

CHAPTER ONE

Introduction

A Trading Nation for the Twenty-First Century

THE RESEARCH FOR THIS BOOK was initially motivated by the critical choices that loom ahead for Japan in the twenty-first century. Can Japan deploy a proactive trade policy to tackle the structural reforms that have hindered its international competitiveness, find a path back to growth, and become a leading voice in drafting rules for the twenty-first century economy? If not, will the country remain shackled to its domestic political constraints, unable to use trade policy to leverage reforms needed to overcome decades of domestic stagnation? And if so, will the third largest economy remain a secondary player in the world of international trade negotiations?

At a time when Japan is concerned about being overshadowed by a rising China, and when its reliance on foreign markets as sources of growth will only increase (the domestic market is projected to shrink to reflect depopulation trends), getting trade policy right has never been more important. Granted, trade policy is not a magic bullet and will not do all the heavy lifting necessary to accomplish Japan's economic revitalization, but it is certainly an essential component of a strategy to advance productivity reforms and secure access to overseas markets.

This research was also animated by the prospect that the Trans-Pacific Partnership (or TPP, a twelve-nation trade negotiation pioneering the wave of mega trade agreements) could recast the role of trade in the U.S.-Japan alliance. In the past, trade had been a source of acrimony and friction in their bilateral relationship, but Japan's TPP entry suggested new horizons. Would the TPP finally allow the United States and

Japan to get past divisive market access issues and use trade policy as a vehicle for deeper economic integration and a joint endeavor in drafting next-generation rules on trade and investment?

At first glance, the substance of bilateral trade negotiations, even within the context of the TPP talks, seemed to have changed little. Disagreements over agricultural market access and the detrimental effects of nontariff barriers on important sectors such as automobiles continued to dominate the headlines. However, this superficial reading misses the significant changes of the last twenty-five years: the gradual but real erosion in the clout of the Japanese agricultural lobby and the changing industrial landscape as Japanese companies relocated production to the United States to avoid import friction, and foreign companies made inroads in Japan in areas such as banking and pharmaceuticals— notwithstanding low cumulative levels of inward foreign direct investment. Most significantly, in the TPP negotiations, the top Japanese leadership drew a direct connection between requests from foreign partners to eliminate access barriers and its number one priority: to revolutionize the “metabolism” of the Japanese economy through productivity-enhancing reforms. In the past, Japan had come reluctantly to the negotiating table to appease American demands for greater opening, but this time, sensing the perils of domestic stagnation and exclusion from the emerging mega trade agreements, Japan eagerly requested to join the negotiations. Moreover, Tokyo’s growing appetite for participation in designing the rules of the road for the twenty-first century economy reinforced U.S. positions in the transpacific trade negotiations. The TPP project offered an entirely new proposition. Anchored in a shared vision of rulemaking, Japan and the United States could work together to close the significant governance gap resulting from negotiation paralysis experienced at the World Trade Organization (WTO).

Advanced as a joint project, the Trans-Pacific Partnership served well the foreign policy objectives of both countries and helped accentuate the broad alignment in core national interests. Central to Japan’s international standing is the ability to arrest the narrative of economic decline. By entertaining greater liberalization of the domestic economy than ever, the TPP helped Japan address long-standing credibility problems related to its resolve to enact economic change. It boosted confidence that the Shinzo Abe government would deliver on needed structural reforms and, in so doing, would create the conditions for “Japan to be back.” The Trans-Pacific Partnership trade deal, therefore, became inextricably

linked to expectations of Japan's economic renewal and greater international leadership.

For the United States, the TPP promised to advance important foreign policy priorities: to execute the Obama administration's policy of Asian rebalance and to upgrade the international economic structure at a time of profound shifts due to the rise of emerging economies. Prior to Japan joining the TPP, this agreement did not augur major economic or political gains for the United States. Participating countries represented small markets or already had trade agreements in force with the United States, while the largest economies of Northeast Asia remained on the sidelines. Japan's entry into the TPP transformed the economic and geopolitical payoffs of this undertaking. By negotiating preferential access to the Japanese market—one of the largest economies in the world—for the first time, the United States doubled its expected economic benefits from the trade agreement. Moreover, Japan's entry put to rest the skepticism about creating an Asia-Pacific economic platform that did not include any of the major Asian economies. With Japan as a partner in the TPP negotiations, the United States gained traction in its campaign to upgrade international trading rules and anchor its place as a committed Pacific power in the world's most dynamic economic region, a region that is also experiencing a major power shift with China's rise.

