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Japan's FTA Strategy and Free Trade Area of Asia Pacific (FTAAP)¹

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I. Introduction

Japan enacted its first free trade agreement (FTA) in November 2002 with Singapore. The formal name of the agreement is the Agreement between Japan and the Republic of Singapore for a New-Age Economic Partnership, or Japan-Singapore Economic Partnership Agreement (JSEPA). JSEPA is a comprehensive economic partnership agreement (EPA), which includes not only the removal of tariff and non-tariff barriers - the traditional elements of FTAs, but also the liberalization of foreign direct investment (FDI), trade and FDI facilitation, economic and technical cooperation in a wide range of areas including development of human resources, information and communications technology (ICT), small and medium enterprises (SMEs), tourism and others. Both Japan and Singapore realized the importance of a broad-ranging comprehensive agreement, in order to have significant impacts on economic activities in the emerging international economic environment where not only goods but also people, funds, and information cross borders freely. Since then Japan has enacted two more FTAs (EPAs), one with Mexico in April 2005 and the other with Malaysia in July 2006. Japan is currently negotiating or studying a number of FTAs.

Japan had pursued trade liberalization under the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) until the late 1990s, and therefore, the recent pursuit of FTAs by Japan is a reflection of the change in its trade policy from a single track approach based on the GATT/WTO multilateral trade liberalization to a multi-track approach including bilateral and plurilateral liberalization. The white paper on international trade 2003 published by Japan's Ministry of Trade and Industry argued the need for pursuing a multi-track approach. Several reasons can be identified for Japan's emerging interest in FTAs.

One important reason is new developments in global trade the scene, where multilateral trade negotiations under the WTO are making little progress and regional trade agreements such as FTAs are rapidly increasing. Faced with this situation, the Japanese government recognized FTAs as an option for achieving trade liberalization. To put it differently, the Japanese government expect FTAs to play a role promoting Japan's economic growth through providing business opportunities for Japanese firms in FTA member countries and promoting domestic policy reforms such as agricultural reform in Japan, which are necessary for achieving sustainable economic growth. Another reason is the expectation that FTAs can play effective roles for the promotion of economic integration in East Asia, in order to contribute to economic growth, and political and social stability, which in turn would have positive impacts on Japan. It should also be noted that desire to take the initiative in regional affairs in East Asia has motivated Japan to pursue FTAs.

In the light of discussions on the idea of Free Trade Area of Asia Pacific (FTAAP), this paper examines Japan's FTA strategies and attempts to identify possible benefits and costs of the FTAAP. The structure of the remainder of the paper is as follows. Section II gives a review of Japan's FTAs, in order to set the stage for the analysis of Japanese FTA strategy. Section III examines the motives behind Japan's FTA strategy, while section IV discusses the possible impacts of FTAs and the FTAAP by referring to the results of simulation analysis. Section V identifies the obstacles to establishing FTAs and the FTAAP, while Section VI provides some several possible policies to overcome the obstacles. Section VII presents Japan's views toward FTAAP.

II. Brief Review of Japan's FTA Developments

Japan had been a passive participant in FTA discussions until November 2002 when Japan proposed a possible FTA with the Association of Southeast Asian Nations (ASEAN). Prime Minister Goh Chok Tong of Singapore proposed an FTA to Prime Minister Keizo Obuchi of Japan in December 1999. They decided to set up a study group consisting of government officials, business people, and academics to investigate the contents of possible FTA and its impacts on their economies. The study group after a series of discussions recommended the prime ministers start FTA negotiations in October 2000. Responding to the recommendation by the study group, the two prime ministers asked their government officials to start FTA negotiations. Negotiations began in January 2001 and reached an agreement in October 2001. After the agreement was signed by Prime Ministers Goh and Junichiro Koizumi of Japan in January 2002, Japan-Singapore FTA (JSEPA) went into effect in November 2002 (Table 1). Negotiations appeared to have moved rather smoothly because contentious issues such as liberalization in agricultural trade were limited for both countries.

JSEPA has both strengths and weaknesses. One of the strengths is its comprehensiveness. Another strength is its symbolic nature as JSEPA sent a message to the world Japan's strong interest in FTAs. One of weaknesses is the limited coverage of trade liberalization on Japan side. Singapore removed tariffs on all imports from Japan, while Japan removed tariffs on 94 percent of imports from Singapore. It should be noted that those imports from Singapore that were not liberalized include not only agricultural products but also selected manufactured products including some petrochemical products and leather goods.

Mexico was the first country that approached Japan for a possible FTA. In November 1998 President Ernesto Zedillo of Mexico proposed FTA to Japan. Following the proposition by the Mexican president, the committee on Japan-Mexico Closer Economic Relations was set up by Japan External Trade Organization (JETRO) and Mexico's Secretaria de Comercio Y Fomento Industrial (SECOFI). In April 2000, JETRO and SECOFI released a joint report on possible Japan-Mexico FTA. Since the report concluded that Japan-Mexico FTA would give significant favorable effects on both nations, Japanese prime minister and Mexican president agreed to establish a business-government-academics study group to examine a possible approach for strengthening mutual economic ties, including FTA. The study group was established in September 2001 and examined the contents of possible FTA. The group presented its recommendation to their national leaders in summer 2002, to start FTA negotiations. The negotiations started in October 2002 with an aim of reaching an agreement in one year. However, the negotiations took much longer than expected and the two countries reached an agreement in September 2004. Japan-Mexico FTA (EPA) was enacted in April 1, 2005.

The most serious obstacle in the negotiations was Japan's strong resistance to liberalization in agricultural products, specifically pork, beef, and chicken products, oranges and orange juice (Table 2). After a strong request from Mexican government, Japan opened up these markets by increasing import quotas, not removing tariffs as it should under FTAs. Mexico agreed to liberalize steel and automobile markets within 10 and 7 years, responding to Japan's strong request. As a result, Mexico agreed to open its market to all imports from Japan, while Japan agreed to open its market to only 84 percent of its imports from Mexico. The Japan-Mexico FTA was strongly supported by the Japanese business sector, which felt that their business had been suffering from losses of business opportunity due to the lack of an FTA with Mexico. Specifically, the cost in the form of lost business is estimated at 400 billion yen in 1999, amounting close to Japan's exports to Mexico². Mexico on the other hand was interested in exporting its agricultural products to Japan, as

Mexican government was under pressure from Mexican farmers, who were unhappy with the negative impacts of the NAFTA. As can be seen from the results of the negotiations noted above, Japan gained substantially and did not give in much on agricultural liberalization. Although it may be a victory for trade negotiators, it certainly is a defeat for those keenly interested in structural reform.

