

ECONOMIC DIPLOMACY

From leading to following in the region

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IN THE post-war period, Japan played an important and active role in creating and providing public goods and development assistance in the region, and in maintaining open and robust markets. For example, Japan effectively led the establishment of the Asian Development Bank, and, together with Australia, was instrumental in the creation of APEC.

But for the past decade or more Japan's foreign economic diplomacy has stalled, and the nation is doing little to actively contribute to shaping a stable and prosperous region at a time when regional and global institutions are under pressure, in a state of transition and flux.

Japan is a member of the G20, the preeminent steering committee for the global economy, but it has been missing in action in that forum as it hankers for the days when it was Asia's sole representative at the G7/G8—a grouping that has outlasted its relevance, given that the global economy is no longer dominated by the rich club of advanced economies.

Characteristic of its role in the G20, Japan's economic diplomacy has been drifting. Long-term economic slowdown has brought with it a stronger tendency of inward-lookingness, exacerbated by the Tohoku triple disaster of 2011. Lack of political leadership and the inability to carry through the liberalisation of agriculture has hampered Japan's participation in any meaningful

foreign economic policy beyond narrow and relatively unimportant trade agreements. Those agreements have come in the form of economic partnership agreements (EPAs) with developing countries that aim to secure Japanese investment abroad while generally avoiding opening markets so that agriculture at home can continue to be protected.

Free trade agreements (FTAs) with Australia and South Korea are being negotiated, a China–Japan–Korea FTA is under study, and an FTA with the European Union is on the horizon. Japan has shown an interest in joining the Trans-Pacific Partnership (TPP) agreement as well, but the main barrier to Japan concluding or joining all these agreements is its inability to reform key areas at home, most notably by opening up agriculture.

It is often the case—perhaps especially so in Japan—that the private sector leads the way while government policy lags behind. That is true on many domestic issues, such as in the labour market, where the inability to

reform has forced companies to hire part-time and non-regular workers, thus dividing the labour market in economically inefficient and socially unhealthy ways. Internationally, Japanese multinationals have continued to lead the offshoring of Japanese manufacturing and development of regional supply chains. And the relocation abroad of Japanese companies of all sizes has led to policies that strengthen investment protection through EPAs, not the other way around.

After multilateral liberalisation, bilateral or preferential agreements (such as FTAs or the TPP) are at most a second- or third-best option for trade liberalisation—and it is not clear whether they may have become the enemy of the first best. If the aim is (as it should be) to further open up protected and inefficient industries and make the economy more flexible, competitive and dynamic, a country's priorities should focus on unilateral liberalisation and reform, from which it stands to gain the most. The difficulties with that strategy are not arguments for a strategy of narrow bilateral deals.

The purpose of Japanese trade or foreign economic policy is to increase the welfare of Japanese people and further Japanese interests abroad. The priorities in Japan are to open its economy to foreign competition, especially in services and agriculture. Japan attracts very little foreign direct investment relative to its size, and regulatory and other barriers

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inhibit the kinds of flows that occur into similar industrial economies. As Japanese firms continue to move operations to China and the rest of East Asia, the Japanese economy needs to continue to open up beyond its low tariffs on manufacturing goods so that it can benefit from deeper integration into the dynamic regional economy, especially with China.

Japanese leaders may need *gaiatsu*, or foreign pressure, to help initiate some of the difficult domestic reforms. This has been the case in the past. The TPP has been seen as just such a tool for opening up agriculture at home, bringing the weight of the TPP members—but most importantly the United States—to play as a lever. Given the political commitment to current FTAs, Japan could use them to help push long-overdue domestic reforms. That should be done not preferentially but in a way that opens up Japan to the world, not just to selected partners.

The multilateral trading system has been important for Japan's development and its peaceful integration into the global economy in the post-war period. Two examples illustrate that.

First, Australia's decision effectively to grant most-favoured-nation status to Japan in 1957—very soon after World War II—and then extend equal treatment to investment and people movement in 1976 helped to secure Japan's dependence on open global markets for raw materials and energy. These arrangements were bilateral but entirely non-discriminatory in character.

The second example is China's accession to the World Trade Organization in 2001 and the process leading up to it. China committed itself to the global trading rules, something most clearly seen in its unilateral liberalisation and 15-year-



A special case: Japan has generally avoided opening home markets to ensure that domestic agriculture can continue to be protected.

long process of showing the world its commitment to those rules, locking in reforms towards a market-based economy. Japanese companies could be confident in dealing with a China that was committing itself to the same rules and norms that governed its own international dealings. That's what allowed the bilateral Sino-Japanese trade and investment relationship to flourish, based on comparative advantage and mutual gain instead of bedevilled by divisive politics. Their unresolved history, regional rivalry and political differences did not prevent them from developing a huge economic relationship. An FTA would not have led to the same outcome.

The importance of the multilateral framework for Japan underlines the country's strategic interest in having a clear strategy towards regional and bilateral agreements that do not pick and choose partner countries to do business with in ways that hurt particular economic or

political interests in the region. For this reason, it would be unwise for Japan to sign on to the TPP without signing on to the China-Japan-Korea agreement or a major East Asian agreement (such as the ASEAN-led Regional Comprehensive Economic Partnership), given the likelihood that China will not be a TPP member any time soon. China is, after all, Japan's largest trading partner, and the same can be said for almost all of Japan's other big trading partners.

Re-awakening Japanese interest in helping to create both regional and global public goods could start with a more active role by Japan in regional community building through institutions such as APEC and actively using the G20 to shape those regional interests. **EAFO**

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