



# Japan's Free Trade Agreement Program

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## Summary

Japan's trade policy historically has centered on multilateral negotiations and dispute settlement mechanisms. Over the past five years, however, Japan has shifted course somewhat by seeking free trade agreements (FTAs) with a number of countries, mostly in Asia. An FTA is an agreement between two countries or regional groupings to eliminate or reduce tariffs and other barriers on trade in goods and services. Non-members find their exports discriminated against.

The pursuit of FTAs is occurring worldwide. The U.S. has an aggressive program and has FTAs in place with two Asian-Pacific countries—Singapore and Australia—and is negotiating one with Thailand. Europe has been pursuing a similar course for years. China and 10 members of the Association of Southeast Asian Nations (ASEAN) began implementing a partial FTA this year. Now Japan is trying to catch up.

By freeing up trade in goods and services, Japan hopes to energize its economy, as well as to better compete with China for influence in Asia—objectives that seem to support U.S. interests. However, Japan's FTA program to date has not been robust enough to have much impact. Constrained by domestic pressures to continue protection of its agricultural sector, the FTA agreements Japan now has implemented with Singapore and Mexico and is scheduled to implement next year with the Philippines, Malaysia, and Thailand are unlikely to have a significant impact on Japan's economy. Agreements with larger countries where the commercial stakes are greater, such as South Korea, Australia, and China, are either stalled or being shied away from.

Agriculture is Japan's biggest constraint on moving forward on FTAs. While some progress is being made in cutting tariffs on food items that serve small markets, highly protected rice and beef markets are not being offered for liberalization. Moreover, in the absence of a substantial farm reform program that would make liberalization of these products easier, many Japanese decision-makers hope protectionist pressures will go away over time with an aging farmer population that is shrinking and increasingly part-time.

Japan's FTA program, assuming the current cautious and defensive course persists, is likely to have varied effects on U.S. interests. On the one hand, it is likely to provide a positive, yet small, boost to increasing Japan's role in the economics and political economy of East Asia. It is also likely to be favorable to bilateral trade ties as other Asian trading partners (instead of just the United States) pressure Japan to open its agricultural market further. On the other hand, the absence of a meaningful agricultural reform bodes poorly for support from Japan in the agricultural negotiations of the Doha Round. There are also concerns that a defensive and weak FTA program could allow China to play a more dominant role in the Asian economy through its own FTA program—perhaps even creating an exclusionary Asian trading bloc. This report will be updated as events warrant.

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## Introduction

Japan's trade policy has historically centered on multilateral negotiations and dispute resolution mechanisms. The rules of the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) have provided Tokyo an ability to interact with its trade partners on an equal basis. Given its global trade interests, a contentious bilateral past with the United States, and historic legacy with Asian countries, particularly Korea and China, reliance on the multilateral system has helped promote Japan's trade interests.<sup>1</sup>

Over the past five years, Japan has shifted course somewhat by pursuing negotiations in the WTO but by also seeking free trade agreements (FTAs) and Economic Partnership Agreements (EPAs) with mostly Asian countries. An FTA is an agreement between two countries or regional groupings to eliminate tariffs and other trade barriers, while an EPA goes further by also attempting to facilitate the free movement of people and capital among the partners to an agreement.<sup>2</sup> Non-members find their exports discriminated against.

As a practical matter, officials at Japan's Ministry of Economy, Trade, and Industry (METI) acknowledge that there is little difference between an FTA and EPA. METI, however, prefers the EPA label based on the view that it does less to provoke domestic political opposition than the "free trade" moniker.<sup>3</sup>

The pursuit of FTAs is occurring worldwide with nearly 300 estimated to be currently in effect. The United States has an extensive FTA program and agenda, and has FTAs in effect with two Asian-Pacific countries—Singapore and Australia. Europe has been pursuing a similar course for years. China and six ASEAN states (Thailand, Malaysia, Indonesia, Philippines, Singapore, and Brunei) are in the process of establishing an FTA by 2010. Now Japan is trying to catch up.<sup>4</sup>

Economists still disagree about the merits of negotiating FTAs on the grounds that discrimination may undermine the multilateral trading system while others believe that FTAs promote multilateral deals in the long run. The concern is that FTAs could lead to a "spaghetti bowl" of overlapping conflicting trading partnerships each with its own set of rules at the expense of a more unified and non-discriminatory set of multilateral rules. But domestic support in Japan for an FTA program appears strong. Prime Minister Koizumi is firmly behind the approach, as well as the ruling LDP-Komeito coalition. While the Democratic Party, the major opposition party, supports the general thrust of the policy, some members maintain that the United States and China should be considered as prospective FTA partners.<sup>5</sup>

Given its own aggressive FTA program, the United States is hardly in a position to criticize Japan's new policy orientation. But it has considerable interest in whether Japan's policy evolves in a manner that is supportive of U.S. interests in Asia—which include promoting a stable balance

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<sup>1</sup> Pekkanen, Saadia M., "The Politics of Japan's WTO Strategies," *Orbis*, Winter 2004, pp. 135-147.

