accounts held by foreign and institutional investors (35% and 18%, respectively). These developments created new corporate governance pressures, as these investors were keenly interested in profitability and efficiency.

The best defense against the threats of shareholder intervention, hostile takeovers, and other market-based mechanisms of corporate control is to run a profitable company. Japan's

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22 Analyses of the bubble economy and subsequent decline can be found in Koichi Hamada, Anil K. Kashyap, and David E. Weinstein, eds., *Japan's Bubble, Deflation, and Long-Term Stagnation* (Cambridge: MIT Press, 2010); and Takeo Hoshi, "The Bubble Economy and Its Aftermath," in *Political Economy of Japan: Growth, Challenges and Prospects for a Well-Being Nation*, ed. Toshihiko Hayashi (Tokyo: Open University of Japan, 2010), 51–70.

23 This section is a summary of the main message and research in Ulrike Schaede, *Choose and Focus: Japanese Business Strategies for the 21st Century* (Ithaca: Cornell University Press, 2008).

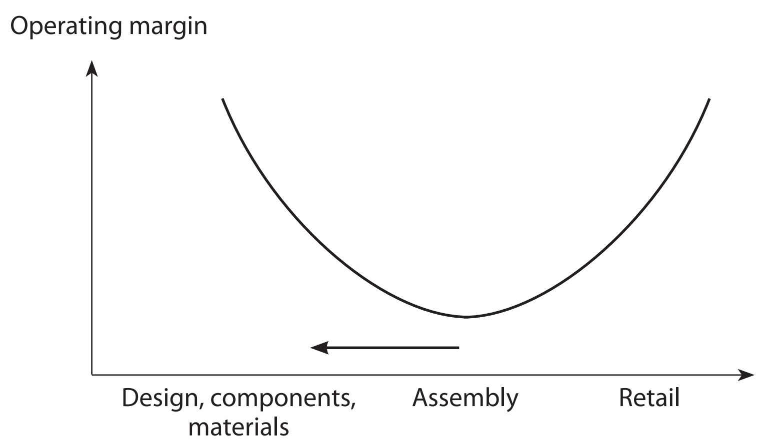
24 While industry insiders recall mismanagement at companies such as RCA and Zenith, for an interpretation of how Japan's approach could be seen as constituting predatory pricing, see David Schwartzman, *The Japanese Television Cartel: A Study Based on Matsushita v. Zenith* (Ann Arbor: University of Michigan Press, 2013).

leading companies embarked on a "choose and focus" campaign: identify the core, high-margin businesses; focus resources on competing in those; and exit all others. In the 2000s, the main new, core categories were upstream materials, such as fine chemicals for electronics, carbon fiber, and production machinery, where Japanese companies came to dominate world markets.[25]

Underlying this transition toward upstream business segments was the rise of South Korea and Taiwan in the 1990s as true competitors in high-quality mass production of consumer-end products. Then, the rise of China as an assembly powerhouse meant that competition within Asia wiped out most profits in end-product assembly, leading the CEO of the Taiwan computer company Acer to draw the "smiley curve of profits" on the back of a napkin (see **Figure 5**). This curve expresses the profit potential for each stage of the production process, with assembly of end products at the bottom of the smiley face. The highest margins were earned upstream (design, input parts, production machinery) and downstream (retail). Having lost their competitiveness in low-margin assembly, Japan's leading companies repositioned themselves to exit the consumer markets and compete in high-tech input materials, components, and machine tools that were difficult to replicate.[26]

These developments coincided with the globalization of the supply chain. In the business use of the term, this means that the "value capture" (i.e., the earning of profit) in the various stages of production is occurring in different countries. Value capture is usually commensurate with "value added" (i.e., the criticality of the contribution made). High value-added is typically anchored in technology, innovation, or mastery of difficult production processes. Until the mid-1990s, value chains had been built inside a company or in a region. In the mid-1990s, three

FIGURE 5 The "smiley curve of profits"



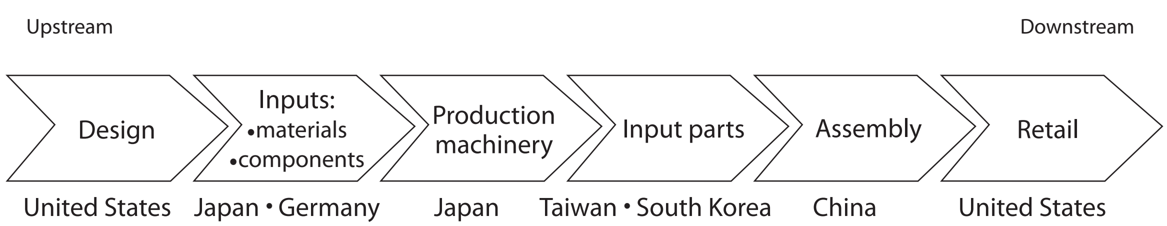
[25] Schaede, *Choose and Focus*, chap. 4; and author's interviews with representatives from several Japanese and German manufacturers in fall 2017.

[26] For a case study, compare Fujifilm's successful repositioning with Kodak's demise. In 2006 the company changed its name from Fuji Photo Film to simply Fujifilm, while Kodak was sitting hamstrung, unable to make the transition into the new century. See Shigetaka Komori, *Innovating Out of Crisis: How Fujifilm Survived (and Thrived) as Its Core Business Was Vanishing* (Berkeley: Stone Bridge Press, 2015); and Charles A. O'Reilly III and Michael L. Tushman, *Lead and Disrupt: How to Solve the Innovator's Dilemma* (Stanford: Stanford University Press, 2016).

factors contributed to the breakout of the stages of production across firms and countries: (1) a steep decline in the costs of transportation and logistics, (2) an increased shareholder focus on specialization and short-term profitability, and (3) a move by large firms to outsource non-core or low-profit production activities in response to the first two factors. Meanwhile, trade agreements reduced tariffs and other trade barriers, and newly emerging economies built production zones to attract outsourced businesses, especially in industries where modularization (the breakdown of the product into modules, like Lego blocks) was easy. The dominant manufacturing model shifted from in-house or within-country production to outsourcing from the cheapest and best location. The largest such modularized industry was perhaps electronics, followed by automobiles and clothing (e.g., tennis shoes).

