

# Japan's FTAs as Tools for Achieving Companies' Commercial Interests: Do Japanese Corporations Need a Region-Wide Trade Liberalization Treaty?

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## Abstract

*Since the 1950s and 60s, Japanese companies have been shifting their manufacturing operations overseas. As the private sector invested more and more abroad and became dependent on the production base in East Asia, it became evident that some sort of formal agreement was needed to stabilize the situation in the FDI-host countries and consolidate the internationalization of production networks. Japanese bilateral free trade agreements (FTAs) were utilized for this purpose. The Ministry of Economy, Trade and Industry (METI) has often stated that FTAs have been developed as a tool for securing firms' commercial interests. They have been a part of a broader policy of supporting rapid industrialization and economic growth since the Yoshida Doctrine. Japan has signed several bilateral FTAs as well as a semi-regional one with ASEAN and is currently participating in three coexisting frameworks with regional economic integration agendas, which include fostering of a region-wide FTA. This study focuses on the use of FTAs by Japanese corporations – FTAs' main clients – to date. It asks, what strategic commercial objectives do different types of existing FTAs (bilateral, semi-regional) fulfill for Japanese corporations, mainly in the electronics and machinery sectors, and how successful are they in performing this role? What additional value-added benefits could the planned region-wide FTA bring? In other words, do Japanese corporations need a region-wide FTA, or do the bilateral agreements and the semi-regional one provide a sufficient response to the firms' foreign commercial goals? I discuss the inter-constitutive nature of the value-added benefits of different levels of Japan's FTAs. Both trade theory and econometric studies of FTAs point to the conclusion that bilateral FTAs are a second-best option to semi-regional agreements, which, in turn, are less welfare enhancing than is regional or global multilateral liberalization. Despite that, this study finds that there is little support among Japanese MNCs in the electronics and machinery sector for a region-wide FTA. Research underpinning this analysis is based on a series of interviews with Japanese MNCs, governmental officials and analysts conducted by the author in Tokyo between 2009 and 2010.*

## 1. Introduction

The Ministry of Economy, Trade and Industry (METI) has often stated that free trade agreements (FTAs) have been developed as a tool for securing firms' commercial interests. Japan has signed several bilateral FTAs as well as a semi-regional one with ASEAN and is currently participating in three coexisting frameworks with a regional economic integration agenda, which includes the fostering of a region-wide FTA. The study focuses on the use of free trade agreements by Japanese corporations – FTAs' main clients – to date. It asks, what strategic commercial objectives do different types of existing FTAs fulfill for the Japanese corporations, and how successful are they in performing this role? What additional value-added benefits could the planned region-wide FTA bring? In other words, do Japanese corporations need a region-wide FTA, or

do the bilateral agreements and the semi-regional one provide a sufficient enough response to the firms' foreign commercial goals? Research underpinning this analysis is based on a series of interviews with Japanese multinational corporations (MNCs), government officials and analysts, conducted by the author in Tokyo between 2009 and 2010. It is a part of a broader research project to analyze the complex interaction between various levels of factors influencing the preferences of Japan's main actors regarding a region-wide FTA. The research argues that these main actors' preferences are central to the process of FTA policy formation. Based on Aggarwal's framework<sup>1</sup> it appears that political and diplomatic efforts are required for a country to sign a new FTA or to harmonize the existing ones. There have to be enough aggregated, expected gains from the outcome to provide sufficient incentive for signing of a treaty.<sup>2</sup> Therefore, the research focuses on the preferences, understood as the optimal, desired outcome, of the main groups of actors. The understanding behind this methodology is that in order for an FTA to be signed, pro-liberalization preferences within the country must exceed anti-liberalization ones. In this study, I focus on one group of actors – the private sector, namely the Japanese MNCs, from the electronics and machinery industries, primarily. This limitation results from the fact that preferences regarding FTAs differ greatly between sectors, making it impossible to define interests of the private sector as a whole. The two selected sectors had vested interests in the formation of an FTA network in East Asia, given the location of their production facilities and the importance of trade in parts and components for their operations.

The present study fits within the 'multilateralizing bilateralism' debate,<sup>3</sup> which focuses on the issue of harmonization and consolidation of FTAs; this union would mean a progression from bilateral agreements to a semi-regional one (ASEAN-Japan Comprehensive Economic Partnership) and, perhaps, a multilateral, region-wide treaty in the future. To this aim, I establish what the companies' preferences for different types of FTAs were in order to explain Japan's overlapping trade treaties with ASEAN members. Then, I look at current preferences for a region-wide agreement in Asia to assess how much support there is for such a treaty, and to understand why, despite Japan's participation in several regional economic integration schemes, there is little progress in this regard. As Japan's MNCs were often referred to as the main supporters of Japan's FTAs,<sup>4</sup> their preferences are an important factor that may tip the scale of domestic support.

Trade theory states that the more countries participate in an FTA, the more economic gains it is likely to bring. The gravity model has been used to research the desirability of different variants of an East Asian FTA, such as an ASEAN+3 FTA, an ASEAN+6 FTA and so on. A wider regional agreement would potentially bring higher economic gains for all members. An ASEAN+3 FTA would have a bigger trade creation effect than a similar agreement between Japan, China and South Korea, though it would, in turn, be less profitable than ASEAN+6.<sup>5</sup> Both trade theory and econometric studies of FTAs conclude that bilateral FTAs are a second-best option to semi-regional agreements, which, in turn, are less welfare enhancing than regional or global multilateral liberalization. The size of benefits from trade treaties for a given economy depends on several factors, out of which the scope and depth of the agreement is not the least important. Even if we assume modest benefits from trade liberalization, according to this reasoning, the private sector should profit from establishing a region-wide FTA in East Asia. Still, this study finds that there is little support among companies in the electronics and machinery sectors for a region-wide FTA. This lack is caused by the type of production organization the Japanese multinational companies use, and by the market-led economic integration in East Asia. This article presents the added benefits of Japan's bilateral FTAs, and those of the agreement with ASEAN, from the private sector's perspective. It explains why the companies are more interested in deepening liberalization under the bilateral treaties than in increasing efforts for a region-wide agreement. Parts two, three and four of this article present the impact of tariff liberalization under FTAs in East Asia on Japanese MNCs. Part five analyzes the current interest in a region-wide agreement.