<sup>2</sup> The concept of an EPA and how it differs from an FTA is not commonly made, but appears unique to Japan.

<sup>3</sup> Interview with Norio Nakazawa, METI Counsellor for Regional Cooperation, June 28, 2005.

<sup>4</sup> Schott, Jeffrey J. "Free Trade Agreements: Boon or Bane of the World Trading System?" In Bergsten, C. Fred., *The United States and the World Economy*, Institute for International Economics, 2005.

<sup>5</sup> Interview with Kenzo Fujisue, Upper House Diet Member, Democratic Party, June 23, 2005.

of power and insuring that U.S. trade and investment interests are not discriminated against in the region.<sup>6</sup>

## Motivations

Japan's FTA program has been motivated by a combination of economic and political objectives. The most important entail avoidance of becoming isolated as other major trading countries actively pursue FTAs, energizing domestic economic activity, and promoting Japanese influence in Asia.<sup>7</sup>

Japan's concern about the possible emergence of economic blocs in the Americas and in Europe goes back to the early 1990s. In 1994 the United States entered into the North America Free Trade Agreement (NAFTA) and announced plans to create a Free Trade Area of the Americas. Europe at the same time was busy entering into preferential trade agreements and subsequently has come to conduct trade relations on a multilateral or non-discriminatory basis with only a handful of trading partners, including Japan and the United States. In 1999 the collapse of multilateral trade negotiations at the WTO Ministerial in Seattle shook Japanese confidence in the future of multilateralism. China's decision in 2001 to negotiate an FTA with ASEAN countries was also a seminal event, providing more ammunition for those in Japan that were advocating a change of policy course.

The case for developing an FTA program was also driven by Asian economic trends and opportunities. METI officials see East Asia as the fastest growing region in the world and a region that is increasingly vital to Japan's economic future.<sup>8</sup> FTAs and EPAs are viewed as one way to deepen economic ties with East Asia and facilitate a new division of labor and production sharing. The experience of the European Union has demonstrated that, as institutional integration develops, so too does intra-regional division of labor that leads to a more effective production network and to more efficient industrial structures. As a result, METI maintains that both individual parties to an FTA, as well as the region as a whole, can enjoy more robust economic growth powered by an expansion of exports and imports.

Reform-minded METI officials also hope that an aggressive FTA-EPA program will serve as a force for promoting domestic agricultural reforms. By entering into negotiations with trading partners that continue to demand liberalization of Japan's protected agricultural sector, it is hoped that domestic support for programs that might aid farmers transition to a less protected environment would be proposed and implemented.

Finally, many decision makers see FTAs providing Japan with varied political and diplomatic advantages. These range from increasing Japan's bargaining power in WTO negotiations to helping Japan better compete with China for influence in Asia. Under the view that FTAs

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<sup>6</sup> CRS Report RL32688, *China-Southeast Asia Relations: Trends, Issues, and Implications for the United States*, by (name redacted) and (name redacted).

<sup>7</sup> Hatakeyama, Noboru. "Japan's Movement toward FTAs," Speech delivered at the Institute for International Economics, Washington, D.C., May 8, 2003.

<sup>8</sup> METI projects that East Asia's share of world GDP will increase to 16% by 2020, up from 5% in 1990, with the shares accounted for by Japan, the United States, and Europe all dropping. East Asia's economic growth is also projected to average 5.5% between 2010-2020, compared to 0.5% for Japan, 1.4% for the United States, and 1.5% for Western Europe.

symbolize special relationships based on political trust, Japan hopes to bolster its diplomatic influence on a range of political and security issues.<sup>9</sup>

## Status of Japan's FTA Negotiations

Three regions—Asia, North America, and Europe—account for 80% of Japan's total trade. Given that the simple average tariff rates imposed by the United States and the European Union are low (3.6% for the U.S. and 4.1% for the EU) compared to East Asia (10% for China, 14.5% for Malaysia, 16.1% for South Korea, 25.5% for the Philippines, and 37.5% for Indonesia), the Government of Japan (GOJ) placed priority on negotiating FTAs with countries in East Asia.<sup>10</sup> Not only do East Asian countries impose the highest trade barriers against Japanese exports, they also account for the highest and most dynamic share of Japan's trade, thereby providing the greatest additional opportunities for expanding Japan's economy via cuts in both foreign and domestic trade barriers.<sup>11</sup>

As shown in **Table 1**, 11 East Asian countries (China, South Korea, Taiwan, Hong Kong, Thailand, Singapore, Malaysia, Australia, the Philippines, Indonesia, and Vietnam) purchased nearly 50% of Japan's total exports in 2004, up from 33% in 1998. Similarly, Japan is sourcing a growing share of its imports from these 11 countries as well. As shown in **Table 2**, these countries supplied Japan with 47.86% of its imports in 2004, up from 39.59% in 1998.