As for the FTA with South Korea, President Kim Dae Jung took the lead in suggesting a closer economic partnership between South Korea and Japan in October 1998. In November 1998 at the Japan-Korea Ministerial Meeting the issue of possible FTA was taken up. Following the meeting, private institutions jointly carried on research activities and released their report in May 2000. The Japanese prime minister and Korean president agreed to establish the "Japan-Korea FTA Business Forum" in the September 2000 summit meeting. In March 2001, this business forum was established, having both nations' business leaders as core members. In January 2002, after adopting their joint declaration that called for concluding a Japan-Korea FTA as soon as possible, the forum submitted a report to the Japanese prime minister and Korean president. Based on this report's recommendation, Japan and Korea agreed to establish a joint study group consisting of government officials, business leaders, and academics. The study group made recommendations to the leaders to start negotiations. FTA negotiations between Japan and Korea started in December 2003 that aimed to conclude the negotiations in two years. Although both Japan and Korea aspired to establish a model FTA for East Asian countries with a high degree of liberalization, the negotiations were deadlocked since their beginning because of their dissatisfaction on the framework of negotiations on market access.

Some specific concerns and problems facing Korea and Japan include the following. Although Korea expects an increase in FDI from Japan from the FTA, Korea is concerned with the possible negative impact on its manufacturing industries except for some electronics products such as semi-conductors because of their lack of competitiveness vis-à-vis Japanese counterparts. In particular, small and medium-sized enterprises (SMEs) strongly oppose the Japan-Korea FTA, as they fear serious competition from increased Japanese imports. These possible negative impacts have made the Korean government concerned with the worsening bilateral trade balance and increasing dependence on Japan, although these views cannot be justified on an economic basis. Both Japan and Korea generally oppose to liberalization of trade in agricultural products, as has been demonstrated in the WTO negotiations as well as their respective FTA negotiations so far. However, in the Japan-Korea FTA discussions Korea feels that Japan is very backward in liberalizing agricultural and fishery sectors.

China's Premier Zhu Rongji informally proposed to the leaders of Japan and Korea the establishment of a trilateral FTA including these three countries at the leaders meeting in 2002. Japan did not accept China's proposal by indicating that Japan would like to make sure that China, a new WTO member, abides by the WTO commitments and rules before discussing an FTA. At least two reasons could be postulated for Japan's rejection. One is its possible negative impacts on non-competitive sectors such as agriculture and labor-intensive apparel industries, and the other is its rivalry vis-à-vis China. We will take up these issues more in detail later again. It should be noted that government think-tanks from Japan, China, and Korea have been actively conducting a joint-study project on the possibility of Japan-China-Korea FTA since 2003.

Japan proposed an economic partnership agreement (EPA) with ASEAN including an FTA in November 2002 only one day after China and ASEAN signed an agreement on closer economic partnership. Compared with the sensational impact that the China-ASEAN Closer Economic Agreement had, the Japan-ASEAN EPA did not attract much attention, as it did not have any

concrete actions. In November 2003 Japan and ASEAN agreed on the framework for comprehensive economic partnership and agreed to start consultations in 2004³. Japan and ASEAN started FTA negotiations in April 2005 with a target of concluding negotiations in two years. Japan is eager to establish FTA with ASEAN because of its importance to Japan not only in economic but also political and strategic aspects. Japan's trade and FDI relationship with ASEAN is still greater than its relationship with China. Japan is interested in improving the business environment in ASEAN by establishing an FTA, through which stable and reliable economic systems such as the protection of intellectual property rights may be developed to benefit Japanese firms operating in ASEAN. It also has to be noted that Japan did not want to be left behind other countries including China, Korea and India, which started negotiations with ASEAN, as the delay in the negotiations would reduce Japan's economic and political presence in East Asia.

While Japan continues to have discussions with ASEAN, some members of ASEAN and Japan started negotiations on bilateral FTA. Japan's FTA negotiations with Malaysia started in January 2004, while its negotiations with Thailand and the Philippines started in February that year. Indonesia was the last country among the original ASEAN members that started FTA negotiations with Japan in July 2005. Japan-Malaysia FTA was successfully negotiated and enacted in July 2006, while the negotiations with Thailand, the Philippines, and Indonesia are still under way. The contentious issues for its negotiations with these ASEAN countries include liberalization in agricultural imports and liberalization in the movement of natural persons, while Japan is eager to reduce barriers on foreign trade and FDI in these countries. These issues will be discussed more fully in section VI.

Despite the realization of the need to establish a Japan-ASEAN EPA, Japan has decided to establish FTAs bilaterally with selected members of ASEAN because it cannot establish speedily an ASEAN-wide FTA, because of the wide differences in economic and non-economic conditions among ASEAN members. Some argue that bilateral FTAs with selected members of ASEAN by not including others would create divisiveness among ASEAN members. Since this is certainly a possibility, Japan needs to conclude its negotiations with ASEAN as early as possible.

Japan is actively participating in discussions on the establishment of an ASEAN+3 (China, Japan and Korea) FTA. The idea of an FTA covering East Asian countries has emerged. At the Leaders' summit meeting of ASEAN+3 in 1998 it was decided to set up the East Asia Vision Group to study the long term vision for economic cooperation. The group has presented the leaders with recommendations including the establishment of East Asia FTA. Currently, the Expert Group, which was set up at the recommendation of ASEAN+3 Economic Ministers, is studying the possibility of an East Asian FTA, comprising of ASEAN+3.

Japan's Ministry of Economy, Trade and Industry released a report titled "Japan's Global Economic Strategy" in April 2006⁴. This report argues for the need to establish an East Asia EPA, whose members include ASEAN+3+3 (India, Australia and New Zealand), to achieve economic prosperity in East Asia. The report further calls for Japan's initiative to formulate and implement East Asia EPA.

As for FTAs with other countries, Japan began negotiations with Chile, and expects to begin negotiations with India early 2007. In addition, Japan is studying the possibility of FTAs with the following countries: Australia, Switzerland, and the Cooperation Council for the Arab States of the Gulf (Gulf Cooperation Council, GCC).

As can be seen from the discussions above, Japan's FTA strategy emphasizes East Asia as a

region for establishing FTAs for economic and political reasons⁵. For Japan, economic prosperity, economic growth, political and social stability in East Asia is critically important, because of Japan's geographical proximity and close economic relations. Japan's establishment of FTAs with East Asian countries is expected to promote not only Japan's economic growth but also East Asia's economic growth, contributing to economic prosperity, social and political stability in East Asia. This in turn contributes to economic growth. We will come back to these issues in the next section, where the motives of Japan's FTA strategy are discussed more in detail.