## 2. Emergence of Vertically Integrated Production Networks and the Impact of the ASEAN FTA (AFTA)

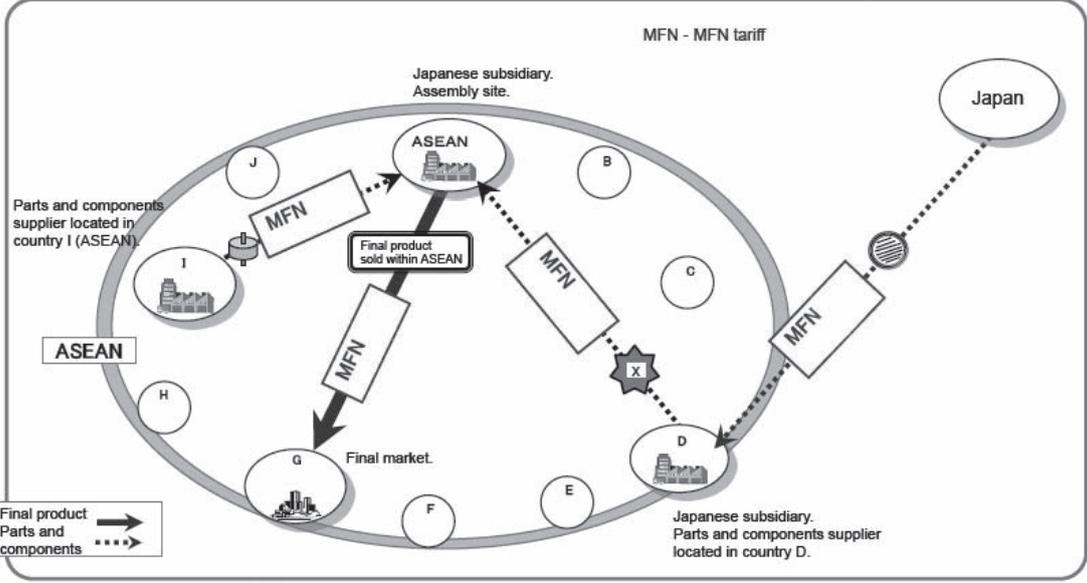
East Asia has been an increasingly important market for Japanese companies over the last several decades. As Japan is a developed economy with an ageing society, the companies would struggle to survive on the local market alone.<sup>6</sup> Japanese companies started investing in moving their production networks to other countries in the 1950s and 1960s. The Plaza Accord of September 1985 reinforced this process. It was the turning point for Japan, commencing the shift from a multilateral approach to liberalization, based on the WTO, to a multi-track one in the late 1990s, whereby the country pursued FTAs parallel to the WTO negotiations. After the Plaza Accord and the realignment of Yen to the US dollar, the dollar depreciated against the appreciating Yen, making Japanese products expensive on the US market. Continuing to manufacture all products within Japan was no longer profitable for many, especially labor-intensive industries. Although Japanese companies, even today, prefer to manufacture core parts and components within Japan, they have continued to move production bases outside the country. This shift was first directed to the newly industrialized economies (NIEs) – Hong Kong, South Korea, Singapore and Taiwan – and then to the ASEAN countries. A large number of the investing companies were in the electronic and electrical appliance sectors as well as machinery and automobile sectors. Japan's core foreign economic goal, at the time, was to consolidate the situation after the Plaza Accord. As the private sector invested more and more abroad and became dependent on the production base in East Asia, it became evident that some sort of formal agreement was needed to stabilize the situation in the foreign direct investment (FDI)-host countries, and to consolidate the internationalization of the production networks. Such agreement would aim to preserve the *status quo*.

The years 1999 and 2000 brought a change in Japan's policy towards trade agreements, as many countries in the region were starting to think about bilateral FTAs, and China proposed a treaty to ASEAN in 2000. China's FTA proposal to ASEAN was the main trigger for Japan's shift to bilateral FTAs, but because so much of the groundwork had already been done, Japan was able to change its policy quickly.<sup>7</sup> The Japanese production networks established in the ASEAN countries were then extended to China in the late 1990s. The core of this network shifted to Thailand, Malaysia and Singapore in the following years. This spread further influenced companies' interest in the region. After securing the country's first FTA with Singapore, the Japanese government had a clear idea of what could help MNCs' operations – an agreement with ASEAN countries. As Japan's production network is located in East Asia, an FTA with ASEAN members would help business operations there. Thailand's average MFN tariff was 8.2 percent, which made importing parts and components expensive for Japanese companies.<sup>8</sup> However, instead of negotiating an FTA with ASEAN as China and Korea did, Japan started by negotiating bilateral agreements with several ASEAN members first. This was the Ministry of Foreign Affairs' (MOFA) preference, as it wanted to use bilateral agreements as a tool for strengthening bilateral relations.<sup>9</sup> Additionally, this strategy allowed Japan to avoid the situation where ASEAN member countries could block its demands during FTA negotiations; it had more bargaining power in bilateral negotiations.

When Japanese companies shifted their production to East Asia, they established vertically integrated production networks. This phenomenon, also known as internationalization of production, production fragmentation or production sharing, occurs when companies move their labor-intensive stages of production abroad to less developed countries while the capital-intensive stages are carried through at home, where parts or intermediate goods are further processed. Hence, manufacturing stages occur in the most cost-efficient locations. In East Asia, the intra-industry trade in parts and components, related to production fragmentation, has not only increased the

overall volume of intraregional trade, but it has also strengthened regional interdependence. Production sharing spread in the region due to ‘the region’s wide range of development levels, strong intraregional links, and capacity for organizational and technological change.’<sup>10</sup>