Accordingly, in developing its FTA strategy, the GOJ placed the highest priority on negotiating FTAs with the Republic of Korea and the four largest ASEAN member states (Thailand, the Philippines, Malaysia, and Indonesia). An FTA with Mexico, now in effect, was also made a priority due to the relatively high tariffs Japanese companies face compared to those companies from the United States, Canada, and European Union. The latter enjoy duty free treatment for the most part due to NAFTA (1994) and the EU-Mexican FTA (2000).

After achieving FTAs with priority countries, the GOJ views China and Australia as the next most promising candidate partners. Consideration is also being given to countries outside East Asia, including Chile and Switzerland.<sup>12</sup>

Since Japan launched its first FTA negotiation with Singapore in 2000, progress has been hampered by a defensive agricultural position. While some liberalization has been achieved, the amount so far has been greatly constrained by an inability to offer major reductions in its most protected crops—beef, rice, starches, wheat, and dairy—and to open up its borders to foreign labor. Some critics have argued that Japan, following a course of least resistance, could end up with numerous watered-down FTAs that neither harm nor energize the Japanese economy. According to this view, the FTAs with the largest benefits for Japan, such as Australia, China, and South Korea, are also the most politically challenging and the most likely to fail.<sup>13</sup>

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<sup>9</sup> Interview with Isamu Ueda, Lower House Diet Member, Komeito Party, June 23, 2005.

<sup>10</sup> According to WTO data, Japan's simple average tariff rate is now around 6.3%.

<sup>11</sup> Japan's Ministry of Foreign Affairs, *Japan's FTA Strategy*, October 2002. Found at <http://www.mofa.go.jp/policy/economy/fta/strategy0210.html>.

<sup>12</sup> "Government Adopts FTA Policy Focusing on Partners in Asia," *The Japan Times*, December 22, 2004.

<sup>13</sup> "Japan Settles for 'Low-Risk, Low-Return' FTA Goals," *The Japan Times*, April 22, 2005.

A short synopsis of the main features and significance of Japan's FTA program follows. The negotiations are divided into four categories: (1) those already entered into force; (2) those agreed to in principle; (3) those under negotiation; and (4) those that are in the pipeline or under consideration.

## FTAs Entered Into Force—Singapore and Mexico

The Japan-Singapore Economic Partnership Agreement (JSEPA), Japan's first EPA/FTA, was entered into force in November 2002. Tariffs were eliminated on 98% of the merchandise trade between the two countries, and further liberalization took place in services and investment. Given that there is virtually no agricultural trade between the two countries, and tariffs were already very low, it reportedly was a very easy FTA to conclude.

According to one report, other than some increase in imports of Japanese beer, Singapore has experienced no major changes from the FTA. The minimal impact may be due to the fact that tariffs were low to begin with and some chemical products in which Singapore companies have a competitive edge, were excluded from the agreement. From Japan's perspective, the significance of this initial FTA seems to be good learning experience for its negotiators in how to negotiate an FTA.<sup>14</sup>

Japan and Mexico signed an FTA/EPA in September 2004 and it went into effect in April 2005. Under the agreement (formally called an EPA), tariffs on 90% of goods that account for 96% in total trade value will be phased out by 2015, making 98% of exports from Japan and 87% of imports from Mexico duty free. Previously, only 16% of Japanese exports received duty-free treatment from Mexico, whereas 70% of Mexican exports entered duty free.<sup>15</sup>

From Japan's perspective, the agreement helps eliminate the disadvantages its companies have incurred in competing against North American and European firms since NAFTA went into effect in 1994 and the EU-Mexican FTA went into effect in 2000. Facing an average Mexican tariff of 16%, Japan saw its share of Mexican imports drop sharply, from 6.1% in 1994 to 3.7% in 2000.<sup>16</sup> Since the FTA became operational, its import share increased to 4.8% in 2001, to 5.5% in 2002, and 4.4% in 2003.<sup>17</sup>

Japan's auto and steel companies are expected to benefit the most. The FTA offers a new tariff-free export quota for Japanese cars, in addition to the existing quota of about 30,000. The duty-free quota will make up 5% of the Mexican market in the first year and the quotas will be expanded before being completely lifted by 2011. With the abolition of the tariffs, exports of Japanese-finished cars are expected to double in the next few years. Steel tariffs are also being eliminated over a 10-year period.<sup>18</sup>

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<sup>14</sup> "Singapore, Thailand Reap FTA Rewards," *The Nikkei Weekly*, May 30, 2005.