Most of the materials, components, and machineries that Japanese companies provided to the Asian supply chain in 2018 were innovative, based on substantial intellectual property and complicated and difficult-to-imitate production processes. Japanese companies produced these in Japan, which was possible because they were located at the upstream section of the smiley curve and earned high margins. **Figure 6** shows a stylized supply chain for the iPhone in 2010, which has been extensively studied as an example of the new reality of trade in Asia.[27] While the iPhone was designed in California (and later sold at margins exceeding 60% for Apple), an estimated 34% of the value-added of building the actual phone was generated in Japan, followed by 17% in Germany, 13% in South Korea, 6% in the United States, and only under 4% in China.[28] Yet, because it was impossible to disentangle these global contributions at the time of export, trade statistics listed the entire production cost of the iPhone as a U.S. import from China. This new trade reality was not accurately represented in the statistics and exaggerated the "made in China" portion of the U.S. trade deficit.

FIGURE 6 iPhone supply chain, 2010



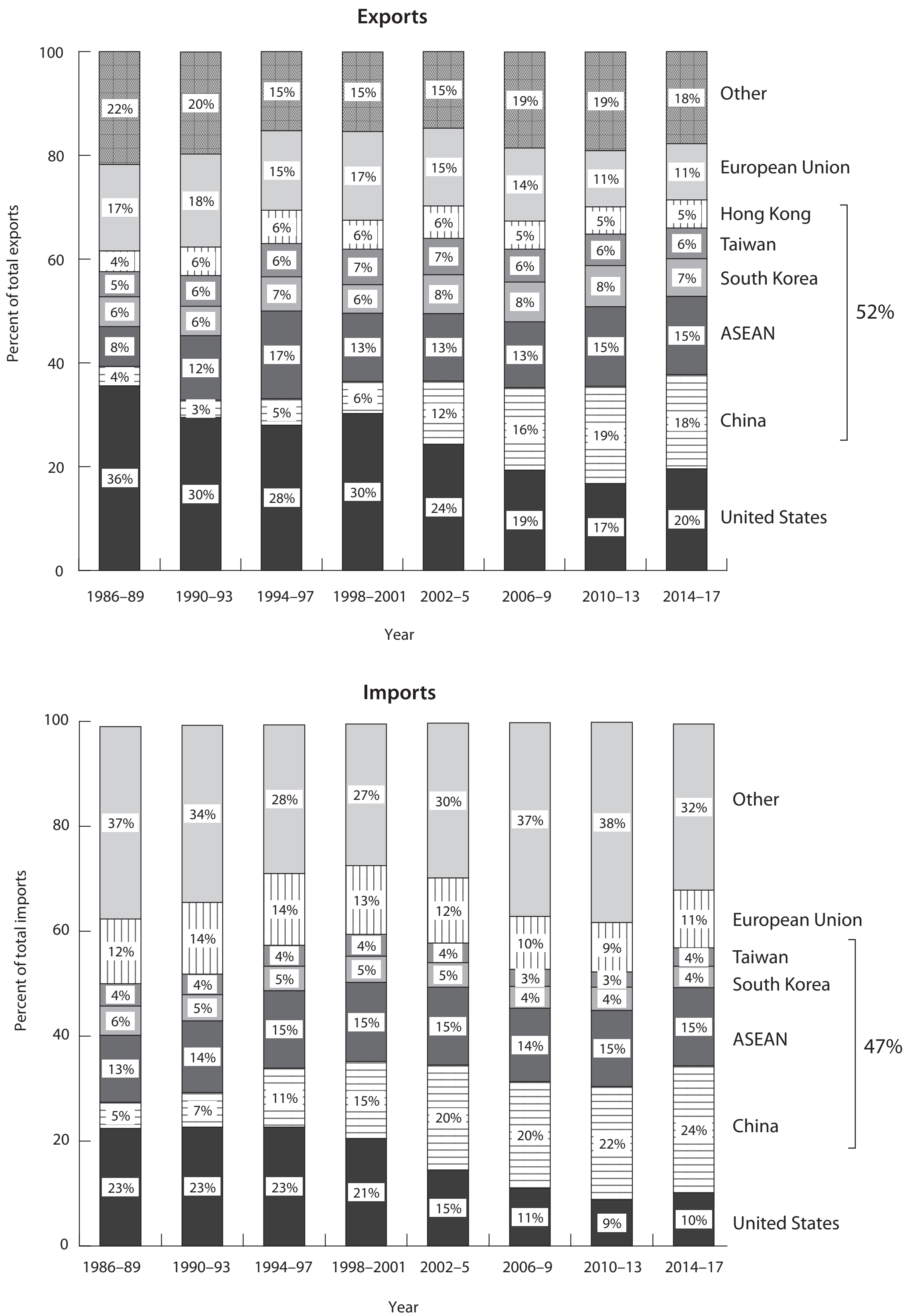
Japan's New Role in the Asian Trade Network

This industrial repositioning meant that the United States was no longer Japan's largest trading partner. **Figure 7** shows that, in 2014–17, 19.6% of Japanese exports were directed at the United States, while 52% went to Asia. In particular, China (including Hong Kong) accounted for 23.5%

[27] Satoshi Inomata, "Trade in Value Added: An East Asian Perspective," Asian Development Bank Institute, Working Paper, no. 451, 2013, https://www.adb.org/sites/default/files/publication/156306/adbi-wp451.pdf.

[28] Andrew Batson, "Not Really 'Made in China': The iPhone's Complex Supply Chain Highlights Problems with Trade Statistics," *Wall Street Journal*, December 1, 2010.