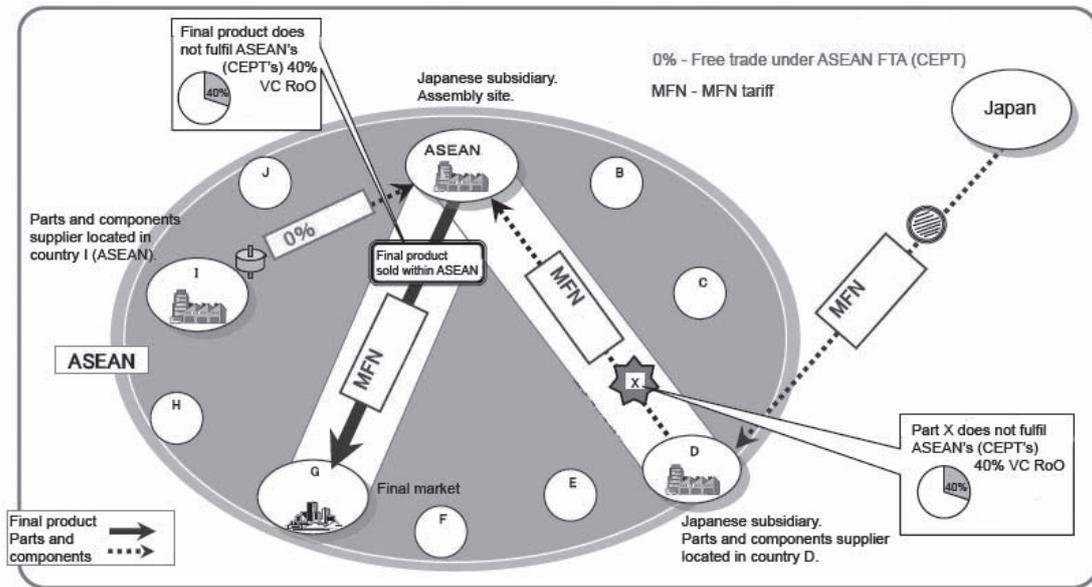
Figure 1



Source: AJCEP: ASEAN-Japan Comprehensive Economic Partnership, METI, October 23, 2008, [http://www.meti.go.jp/policy/trade\\_policy/epa/data/081023\\_AJCEPgaiyo.pdf](http://www.meti.go.jp/policy/trade_policy/epa/data/081023_AJCEPgaiyo.pdf) (Accessed June 20, 2010). (Author’s translation)

Figure 1 presents the situation in East Asia before 1992 from the perspective of Japan’s MNCs with a vertically integrated production network. In the 1990s, a Japanese company operating a parts production facility (D) and an assembly site in ASEAN had to pay tariffs at universal rates (most favorite nation tariff – MFN), while exporting parts and components from Japan to the respective factories. Similarly, MFN tariffs had to be paid when exporting a part from one ASEAN member country to another (D), when obtaining additional parts originating in ASEAN (I), and when exporting the finished good to the ASEAN market (G). In this figure, the dotted line represents parts, components and intermediates. The solid line represents trade in finished goods.

Figure 2



Source: AJCEP: ASEAN-Japan Comprehensive Economic Partnership, METI, October 23, 2008, [http://www.meti.go.jp/policy/trade\\_policy/epa/data/081023\\_AJCEPgaiyo.pdf](http://www.meti.go.jp/policy/trade_policy/epa/data/081023_AJCEPgaiyo.pdf) (Accessed June 20, 2010). (Author's translation)

Figure 2 represents how the 1992 signing of the ASEAN Free Trade Agreement (AFTA) affected the production networks of Japanese MNCs. AFTA allowed the assembling site to import parts and components from other ASEAN member states (I) without paying tariffs. As the agreement set a 40 percent minimum local content rule of origin (RoO) for the good to be traded under preferential tariffs, any product exceeding this amount was still exported from a parts production facility (D) and assembly site under the MFN tariff.

### 3. Bilateral Free Trade Agreements

Japanese companies started supporting FTAs due to the increasing competition in the Asian markets. Bilateral FTAs offer Japanese multinational firms many benefits. For instance, they protect companies from the competition of other countries entering the same market. Companies are able to import parts and machinery from Japan to the FTA partner country, where their production facilities are located, under reduced tariffs. This deal is mainly the case for ASEAN members, which provide Japanese MNCs with resources and intermediates. Manger argues that "Japanese firms with vertically integrated operations in the host country emerge as key supporters of FTAs, in particular when their profits are under threat from FTAs signed by other countries."<sup>11</sup> Vertically integrated multinationals have production facilities, as well as parts and components suppliers, in different countries. The removal of tariffs under an FTA facilitates the movement of parts and materials between production and assembling facilities, and also the sale of the final good. Additionally, companies lower their costs and increase returns on investments. Therefore, Japan's subsidiaries in host countries made their support for bilateral free trade agreements known to the local and Japanese governments. Blechinger and Legewie state that "regional cooperation was mainly promoted by multinational firms interested in building up a horizontal division of labour

with regional production and sales networks to connect their various overseas activities on a more efficient regional scale.”<sup>12</sup> The proliferation of bilateral or preferential trade agreements, worldwide and in the region, is one of the reasons behind Japan’s pursuit of FTAs, as explained by Baldwin’s domino theory and the competitive liberalization theory (Baldwin 2004; Bergsten 1994; Dobson 2001). It implies that the proliferation of FTAs in a region causes other countries to sign further trade agreements to offset the trade diversion effects of those already in existence. In other words: FTAs beget further FTAs. In particular, the agreements signed by the US, China, and recently, Korea, are of great concern to Japan’s private sector. Currently, the FTA between the EU and South Korea worries Japan. The EU tariffs are considerably high, especially on electrical appliances, with a maximum tariff of 14 percent.<sup>13</sup> On the other hand, the EU is also negotiating an agreement with ASEAN and India. An EU-ASEAN FTA would be good for Japan as the country’s production base is located mainly in the ASEAN region.

The private sector also profits from the type of FTAs Japan is signing. Japan names its FTAs Economic Partnership Agreements (EPAs), given the inclusion of some elements and various provisions aiming at the harmonization of regulations and economic cooperation. They are, so called, ‘broad band’ agreements. ‘Broad band FTA’ is a generic name for FTAs including comprehensive commitments to liberalization of non-tariff barriers to trade. They can include various provisions ranging from eliminating technical barriers to trade (TBTs) and enforcing rules on intellectual property rights (IPR) and government procurement, to overseeing competition policy and investment measures. They are also concerned with issues such as labor and environment, as well as various forms of further cooperation. Broad band FTAs include ‘deep’ integration measures, meaning that they remove not only border barriers, but also beyond-the-border measures.<sup>14</sup> They can include provisions on: transparency in government procurement, trade facilitation, investment, competition policy, cooperation in environmental issues, IT, or labor standards. This type of FTA is directly aimed at certain companies’ interests, particularly in the manufacturing sector. For them, tariff reduction is still important, despite the falling of MFN rates, but a strong focus is also placed on how FTAs can further improve operations of production networks and secure Japanese investments in East Asian markets. Therefore, the country’s FTAs focus on elements that help to achieve that, such as: trade facilitation, investment protection or facilitation, economic cooperation, and international financial policy cooperation. Improving the business environment in partner countries and influencing the East Asian states to introduce necessary reforms is an important motivation for Japan.<sup>15</sup>

