AN ANALYSIS OF A POSSIBLE JAPAN-US FREE TRADE AGREEMENT

Scott Bradford
Brigham Young University and
Peterson Institute for International Economics

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INTRODUCTION (1 of 2)

- Historic opportunity for starting work on Japan-US FTA
  - Economic growth in both nations.
  - Japan’s reforms
    - Recent progress and continued momentum will make FTA with US easier than before.
    - Growing consensus that major agriculture reforms inevitable.
  - Korea-US FTA
    - Increased Japanese interest in Japan-US FTA.
    - Sent signal that rice can be excluded.
  - Japan-Mexico FTA (2005)
    - Japan opened agriculture in FTA for first time.
  - Doha stagnation
  - Rise of China
    - Motivates Japan and US to strengthen their ties.
  - Labor and environmental standards
    - Japan’s high standards increase its attractiveness relative to other potential partners.
  - Global security threats.
• Many hurdles persist, though.
  – Persistent US suspicions
    • Many in US believe that Japan has widespread hidden barriers that will not be rooted out, even with FTA.
    • Beef, auto, insurance, medical device, drug industries, and USDA, among others, have reiterated deep frustration.
    • Many in Congress generally irritated with Japan.
    • Stiff opposition to KORUS FTA gives us preview of Congressional reaction to a J USFTA.
  – Increased protectionism in US
    • General increase in globaphobia.
    • FTA skepticism and lapse of TPA.
  – Stiff opposition in Japan
    • Agriculture reforms have stalled.
    • Services.
  – Concerns about hurting WTO.
POTENTIAL IMPACTS OF JAPAN-US FTA
Economic (1 of 8)

• Applied General Equilibrium (AGE) Model
  - 39 sectors, 8 regions, 5 factor inputs.
  - Standard economic structure
    • Perfect competition.
    • Constant returns to scale.
    • Full employment.
    • Factors move between sectors but not regions.
  - Data
    • GTAP6 data: latest version of state-of-the-art global modeling dataset.
    • Additions: 1) Bradford NTB estimates for agriculture and manufacturing in Japan; 2) Services border barriers and internal frictions, drawn from literature. ➔ Table 3.

• Scenarios
  - Baseline: Full goods opening with 10% services opening.
  - 3 variations: Exclude rice, exclude services, exclude both.
  - Also: 20% and 30% services opening.
• Permanent Welfare Gains (from Table 4).

<table>
<thead>
<tr>
<th></th>
<th>Baseline</th>
<th>Rice Excluded</th>
<th>Services Excluded</th>
<th>Both Excluded</th>
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</thead>
<tbody>
<tr>
<td><strong>Japan</strong></td>
<td>$130 billion (2.7%)</td>
<td>$110 billion (2.3%)</td>
<td>$22 billion (0.44%)</td>
<td>$2 billion (0.03%)</td>
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<td><strong>US</strong></td>
<td>$150 billion (1.1%)</td>
<td>$150 billion (1.1%)</td>
<td>$38 billion (0.28%)</td>
<td>$42 billion (0.31%)</td>
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POTENTIAL IMPACTS OF JAPAN-US FTA Economic (3 of 8)

- Permanent Welfare Gains (from Table 4).

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<tr>
<th></th>
<th>Baseline</th>
<th>20% Services Reduction</th>
<th>30% Services Reduction</th>
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<tbody>
<tr>
<td><strong>Japan</strong></td>
<td>$130 billion (2.7%)</td>
<td>$240 billion (4.9%)</td>
<td>$350 billion (7.1%)</td>
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<tr>
<td><strong>US</strong></td>
<td>$150 billion (1.1%)</td>
<td>$250 billion (1.9%)</td>
<td>$350 billion (2.6%)</td>
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POTENTIAL IMPACTS OF JAPAN-US FTA
Economic (4 of 8)

• Japan output changes (Table 6)
  - Baseline
    • Rice and wheat contract over 90% each; beef, over 80%; other meat, over 50%. Grains contraction: $19 billion; meat, $22 billion.
    • All manufacturing sectors expand, except leather products.
    • All services expand, except construction.
  - Rice excluded
    • Wheat and meat still contract by about the same amount. Grains contraction drops to $5 billion.
    • Expansions in manufacturing and services are dampened.
  - Services excluded
    • Ag contractions are slightly larger overall.
    • Manufacturing expansion dampened.
    • General contraction in services.
  - Larger services opening
    • Greater expansions and smaller contractions in all sectors except rice, wheat, and meat.
POTENTIAL IMPACTS OF JAPAN-US FTA
Economic (5 of 8)