FIGURE 7 Japanese exports and imports by country, 1986–2017



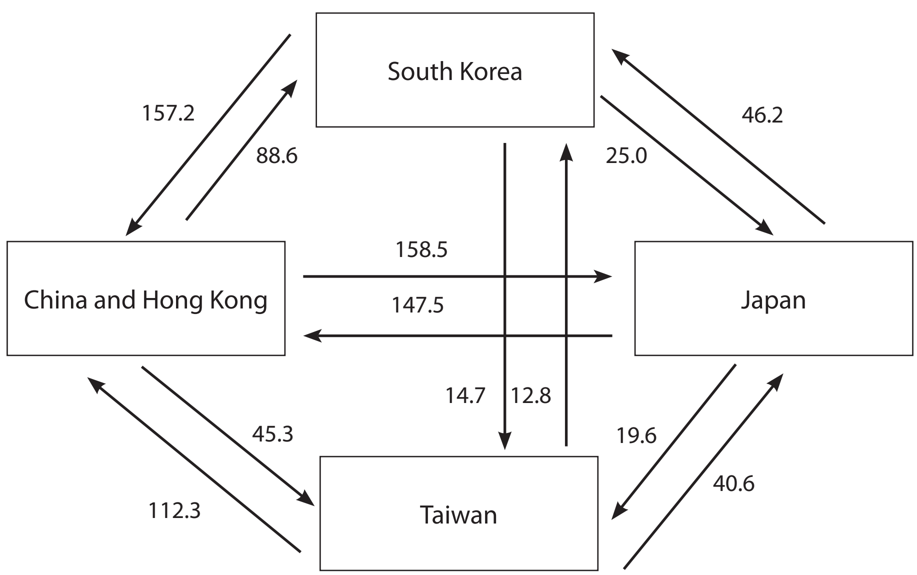
SOURCE: Author's construction of data from Japan Customs, http://www.customs.go.jp/toukei/info.

of exports.[29] In terms of Japan's imports, Asia accounted for 47% (with 24% coming from China), while only 10% of imports were from the United States.

Figure 8 maps the trade relations between the main players in the Asian supply chain as of 2016. The two center arrows show that Japan's trade with China totaled $306 billion, which was about $100 billion more than Japan's total trade with the United States of roughly $200 billion in that year. Moreover, Japanese and Chinese trade with South Korea and Taiwan was a large portion of the Asian supply chain. These two countries both had trade deficits with Japan, of $21 billion each, whereas China had trade deficits with South Korea and Taiwan of $69 billion and $67 billion, respectively. Taken together, this shows how Japan anchors Asia's supply chain.

Figure 9 takes a closer look at the China-Japan trade. In 2017, Japan imported a wide variety of goods from China, ranging from soybeans and t-shirts to landline phones and branded consumer-end products (many of which were U.S.-, South Korean-, or Japanese-manufactured goods assembled in China). In return, Japan exported cars, machinery, and chemicals. Although this trade relationship was very large and important to Japan, it is fair to say that China's dependence on imports from Japan exceeded Japan's dependence on imports from China.

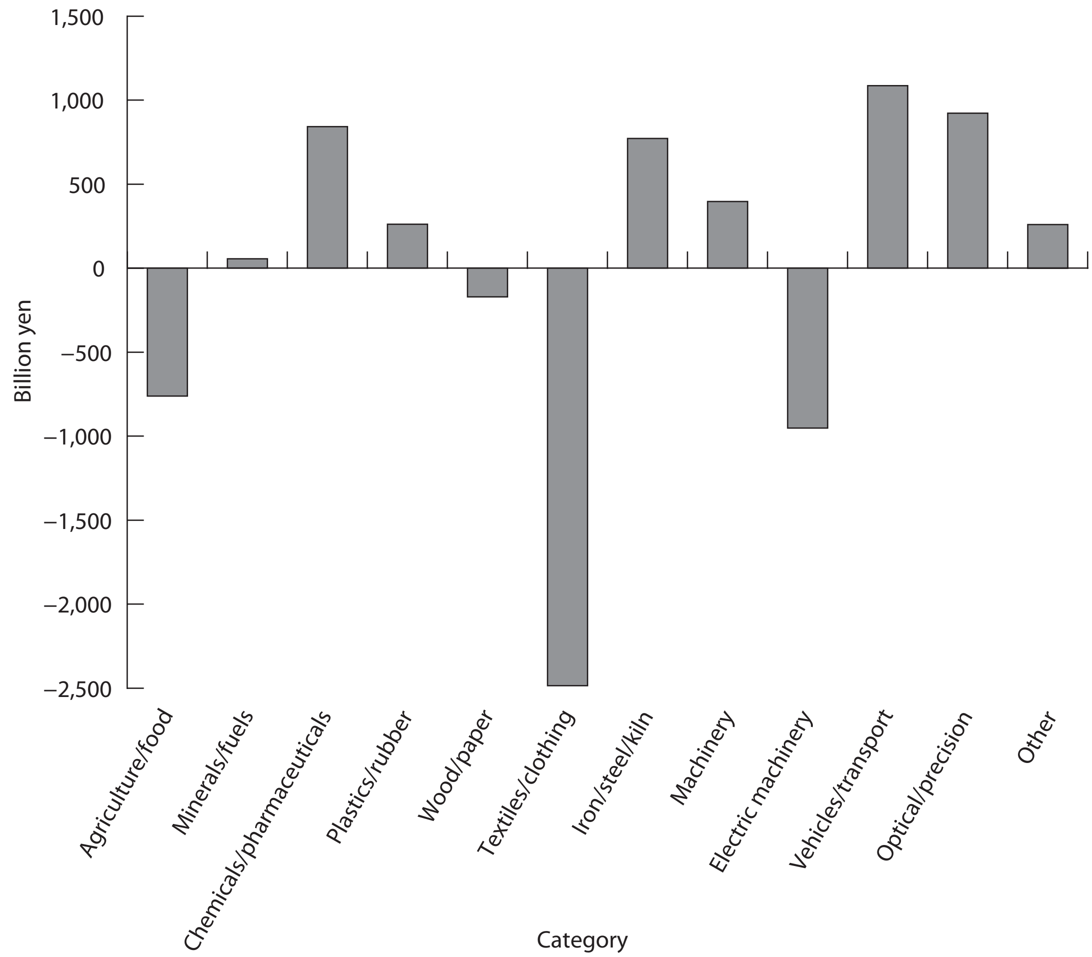
FIGURE 8 Trade relations between China/Hong Kong, Taiwan, South Korea, and Japan ($ bn)



SOURCE: Author's construction of data from UN Comtrade database, World Bank WITS database, and the Taiwan Bureau of Foreign Trade.