<sup>15</sup> "FTA with Mexico Paves Way for Talks with Asian Nations," *The Nikkei Weekly*, March 15, 2004.

<sup>16</sup> Ministry of Foreign Affairs, *Promotion of Economic Partnership Agreements (EPAs) and Free Trade Agreements (FTAs)*, p. 35.

<sup>17</sup> *IMF Directions of Trade Yearbook - 2004*.

<sup>18</sup> "With Mexico FTA set, Japan turns toward Asia," *The Japan Times*, March 12, 2004.

The agreement is notable in that Japan agreed to reduce some protection of agricultural products. While the details remain sketchy, Japan reportedly cut tariffs on a variety of products such as pork, orange juice, fresh oranges, beef and poultry although these commodities will still be regulated by quotas. (Actual tariff rates are to be negotiated after the FTA is in place for two years). Yet, the value of Mexico's agricultural products exempt from import tariffs will still be less than 50% of its total agricultural exports to Japan.<sup>19</sup> Furthermore, Mexico supplies only 1% of Japan's total imports of agricultural products, suggesting that the limited liberalization will not pose much of a threat to Japanese producers nor be a precedent for other FTAs.<sup>20</sup>

## FTAs Agreed in Principle—Philippines and Malaysia

Negotiations with the Philippines began in February 2004 and a basic EPA was reached in principle at a bilateral summit in November 2004. The agreement, which covers investment, trade in services, customs procedures, intellectual property, and competition policy, is expected to be finalized this year and become effective in 2006.<sup>21</sup>

A key bargain in the agreement calls for the Philippines to lower its tariffs on most steel products and autos by 2010 in exchange for lower Japanese tariffs on pineapples and bananas. Bananas are not grown in Japan and pineapples are only grown in a small area of Okinawa. For the most part, Japan negotiated not to open its market further to sensitive agricultural products such as rice, wheat, barley, designated dairy products, beef, pork, starches and selective fishery products. Liberalization of Japan's protection of raw cane sugar will be reconsidered after the agreement has been in effect for four years. In return, Japan agreed to allow more Philippine nurses and care givers to work in Japan if they pass Japanese qualification examinations (in Japanese). The number and selection process of such care providers has not yet been determined, and remains a major stumbling block to finalizing the agreement.<sup>22</sup>

Negotiations with Malaysia began in January 2004 and a basic EPA agreement was reached in May 2005. The two sides hope to sign the agreement before the year-end, putting it into effect in 2006. One estimate is that the agreement will increase Japan's gross domestic product by 0.08% in real terms and boost Malaysia's real GDP by 5.07%.<sup>23</sup> The FTA will eliminate or reduce tariffs on industrial goods by 2015. Of particular interest to Japan, Malaysia has agreed to immediately remove tariffs on all parts imported for local car production (used for the so-called breakdown format, under which components are imported to Malaysia for assembling). Customs duties on most finished vehicles (i.e. large cars that do not compete with Malaysian cars) and other car parts will be gradually removed by 2010. Japanese automakers that manufacture locally can cut production costs if tariffs on auto parts from Japan are removed. Tariffs on small vehicles which compete with Malaysia's Proton "national car" will be abolished in stages by 2015. The grace period is designed to shield the market for small Malaysian-made autos, like those produced by Proton Holdings, from outside competition for five years. National car Proton and privately

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<sup>19</sup> "FTA with Mexico Paves Way for Talks with Asian Nations," *The Nikkei Weekly*, March 15, 2004.

<sup>20</sup> "Mexico Expects Bonanza in FTA with Japan," *The Nikkei Weekly*, March 28, 2005.

<sup>21</sup> "EPA Deal Makes Philippines Third Free Trade Partner," *The Nikkei Weekly*, December 6, 2004.

<sup>22</sup> "Japan to Allow Nurses from Philippines," *The Nikkei Weekly*, November 22, 2004.

<sup>23</sup> "Japan-Malaysia FTA Gets Chiefs' Approval," *The Japan Times*, May 26, 2005.

manufactured Perodua, have more than 70% of the market in Malaysia. Malaysia also agreed to eliminate tariffs on essentially all steel products within 10 years.<sup>24</sup>

Japan for its part will eliminate tariffs on selective farm and fishery products within 10 years, with immediate abolishment of tariffs on such products as mangoes, durians, papayas, okra, shrimp, prawns, jellyfish, and cocoa. The tariff on margarine will be lowered from 29.8% to 25% in five years, and up to 1,000 tons of bananas will be duty free immediately. Tariffs on all forestry products except plywood, which is one of Malaysia's top exports to Japan, will also be eliminated immediately. But sensitive products such as rice, wheat, barley, dairy, beef, pork, starches, and fishery items under import quota are excluded from liberalization.<sup>25</sup>