• US output changes (Table 7)
  – Baseline
    • Ag and private services uniformly expand. Meat: $45 billion; private services, $130 billion.
    • Widespread manufacturing contraction. Nine major sectors shrink by $60 billion; transport equipment, electronics, machinery, and equipment account for > 75% of this.
  – Services excluded
    • Sacrifice huge services output gains, but manufacturing contraction is muted.
  – Larger services opening
    • Greater expansions and smaller contractions, except other transport, electronics, machinery, and equipment.
POTENTIAL IMPACTS OF JAPAN-US FTA
Economic (6 of 8)

• Japan job changes (Table 8)
  – Baseline
    • Large job losses throughout agriculture: about 170,000 full-time equivalents in rice; about 60,000 in the rest of agrifood.
    • Job gains in manufacturing.
    • About 60,000 losses in construction; another 30,000 in other services.
  – Rice excluded
    • Prevent huge losses in rice; other sectors about the same.
  – Services excluded
    • Losses in ag about the same.
    • Larger gains in manufacturing.
    • Construction losses drop to 40,000; distribution switches from gains to losses.
  – Larger services opening
    • More job losses and gains throughout economy: greater adjustment.
POTENTIAL IMPACTS OF JAPAN-US FTA
 Economic (7 of 8)

• US job changes (Table 8)
  - Baseline
    • Large gains in agriculture, especially meat.
    • Large losses in manufacturing: about 300,000 overall.
    • Large gains overall in services.
  - Services excluded
    • Overall, less adjustment: fewer losses in manufacturing and fewer gains in services.
  - Larger services opening
    • More losses in manufacturing and more gains in services.
Gravity model analysis of trade flows

- Increase in Japan-US trade between 40% and 230%.
- Central estimate: about 100% increase.
POTENTIAL IMPACTS OF JAPAN-US FTA
Political (1 of 2)

• Japan
  - Spur and strengthen reforms within Japan.
  - Sustain Japanese domestic support for US involvement in the region.
  - Cause protectionist backlash.

• US
  - Negotiations and Congressional debate could inflame Japan bashing.

• Japan-US Relations
  - Improve bilateral communication.
  - Strengthen security ties.
  - Should consider what failed negotiation might mean. This could harm Japan-US relations.
POTENTIAL IMPACTS OF JAPAN-US FTA
Political (2 of 2)

- Rest of World
  - WTO: Depends on state of WTO at the time.
    - Strong Doha deal in place: WTO can weather this FTA.
    - Weak deal in place: This FTA would further weaken WTO.
    - Doha deal still in progress: This FTA would help to spark Doha deal.
    - Doha failure: This FTA would reduce chance of WTO revival.
  - APEC area
    - This FTA would probably increase chance of Free Trade Area of the Pacific (FTAAP).
    - Chance of high quality FTAAP, though, is quite small in near term because US will not approve an FTA involving China anytime soon.
  - Further reduce chance of East Asia bloc (as would Korea-US FTA).
- China
  - Stronger partnership between Japan and US may motivate China to maintain constructive, strong relations with each.
  - Japan-US FTA could pressure China to join eventually.
- Others: could foster reforms in any other nation that would want to join.
PROSPECTS FOR REACHING A DEAL

Other Key FTAs (1 of 2)

• KORUS FTA
  - Rice excluded, but nothing else was.
  - Most ag trade would open immediately; various phase-ins for other products.
  - Virtual free trade in manufacturing.
  - Major services opening in Korea. For US, winners include financial services, insurance, telecom, express delivery, professional services.
  - Set up trade dispute settlement body for autos.
  - Incorporated non-tariff barriers procedures.
  - 10-year phase-out of truck tariff.

• Japan-Australia
  - What will happen with beef? What about rest of agriculture? What kinds of deals in services?
EU is key player.

- EU-South Korea FTA would probably cause Japan to pursue EU-Japan before Japan-US. But EU claims Japan is too big, while Korea is not.
- Advantages of EU deal: EU has higher barriers; EU less demanding in agriculture.
PROSPECTS FOR REACHING A DEAL
Key Issue Area: Agriculture (1 of 2)

• Agriculture stakes in this potential FTA especially high.
  - Japan is US’s largest non-NAFTA agriculture export market; US is Japan’s largest agriculture supplier.

• Japan has far more barriers than US.
  - Not much scope for reciprocal opening.
  - Wide-scale opening in Japan will likely require unilateral reform within Japan or US “concessions” in other areas.
  - It appears, though, that major agriculture reform in Japan is inevitable.
  - At least, they need to convert from price supports to direct subsidies, which are much more efficient.