[29] China accounted for 18.1% of this total, and Hong Kong for 5.4%. While trade statistics break out Hong Kong separately from China, experts agree that it is fair to assume that more than 90% of Japanese shipments to Hong Kong are routed to mainland China. Japan has a deficit in its direct trade with China but a large surplus with Hong Kong, resulting in an almost even trade relationship. I am grateful to my colleague Barry Naughton for his advice on this matter.

FIGURE 9 Japan's trade balance with China/Hong Kong in 2017 by category



SOURCE: Author's construction of data from Ministry of Finance (Japan) and Japan Customs, http://www.customs.go.jp/toukei/info.

Japan also had significant on-the-ground investments in China. According to a survey by the Japanese Chamber of Commerce in China, Japanese companies recorded partial ownership stakes in over 30,000 companies in China, making Japan the largest of all foreign interests in 2018.[30] Moreover, companies such as Komatsu (construction), Fanuc (robotics and numerical controls), and most manufacturers of consumer products, such as Uniqlo in apparel, had production facilities in China. The U.S. tariffs imposed on China in 2018 triggered an unraveling of these stakes, as companies began to explore other production sites in Asia; however, China's role in the supply chain could not be easily substituted elsewhere.[31] Even in presumably low-tech industries such as textiles, Chinese manufacturers were considered far advanced. The U.S. trade war with

30 Pan Mangqi, "B&R Initiative Boosts Sino-Japanese Links," *China Daily*, June 21, 2018, http://global.chinadaily.com.cn/a/201806/21/WS5b2b0329a3103349141dd74e.html.

31 Ju-Min Park and Makiko Yamazaki, "Japanese and Other Asian Firms Shifting Production from China as U.S. Tariffs Take Toll," *Japan Times*, September 23, 2018, https://www.japantimes.co.jp/news/2018/09/23/business/corporate-exodus-china-underway-fresh-u-s-tariffs-hit.

China is likely to cause a Pan-Asian economic downturn, at least in the short term. In a survey of 114 major Japanese corporations in China, 12% saw definite harm to their earnings, and 50% reported a likely impact due to increased uncertainty inhibiting further investments.[32] Yet many Japanese businesses also agreed that in the long run a diversification of trading partners and reduced dependence on China would be beneficial for trade and the overall stability of the region.

Conclusions: U.S.-Japan Trade Relations Going Forward

The largest effect of the 2018 trade war in Asia was to cause great uncertainty, reduce new investments in China, and bring to the fore concerns about trade dependencies. At the G-20 summit in December, the deadlines for increased tariffs on China were extended until March 2019, further increasing uncertainty. Some began to refer to the U.S.-China confrontation as the "new Cold War."[33]

The U.S. trade war would affect Japan both directly through bilateral tariffs and indirectly as a result of Japan's pivotal role in the Asian trade network. For the bilateral relationship, the main issues are the deep business interdependence between the United States and Japan, the focus on high-technology goods such as cars and aircraft, and of course the implications for the underlying security alliance. The positive scenario going forward is that Japan will value the security umbrella and fear the pains of reduced trade so much that it does what is required to please the United States in order to avoid a prolonged trade war. Along these lines, Japan's purchase of additional military equipment has served to bolster the alliance.

The negative scenario is that Japan will come to dislike its dependence so much that it seeks to nurture other markets and slowly begins to reduce trade with the United States and withdraw from U.S. investments. This might cause a recession in the United States, which is highly dependent on Japan for critical input parts. Under such a scenario, Japan would actively engage new consumer markets in Asia and the European Union that might also turn away from the United States. In the long run, the United States would lose its relevance and would eventually look back on the year 2018 as the watershed moment when it lost its closest ally in Asia.

As of December 2018, most observers still assumed the positive scenario, but the Trump administration should not take Japan for granted. Japan already trades much more with Asia than with the United States, and especially if the United States were to fall into a recession, Japan might well reorient its efforts toward China. The Trump administration's short-term focus on levying tariffs on automobiles or requesting large-scale aircraft purchases from Japan carries the risk of alienating the country. And while the United States is still highly relevant for Japan through joint, long-term collaboration and investments in next-generation technologies, there is concern that policies constraining investments in U.S. innovation, while targeted at China, could also restrain Japan.

Japan's changing trade patterns, in fact, make the negative scenario even more likely. During the U.S.-Japan trade war in the 1980s and 1990s, there was a saying that when the United States catches a cold, Japan catches pneumonia, which underscored the impact of the United States on

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[32] Yuji Ohira, "Trade War Likely to Hurt Profits for 60% of Japan's Tops Companies," *Nikkei Asian Review*, September 11, 2018, https://asia.nikkei.com/Economy/Trade-War/Trade-war-likely-to-hurt-profits-for-60-of-Japan-s-top-companies.

[33] See, for example, Hiroyuki Akita, "U.S.-China Confrontation Weighs Heavily on Japan," *Nikkei Asian Review*, November 25, 2018, https://asia.nikkei.com/Economy/Trade-War/US-China-confrontation-weighs-heavily-on-Japan.

Japan's export economy. The new reality today is that if China catches a cold, the rest of Asia catches pneumonia. As a result of globalization, trade in Asia has become so interconnected that China is in many ways more important than the United States.

In the Asian context, the most positive scenario for U.S.-Japan trade relations is that Japan takes a short-term hit and relocates many of its investments from China to elsewhere in Asia.[34] In terms of the supply chain, because Japan produces the pivotal input materials and components domestically and then routes them through South Korea and Taiwan, it is at a minimum neutral toward the location of the final assembly. In fact, Japan would stand to gain from diversifying its assembly sites in Asia and building a network of economic and political allies throughout the region. Relatively short-term economic pain might translate into a stronger position in Asia. To some, this was the intended effect of the new U.S. trade policies,[35] and from this viewpoint these policies would also bolster U.S.-Japan relations.

In the negative scenario, the economic pains from an interruption of the Asian supply chain run deeper and Japanese companies are unwilling or unable to carry out a reorganization into a pan-Asian business network.[36] A recession in China would have a significant impact on Japan and could compel the two countries to forge a new trade relationship based on a mix of pragmatic opportunism and mutual distrust of the United States. The Asian supply chain would provide a mechanism to retaliate against the United States by limiting U.S. companies' access in Asia. The new partnership between China and Japan would change the geopolitics of the region and threaten to marginalize the United States.