As was noted above, the Japanese government set up a study group consisting of private sector representatives, government officials, and academics to examine possible FTAs before entering negotiations. The idea of study group was quite useful in formulating the appropriate contents of FTAs because in study group discussions pro-liberalization voices of business and academics rather than pro-protection views of government officials were adopted. Officials of the Ministry of Agriculture, Fishery and Forestry and representatives from agriculture associations oppose any import liberalization of agricultural products by arguing the need for food security and multi-functionality of agriculture. In other words, they argue that the maintenance of agriculture would contribute to conservation of environment, preservation of rural life, and others. By contrast, business representatives, academics, and in some cases officials of Ministry of Economy, Trade, and Industry and Ministry of Foreign Affairs present arguments for liberalization.

III. Motives behind Japan's FTA Strategy

As already mentioned earlier, Japan came to recognize FTA as one of its trade policy options in addition to multilateral framework under the WTO. Several factors contributed to this shift in Japan's trade policy. This section investigates these factors.

First, greater access to foreign markets was one of the important motives that aroused Japan's interest in FTAs. Japan was one of few countries that did not have any regional trade arrangements such as FTAs in the world until the early 21st century, where an increasingly greater number of FTAs had become established. Facing a world market with many discriminatory regional trading arrangements, in particular those in Europe and North America, Japan felt the need to secure a market for Japanese firms by setting up FTAs. As FTAs would eliminate trade barriers in FTA partners, Japanese firms are surely able to enjoy more business opportunities. This kind of thinking led to a positive perspective on FTAs, especially when multilateral trade negotiations under the WTO were making little progress.

For internationally competitive Japanese firms, it is very important to have more business opportunities when competing with foreign companies. For example, FTAs with East Asian countries with high growth potential would increase Japan's exports to these countries, which are presently protected with high tariff and non-tariff barriers (Table 3) In addition Japanese firms could expand their business in FTA member countries via FDI because FTA, or EPA, include not only trade but FDI liberalization and economic cooperation such as human resource development and infrastructure development, which would contribute to establish a business friendly environment in East Asia.

The market access motive clearly played an important role for Japan in pursuing FTA with Mexico. Thanks to NAFTA and the EU-Mexico FTA, EU and US firms can export their products to Mexico without tariffs. Japanese firms have to pay high tariffs to export their products to Mexico, whose market is protected by high tariffs. Indeed, the simple mean tariff rate for Mexico was very high at 16.2 percent in 2001⁶. Among Japanese manufacturing sectors, automobile and steel

industries were very eager to have an FTA with Mexico. Japan's automobile industry is interested in expanding exports of finished cars to Mexico, while its steel industry is interested in exporting steel products, which are used for production of electronics, household electrical appliances, general machineries, and automobiles by Japanese assembly firms operating in Mexico. Besides, the Mexican government only allows FTA members to participate in the government procurement market. Mexico can impose such restrictions on government procurement because it is not a signatory to WTO's government procurement code. Faced with these market access problems in Mexico because of its non-FTA member status, Japanese business has pushed rigorously Japanese government to have an FTA with Mexico.

Second, stimulation of structural reforms is a motive for Japan to pursue FTAs, because structural reforms are essential to revitalize economic activities and to regain competitiveness for Japan. Since the collapse of a bubble economy in the early 1990s, the Japanese economy was in a long recession. Indeed, the 1990s was characterized as the "lost decade" for Japan. Although Japan's post-war systems contributed to high economic growth in the past, they have recently become ineffective. This is one of the reasons why Japan failed to recover from such long recession. Although the Japanese economy has shown signs of recovery in recent years, it is too early to tell whether the recovery is long lasting enough to achieve sustainable economic growth. One serious challenge is rapid demographic change reflected in declining population and aging, which is likely to result in a loss of economic and social dynamism.

To deal with these challenges, many observers agree that further structural reform is necessary for achieving potential growth as it leads to more efficient use of limited resources including human and financial resources. As for the specific sectors related to current FTA negotiations, we can identify the following sectors for the need of structural reforms, agriculture and fishery and medical, educational, and other services.

In the post World War II period Japan had made use of international frameworks (e.g., GATT and OECD) and external pressures (especially, pressures from the United States) to reform its domestic structures through trade liberalization. Indeed, structural reform contributed significantly to improve the competitiveness of Japan's manufacturing sector. However, in the latter half of the 1990s, liberalization was getting more difficult under the WTO framework. There are several reasons for slow progress under the WTO. First, as a result of substantial trade liberalization under the GATT, there remain only difficult areas for further liberalization, slowing down further liberalization. Second, the number of WTO members increased significantly over time to reach 149 (as of December 2005), making it difficult for the WTO to make decision on trade liberalization, because decision making at the WTO is based on consensus. One seriously contentious issue is liberalization of agricultural and industrial products, because of different views on these issues among major WTO members including the US, the EU, Japan, and some developing countries.

The US pressure on Japan concerning trade related issues weakened after the establishment of the WTO. This is because the US, Japan and other WTO member countries began to use the strengthened dispute settlement mechanism under the WTO to settle trade disputes. It should also be noted that Japan undertook a number of policy reforms such as those in financial system, and corporate governance system, which were main causes of US concerns over macroeconomic performance of Japanese economy.

Faced with a lack of external pressures, especially from the WTO's multilateral trade negotiations, Japan became interested in FTAs as one of the policy options to promote structural reform. Japan came to look at FTAs in a positive light, because it found that the EU and NAFTA

promoted structural reforms in member countries.

Third, Japan is interested in assisting developing countries, especially those in East Asia to promote economic growth by FTAs, because economic growth in East Asia would benefit Japan by providing business opportunities for Japanese firms and by achieving political and social stability in the region. East Asian countries could promote their economic growth by establishing FTAs with Japan, as they can not only enjoy greater access to Japanese market but also receive various factors such as FDI and economic assistance under EPA. To maximize the benefits from FTAs with East Asian countries, Japan is keen on establishing an East Asia FTA by including all East Asian economies.

Fourth, obtaining an access to natural resources such as oil and foods, which have vital positions in the Japanese economy, is one motive for establishing FTAs. FTA discussions with GCC countries are certainly motivated by the desire to secure oil and natural gas supplies, while one of the motivations for a possible Japan-Australia FTA is to secure food and mineral supplies. Securing natural resources is of critical importance for Japan, because it is poorly endowed with natural resources, and the importance of this issue is rapidly increasing as largely populated countries, China and India, have been absorbing tremendous amounts of natural resources.