## FTAs Under Negotiation—Republic of Korea, Thailand, and Indonesia

Japan's negotiations with Korea, which began in December 2003, are currently stalled. The two sides initially planned to submit liberalization offers by January 2005, but both countries developed reservations. Reportedly, Japan expressed reluctance to abolish tariffs on agricultural and marine products, while South Korea hesitated to cut tariffs on industrial goods, particularly those that could affect its auto sector. South Korean officials are also worried that an FTA could exacerbate its large trade deficit with Japan. Prospects for more flexible negotiating positions were not helped by a recent WTO case that Korea filed against Japan's import quotas for dried laver seaweed. Korea reportedly took a hard line on this marine product that it does not export in great quantities to symbolize its protest over Japan's refusal to negotiate "seriously" on agricultural issues.<sup>26</sup>

Japan's negotiation with Thailand, which began in February 2004, has proved difficult due in large part to agriculture. Japan and Thailand initially agreed that rice—long considered the main obstacle in the negotiations—would not be subject to tariff cuts. But Thailand still continues to demand elimination of Japan's tariffs on chicken, sugar, starch and forestry and fisheries products. Thailand also wants Japan to accept more chefs and spa specialists. Japan's demands on Thailand center on autos and steel. Cuts on Thai auto tariffs—which are 80% for Japanese built cars—are complicated by heavy Japanese foreign direct investment in the Thai auto sector. Japanese companies control over 80% of the production, sales, and exports of autos in Thailand.

Japan and Indonesia agreed in June 2005 to launch FTA/EPA negotiations with a view to reaching agreement by June 2006. The agreement would cover trade in goods and services, investment, labor flows, technological exchanges, and intellectual property rights. Indonesia, which is a major provider of crude oil, coal, and natural gas to Japan, hopes to see the agreement facilitate a large-scale increase in Japanese foreign investment. Japan's agricultural protection, along with Indonesia's protection of its auto and steel sectors, are likely to be divisive issues.

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<sup>24</sup> Joint Press Statement: "Japan-Malaysia Economic Partnership Agreement," found at <http://www.mofa.go.jp/region/asia-paci/malaysia/joint0505.html>.

<sup>25</sup> "Japan-Malaysia FTA Gets Chiefs' Approval," *Japan Times*, May 26, 2005.

<sup>26</sup> "FTA Talks with Seoul Deserve Fresh Start," *The Nikkei Weekly*, March 7, 2005.

## Other FTA Candidates

Japan is considering FTA/EPA negotiations with a number of other countries, including Australia, Chile, China, and Switzerland. In addition, after concluding agreements with Malaysia, the Philippines and Thailand, Japan hopes to expand those agreements (including the one with Singapore) to ASEAN as a whole.<sup>27</sup> Malaysia, the Philippines, and Thailand account for about 75% of Japan's trade with ASEAN.<sup>28</sup> The conclusion of an FTA with either the United States or the European Union is not being considered, due largely to constraints on liberalizing trade in agricultural, forestry, fishery products.

Australia is an important trading partner for Japan and a key supplier of Japan's oil, coal, iron ore, and natural gas. Two years of FTA discussions, however, have not progressed far reportedly due to Japan's resistance to open its market to more beef, rice, and dairy products from Australia. While a high-level agreement was made in April 2005 to continue discussing the feasibility of an FTA, most observers think that Australia won't enter into negotiations if agriculture is not on the table. In effectively downplaying the prospects for this FTA, Prime Minister Koizumi noted that an FTA with Australia that included beef would have an adverse effect on relations with the United States.<sup>29</sup>

While many Japanese officials are intrigued by the possibility of negotiating an FTA with China, the consensus is that it is much too early to move forward. For the present, Japan wants to monitor China's fulfillment of WTO obligations, the status of its state-owned sectors, and progress in Doha Round of multilateral negotiations.<sup>30</sup>

Switzerland is what one Japanese trade official calls a good pipeline project. An attractive feature of this prospective negotiation is that the Swiss do not want to liberalize agriculture so there would be no major impediment to a negotiation. Lacking much liberalizing content, such an agreement would have mostly geo-political merit.<sup>31</sup>

## Challenges to Advancing FTA/EPA Negotiations

Japan's ability to promote its economic interests through an aggressive FTA/EPA program is constrained by protection of its agricultural sector and rigid immigration policies. While the FTA/EPA negotiations themselves provide pressures for more open policies, the ministries charged with these portfolios (Agriculture and Justice, respectively) have not yet advanced effective reform policies that would make a substantial difference.

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<sup>27</sup> "Japan, ASEAN Seek Trade Rules," *The Nikkei Weekly*, April 18, 2005.

<sup>28</sup> The 10 members of ASEAN (the Association of Southeast Asian Nations) are Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

<sup>29</sup> "Japan, Australia to Mull FTA," *The Japan Times*, April 21, 2005.