At the beginning of 2019, it is difficult to assess the probabilities of these various outcomes, because the trade war is still unfolding and the U.S. stance on key issues is shifting. However one may think about a trade war with China, trade with Japan has different and complicated dimensions. The United States is taking a huge gamble on Japan by including it in the trade wars. Given the great transformation in the Japanese business and political economy since the 1990s, Japan can no longer be taken for granted as a core ally and trading partner in Asia.

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[34] See, for example, Cory Baird, "Japanese Firms Face Tough Choices as U.S.-China Trade War Drags On," *Japan Times*, August 24, 2018, https://www.japantimes.co.jp/news/2018/08/24/business/economy-business/japanese-firms-face-tough-choices-u-s-china-trade-war-drags/#.XAQpay2ZMyk; and Frank Feng, "Japanese Companies Shift Manufacturing Operations Out of China due to Sino-U.S. Trade War," *Epoch Times*, October 29, 2018, https://www.theepochtimes.com/japanese-companies-shift-manufacturing-operations-out-of-china-due-to-sino-us-trade-war_2636316.html.

[35] Greg Autry, "Trump's China Policy Is a Triumph," *Foreign Policy*, November 28, 2018, https://foreignpolicy.com/2018/11/28/trumps-china-policy-is-a-triumph-wto-trump-gdp.

[36] For a discussion in terms of "be careful what you wish for," see Peter Landers, "The Old U.S. Trade War with Japan Looms Over Today's Dispute with China," *Wall Street Journal*, December 13, 2018, https://www.wsj.com/articles/the-old-u-s-trade-war-with-japan-looms-over-todays-dispute-with-china-11544717163.

THE NATIONAL BUREAU *of* ASIAN RESEARCH

NBR SPECIAL REPORT #75 | FEBRUARY 2019

Negotiating a U.S.-Japan Trade Agreement: Prospects and Challenges

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EXECUTIVE SUMMARY

This essay examines the prospects for a U.S.-Japan trade agreement and discusses the implications for other regional frameworks such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the Regional Comprehensive Economic Partnership (RCEP).

MAIN ARGUMENT

The Asia-Pacific region needs a high level of trade liberalization and advanced rules for trade and investment for the enhancement of global value chains. This goal can be achieved solely through a region-wide FTA or the establishment of the Free Trade Area of the Asia-Pacific (FTAAP). Despite Japan's efforts to convince the U.S. to rejoin the Trans-Pacific Partnership (TPP), which could pave a path toward this high-standard framework for trade and investment rules in the region, the U.S. indicated a preference for a bilateral trade agreement with Japan. Japan has agreed to begin negotiations on the bilateral deal early this year. Although the U.S.-Japan trade agreement will by itself have a very limited impact on the creation of an FTAAP, it could be a stepping stone to achieving this goal.

POLICY IMPLICATIONS

- The scope of the first phase of U.S.-Japan negotiations will likely focus on market access, including the important but sensitive issue of access for U.S. agricultural products and automotives to the Japanese market. Given that the European Union is benefiting from widespread market access in Japan due to the recently concluded Japan-EU trade agreement, it would be wise for the Trump administration to swiftly wrap up first-stage negotiations so that U.S. exporters remain competitive.
- A common platform of rules for the management of global value chains that will host both the U.S. and China, as well as the rest of the Asia-Pacific region, is needed. In the medium to longer term, this goal can be achieved solely through a region-wide FTA that includes both the U.S. and China.
- Although the 2016 Lima Declaration on FTAAP envisioned the TPP and the RCEP as two possible options to create an FTAAP, the RCEP is not a viable path to this goal because it provides a lower level of trade liberalization and less advanced rules for trade and investment than the TPP. Instead, the most viable pathway to an FTAAP is the United States either returning to the TPP or joining the expanded CPTPP.

After their summit meeting of September 26, 2018, Prime Minister Shinzo Abe and President Donald Trump announced their shared intention to enter into negotiations for a U.S.-Japan trade agreement.[1] This was a major breakthrough in the trade relationship between the two countries, which had been upended by the United States' withdrawal from the Trans-Pacific Partnership (TPP) in January 2017. The decision to pursue negotiation of a bilateral trade agreement represented a sharp turn in Japan's strategy, which had until then prioritized persuading the Trump administration to rejoin the TPP.

This essay will explore the reasons behind the Abe administration's change in policy and examine the possible outcomes of a U.S.-Japan trade agreement and how it could work alongside other regional frameworks such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the Regional Comprehensive Economic Partnership (RCEP). I will argue that the U.S.-Japan trade agreement should be a stepping stone to the United States joining the TPP or the CPTPP, which would lay a path toward a high-standard framework for trade and investment rules in the region. The first section of the essay traces the development of bilateral trade diplomacy since the United States' withdrawal from the TPP. The next section examines the content of the September 2018 agreement between Japan and the United States to negotiate a trade deal, while the third section explores the possible outcome of the negotiations. Section four then addresses the possible impact of a U.S.-Japan trade agreement on regional economic integration.

Recent Developments in U.S.-Japan Trade Diplomacy

On his first day in office, President Trump directed the U.S. trade representative to permanently withdraw the United States from the TPP.[2] This meant that the TPP, signed by the twelve negotiating countries in February 2016, ceased to be in effect, as there would be no chance of its entry into force without the participation of the largest economy, the United States.[3] The initial reaction of the Abe administration was to try to persuade the Trump administration to return to the TPP. At his first summit meeting with President Trump in February 2017, Prime Minister Abe repeatedly encouraged the president to change his mind and return to the TPP, with no positive result. In May 2017, the Abe administration changed its policy and decided to rescue the TPP by negotiating the TPP-11, formally known as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, with the eleven remaining members of the TPP without the United States. Japan took the initiative in negotiating the CPTPP and successfully concluded the negotiation with the signature of the agreement in March 2018.