Finally, Japan is keen on using FTAs to strengthen its position in international affairs such as in the WTO negotiations and regional affairs. This is partly in response to the many countries that have been using FTAs for those purposes. Japan would like to contribute to the strengthening of the WTO system by successfully forming EPAs (like Japan-Singapore EPA) that include issues not covered in the existing WTO framework. While GATT/WTO does not have specific rules on competition policies or investments, Japan-Singapore EPA (JSEPA) does cover these fields. Japan has been trying to include these new features in all EPAs including those under negotiations. The WTO and other international organizations may establish specific rules applicable to competition policies and investment in the future by using JSEPA as a model. In this way Japan may be able to contribute to forming international frameworks through forming FTA and EPA with other countries.

IV. Impacts of FTAs on the Japanese Economy

The motives behind Japan's FTA strategy were discussed in the previous section. An assessment of the impacts of FTAs on Japanese economy is in order not only to evaluate the fulfillment of such motives but also to help formulate an appropriate FTA strategy. This section briefly discusses FTA's economic effects and also examines how much different FTAs will give impacts on Japan and its trading partners based on simulation analysis.

One can classify the economic impacts of FTA into two groups: static effects and dynamic effects⁷. Static effects include "trade creation effect," "trade diversion effect" and "terms of trade effect," while the dynamic effects are "market expansion effect" and "competition promotion effect." The "trade creation effect" means that FTAs eliminate trade barriers on trade among FTA members and, therefore, creates trade among them. The "trade diversion effect" means that FTA would replace imports of most efficient non-member countries by imports from less efficient FTA members. The "terms of trade effect" represents that FTA would expand trade volume among its parties, strengthen the parties' influence on non-members and, then improve their terms of trade. The "market expansion effect" indicates that the elimination of trade barriers among members would expand market size to achieve efficient production/distribution by realizing economies of scale. The "competition promotion effect" means that market integration would make oligopolistic industries more competitive to achieve higher productivity by introducing competitive pressures.

From the viewpoint of FTA members, the “trade creation effect,” “terms of trade effect,” “market expansion effect,” and “competition promotion effect” will give positive impacts. However, the “trade diversion effect” would have adverse effects on them under certain circumstances. On the other hand, from the viewpoint of non-member states, the trade diversion effect and terms of trade effect will give negative impacts, while other effects tend to have positive impacts on them. If FTA expands market size, promotes competition, and encourages economic growth in member countries, its positive effects will spread out to non-member states as well. The FTA option has recently gained popularity, because governments expect FTAs to realize positive dynamic effects. However, if a country gives preferential treatment only to certain trade partners, other countries might form exclusive economic blocs in order to countervail “trade diversion effects” created by such preferential treatment. In this case, the world economy will suffer from significant adverse effects like what happened during the Inter-War era.

Recognizing the negative impacts of trade diversion and excluding non-members, one argues that FTAs should cover a lot of countries and include some highly competitive countries because such FTAs will be able to minimize possible negative impacts from the trade diversion effect⁸. This observation indicates the importance of successful multilateral trade negotiations under the WTO. Indeed, it is the optimal outcome. However, under the circumstances that the WTO falters, an FTA such as the FTAAP with a large number of members can be a viable option and it is certainly better option than FTAs with smaller number of members.

In addition to the impacts on trade, FTAs also affects foreign direct investment (FDI). As the FTA eliminates regional trade barriers and expands the market size, FDI will flow into the regional market, hoping to sell more products. In addition, if the FTA enables firms to conduct efficient production in the region, foreign firms will undertake investments in the region to take advantage of the more favorable production environment, in order to export their products. This is called FTA’s investment creation effect. Investment may be undertaken in member countries at the expense of investment in non-member countries because of increased attractiveness of member countries for investment. This is FTA’s investment diversion effect. It should be added that FDI creation and diversion effects can occur in a more direct fashion, if FTA includes FDI liberalization.

Many empirical studies have been conducted on the economic impacts of FTAs. In these studies the EU and NAFTA have attracted most attention⁹. Although these analyses draw different conclusions to a certain extent, they generally show that FTAs basically expanded regional trade/investment, encouraged competition within the region and brought some other positive effects to the members. On the other hand, some analyses show that FTAs have diverted trade and investment, and might have given had some negative effects on non-member countries. According to the estimation by Japan’s Ministry of Economy, Trade and Industry, NAFTA trade diversion incurred a loss of Japanese exports amounting to 395 billion yen in 1999¹⁰. Investment diversion was also reported as the NAFTA attracted FDI inflows in electronics and apparel industries to Mexico, which would have flowed to East Asia.

We are able to measure FTAs’ overall economic impacts for the world as a whole by comparing FTA members’ benefits and non-members’ costs. As a lot of research projects prove that the former exceeded the later, FTAs would generally bring positive impacts on net basis. Because existing empirical analyses tend to ignore FTA’s dynamic effects, they are likely to underestimate FTA’s positive impacts. If an FTA has large dynamic effects, it will surely bring more positive impacts on the member countries as well as on non-member countries.

Let us examine the impacts of FTAs on Japan, which are obtained from a simulation analysis based on computable general equilibrium (CGE) model, specifically GTAP model version 5, which was carried out by Scollay and Gilbert (2001). They conducted a large number of simulation analyses by considering a variety of groupings of the countries involved in FTAs. Figure 1 shows the impacts of various FTAs on Japan's welfare. The results show an unambiguous pattern in that an increase in the number of countries involved in FTAs leads to a larger benefit to Japan. The largest gain in welfare (0.98 percent of GDP) is expected from global trade liberalization, while the smallest gain (0.01 percent of GDP) is expected from Japan-Korea FTA. Two different types of FTAs are simulated for APEC. One is trade liberalization of APEC members vis-à-vis the rest of the world (APEC MFN), and the other is discriminatory trade liberalization of APEC members vis-à-vis their members only (APEC FTA). The results show that the larger gain can be expected from APEC FTA than APEC MFN. This is due to the terms of trade effect, whose improvement is larger in the case of APEC FTA than APEC MFN. One should note, however, that APEC FTA would result in negative impacts on non-members as the welfare impacts of APEC FTA on total world is 0.27 percent of GDP, a significantly smaller than the corresponding value of 0.34 percent in the case of APEC MFN.

It is worth noting that FTAs with East Asian countries including agricultural products would yield lower benefits than FTAs excluding them because of the trade diversion effect in that imports from efficient agricultural producers such as the US and Australia are replaced by those from less efficient Asian producers¹¹.

It is to be noted that the results are likely to underestimate the true impacts, because the simulation analysis only incorporates static effects but not dynamic effects nor the impacts on FDI due to difficulty in introducing these features in the model. Indeed, many observers emphasize the importance of dynamic effects from the formation of FTAs. Underestimation of the impacts of FTAs using CGE models is likely to be substantial if FTAs include not only trade liberalization but also other features such as FDI liberalization, trade and FDI facilitation and economic cooperation, as in the case of EPA¹².