• US will likely demand minimal beef restrictions (no worse than World Organization for Animal Health (OIE) standards).
PROSPECTS FOR REACHING A DEAL
Key Issue Area: Agriculture (2 of 2)

• Japan would seek rice carve out. US likely would agree, given what happened with Korea.

• Japan seems to have finally accepted apple opening, but fruits/vegetables in general will need fundamental change.

• US has number of other concerns: poultry, pork, fish, cheese, wheat, nutritional supplements, food labeling.

• Japan’s concerns: US farm subsidies, emergency restrictions or bans on food imports, fresh fruits.
PROSPECTS FOR REACHING A DEAL
Key Issue Area: Manufacturing (1 of 2)

• Overarching theme: Hidden barriers vs. Safeguards.
  – US will not renounce ADDs and other safeguards, especially in relation to country that has frustrated US for so long.
  – At minimum, Japan probably wants bilateral dispute settlement mechanism, a la NAFTA. KORUS FTA has one.
  – US may agree to this if it gets progress on hidden barriers.

• Autos and parts will loom large in any FTA talks.
  – Huge trade imbalance: $58 billion to $2 billion.
  – Japan has 30% of US market; US has 2% of Japanese market.
  – US automakers worked up over perceived Japanese currency manipulation.
PROSPECTS FOR REACHING A DEAL
Key Issue Area: Manufacturing (2 of 2)

• Other US concerns: medical devices, pharmaceuticals, wood products, marine craft, footwear.

• Other Japanese concerns: trucks, auto regulations, flat screens, bearings, steel, drugs.
  - Truck tariff is one of few US bargaining chips, though auto industry woes complicate this.
  - Auto regulations that hinder Japan’s exports: CAFEs, safety regulations, having to declare which engines are not US.
PROSPECTS FOR REACHING A DEAL
Key Issue Area: Services

• More barriers in Japan.

• Key sectors from US perspective: insurance, financial services, telecom, construction, distribution.
  – Potentially huge gains from opening.
  – Caveat: US companies already in Japanese market don’t want change.

• Progress on regulation transparency would facilitate services opening in Japan.

• Key sectors from Japanese perspective: shipping, telecom, financial services.
PROSPECTS FOR REACHING A DEAL
Key Issue Area: FDI

• As with services, more barriers in Japan.

• As with services, progress on internal barriers would facilitate FDI opening.

• Koizumi expressed desire to open FDI. What is Fukuda’s view?
  – Two countries have been conducting regular talks.
  – Appears to be progress: Inward stock has doubled in recent years.

• Japan worried about CFIUS and impact of Dubai ports uproar. Japan does not want arbitrary government interference with legitimate FDI.
PROSPECTS FOR REACHING A DEAL

Key Issue Area: Other

• Government Procurement
  – Japan has concerns about Buy America policies at Federal and local levels.
  – US especially worried about procurement in construction; US perceives lots of bid-rigging.

• Customs Procedures
  – Japan worried about excessive inspections in efforts to protect against terrorism.

• US visa requirements
POSSIBLE PATHWAYS TO A DEAL (1 of 2)

<table>
<thead>
<tr>
<th>Agriculture/Processed Food</th>
<th>Rice</th>
<th>Farm Aid</th>
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<td></td>
<td>Wheat</td>
<td>Emergency Export Restrictions/Bans</td>
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<td>Potatoes</td>
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<td>Nutritional supplements</td>
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<td>Manufacturing</td>
<td>Autos and Auto Parts</td>
<td>Trucks</td>
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<td>Medical Devices</td>
<td>Autos: Regulations</td>
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<td>Mergers/Acquisitions</td>
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<td>Cross-Cutting Areas</td>
<td>Competition Policy</td>
<td>Dispute Settlement (Anti-dumping, Safeguards)</td>
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<td>Politics</td>
<td>UN Security Council?</td>
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POSSIBLE PATHWAYS TO A DEAL (2 of 2)

- Adjustment assistance would facilitate needed reforms, especially in agriculture.
  - Koreans have proposed buying out farmers for $135 billion over 10 years.
    - What about a similar deal for Japan?
    - David Asher: The Samurai were paid to turn in their swords. Might we pay farmers to turn in their plows?
  - US auto workers may need similar help.
  - Lump sum payments to all current workers would be most efficient. Wage subsidies would probably be second best.
SUMMARY

• This bilateral FTA would be largest and most important so far.

• Potentially very large economic and political effects from Japan-US FTA.

• Perhaps historic opportunity for starting work on Japan-US FTA.

• Many hurdles persist, though.
  - Will not be simple matter to overcome extensive barriers in Japan and suspicions in US.
  - Timing may not be right for a while
    • Japan’s divided parliament, US presidential elections
    • Doha, EU-Japan FTA may come first.