By pursuing the CPTPP, however, the Abe administration did not give up its intention to persuade the United States to return to the TPP. The CPTPP "froze" around two dozen provisions of the original agreement instead of eliminating them, and these provisions can be "defrosted"

1 "Joint Statement of the United States and Japan," White House, September 26, 2018, https://www.whitehouse.gov/briefings-statements/joint-statement-united-states-japan.

2 "Presidential Memorandum Regarding Withdrawal of the United States from the Trans-Pacific Partnership Negotiations and Agreement," White House, January 23, 2017, https://www.whitehouse.gov/presidential-actions/presidential-memorandum-regarding-withdrawal-united-states-trans-pacific-partnership-negotiations-agreement.

3 Article 30.5.3 of the TPP provides that it shall enter into force 60 days after the date on which at least six of the original signatories that together account for at least 85% of the combined GDP of the original signatories have completed the ratification procedure.

if the United States returns to the TPP.[4] In January 2018, President Trump suggested that he was open to rejoining the agreement if the United States could negotiate a "substantially better deal."[5] The priority for the Trump administration, however, was negotiating a bilateral deal with Japan, and it repeatedly urged the Abe administration to start this process. The tug-of-war between the two governments resulted in the U.S.-Japan Economic Dialogue between Vice Prime Minister Taro Aso and Vice President Mike Pence in April 2017 and more bilateral trade talks in August 2018, followed by the Trump-Abe summit in September announcing the decision to begin negotiation of a bilateral trade agreement.

Negotiating a Bilateral Trade Agreement

What exactly would a U.S.-Japan trade agreement entail? At the press conference after the summit meeting, Prime Minister Abe explained it as a trade agreement on goods (TAG) and denied that it was a free trade agreement (FTA), which would cover services and investments as well as traditional trade in goods. This explanation was, however, inaccurate. The joint statement of the summit meeting declared that the two countries "will enter into negotiations…for a United States–Japan Trade Agreement on goods, as well as on other key areas including services, that can produce early achievements." It further declared that the two countries "intend to have negotiations on other trade and investment terms following the completion of the discussions of the agreement mentioned above."[6] Although there is no universal definition of an FTA, the General Agreement on Tariffs and Trade, which is still in effect under the World Trade Organization (WTO), provides that a free trade area shall be understood to mean a group of two or more customs territories in which the "duties and other restrictive regulations of commerce…are eliminated with respect to substantially all the trade between the constituent territories."[7] According to this definition, the U.S.-Japan trade agreement will qualify as an FTA in two stages. The TAG will be the first stage of the negotiation, followed by a full-fledged negotiation covering trade and investment.[8]

Why did Japan finally agree to the United States' request to negotiate a bilateral trade agreement? The primary reason was the U.S. threat of using Section 232 of the 1962 U.S. Trade Expansion Act to impose tariffs on automotives. When the United States applied additional tariffs on steel and aluminum products from Japan under Section 232 in March 2018, Japan did not join China, the European Union, and several other countries in retaliating against the measure, nor did it insist that the United States waive the measure against Japan. The reason is that the tariffs on steel and aluminum products did not function as leverage over Japan. However, the negative economic impact of the automotive tariffs would be far more serious, as this industry produces Japan's largest export earnings. The bilateral trade deal that the EU and the United States began

4 For the list of provisions of the TPP that were suspended under the CPTPP, see "Annex to the CPTPP," February 21, 2018, available at https://www.mfat.govt.nz/en/trade/free-trade-agreements/free-trade-agreements-concluded-but-not-in-force/cptpp/comprehensive-and-progressive-agreement-for-trans-pacific-partnership-text/#annexes.

5 See "Dèjá vu? Trump's Davos Swing Restores TPP, TTIP to the Conversation," Inside U.S. Trade, January 30, 2018, https://insidetrade.com/trade/d%C3%A8j%C3%A1-vu-trumps-davos-swing-restores-tpp-ttip-conversation.

6 "Joint Statement of the United States and Japan."

7 See Article 24 of the General Agreement on Tariffs and Trade, available from the WTO website at https://www.wto.org/english/tratop_e/region_e/region_art24_e.htm.

8 As noted earlier, it is misleading to interpret the U.S.-Japan trade agreement under negotiation as a trade agreement that would cover solely goods trade. The joint statement refers to "a United States–Japan Trade Agreement on goods, as well as other key areas including services, that can produce early achievements." The first stage of the negotiation will cover not only goods but also services and other key areas.

negotiating in July 2018 also set an important precedent. The EU, facing the same threat, agreed to discuss the elimination of industrial tariffs on the condition that the United States would not impose additional tariffs on automotives during the negotiations. Likewise, the United States pledged to refrain from taking measures against the spirit of the statement during the process of these consultations.

A prominent concern of the Abe administration about a bilateral FTA with the United States was that Japan might be forced to accept market access commitments on agricultural products beyond the level of what already had been agreed to in the TPP. To address this concern, the United States declared in the joint statement that it would respect the position of Japan with regard to agricultural products. That is, any deal would not go beyond market access concessions that Japan had already made in previous economic partnership agreements. With these two commitments from the United States, Japan agreed to enter FTA negotiations.

Possible Outcome of the U.S.-Japan Trade Agreement

Negotiations for the TAG were supposed to begin in January 2019 but have been delayed due to the United States' focus on negotiating economic terms with China, as well as the prolonged government shutdown. Negotiations will likely begin in the spring and will aim to reach an agreement on goods and other key areas, including services, that can produce early achievements. The scope of the negotiation is yet to be decided. On the U.S. side, the focal point of the negotiations will likely be the access of U.S. agricultural products to the Japanese market. While U.S. farmers lost improved market access opportunities when the United States withdrew from the TPP, competitor farmers and ranchers in Canada, Australia, New Zealand, Mexico, and other countries will enjoy these benefits under the CPTPP. The situation will worsen now that the Japan-EU Economic Partnership Agreement has entered into force, and EU farmers and ranchers enjoy improved market access in Japan. Given that the joint statement from the September summit meeting between Abe and Trump set the cap on the level of Japan's market access commitment on agricultural products, if the United States aims at achieving Japan's market access commitment within this cap, negotiations could be concluded swiftly.