V. Obstacles to the Formation of FTAs and FTAAP for Japan

We saw in the previous sections that Japan can expect economic and non-economic benefits from FTAs. Recognizing the benefits from FTAs, Japan has become active in establishing FTAs. However, Japan faces various obstacles in its pursuit of FTAs. This section examines such obstacles for Japan, with a particular focus on obstacles for establishing FTAs with APEC economies.

One can identify economic and non-economic obstacles. Let us begin with economic obstacles and then turn to non-economic obstacles. Although FTAs are likely to bring economic benefits to Japan as a whole as shown by the simulation result reported in the previous section, the benefits would not accrue to all the sectors/people. Some sectors or groups are likely to suffer from negative consequences. Specifically, competitive sectors are likely to benefit as FTAs would bring them business opportunities in overseas market, while non-competitive sectors are likely to lose out to competitive foreign firms. These mixed impacts are expected from any type of trade liberalization, either multilateral liberalization under the WTO or FTAs.

For Japan, the agriculture sector is the most sensitive sector in trade liberalization, regardless of its form, that is, bilateral or regional framework under FTAs, multilateral framework under the WTO, or unilateral framework. Japan has relatively low tariff protection on agricultural

products in general, compared to other agricultural product importing countries. Specifically, according to the OECD (1999), average tariff rate for agricultural products for Japan is 12 percent, significantly lower than the rates for other countries, Norway (124%), Korea (62%), Switzerland (51%), and the EU (20%). What is notable for agricultural protection in Japan is the very high protection given to several products through a complicated protection system, which combines import quotas and high tariffs. For example, the ad valorem tariff equivalent for some selected items are very high as follows: rice (490%), wheat (210%), sugar (270%), butter (330%), and konnyaku potato (990%). In addition, as a part of the Uruguay round agreement Japan introduced a special safeguard system to deal with the damage caused by import surges, contributing to stronger protection policy on agricultural products

Among these highly protected items, rice is by far the most difficult item to be liberalized because of several reasons. One is its large share of agricultural production, amounting to approximately 25 percent of agricultural production¹³. Another is the geographical location of production spreading over more or less throughout Japan. These two factors result in strong political factor.

Import liberalization of agricultural products has been an obstacle in FTA negotiations for Japan. Japan excluded agricultural products from trade liberalization in Japan-Singapore FTA, although agricultural production in Singapore is very small. Pork products became a contentious issue in Japan-Mexico FTA negotiations. Despite strong demands from Mexico to reduce the level of protection on port imports, Japan did not give in. Japan instead increased import quotas on beef, chicken, oranges and orange juice, which was not included in the initial request. Japan's FTA negotiations with other countries have also encountered the problem of import liberalization of agricultural products. Agricultural products, which faced Japan's strong opposition, include the following: Japan-Philippine FTA (bananas, rice, wheat, starch, dairy products, beef, pork, sugar, canned pineapples, etc.), Japan-Malaysia FTA (plywood), Japan-Thailand FTA (rice, sugar, boneless chicken, processed chicken), Japan-Chile FTA (fish products, pork, etc.). Besides the sensitive agricultural products listed above for Japan's past and present FTA negotiations, various sensitive agricultural products can be identified in the possible FTAAP negotiations, rice (Australia, US, China), beef and pork (Australia, US), sugar (Australia), and dairy products (Australia, US).

Indeed, the possible difficulty in the liberalization of the agriculture sector under an FTAAP can be identified as the shares of agricultural products and food products in Japan's total imports from Australia, Canada, and the US are high at 16.6, 25.1 and 20.0 percent, respectively in 2005. It should be noted that the corresponding shares for imports from China is significantly lower at 7.2 percent.

The main reason for the difficulty in liberalizing agriculture is its negative impact on employment. It is important to recognize that protection of agriculture sector does not ensure employment of farmers alone, but also the workers engaged in agriculture sector such as construction workers building irrigation systems and workers at farmers' cooperatives.

If the FTAAP covers mobility of natural persons, Japan's Ministry of Welfare and Labor oppose various types of foreign workers. Japan opposed mobility of labor as a part of FTAs with Thailand and the Philippines, while they are keenly interested in "exporting" medical care givers such as nurses and massage therapists. As aging of Japanese population is projected to accelerate in the future, Japan is likely to be short of medical-care givers for the aged. In light of such future projections, "importation" of medical-care givers can be justified. However, nurses associations and medical associations strongly opposed importation of these people because it would threaten job

opportunities for Japanese nurses and other medical-care givers. Mobility of labor was included in JSEPA but its coverage and form was very limited in that temporary stay is permitted only for short-term visitors for commercial purposes, intra-firm transferees, investors, and engineers with high technological knowledge¹⁴.

Let us turn to non-economic obstacles¹⁵. The issue of national security is an obstacle for Japan and other East Asian countries to form FTAs in East Asia. Japan and Korea have strong security alliances with the United States, while China is not an ally with the US. ASEAN countries regard the US forces as a security balancer in the region. Because of these different stances on national security, true regional integration based on mutual trust is not likely in the near future. Specifically, the Taiwan issue highlights possible conflict between China and US allies. Somewhat related to the national security issue, differences in political systems, namely democratic states like Japan, and many other East Asian countries on the one hand and authoritarian states like China and Vietnam on the other hand, prevents East Asian countries from establishing truly trustful relationship, which is a necessary condition to establish a true FTA. Indeed, Japan's mistrust of China in the areas of national security and political system, coupled with increasing presence of China in the areas of economic as well as political and military areas, is a crucial factor preventing the discussions on a possible FTA

In the pursuit of establishing FTAs with China and Korea, Japan faces historic problem as Japan colonized these countries (part of China) during the WWII period. Specifically, a large proportion of people in China and to lesser extent in Korea remember sad experiences under the occupation and thus do not have a good impression of Japan, making cooperative arrangement such as FTAs difficult to be realized. Despite the historic problem, Japan and Korea have been successful in starting the process toward the establishment of FTA mainly for two reasons. One is mutual reconciliation over historic issues between the political leaders and the other is increased mutual understanding of the needs for closer economic and social ties among people of the two countries. Mutual reconciliation between the political leaders was realized thanks to strong political leadership of Korean President Kim Dae Jung who accepted an apology from Prime Minister Keizo Obuchi for Japan's atrocity done on Korean people in the past. Increasing awareness of the need for closer economic and social relationships by the peoples of two countries appears to result from the change in people's perception of mutual relationship from backward-looking to future-looking stance, which in turn results from successful economic growth. This case shows the importance of political leadership and successful economic growth for establishing FTAs.