In many cases, FTAs function as a defensive tool; they are signed as a result of domestic pressure from the private sector, namely by companies in a disadvantaged position due to trade treaties signed by other countries. For example, following the implementation of NAFTA and the signature of the Mexico-EU Free Trade Agreement, Japanese manufacturers found themselves in a disadvantaged position on the Mexican market. They had an incentive to lobby the government to negotiate a similar treaty that would provide them with equal market access. Whereas their American and European counterparts enjoyed preferential access, Japanese MNCs, among the OECD members, were the only ones to pay high customs duties on automobiles in Mexico. At the time, Mexico’s tariffs averaged 16 percent and tariffs on automobiles were 50 percent.<sup>16</sup> NAFTA members exported automobiles to Mexico duty-free, while the EU countries paid 10 percent tariffs. The Japanese automobile sector demonstrated its losses and asked the government to sign an FTA. It was not the only sector that lobbied for the establishment of this treaty. Mexico grants a preferential status in government procurement to its FTA partners. This setup prevented Japanese companies in the electronics sector, among other companies, from selling power generation equipment and hospital-use medical equipment to that country.<sup>17</sup> For example, X-ray medical equipment exported to Mexico was subjected to a 40 percent customs duty.<sup>18</sup>

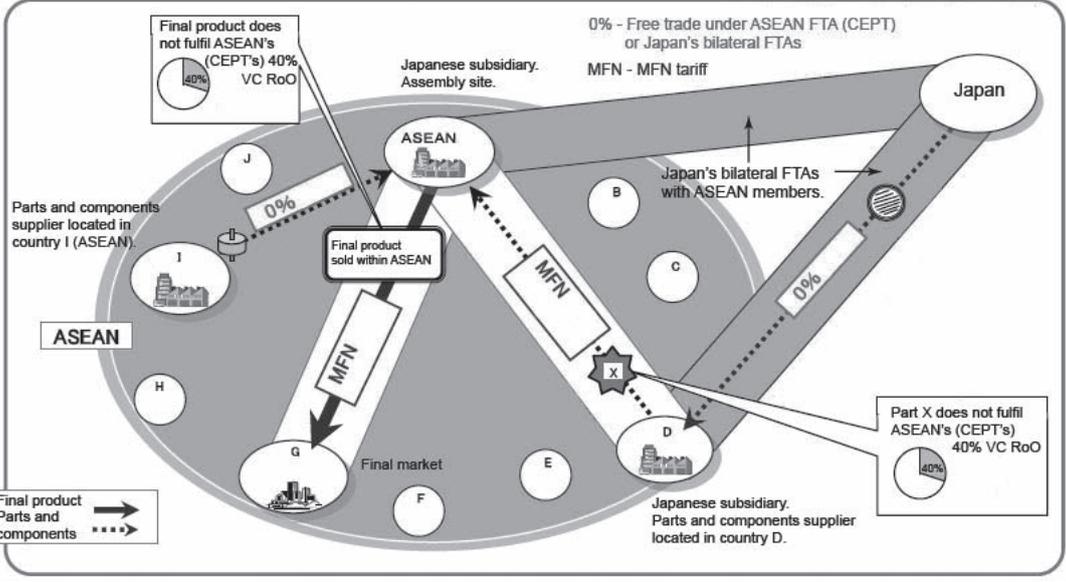
As explained earlier, the companies’ preferences regarding bilateral FTAs differ from sector

to sector. They can also differ substantially within the sectors, depending on how much a given company has invested and operates in the prospective FTA partner country. The 'big three' of Japanese auto companies, Toyota, Nissan and Honda, have already had operations in Mexico and enjoyed a tariff-free quota on imports. This tariff-free quota was available under a Mexican government's provision, whereby it "allowed for duty-free imports of finished vehicles, equivalent to 10 percent of their local production, for foreign assemblers in Mexico."<sup>19</sup> Those companies had an advantage over other Japanese automakers such as Suzuki or Mazda, which had to pay high taxes in order to penetrate the Mexican market and had no export quota. Hence, the 'big three' companies did not strongly support the Japan-Mexico FTA. The preferences of automobile companies differed also in the case of the Japan-Malaysia FTA. Malaysia implemented high tariffs on cars and supported its domestic auto industry with subsidies and a national car policy. One of the two dominant Malaysian producers, Perodua, cooperated with Japanese automobile company Daihatsu Motor in a joint venture.<sup>20</sup> Daihatsu provided a substantial amount of technology and sent staff members to cooperate with the national brand. The company enjoyed high tariff protection that gave it an advantage on the Malaysian market. Therefore, it was against the Japan-Malaysia FTA. A similar situation is taking place in India, where Suzuki produces automobiles for the local market through a Maruti Suzuki joint venture; here, Suzuki holds over 50 percent of stakes. As India implements high tariffs on cars, an India-Japan FTA would have a negative impact on Suzuki's operations in the country.

According to Japan External Trade Organization (JETRO) statistics, out of all its bilateral FTAs, Japan uses the agreement with Thailand and Malaysia the most.<sup>21</sup> These countries are hubs for Japanese companies' production in the region. Japan-Thailand and Japan-Malaysia Economic Partnership Agreements are followed by AFTA,<sup>22</sup> which is heavily utilized by Japanese MNCs for obtaining parts and components as well as selling finished goods to other ASEAN countries. Given the location of those companies' production bases, FTAs between third parties often play a crucial role. This trend is particularly true in case of the electronics sector, in which most products are produced in East Asia, and hence, there are few finished goods to export from Japan. A great majority of the industry's finished goods, still manufactured in Japan, are on the Information Technology Agreement (ITA) product list and are therefore exported duty-free. Thanks to ITA, companies import parts and components to their production sites in ASEAN states without customs duties. With no products to export and no customs duties to pay, the impact of an FTA is limited at best. Industries such as automobile, chemical and apparel still manufacture a part of their goods in Japan and so use Japan's FTAs.<sup>23</sup> A substantial number of companies in the electronics industry use AFTA to obtain parts and sell goods to ASEAN. For example, one of Japan's leading multinational companies in the electronics sector produces many of its goods in Thailand, to which it imports parts from other ASEAN countries under AFTA.<sup>24</sup> A few parts are also imported from Japan under the Japan-Thailand FTA (JTEPA), or from China and Korea under their respective FTAs with ASEAN. Finished goods are exported from Thailand to other ASEAN countries under AFTA and to third parties under, for example, the ASEAN-India FTA. Hence, Japanese companies use many FTAs of which Japan is not necessarily a member. Japanese automobile companies manufacture their products for Indian and Australian markets in Thailand. Both of these countries are large and important markets. The increase in the volume of automobile exports from Thailand to Australia is strongly related to sales of cars made in Thailand by Japanese companies, such as Honda and Toyota.<sup>25</sup> A substantial amount of Suzuki's production is located in India through Maruti Suzuki. Thailand-Australia and Thailand-India FTAs are heavily utilized by Japanese companies both in the electronics and automobile sectors. For example, representatives of Japan's private sector located in Thailand communicated closely with the Thai government, expressing their preferences regarding a free trade agreement with India.<sup>26</sup> As a result, 82 products, selected for the Early Harvest Program between Thailand and India (84 Har-

monized Commodity Description and Coding System subheading categories), included parts for televisions, air conditioners and gear boxes – goods produced by Japanese companies in Thailand.