<sup>30</sup> Interview with Ichita Yamamoto, Upper House Diet Member, Liberal Democratic Party, June 23, 2005.

<sup>31</sup> Interview with Norio Nakazawa, METI Counsellor for Regional Cooperation, June 28, 2005.

## Agriculture

Agriculture accounts for only 1.3% of Japan's GDP and 4.6% of its total employment, but remains heavily supported and protected from import competition. According to the OECD, support to producers as a percent of gross receipts was 58% in 2002-04, down from 61% in 1986-1988, but still almost twice the OECD average. Rice, wheat, other grains, meat, sugars, and dairy are the most heavily supported commodities. Tariff-rate quotas are employed to shield these commodities from international competition, resulting in food prices that in Tokyo are on average 130% higher than the rest of the world.<sup>32</sup>

Many in Japan believe that support for agricultural protection will disappear over time. They cite the declining share of the population engaged in agriculture and the high percentage of farmers (60%) who are over 65 years old and who derive the majority of their income from non-agricultural activities. In the process, the hold of the agricultural lobby is said to be slipping as evidenced by the slippage of the LDP in the 2004 Upper House election.<sup>33</sup> The LDP derives most of its support from rural areas, in part, due to Japan's disproportionate electoral districting system; each rural vote is worth an estimated 2 urban votes.<sup>34</sup>

However, policy reforms to help move Japan away from considerable agricultural protection have been slow to materialize. While the Ministry of Agriculture, Forestry, and Fisheries has released papers that have raised the idea that Japan should stop wasting resources on crops that can be imported more cheaply, little follow-up has occurred. These reports advocate consideration of policies that would increase competition in the sector by encouraging new entrants and providing direct compensation to farmers through tax incentives in lieu of price controls and high tariffs.<sup>35</sup> In large measure, this is due to opposition from influential members of the LDP's "farm tribe." In the absence of a substantive reform plan to make Japan's farm sector more efficient, agriculture is bound to continue to be a major stumbling block for concluding economically meaningful FTAs/EPAs.

## Immigration

Among industrial nations, Japan maintains the tightest policy towards accepting foreign workers and remains extremely cautious about changing course. However, due to a declining birthrate and an aging workforce, Japan's decision-makers are under increased pressure to accept more foreign workers to keep the economy from stagnating. The demands of FTA negotiating partners such as the Philippines and Thailand to liberalize Japan's labor market prohibitions have brought added pressures and debate about a more open door policy.<sup>36</sup>

A 1999 government employment plan called for Japan to promote foreign employment in "specialized and technical areas," but a "careful approach based on national consensus" towards

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<sup>32</sup> *OECD*, "Agricultural Policies in OECD Countries: Monitoring and Evaluation 2005."

<sup>33</sup> Although the LDP largely held its own in the vote—it lost one seat, to bring its total in the 245-seat Upper House to 115—the election was largely seen as a significant setback for the LDP because the Democratic Party of Japan (DPJ) won 12 new seats to bring it to 82 seats.

<sup>34</sup> CRS Issue Brief IB97004, *Japan-U.S. Relations: Issues for Congress*, by Mark Manyin (Coordinator).

<sup>35</sup> Fujisue, Kenzo and Koike, Masanari, "Opening Up, Reluctantly," *Far Eastern Economic Review*, April 2005.

<sup>36</sup> "Foreign Workers at the Gate," *Japan Times*, August 23, 2004.

manual workers. Despite the needs in certain sectors to accept more foreign workers, such as nurses and care providers, public support is lacking. Concerns about increased crime rates, the social costs of accepting more foreigners, and an adverse impact on Japanese homogeneity tend to dominate, along with the resistance of labor unions. In addition, neither the LDP or the Democratic Party stand clearly in favor of liberalizing immigration.<sup>37</sup>

The significance of the immigration issue transcends the problems it creates for Japan reaching closure on FTA negotiations with its Asian partners, such as Thailand and the Philippines. The continuation of exclusionary immigration policies may also undercut Japan's ambition to play a leading role in a more integrated and interdependent Asian economy.

## **Implications for U.S. Interests**

Japan's FTA program, assuming the current defensive course persists, may have varied effects on U.S. interests. On the one hand, it is likely to provide a positive, yet small, boost to increasing Japan's role in the economics and political economy of East Asia. It is also likely to be favorable to bilateral trade ties as other Asian trading partners, instead of the United States, pressure Japan to open its agricultural market further. In the absence of a Japan-U.S. FTA as a realistic option, other forms of comprehensive engagement may be considered. On the other hand, lack of a meaningful agricultural reform program bodes poorly for positive support from Japan in the agricultural negotiations of the Doha Round. There are also concerns that a defensive and weak FTA program pursued by Japan could allow China to play a more dominant role in the Asian economy—perhaps even creating an exclusionary Asian trading bloc.