Finally, there is a view that the establishment of a large FTA such as FTAAP, which includes two of the world's largest economies, the US and Japan, and other large economies such as China and Korea, would undermine the WTO trading system, because the FTAAP (with a preferential trading arrangement) is a discriminatory arrangement. To put it differently, the non-members, especially the small countries that are excluded from major FTAs such as the EU would suffer tremendously from discrimination in trade. This is a valid criticism and indicates the importance of FTAAP to become a building block and not a stumbling block to the global trade liberalization.

VI. Policies to Overcome the Obstacles

We identified several obstacles on the establishment of FTAs, which include both economic and non-economic obstacles. This section discusses the policies to overcome these obstacles.

The most difficult problem has to do with displaced workers resulting from FTAs. At least two schemes can be applied to deal with this issue. One is income compensation for the duration of unemployment with the ceiling on the length of payment and the other is provision of technical assistance to improve their skills for getting more productive jobs. With assistance, affected workers should be able to make necessary adjustments. Recognizing that many farmers are very old and would find it difficult to find new jobs, income compensation should be a major policy.

For Japan, the agricultural sector is likely to suffer as imported agricultural products would cause a decline in output and employment. A more forward-looking, pro-active agriculture policy, specifically rice policy, can be considered by providing subsidy to full-time farmers with large cultivated land.¹⁶ With this policy, cultivated land will be integrated so that farmers can improve productivity. Besides, the market will be liberalized and, as a result, not only consumers do not have to bear all the burdens, but also one big obstacle for FTAs will be removed. It should be noted that Japan's Ministry of Agriculture, Forestry, and Fisheries have been carrying out structural reforms to strengthen competitiveness of Japanese agricultural sector. Although this policy may be considered forward-looking and therefore desirable, one serious problem is the absence of import liberalization. Without import liberalization, strengthening agricultural sector is difficult.

To deal with trade adjustment in the agricultural sector, which was necessitated by partial liberalization of rice imports as a result of the Uruguay round of trade negotiations under the GATT, Japanese government provided as much as six trillion yen. Although the intention can be justified, the program was not successful in facilitating adjustment, because a large part of the funds were spent not for upgrading skills of affected workers but for different purposes such as drilling hot springs or paving the country roads. Such mistakes must not be repeated.

Some argue the importance of protecting agriculture to achieve various objectives such as food security and multi-functionality, i.e. preserving nature, environment, culture, and so on. These objectives may be justified but protection of agriculture is a wrong and inefficient policy. Appropriate policies can be designed to achieve these goals. For example, food security may be achieved by establishing FTAs, especially the FTAAP that includes a number of agricultural exporters to assure stable and sufficient supplies of agricultural products. To achieve preservation of nature and environment, direct subsidies are known to be most efficient. In essence, import protection is only a second best or third best policy and not the optimum policy to achieve these goals that protectionists attempt to achieve. Coupled with substantial costs of protection discussed above, the discussions in this section strongly indicate that protection of agriculture should be removed, not only in order to promote FTAs but also to promote Japan's economic growth.

These arguments suggest that liberalizing, rather than protecting, Japan's agricultural sector will help Japan to achieve sustainable economic growth. If this point is understood and shared with many Japanese, a major obstacle for FTAs will be removed. Of course, when liberating the agriculture sector, it is necessary to minimize the resultant unemployment and adjustment costs. For example, a possible approach will be to liberalize competitive sectors first and, then, deregulate less competitive sectors after some interval¹⁷. Many FTAs have such schemes of sequential liberalization for different sectors, depending on their competitiveness. However, even in this case, it is necessary to specifically decide the timetable and liberalize the market strictly based on the timetable.

Liberalization of the labor market to foreign workers faces strong opposition basically because of its negative impacts on employment. As such, the policies and measures discussed above to deal with agricultural sector problem can be applied to this problem as well. Despite the similar

nature of the problem between liberalization of agricultural sector and labor market, one has to recognize their differences. One of the serious issues regarding liberalization of labor market is possible negative impact of foreign workers in the Japanese society. Although it is very often exaggerated, the number of crimes committed by foreigners is rising, giving an impression that foreign workers would cause security problems. Regardless of the validity of this assertion between foreign workers and security issues, the governments, especially local governments and local community have to provide an environment, under which foreign workers and their family can adopt themselves to the Japanese life by providing various necessary services such as language education.

As to the specific issue of accepting medical-care givers, Japan should accept foreign workers, who satisfy certain conditions. In the case of Japan-Philippines FTA, Japanese government imposed the following two qualifications, professional capability and Japanese language proficiency. Both of these qualifications can be satisfied by passing national examinations. As far as those qualifications are concerned, Japanese government policy appears justified. However, Japanese government policy to set the maximum number of Filipino medical-care givers cannot be justified. A more desirable policy is to let the market decide on the number.

To promote FTAs by Japan, Japanese people, policy makers and government officials, in particular, have to have a sense of urgency concerning Japanese economy and Japan's future. Without such recognition, no meaningful efforts for the promotion of FTAs can be expected¹⁸. To promote FTAs, Japanese people, policy makers, and government officials have to realize the importance of establishing Japan's strong relationship with FTA members, which would bring economic prosperity, political and social stability.

Various means can be used to increase such awareness on the part of Japanese people as well as people in FTA partners for the need of deepening mutual relationship to promote FTAs. One effective way is to increase the exchange of people of all levels. Among those, non-business people need to increase their exchange with their counterparts in FTA partners.

One of the most important factors for the promotion of FTAs is strong political leadership. To establish FTAs political leaders have to lead the discussions and policy making processes of FTA strategies based on deep understanding of the costs and benefits of FTAs. With such strong and capable political leadership, inter-ministerial differences in opinion on FTAs will be overcome, and FTA negotiations move forward. Indeed, in Japan inter-ministerial differences in opinions on FTAs between Ministry of Economy, Trade and Industry, and Ministry of Foreign Affairs on the one hand and Ministry of Agriculture, Forestry and Fisheries and Ministry of Welfare and Labor on the other hand are well known, as the former group is basically in favor of FTAs while the latter against FTAs. Because of inability on the part of political leaders, these differences remain unresolved and protract FTA negotiations. It should be noted that various forums involving politicians have been set up to promote FTAs and even some politicians known as *Norin-zoku*, or the group supported by farmers, have expressed the positive views toward FTAs. In light of the changing attitude of politicians on agricultural issues in FTAs, it may be bureaucrats that take a firm stand against liberalization of agricultural sectors in FTA issues.

VII. On FTAAP: A View from Japan

Currently, the Japanese government is engaged in various bilateral FTA negotiations as well as Japan-ASEAN FTA negotiations. One important FTA, which is going to be discussed in the

near future, is the East Asia FTA (EAFTA), which is likely to begin with ASEAN+3 countries with a possibility of including other East Asian countries such as India, Australia and New Zealand, the members of East Asian Summit. The discussions on FTAAP have to be conducted in the light of these developments.