Figure 3



Source: AJCEP: ASEAN-Japan Comprehensive Economic Partnership, METI, October 23, 2008, [http://www.meti.go.jp/policy/trade\\_policy/epa/data/081023\\_AJCEPgaiyo.pdf](http://www.meti.go.jp/policy/trade_policy/epa/data/081023_AJCEPgaiyo.pdf) (Accessed June 20, 2010). (Author’s translation)

Figure 3 shows the impact of tariff reductions only. Of course, Japan’s bilateral FTAs are comprehensive agreements and the broad band FTA provisions within them are the main source of companies’ benefits, as was explained earlier. After signing bilateral agreements with ASEAN members, companies with vertically integrated production networks were able to import parts and intermediates from Japan to the parts factory (D) and the assembling site. However, they still needed to pay the MFN tariff when trading goods exceeding 40 percent local content within ASEAN.

**4. ASEAN-Japan Comprehensive Economic Partnership (AJCEP)**

After the signing of bilateral agreements with ASEAN members, what was the incentive for signing a semi-regional FTA with ASEAN as a group? And why were the bilateral agreements kept after AJCEP was reached? For the countries with which Japan already had a bilateral FTA, companies could choose under which agreement they wanted to trade. An exporter wishing to sell products to Thailand may compare the tariff rates for that good between the MFN tariff, the Japan-Thailand FTA, and the Japan-ASEAN FTA and simply choose the lowest one. Keeping the bilateral FTAs while implementing AJCEP was discussed with members of the private sector, who stated that they were used to utilizing particular provisions of the existing treaties. As companies are used to utilizing particular parts of bilateral treaties and their areas of operation

are quite narrow, the coexistence of the two types of agreements, from their perspective, does not pose a problem.<sup>27</sup>

The objectives of bilateral and semi-regional agreements are somewhat different. Bilateral FTAs with ASEAN members often offer deeper tariff concessions than AJCEP, as well as some WTO-plus provisions. AJCEP is an agreement on goods only. Additionally, the tariff reduction schedules in AJCEP were incorporated from bilateral agreements with particular countries. This means that AJCEP does not have a common implementation schedule. As the bilateral agreements were signed earlier, their implementation schedules started earlier and hence, the current tariffs are often lower, even if the liberalization schedule is the same for both agreements. If under JTEPA Thailand was allowed to liberalize a tariff for a product over 10 years, under the semi-regional agreement (AJCEPA), the phase-in schedules were, in most cases, set for the same amount of time.<sup>28</sup> However, in the case of Malaysia and Singapore, bilateral agreements went into effect in 2006, two years before AJCEPA. For Thailand, this gap is one year. On the other hand, for some goods, such as textiles, AJCEP is more profitable for Japanese companies as it introduces immediate tariff elimination. The treaty also covers all ASEAN countries, including the least developed ones (Myanmar, Brunei and Cambodia). In a way, it could be conceptualized as the lowest common denominator in terms of trade liberalization between Japan and the Association's members. It was politically important to have an agreement with all ASEAN countries.<sup>29</sup> An agreement with Thailand, Malaysia, the Philippines, Indonesia, Singapore (the ASEAN 5) and perhaps Vietnam was important for companies in the discussed sectors. The other four countries were attractive FTA partners from the perspective of textile and apparel industries.<sup>30</sup>

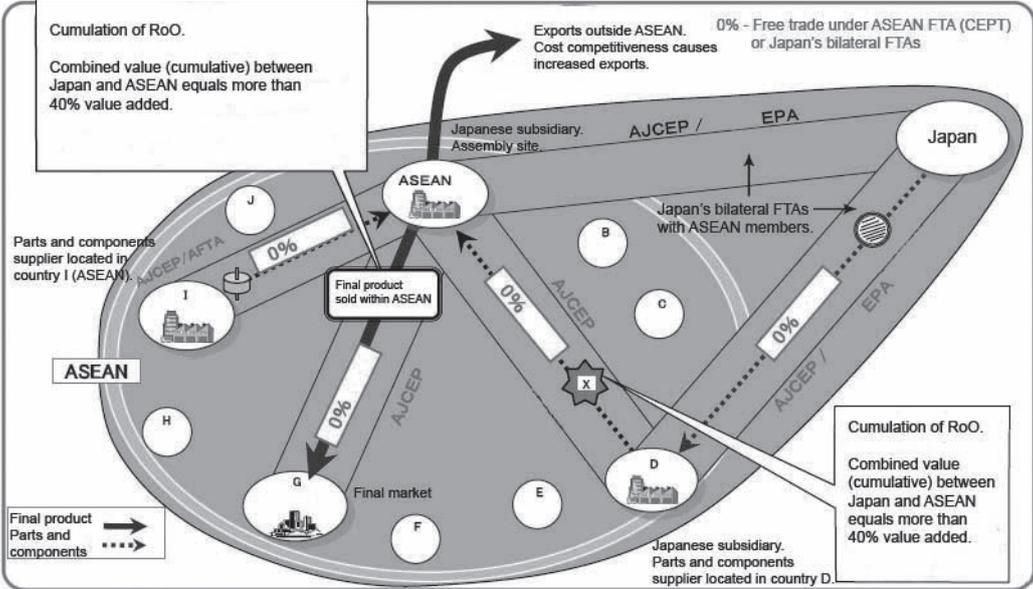
Rules of origin (RoO) determine the origin of a given good, preventing third parties (non-members) from using preferential tariffs. Their existence has a big impact on Japanese MNCs' operations. As one of the non-tariff barriers (NTBs) to trade, RoO can limit the company's ability to use FTAs. AJCEP simplifies the rules of origin by allowing companies to choose between VC and CTC rules. The VC rule of origin is based on a minimum local value-added content. The change in tariff classification (CTC) rule of origin requires a change of heading level under the Harmonized Commodity Description and Coding System (HS), an international classification system under World Customs Organization (WCO) that describes goods and products. This type of provision, known as co-equal RoO, is now becoming a standard in the region. According to recent studies, it is the preferred solution for most Japanese companies.<sup>31</sup> First, Japan introduced such criteria for several product lines in ASEAN-Japan and bilateral FTAs, with those between Japan and Malaysia<sup>32</sup> or Thailand as examples. Then, ASEAN-Korea<sup>33</sup> and ASEAN-Australia-New Zealand FTAs, and even ASEAN itself, adopted that system.<sup>34</sup> AANZFTA uses co-equal approach on approximately 83 percent of all tariff sub-headings.<sup>35</sup> Extending co-equal rule could offset the negative aspects of overlapping agreements and allow for the harmonization of RoOs in the future. When all FTA members use the same type of rules of origin, diagonal cumulation is possible as it was done in the case of the Pan-European Cumulation System from 1997 (PECS). It allows for cumulation of added value in all member countries when determining the origin of a given product. Materials originating in one member country are treated as local in other countries within the FTA. The product does not change origin once it enters the FTA territory. Diagonal cumulation creates a sort of 'RoO custom union' with common external rules of origin.