In addition to agriculture, automotives will likely be taken up in the first stage of negotiations. Japan agreed in the joint statement to respect the position of the United States that any provisions regarding market access in the automotive sector need to be designed to increase production and jobs in the United States in this industry. It is, however, not clear what this means. As Japan's tariffs on automotives are already set at zero, a further tariff reduction is not possible. One possible means to improve U.S. market access to Japan's automotive sector might be to address non-tariff barriers in the Japanese market, such as issues relating to certification and unique standards and testing protocols.[9] However, this might not be effective, given the relative success of other foreign auto manufacturers in Japan's domestic market, which are subject to the same regulations and standards as U.S. auto manufacturers. The other foreign automakers are doing well because of their strategies for developing and marketing products that are appropriate for Japanese road conditions.

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[9] See Office of the U.S. Trade Representative (USTR), *2018 National Trade Estimate Report on Foreign Trade Barriers* (Washington, D.C., March 2018), 274.

Another option might be to agree on a long tariff phaseout on Japanese exports of light trucks to the U.S. market under the TPP.[10] However, as this policy would just be a continuation of the status quo, it would not have any positive effect in increasing production and jobs in the U.S. automotive industry. Instead, to achieve this goal, Japan would need to either curb its automotive exports to the U.S. market or urge its auto manufacturers to increase investment and employment in the United States. Both options should be avoided, as the former is prohibited under the WTO and the latter is beyond the reach of a trade agreement.[11] Yet another option might be using the tightened rules of origin for automotives that were adopted under the recently concluded U.S.-Mexico-Canada Agreement (USMCA). However, such rules would be too stringent for Japanese auto manufacturers, whose value chains extend beyond Japan and the United States. If the Trump administration insists on this option, there will be no chance of an early conclusion of the negotiations.

If the United States uses the USMCA as a template for the U.S.-Japan trade agreement, the chapter on macroeconomic policies and exchange rate could be another U.S. starting point for negotiations. Much of this chapter's language echoes the Joint Declaration of the Macroeconomic Policy Authorities of TPP countries.[12] While the CPTPP did not adopt this joint declaration, the United States may want to revive it in the chapters of the U.S.-Japan trade agreement. One advantage of including this declaration is that it may be enforceable through the dispute-settlement procedure. However, a possible topic that might slow negotiations would be the USMCA's provision that entitles a party to terminate the agreement if another party concludes an FTA with a country that does not have a market economy.

Neither of these provisions would be acceptable to Japan. Japanese authorities overseeing macroeconomic policy would resist introducing legally enforceable obligations that might constrain their discretionary power, including over exchange rate policy. The provision to prohibit concluding FTAs with a non-market country would also not be acceptable, as Japan is currently negotiating two FTAs with China (the RCEP and China-Japan-Korea FTA).

In sum, the scope of the U.S.-Japan trade agreement will likely be very narrow, mainly addressing the access of U.S. agricultural products to the Japanese market and Japan's non-tariff barriers in the automotive sector. If the United States insists on addressing other issues, negotiations will be protracted, and this will increase the opportunity cost for U.S. farmers and ranchers. It thus would be wise for the Trump administration to swiftly wrap up first-stage negotiations by focusing on a limited agenda and deferring the negotiation of a full-fledged FTA until the next stage.

The Possible Impact of the U.S.-Japan Trade Agreement on Regional Economic Integration

Supposing that the U.S.-Japan trade agreement covers mainly agricultural market access and non-tariff barriers in the automotive sector, the negotiations will not take long to conclude and

10 Under the TPP, the United States committed to maintaining its 25% tariffs on light trucks for 29 years after the entry into force of the agreement. Office of the USTR, "TPP, U.S. Tariff Elimination Schedule," https://ustr.gov/trade-agreements/free-trade-agreements/trans-pacific-partnership/tpp-full-text.

11 Article 11.1 (b) of the Agreement on Safeguards provides that a WTO member shall not seek, take, or maintain any voluntary export restraints.

12 "Joint Declaration of the Macroeconomic Policy Authorities of TPP Countries," U.S. Treasury, November 5, 2015, https://www.treasury.gov/press-center/press-releases/Pages/jl0254.aspx.

could be wrapped up by the end of 2019. Accordingly, the agreement's impact on regional economic integration will also be limited. The real regional impact of a U.S.-Japan trade agreement would not be known until the two countries negotiate a full-fledged FTA at the next stage.

What might a U.S.-Japan FTA look like? As discussed above, the recently concluded USMCA offers a good example because it reflects the interests and policy concerns of the Trump administration. A close look at the chapter lineup and text of the USMCA reveals that the vast majority of its chapters reproduce those of the TPP in the name of "modernizing NAFTA."[13] In fact, several chapters are almost a verbatim reproduction of the TPP, such as those on digital trade, small and medium-sized enterprises, competitiveness, anticorruption measures, and good regulatory practices.[14] Many other chapters reproduce corresponding chapters of the TPP with minor changes, such as those on national treatment and market access for goods, origin procedures, customs administration and trade facilitation, sanitary and phytosanitary measures, and intellectual property rights, to mention a few.

This is not surprising, given that the United States took the lead in the negotiation of the TPP, and the text of the TPP reflects U.S. interests and policy concerns. It is, therefore, likely that a full-fledged U.S.-Japan FTA will reproduce a vast majority of the TPP chapters. It is also likely that the CPTPP will be expanded with new members such as Thailand, Indonesia, South Korea, Taiwan, and even the United Kingdom by the time a U.S.-Japan FTA is concluded.[15] We may also expect that the negotiation of the RCEP will be wrapped up by then.[16] Accordingly, the U.S.-Japan FTA will likely be part of a network of FTAs in the Asia-Pacific, including two mega-FTAs (the expanded CPTPP and the RCEP).