For Japan, the economic benefits from the FTAAP are likely to be greater than the benefits resulting from any FTAs currently in force, under negotiation or under study. This observation can be supported by various evidences. First, for Japan's foreign trade, APEC has significantly larger position than East Asia, the next largest grouping considered for FTAs involving Japan after APEC. Specifically, in 2004 the shares of East Asia in Japan's exports and imports are 46.4 and 44.9 percent, respectively, significantly lower compared to 75.2 and 67.8 percent for APEC. The greater importance of APEC for Japanese economy is reflected in the results of simulation studies on the impacts of FTAs (Figure 1). It should be emphasized that the FTAAP can avoid trade diversion effects, which may arise from smaller FTAs such as EAFTA. Specifically, Japan may lose from EAFTA in that it diverts Japan's agricultural imports from very efficient producers such as Australia, Canada and the US to less efficient Asian countries. This negative impact can be avoided by FTAAP.

Another big benefit comes from unified definition of the rules of origin under FTAAP. Without FTAAP, many different definitions of the rules of origin are used for trade involving APEC economies, giving rise to the spaghetti bowl effect. An FTAAP with a simple and unified definition of the rules of origin results in a large integrated market, resulting in various economic benefits such as those arising from scale economies and increased competition.

In addition to those benefits accrued from trade liberalization under an FTAAP, Japan can expect to gain by the establishment of business friendly environment in APEC via FTAAP if it includes other components such as trade facilitation, FDI liberalization and facilitation, and economic cooperation, as those in EPA. As the FTAAP includes developed economy members along with Japan, we can expect comprehensive and high quality FTA including competition policy, protection of intellectual property right and others, which contribute to the establishment of a business friendly environment. Furthermore, FTAAP could contribute to establishing economic and social environment, under which transparency, accountability, and important principles can be appreciated.

One major obstacle for the establishment of FTAAP for Japan is the liberalization of agricultural sector because of its possible negative impacts on employment and other aspects of agricultural production such as preservation of the natural environment. On this point Japan's decision on the FTA negotiation with Australia, which is expected to take place sometime soon, can be the litmus test to see the attitude of Japanese government toward FTAs and in particular toward the FTAAP. Liberalization of labor market may arise if the FTAAP includes such components. The discussions on this issue in sections V and VI indicate several ways to overcome these obstacles by adopting gradual liberalization and appropriate adjustment policies to deal with negatively impacted workers. On liberalization of agricultural imports under FTAAP one important positive impact for Japan is to ensure stable supply of food and some natural resources. In this regard it is important to have an agreement in the FTAAP to assure the strict implementation of business contracts on import and export transactions, and not to restrict export of these products.

One of the most important factors for the promotion of FTAs is strong political leadership as argued in the previous section. To establish an FTAAP, APEC Leaders have to lead the discussions and policy-making processes. In order for the leaders to exercise their leadership, they

need support from general public. Various means can be used to increase the awareness of general public for the need of FTAAP. One effective way is through mutual understanding, specifically, increasing the exchange of people of all levels is important to achieve this objective. Since business people have developed close networks, it is non-business people that need to increase their exchange with their counterparts in FTAAP member economies.

The need to revitalize APEC has to be emphasized to promote the FTAAP. One can expect that discussions on FTAAP would reinvigorate APEC, but policy makers' interest in APEC as an economic forum have to be revived, since their interest in APEC as an economic forum have been quite low after its failure to deal with financial crisis and with an increase in interests in political issues such as terrorists' attacks. One important contribution that the business sector can make toward increasing awareness of the need for an FTAAP is to appeal to political leaders that the emergence of bilateral and minilateral FTAs in the Asia Pacific region is making their business difficult due to the different rules associated with different FTAs and thus the establishment of FTAAP, which adopts unified rules, is needed.

Finally, considering that moves toward establishing East Asia FTA (EAFTA) are gaining momentum and a lack of active interest in establishing FTAAP in Japan, it seems natural to assume that FTAAP is considered as an agenda after EAFTA. However, it is in the interest of Japan to promote FTAAP as it generates substantial benefits for Japan.

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Table 1 Japan's FTA Developments

Country	Status	Year
Singapore	In effect	November 2002
Mexico	In effect	April 2005
Malaysia	In effect	July 2006
Philippines	Broad agreement	November 2004
Thailand	Broad agreement	September 2005
Korea	In negotiation	December 2004
ASEAN	In negotiation	April 2005
Indonesia	In negotiation	July 2005
Chile	In negotiation	February 2006
Brunei	Agreed to negotiate	May 2006
GCC Countries	Scheduled to begin negotiation	July 2006
Vietnam	Under study	February 2006
India	Agreed to negotiate	Early 2007
Australia	Under study	November 2005
Switzerland	Under study	October 2005

Source: Ministry of Economy, Trade and Industry

Table 2 Major Contentious Issues for Japan in FTA Negotiations: Selected Cases

Mexico	Trade liberalization in agricultural products including pork, beef, and chicken products, oranges, and orange juice.
Thailand	Trade liberalization in rice Liberalization of the movement of natural persons, specifically cooks, nurses, massage therapist, and care-givers for the elderly.
Philippines	Trade liberalization in bananas Liberalization of the movement of natural persons, specifically nurses, and care-givers for the elderly.
Malaysia	Trade liberalization in plywood
Korea	Trade liberalization in fish products, refined copper products

Source: Nihon Keizai Shimbun, October 10, 2004 and hearing from the country officials