Cumulation of rules of origin is one of the most important features of AJCEP. Co-equal rule in the ASEAN-Japan FTA enabled companies to use parts and components of any origin.<sup>36</sup> They can now produce in Thailand using Korean parts under the ASEAN-Thailand FTA and export the finished product to other ASEAN countries duty-free under the AJCEPA, even if Korean parts constitute more than 40 percent of the finished good. A multinational company wishing to export parts and components to its subsidy or production site in ASEAN would use a bilateral agreement. AJCEPA, with the CTC rule, is more profitable for exporting the finished good to another

ASEAN member. This change is significant for many industries, especially those where the prices of products are similar and even small changes in tariff rates can decide who has the comparative advantage. For most sectors, the Japan-ASEAN FTA had little meaning in terms of tariff liberalization. Its value added lay in the possibility of cumulation. However, this potential for profit is utilized only by a few Japanese MNCs, who have vertically integrated production networks in ASEAN. Therefore, the private sector, as a whole, did not strongly support AJCEP.<sup>37</sup>

The electronics sector provides a good example of how an FTA with ASEAN is significant. The production bases of electronics companies are located mostly outside Japan and they often manufacture only a handful of products at home. Japanese TV manufacturers, for example, have production sites in ASEAN member countries.<sup>38</sup> A company producing an LCD TV within ASEAN imports the LCD flat panel from, for example, Japan, Korea, Taiwan or China, where they are produced. The panel in itself constitutes almost 60 or 70 percent of the final product's price, and in order to comply with AFTA, to be sold within ASEAN duty-free, the product should have a minimum of 40 percent local content. Japanese companies, though, import panels from outside ASEAN; this fact, given the value of the LCD panels, clearly means that the 40 percent local content requirement was not met. Having only the bilateral agreements with ASEAN members, Japanese companies would have benefited from importing the panel to ASEAN from Japan, Korea or China – which would have been duty-free under the ITA – and then sold the finished good locally under the bilateral FTAs. However, due to AFTA regulations dealing with export to other ASEAN countries, the MFN tariff had to be paid. At the same time, Korea signed an FTA with ASEAN, enabling it to export Korean LCD panels from one ASEAN country to another. Therefore, LCD panels produced in Japan lost their competitive advantage. So, in order to retain competitive advantage of panels and other high value added parts and components, Japanese companies from this sector strongly urged the government to sign a similar agreement.

Figure 4



Source: AJCEP: ASEAN-Japan Comprehensive Economic Partnership, METI, October 23, 2008, [http://www.meti.go.jp/policy/trade\\_policy/epa/data/081023\\_AJCEPgaiyo.pdf](http://www.meti.go.jp/policy/trade_policy/epa/data/081023_AJCEPgaiyo.pdf) (Accessed June 20, 2010). (Author's translation)

Figure 4 presents the impact of cumulation of RoO under the AJCEP. The ASEAN-Japan treaty liberalized trade in goods only, and there were no additional broad band provisions. A company with a vertically integrated production network was now able to trade both intermediates and the finished good within ASEAN under no tariffs, even if the finished product fell below 40 percent local ASEAN content.

There are additional reasons for implementing co-equal rule in AJCEP. For industries using a specific production process and technology, such as the chemical industry, CTC rule of origin is often impossible to apply. On the other hand, rules of origin based solely on the VC can be restrictive and difficult to comply with. An automobile is comprised of around 30 thousand parts and components which makes applying the local content rule of origin difficult. Big companies purchase parts from several to several hundreds of vendors and local suppliers, who often have little knowledge of rules of origin requirements. The company, on the other hand, requires a certificate to prove the origin of a given good. If the supplier refuses to issue a certificate, the buyers cannot buy the parts.

In 2010, the ASEAN Trade in Goods Agreement (ATIGA) consolidated the Common Effective Preferential Tariff (CEPT) and ASEAN Free Trade Agreement (AFTA) provisions, which were in force since 1992. The change, made after the ASEAN-Japan Comprehensive Economic Partnership was enacted, greatly diminished the benefits of the AJCEP agreement. Many Japanese MNCs, in the discussed sectors, no longer needed AJCEP, as they could profit from cumulation under AFTA. Companies tend to use bilateral FTAs, as they offer deeper concessions for exporting parts, components or finished goods from Japan to facilities in ASEAN countries. In order to further export products to other ASEAN members, they can use either AJCEP or ATIGA. Using ATIGA has an advantage for many companies. Japanese companies have been using the agreement since it went into effect, and hence, they are familiar with its provisions and functioning. The number of companies using AJCEP is very low.<sup>39</sup> This statement has been confirmed by the interviewed companies.