In this scenario, the content of the FTAs will be similar, aside from the RCEP, because they will be based on the provisions of the TPP.[17] As the provisions of the TPP reflect the needs of the 21st-century global economy, in which goods and services are produced and supplied across borders, this network of FTAs will be useful for the enhancement of global value chains in the Asia-Pacific. However, this network will have a crucial defect: the United States and China, the two largest economies in the region, will not share a common platform of rules for the management of value chains. While the United States will be a party to several FTAs in the region, including the U.S.-Australia FTA, Korea-U.S. FTA, USMCA, and U.S.-Japan FTA, these agreements will have limited benefit for streamlining and reducing costs for global value chains. In a multilateral FTA, the value added in the FTA region is considered when calculating rules of origin that stipulate which goods are eligible for tariff-free status under the agreement. By contrast, with individual FTAs there is no cumulative benefit for the calculation of regional value content for rules of origin. Similarly, China will enjoy the benefit of cumulative regional value content under the RCEP, but it will not be able to enjoy this benefit in trade relations with the United States and other non-

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13 See, for instance, Office of the USTR, "The United States–Mexico–Canada Trade Fact Sheet: Modernizing NAFTA into a 21st Century Trade Agreement," https://ustr.gov/about-us/policy-offices/press-office/fact-sheets/2018/october/united-states%E2%80%93mexico%E2%80%93canada-trade-fa-1.

14 See Law Offices of Stewart and Stewart, "The United States–Mexico–Canada Agreement (USMCA) of 2018, the North American Free Trade Agreement (NAFTA) Text, and the Trans-Pacific Partnership (TPP) Text Side-by-Side," November 30, 2018, http://www.stewartlaw.com/PracticeAreas/USMCASidebySide.

15 See "TPP Countries to Start Accession Talks for New Members in 2019," Kyodo, July 19, 2018, https://www.japantimes.co.jp/news/2018/07/19/business/tpp-countries-start-accession-talks-new-members-2019.

16 See Kentaro Iwamoto, "Ministers Defer Agreement on RCEP Trade Deal to 2019," *Nikkei Asian Review*, November 12, 2018, https://asia.nikkei.com/Politics/International-Relations/Ministers-defer-agreement-on-RCEP-trade-deal-to-2019.

17 The content of the RCEP will likely be less ambitious than that of the CPTPP or the U.S.-Japan FTA, reflecting the trade policies of China and India.

member countries. In light of the fact that the great majority of global value chains in the region involve both the United States and China, the absence of the former from the RCEP will produce a huge loss.

Given this reality, a common platform of rules for the management of global value chains that will host both the United States and China, as well as the rest of the Asia-Pacific region, is needed. To this end, both countries should revisit the idea of the Free Trade Area of the Asia-Pacific (FTAAP) that has been developed within the framework of the Asia-Pacific Economic Cooperation (APEC) since 2004.[18] The FTAAP would create a common platform comprising all APEC members, including the United States and China. It must be noted that the 2016 Lima Declaration on FTAAP reaffirmed the commitment of the APEC members that the FTAAP should be built on ongoing regional undertakings.[19]

In 2016 the TPP and the RCEP were the two possible pathways to establish the FTAAP. In the current scenario, however, the expanded CPTPP and the RCEP would be the two possible pathways to create such a free trade area. A major obstacle is the absence of the United States from the expanded CPTPP. If the United States is to pursue the goal of the 2016 Lima Declaration on FTAAP, it will need to return to the TPP, join the expanded CPTPP, or join the RCEP. Of these three options, joining the RCEP should not be the priority because this partnership will be less ambitious than the TPP or the CPTPP in terms of trade liberalization and trade and investment rules. The remaining two options both have merits and defects. If the United States returns to the TPP, the provisions of the CPTPP that were "frozen" will be "defrosted," and the United States will enjoy the benefit of full implementation of the TPP. On the other hand, it will have to wait until five other members comprising 85% of the combined GDP of the original signatories ratify the TPP before the agreement enters into force.[20] Because the TPP and the CPTPP are two separate treaties, parties to the expanded CPTPP will not automatically become parties to the TPP. The parties to the expanded CPTPP will need to either ratify the TPP, if they are original signatories, or negotiate and accede to the TPP if they are not original signatories.[21]

Given the time and administrative cost required for the cumbersome negotiations in this scenario, the United States might wish to accede to the CPTPP instead of returning to the original TPP. The downside of this option is that the United States would not be able to enjoy the provisions of the TPP that were suspended under the CPTPP, most of which reflect specific U.S. trade interests, including data-exclusivity obligations regarding patents on pharmaceutical products. It is extremely unlikely that the U.S. Congress would ratify the CPTPP without these provisions.

Despite these merits and defects, the United States should pursue the TPP or the expanded CPTPP as a pathway to the FTAAP. The two agreements have only minor textual differences, and they both provide rules that are needed for the enhancement of global value chains in the 21st century. The U.S. participation in either agreement would be a game changer in the FTAAP process, and China would likely have no choice but to join the TPP or the expanded CPTPP to complete the process.

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18 See Terada Takashi, *East Asia and the Asia-Pacific* (Tokyo: University of Tokyo Press, 2013), 169–70.

19 See the section "Completing and Enhancing the Possible Pathways" in Annex A of the Lima Declaration on FTAAP, available at https://www.apec.org/Meeting-Papers/Leaders-Declarations/2016/2016_aelm/2016_Annex-A.

20 See Article 30.5.3 of the TPP for this provision.

21 See Article 30.4 of the TPP for the accession clause.

Conclusion: Beyond the U.S.-Japan Trade Agreement

This essay discussed the possible outcomes of efforts to negotiate a U.S.-Japan trade agreement. According to the joint statement from the summit meeting between the two countries in September 2018, the negotiations will be a two-stage process that aims to produce a "mini FTA" by the end of 2019 and a full-fledged FTA by the end of 2020.

However, this essay has argued that the conclusion of this FTA should not be the end of the story. The Asia-Pacific region needs a high level of trade liberalization and advanced rules for trade and investment for the enhancement of global value chains, and this goal can be achieved solely through a region-wide FTA, or the establishment of an FTAAP that includes both the United States and China. Although the 2016 Lima Declaration on FTAAP envisioned the TPP and the RCEP as two possible options to create an FTAAP, this essay has argued that the RCEP is not a viable path to this goal because it provides a lower level of trade liberalization and less advanced rules for trade and investment than the TPP. Instead, the most viable pathway to an FTAAP is the United States either returning to the TPP or joining the expanded CPTPP. Although the U.S.-Japan trade agreement, as a bilateral FTA, will by itself have a very limited impact on the creation of an FTAAP, it could be a stepping stone to achieving this goal.

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