## **Japanese Growth**

More than a decade ago, there was concern in the United States that Japan was an economic threat because its economy was too strong. Subsequently, U.S. policymakers have come to believe that Japan is more of a problem when its economy is weak. A lackluster growth position in Japan not only affects U.S.-Japan trade and financial ties adversely, but also undermines growth of the East Asian economy. Moreover, an economically strong Japan is needed to serve as a counterweight to a rising China.<sup>38</sup>

Despite regaining a good deal of financial stability in recent years, Japan's economy remains weak. With growth projections of no more than 1.3%-1.6% over the next five years, Japan will not be in a position to play much of a locomotive role either for the United States or the region. This assessment is not likely to be altered by the estimated weak impact of Japan's FTA program on growth. Lagging China in FTAs with Asian countries, as well in other trade and investment linkages, Japan currently cannot be said to be moving rapidly to establish itself as a credible counterweight to a rising China.<sup>39</sup>

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<sup>37</sup> Fujitsu, Kenzo and Masanari Koike, "Opening Up, Reluctantly," *Far Eastern Economic Review*, April 2005, p. 39.

<sup>38</sup> Katz, Richard. Testimony before the House International Relations Subcommittee on Asia and the Pacific, April 20, 2005.

<sup>39</sup> *Ibid.*

## U.S.-Japan Economic Ties

Post 9/11, U.S.-Japan trade relations arguably have received less attention than security issues. With the exception of Japan's ban of the imports of beef from the United States, there have been few bilateral trade disputes and tensions. Perhaps due to a declining share of the U.S. trade deficit and a stagnant economy for much of the 1990s, Japan's economy is no longer seen as threat to major U.S. industries.<sup>40</sup>

The reduction in bilateral tensions has been accompanied by Japan's FTA negotiating partners replacing the United States as demanders of agricultural trade liberalization. To the extent that these pressures lead to cuts in Japan's agricultural protection or agricultural reform proposals, this will be helpful to U.S. agricultural interests not only in bilateral context, but also in the context of the Doha Round. Unfortunately, slow movement or progress along these lines is occurring.

At the same time, Japan's FTAs could diminish the benefits that the United States has obtained from FTAs. The Japan-Mexico FTA and the Japan-Singapore FTA are cases in point, moving Japan towards an equal footing with these trading partners.

Although proposals have been made in the past for negotiation of an FTA between Japan and the United States, Japan's reluctance to reduce its agricultural protection has proved a formidable stumbling block. Nothing has changed in recent years to alter that calculation, but concerns have been raised that the respective FTA programs of the two sides could allow the bilateral economic relationship to drift and weaken as Japan engages increasingly with its Asian neighbors and the U.S. seeks new partnerships throughout the world. One consequence could be lost economic opportunities for the two largest economies in the world, as well as a weakening of political and security cooperation. In this context, one former U.S. trade negotiator has proposed consideration of what he calls a "Comprehensive Economic Initiative" (CEI) between Japan and the United States. The CEI is seen as a way for Japan and the United States (both governments and private sector representatives) to consider actions to promote trade, investment, financial flows, and deregulation, and to harmonize standards and coordinate competition policy.<sup>41</sup>

## Rising China

China has been much more aggressive than either Japan or the United States in negotiating FTAs. Beijing has concluded a partial FTA with ASEAN ahead of Japan and South Korea.<sup>42</sup> China has also opened its tropical farm products to Thailand in a partial FTA, and has also agreed to start FTA negotiations with Singapore, Australia, and New Zealand. Moreover, China's long-term goal may be to form the center of an East Asian trade bloc.<sup>43</sup>

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<sup>40</sup> CRS Report RL32649, *U.S.-Japan Economic Relations: Significance, Prospects, and Policy Options*, by (name redacted).

<sup>41</sup> See interview with Glen S. Fukushima, in *The Asahi Shimbun/International Herald Tribune*, June 28, 2004.

<sup>42</sup> The China-ASEAN pact took effect on July 1, 2005. The agreement is less than comprehensive, with only 40% of goods subject to a reduction in tariffs to 5% or less. The accord will seek to broaden the range of goods to 60% of imports within two years, but the agreement has also incorporated many exceptions for sensitive products. See "Japan needs trade pact with Asean," *The Yomiuri Shimbun*, July 19, 2005.

<sup>43</sup> Mastel, Greg. "How China Threatens America," *The International Economy*, Spring 2005.