## **5. Region-wide Agreement and the Importance of Trade Facilitation**

In December 2004, Japan's Ministry of Foreign Affairs (MOFA) published a document entitled "Basic Policy Towards Further Promotion of Economic Partnership Agreements (EPAs)." This document presents Japan's strategy towards FTAs in East Asia: "EPAs contribute to the creation of international environment further beneficial to our country from the politically and diplomatically strategic points through, among others, fostering the establishment of an East Asian community."<sup>40</sup> A region-wide FTA would be the first and crucial step on this path. Japan stated its support for such initiative on many occasions and is currently participating in three coexisting frameworks with regional economic integration agendas, which include fostering of a regional FTA: ASEAN plus China, Japan and South Korea (ASEAN+3); ASEAN plus China, Japan, South Korea, India, Australia and New Zealand (ASEAN+6); and the Asia-Pacific Economic Cooperation (APEC). How do the FTAs' main clients – multinational corporations – see the prospects of a region-wide FTA? Is there a need for a further trade treaty?

The signing of the ASEAN-Japan FTA and the changing of rules under AFTA allowed companies to profit from cumulation between their sales and manufacturing facilities in member countries and headquarters in Japan. Additionally, the expanding FTA network offers them indirect access to other foreign markets. Under the current circumstances, the companies have worked out a way to maximize their profits and avoid paying tariffs where possible. They have found the best localization for their production and assembly facilities. As shown in Figure 4, the

cumulation of RoO under AJCEP, together with comprehensive, broad band provisions under bilateral FTAs, significantly dulled the issue of tariffs in East Asia. Of course, there are other matters of importance for Japanese industry, such as access to the Indian or Australian markets and inclusion of Taiwan in the FTA network. There are also other types of governmental incentive schemes that further complicate the spaghetti bowl effect in East Asia, and also factor into companies' choices of production location. For example, Thailand has introduced the eco-car incentives scheme for companies manufacturing green cars within the country. Under this program, the Thailand Board of Investment offers corporate income tax exemption for 8 years and duty-free importation of machinery for qualifying projects. In addition, the Finance Ministry offers further tax incentives. In order to qualify for the eco-car incentive scheme an auto-maker company needs to meet certain requirements: meet environmental standards, fulfill the minimum investment value, and be able to produce over 100,000 automotive units per year after five years from the beginning of the project. Furthermore, the company should manufacture certain key parts and assemble the car in Thailand. Nissan Motor Corporation was the first company to produce an eco-car under this scheme. Mitsubishi Motor, Toyota Motor and Honda Motor are among other companies interested in producing the eco-car in Thailand. The existence of such government incentive schemes, on top of preferential provisions under various FTAs, further complicates the situation in East Asia. The companies try to choose the best possible location for their production and assembly facilities amid a complex network of tariff reductions and various other regulations.

Keeping all of the above in mind, for the Japanese companies, the issues of investment liberalization and trade facilitation are becoming increasingly significant aspects of regional economic integration. Deep liberalization provisions have the potential to improve Japanese MNCs' operations in East Asia. Japan would like to see further integration with ASEAN, but to the extent that it would exceed tariff reduction and include provisions on trade facilitation.<sup>41</sup> Within existing FTAs, Japan usually sets up a bilateral committee aiming to facilitate development of the business environment and improvement of investment regulations. Its goal is to harmonize procedures as much as possible within the existing treaty. For example, Article 14 of the Japan-Malaysia Economic Partnership Agreement (JMEPA) speaks of establishing a Sub-Committee on Improvement of Business Environment. Companies located in Malaysia can voice their concerns regarding local regulations to liaison offices of the Sub-Committee. The complaints are then passed to the Joint Committee under JMEPA and, if needed, are forwarded to the relevant ministry to ensure better functioning of the agreement.

One element that the Japanese companies would like to see included in prospective free trade agreements is further liberalization of investment.<sup>42</sup> Apart from agreements with ASEAN and Vietnam, all of Japan's FTAs include an investment chapter; this mainly entails provisions related to investment treatment: national treatment and MFN treatment, as well as performance requirements and state vs. investor dispute settlement provisions. Japanese companies in the discussed sectors have already widely invested in ASEAN countries and would now like to see the removal of remaining barriers to investment. Investment liberalization achieved under an FTA or bilateral investment treaty (BIT) can bring several benefits. However, for many, especially developing countries, investment liberalization is a sensitive area. Given its operations in ASEAN countries, the Japanese private sector would welcome the removal of regulatory hurdles to investment. This means introducing investment liberalization provisions – for example, deregulation or removal of limitations on foreign investment – which may mean prohibiting foreign investors from engaging in a joint venture.<sup>43</sup>

The simplification of procedures and standards is another important part of trade facilitation provisions. In this respect, the reduction of lead time is deemed most crucial from the private sector's perspective. Lead time is the time from when the decision to start the production is

made, to when the final good is completed and reaches its destination. It includes elements such as ordering of the product, procuring of parts, assembly, transportation, custom clearance, and/or safety checks. Lead time can be measured in days depending on the type of product. In traditional manufacturing networks, Japanese companies had a well-established pyramid structure of suppliers. Each big company had a group of permanent subcontractors who sold them parts and components purchased from the third level of producers, forming vertical distribution networks. As this type of arrangement continued for many years, companies knew what to expect and lead time was short. However, this consistency ended when parts of the production networks were moved to East Asia. Lead time depends on the RoO and regulations of the country from which the parts are procured, and from that where the assembly site is located. Therefore, the MNCs started to pay more attention to the issues of supply chains logistics and efficiency. Procurement of parts is an important factor behind the total lead time. Further, lead time is influenced by tariffs as well as RoOs and regulations between the country that sells and the country that buys a part. For example, an interviewed company manufacturing electronic goods has a lead time of about 88 days in order to produce a certain model for a given market. That means that if it wants to sell the product in December, it needs to start to work in October. If during this time the company or the customer wants to change or cancel their orders, adjustments cannot be made before the 88 days. If the goods are no longer required, they need to be stocked, which implies additional costs. Reducing lead time makes the production process more flexible and adaptable.

**Table 1: Lead Time**

Total Lead Time	Planning and Ordering	Parts Procurement	Checks	Transport to the Assembly Site	Manufacturing
Existing: 88	20	30-60	2	1	5
Desired: 46.5	10	30	0.5	1	5

*Source:* Research interview with business representative, MNC in electric and electronic sector, May 2010, Tokyo.