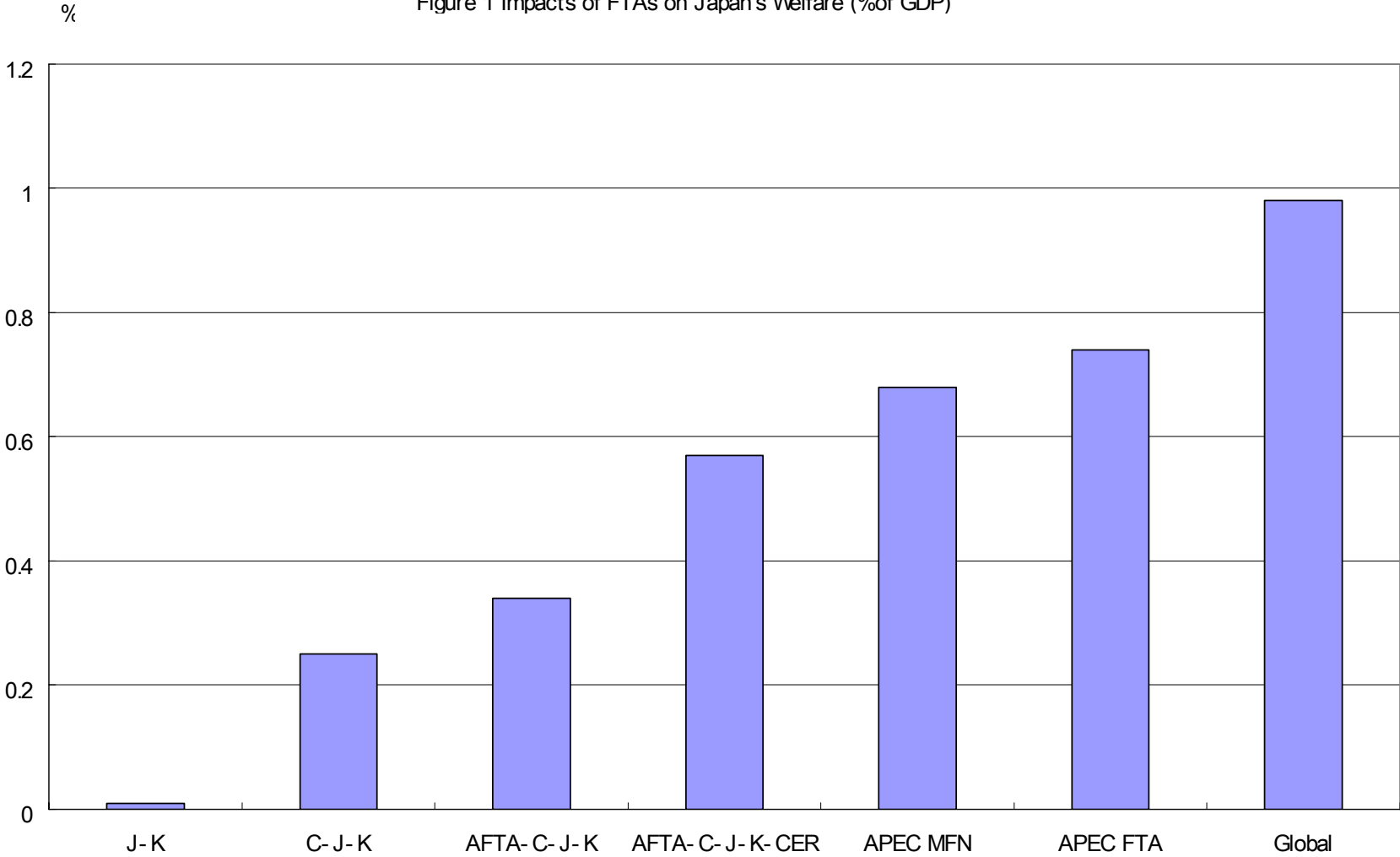
Table 3 Average tariff rates in ASEAN+3, 2001

(%)

	Japan	China	Korea	ASEAN	Indonesia	Malaysia	Philippines	Singapore	Thailand	Vietnam
Agriculture and food	30.2	37.6	81.7	13.9	5.0	17.1	9.5	0.4	29.4	30.7
Natural resources	0.1	0.3	3.8	0.8	0.3	1.4	3.1	0.0	0.4	3.2
Textile and apparel	9.0	20.5	10.0	11.1	8.6	12.3	6.5	0.0	18.5	21.4
Wood and paper products	1.1	9.0	4.0	5.4	3.4	6.6	4.7	0.0	11.0	12.0
Chemical products	1.1	13.0	6.7	5.2	4.4	5.9	4.5	0.0	11.7	7.3
Metal products	0.5	7.5	3.8	5.6	5.9	8.5	3.9	0.0	9.3	4.7
Machinery	0.1	13.1	6.1	3.3	3.0	3.9	2.3	0.0	8.2	7.5
Electronic machinery	0.0	10.1	1.1	0.8	2.1	0.4	0.1	0.0	4.7	8.8
Transport equipment	0.0	20.5	3.9	14.6	9.6	31.7	11.5	0.0	24.0	42.1
Other manufacturing	5.3	13.9	8.5	6.1	6.5	6.8	6.1	0.0	7.1	18.4
Trade	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Construction	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transport and communication	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public services	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other services	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Manufacturing	1.7	12.7	4.7	4.2	5.0	4.8	2.4	0.0	9.6	13.0
Total	4.1	11.6	8.5	4.0	3.6	4.7	2.8	0.0	8.8	10.0

Data source: GTAP ver.6 database.

Figure 1 Impacts of FTAs on Japan's Welfare (%of GDP)



Endnotes

¹ This paper expands extensively Urata (2005).

² Keidanren (2003)

³ Ministry of Foreign Affairs, <http://www.mofa.go.jp/region/asia-paci/asean/pmv0310/framework.html>

⁴ The Ministry of Economy, Trade and Industry (2006).

⁵ The Ministry of Foreign Affairs of the Japanese government released a document entitled “Japan’s FTA Strategy” in November 2002. http://www.mofa.go.jp/mofaj/gaiko/fta/senryaku_05.html

⁶ World Bank, World Development Indicators 2003, publication.

⁷ For the impacts of RTAs, see, for example, Winters (1991).

⁸ See Schiff and Winters (2003) for useful discussions on the dos and don’ts of regional trade agreements.

⁹ METI (2001) also provides detailed analysis on economic impacts of EU and NAFTA.

¹⁰ METI, an internal document.

¹¹ Scollay and Gilbert (2001)

¹² See, for example, Kawasaki (2003), Ando and Urata (2006) for the impacts including some dynamic impacts

¹³ Ministry of Agriculture, Forestry, and Fisheries home page.
<http://www.maff.go.jp/hitokuti/top.htm#mokuji1>

¹⁴ Ministry of Foreign Affairs, Japan-Singapore Economic Partnership Agreement,

<http://www.mofa.go.jp/mofaj/area/singapore/kyotei/pdfs/f-6.pdf>

¹⁵ It may not be appropriate to take up non-economic obstacles in the discussions of FTA, because all APEC economies are WTO members and thus can be FTA partners. However, some politicians and observers regard non-economic factors to be important in discussing FTAs because to them FTAs are more than trade policy but the policies built on mutual trust.

¹⁶ See Yamashita (2004) for the discussion.

¹⁷ The GATT/WTO rules allow ten years to complete trade liberalization under FTAs.

¹⁸ In Japan various forums have been established for the promotion of Japan’s FTAs mainly involving business and academics. Although such activities are gaining momentum and therefore are likely to increase the awareness of the importance of FTAs among Japanese people, there is still a need for further and greater efforts to make the FTA issue as high-priority agenda.