Given that the United States has a limited FTA agenda with Asian countries (FTAs in place with Singapore and Australia and talks contemplated with only South Korea), an East Asian trade bloc could have the potential for substantial discrimination against U.S. exports. In addition, such a bloc could have adverse effects on U.S. influence in the region.<sup>44</sup>

Also worrisome is the possibility of a Japan-China FTA. Much of Japan's private sector reportedly is enthusiastic about such a deal.<sup>45</sup> A Japanese government sponsored study found that a China FTA could boost Japan's GDP by 0.5%, the most among any potential partner country or region.<sup>46</sup> While many big obstacles stand in the way of a Japan-China FTA, the possibility should give pause to U.S. policymakers. Some observers opine that the United States would actively work to deter Japan from entering into an FTA with China.<sup>47</sup>

At the same time, China's aggressive FTA program is said to being used by Tokyo's opposing FTA negotiators for negotiating advantage. Trade negotiators representing ASEAN, for example, reportedly have played this "China card" by telling Japan that China is more forthcoming and willing to negotiate an FTA than Japan.<sup>48</sup> Presumably, this kind of gamesmanship could nudge Japan to take more aggressive and trade liberalizing FTA positions.

How this confluence of FTA developments in Asia ultimately impacts U.S. interests is uncertain. What seems clear, however, is the need for U.S. policymakers to give appropriate attention to how U.S. trade policies can best affect trends in the region to evolve in a direction favorable to U.S. interests.

**Table 1. Japan's Top Export Markets, 1998, 2000, 2002, and 2004**  
(% share)

Country	1998	2000	2002	2004
United States	30.53	29.73	28.51	22.45
China	5.18	6.33	9.59	13.07
South Korea	3.97	6.41	6.87	7.82
Taiwan	6.60	7.50	6.30	7.43
Hong Kong	5.81	5.67	6.10	6.26
Thailand	2.41	2.84	3.17	3.58
Germany	4.92	4.17	3.39	3.35
Singapore	3.81	4.35	3.40	3.18
United Kingdom	3.76	3.10	2.87	2.65
Netherlands	2.80	2.63	2.54	2.37
Malaysia	2.41	2.90	2.64	2.22
Australia	2.07	1.79	2.0	2.09

<sup>44</sup> Ibid.

<sup>45</sup> "Many Unlikely Voices back FTA with China," *The Nikkei Weekly*, July 5, 2004.

<sup>46</sup> "China Deal Could Boost Japan's GDP 0.5%," *The Nikkei Weekly*, January 11, 2005.

<sup>47</sup> "Japan, U.S. Set for Game of Diplomacy on FTA," *The Nikkei Weekly*, June 7, 2004.

<sup>48</sup> "Japan Settles for Low-Risk, Low Return FTA Goals," *The Japan Times*, April 22, 2005.

Country	1998	2000	2002	2004
Philippines	1.87	2.14	2.03	1.70
Indonesia	1.11	1.58	1.50	1.60
France	1.60	1.56	1.47	1.48
Canada	1.63	1.56	1.76	1.35
Belgium	1.16	1.09	1.10	1.28
Italy	1.10	1.21	1.07	1.14
Panama	1.57	1.35	1.10	1.07
Mexico	1.09	1.09	0.90	0.92
Spain	0.68	0.67	0.63	0.86
United Arab Emirates	0.74	0.53	0.71	0.82
Saudi Arabia	0.73	0.64	0.90	0.65
Vietnam	0.34	0.41	0.51	0.56
Russia	—	—	0.23	0.55

Source: *World Trade Atlas*.

**Table 2. Japan's Top Suppliers of Imports, 1998, 2000, 2002, and 2004**  
(% share)

Country	1998	2000	2002	2004
China	13.22	14.52	18.31	20.73
United States	23.89	19.01	17.21	13.73
South Korea	4.32	5.39	4.59	4.84
Australia	4.64	3.90	4.15	4.27
Indonesia	3.87	4.31	4.21	4.11
Saudi Arabia	2.56	3.74	3.45	4.06
United Arab Emirates	2.98	3.91	3.44	4.03
Germany	3.82	3.35	3.68	3.75
Taiwan	3.65	4.72	4.02	3.67
Malaysia	3.10	3.82	3.31	3.10
Thailand	2.91	2.79	3.11	3.10
Canada	2.73	2.29	2.12	1.85
France	2.05	1.69	1.94	1.84
Iran	0.87	1.41	1.41	1.82
Philippines	1.58	1.90	1.93	1.81
Qatar	1.00	1.54	1.56	1.73
Italy	1.82	1.40	1.61	1.52
United Kingdom	2.09	1.73	1.60	1.46
Singapore	1.68	1.69	1.48	1.38

<b>Country</b>	<b>1998</b>	<b>2000</b>	<b>2002</b>	<b>2004</b>
Kuwait	0.84	1.31	1.25	1.26
Russia	1.04	1.21	0.97	1.25
Switzerland	1.08	0.86	0.98	1.06
South Africa	0.83	0.79	0.86	1.01
Chile	0.85	0.75	0.64	0.92
Vietnam	0.62	0.70	0.75	0.85

**Source:** *World Trade Atlas*.

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