In this example, production takes only five out of 88 days. The procurement of parts is the longest stage. The company has little control over this process as it includes transport and border clearance. If a company is procuring parts from different countries, their delivery times usually differ. The final lead time depends on the last delivery date. Transportation and custom clearance stages cannot be accurately calculated beforehand as it depends greatly on the customs officer and other external conditions. Traffic in the port might hold up the vessel for a number of days. If the customs officer is not sure whether the exported parts require duties, or the description of the shipped product is unclear, the border clearance procedure may easily be extended several days.<sup>44</sup> The producer might need to provide additional, detailed information. Alternatively, the customs officer may wish to conduct random openings and checks of the cargo. In such a case, the company may provide a bank guarantee to pay duties for one to three months; this means that the company authorizes the bank to set aside the amount of money that may be required if the product is taxable, and further, it aids in the answering of questions posed by the customs officers in exchange for the immediate release of held goods. This, however, is not a real solution to the problem. Moreover, in case of large investments, setting aside such funds is problematic for the company. According to one of Japan’s top MNCs, from the heavy industry and machinery sector, in terms of medium technology products (like parts and components, for example), even the

naming of the product in the invoice and packing list may change the duration of customs procedures.<sup>45</sup> If a part is called, for instance, “steam turbine component” it will most likely pass the border quicker. On the other hand, if it is called “piping” or “tubing,” the insufficient information might cause additional inquiry.

Apart from customs clearance, the transportation of parts is another stage of parts procurement, during which process a region-wide FTA could help reduce lead time. Under existing FTAs in East Asia, spare parts can be imported duty free if they are shipped on the same vessel as the finished good.<sup>46</sup> If shipped separately, every part requires a certificate of origin. This regulation was formed because the business of spare parts is very profitable and importers wish to control their trade. Therefore, they lobby the government to introduce appropriate provisions. If spare parts are sold by an authorized service parts distributor or service point, the profit is kept within the same company. Unaffiliated parts vendors reduce companies’ profit. On the other hand, such procedures lengthen lead time. Therefore, some big companies oppose this rule. One of the interviewed MNCs claimed that even if parts are sold by an authorized service center, the company uses mainly local, small service points, and therefore does not make profit from selling spare parts. It would like to be able to make a list of parts registered in advance to export freely, even if they are to be sold separately. At the moment, the CTC rule of origin is applied to spare parts. The companies would prefer either 40 percent VC or elimination of duties for parts. As those external factors are not directly related to the quality of the finished good, MNCs would prefer to reduce this stage. Others, such as safety checks or testing, cannot be shortened. Companies’ main preference, and a possible incentive for a wider and bigger FTA, would be an opportunity to procure parts more quickly and with no cost. The current FTA network allows companies to lower the costs relating to tariffs. Over time, however, FTAs’ ability to reduce lead time has become the key interest of many companies.

## 6. Conclusion

Japanese companies established extensive production networks in East Asia long before the country signed its first FTA with Singapore in 2002. They paid MFN import duties, or in some cases, enjoyed special investment incentive schemes offered by ASEAN governments. When AFTA was signed, companies could trade under reduced tariffs within ASEAN, but imports from Japan were still subject to the MFN rate. Bilateral FTAs allowed MNCs located in ASEAN to import semi-finished products from Japan, but the finished goods could not move freely within AFTA. The ASEAN-Japan FTA allowed for cumulation to be applied between Japan and ASEAN. What Japanese companies expect from further trade liberalization in the region is not primarily reduction of tariffs, but improvement of business environment, trade facilitation and services liberalization. While existing FTAs are important for procuring parts without duties, provisions enhancing the business environment would further improve MNCs’ operations in East Asia. An ideal solution, although inconceivable in the short term, would be a one-market scenario with no duty and no customs clearance. For Japanese companies, whether improvement of the business environment will take place under the existing FTAs, a region-wide one with Japan’s participation, under third party FTAs, or under the WTO’s negotiations, there is little difference.

Trade theory states that the bigger the FTA, the more economic gains it brings. Hence, putting aside political considerations, a wider FTA should bring bigger economic results. In *Bilateral Trade Agreements in the Asia-Pacific*, Aggarwal writes:

*Each of these agreement types derives its advantages and disadvantages from tradeoffs between political and economic efficiency. For example, agreements among few states develop*

*easily, but implicitly involve welfare losses due to trade diversion and marginalization of weaker countries. Conversely, larger agreements maximize economies of scale by expanding markets, promoting broad-based trade liberalization, and enabling global integration, but demand more political effort to negotiate.*<sup>47</sup>

While negotiating a multilateral FTA, even one that does not include deeper liberalization issues, a state has little control over the negotiation process. Negotiating and finding a compromise among several members is an additional difficulty. The higher the number of members of an FTA, and the more difficult it is to reach a compromise on conflicting issues, the more political effort is required on the side of each negotiating state. Additionally, differences of development need to be considered. Taking an example from Japan's FTAs, it can easily be seen that the bilateral FTAs offer much deeper liberalization and are a 'broad band' type of treaties. The AJCEP, on the other hand, includes all members of the Association, but is limited to liberalization of goods only. There is a clear difference in terms of the scope of liberalization between the two types of agreements. For Japanese companies, it is that difference that causes them to be cautious about a region-wide FTA. The Deputy Director of the International Economic Research Division at JETRO confirms that companies would prefer to see an improvement of the existing agreements to an establishment of a region-wide one.<sup>48</sup> This preference is due to the expectation that such an FTA will be difficult to negotiate, and a high number of members may cause it to be the "lowest common denominator" FTA. Such agreement would not improve the business environment in the region and would not include provisions leading to the reduction of lead time. Therefore, for Japanese companies in the discussed sectors, there is little value added in a region-wide FTA. There is also no common preference regarding which of the three coexisting schemes would be the best option. Having no particular direct interest in such a treaty, the MNCs are cautious in expressing their interest and do not lobby the government to increase efforts in this respect. Instead, there is a preference for strengthening the deep liberalization provisions and enhancing the implementation of the existing agreements. Given the internationalization of Japanese production networks and the level of regional interdependence, it is not the size of the agreement that companies are concerned about, but the scope and depth of liberalization.

Analyzing the business sector's preferences for FTAs can provide useful conclusions regarding the benefits and options for further regional economic integration. Furthermore, it can help determine which regional framework would be a suitable base for a prospective wider trade liberalization treaty. This study reflects on the interest of Japanese companies in different levels of FTAs, based on research done within the electronics and machinery industries. Both of those sectors are among those with the highest share of value of exports to East Asian states. Still, as companies' interest in trade treaties depends greatly on production and trade patterns, further research is needed within other sectors of the manufacturing industry. For example, the chemical or textile industry's products are subject to different production processes and rules of origin than electronic equipment or vehicles (i.e., two step-rules of origin for textile industry).

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## Notes

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