The potential for proactive trade policy to help Japan address its economic challenges, redefine the U.S.-Japan economic agenda, and open new venues of bilateral cooperation to address multilateral governance challenges initially drove this research. But in the course of writing this book, the ground shifted. Profound questions related to the merits of globalization eroded support for economic liberalization in countries that have long been stalwarts of openness. The Brexit referendum vote—the decision of UK voters on June 23, 2016, to leave the European Union—is a stunning example, but certainly not the only one. Trade has been a hard sell in U.S. domestic politics since the negotiation of the North American Free Trade Agreement (NAFTA), when the consensus on free trade began to fracture, and labor and environmental groups increasingly challenged the benefits of these trade agreements. The rise of anti-trade populism on the right and the left of the political spectrum signaled an even deeper rift, one that cannot be wholly attributed to the magnifying effect of a full-blown presidential campaign in 2016.¹ Rather, the United States has veered toward what some aptly refer to as the politics of grievance: blaming trade for most of our economic

hardships.² The political battle lines on trade policy have been redefined as the Republican Party officially nominated a presidential candidate, Donald Trump, who promised to withdraw from the TPP, renegotiate or terminate NAFTA, and impose punitive tariffs on the main trading partners of the United States to bring back manufacturing jobs. The deeper rifts on trade in the American body politic came into full view at a time when the TPP—the most ambitious trade initiative of a generation—awaited a vote from Congress to enter into force.

Therefore, along the way, this book became also about the critical choices faced by the United States, especially in the aftermath of the Trump administration's withdrawal from TPP: Will the United States abdicate leadership in sustaining open trade policies as it finds itself unable to create a consensus in favor of international economic engagement? How will it manage the economic and geopolitical fallout of losing preferential access to large markets in the most vibrant region in the world, making the trade agenda falter on other fronts as it loses negotiating credibility, planting doubts among friends and rivals about its ability to remain a committed Pacific power, and giving up on one instrument of international economic diplomacy that allowed it to be both proactive and inclusive (with the potential for China's future entry)? And more important, will it use this critical juncture to launch policies that address the growing income inequality that is eating up support for open economic policies?

Trade policy has catapulted to front and center in the national conversations taking place in each country about its desired future direction—economic renewal, relaunched social compact, and projected international influence. Trade liberalization has become a polarizing issue both because we expect it to do more (to offer off-budget sources of growth and impetus for structural reforms to kick-start slow-growing economies), and because we blame it for many of our tribulations (the rise of income inequality, or, in a more extreme rendition, the loss of sovereignty and the subversion of national identity). This book offers a new way to think about the domestic politics of trade, one that highlights the tensions that pervade national choices on trade policy.

THE ARGUMENT

Trade policy has become incredibly complex with attempts to negotiate mega trade deals, a far more intrusive trade agenda that reaches into policy realms behind the border; profound changes in the nature of international production and trade flows with the rise of global value

chains; a stagnant multilateral trade regime; and the increased questioning of the distributional consequences of globalization. Therefore, national choices on trade have also become more complicated, and we need an analytical framework that can capture the vexing challenges of articulating a trade strategy in a rapidly shifting landscape.

The workhorse model of the domestic politics of trade offers a predictable causal chain to explain liberalizing or protectionist outcomes:

Preferences → Coalitions → Institutions → Outcomes

The first step is to determine the preferences of economic actors based on their international competitiveness. Efficient producers will favor market opening, as they can reap the benefits of increased access to foreign markets, whereas noncompetitive manufacturers will advocate protectionist policies to avoid the onslaught of inexpensive imports.³ The next step is to establish the emergence of pro- and anti-trade coalitions that can make use of a wide range of advocacy tactics, from technical advice to political contributions, media campaigns, and judicial action, among others.⁴ The success of these lobby groups will hinge largely on the institutional setup for trade decisionmaking (the third stage), as it will empower some interests over others.⁵

This book offers a different interpretation of the domestic dynamics of trade politics, one that does not see trade policy formulation moving in a straightforward progression depicted in conventional models. Instead, this study uses trade policy design as its focal point; identifies the essential goals of trade policy (competitiveness and leadership, social legitimacy, and political viability); and places the difficult trade-offs that emerge from attempting to reconcile these objectives at the crux of the analysis.

The Goals of Trade Policy

Each goal is, of course, challenging in its own right, as this brief overview makes clear.

COMPETITIVENESS AND LEADERSHIP

At the most fundamental level, trade is about enhancing economic competitiveness by harnessing the forces of specialization, efficiency, productivity, and innovation. The payoffs of trade agreements come not just from opening large markets abroad, but also from leveraging needed internal reforms. These gains—expanded reach in overseas markets and

domestic transformation—will be realized only with ambition at the negotiation table; that is, by signing high-quality trade agreements. The quality of the liberalization effort can be gauged by the extent to which trade agreements open sizable foreign markets, achieve comprehensive tariff elimination, tackle nontariff barriers, and provide governance in new areas of the global economy. Trade agreements are not negotiated exclusively for the expected economic gains; they are also important tools of diplomacy. States can pursue a number of foreign policy objectives through trade deals, but only large powers will possess the requisite resources to advance “architectural trade agreements,” to be understood as multilateral frameworks that codify rules of economic exchange to derive mutual gains. These mega trade deals can become bids for international leadership.

SOCIAL LEGITIMACY

Policymakers need to ensure society’s support for open trade policies, but skepticism on the merits of trade liberalization has grown over time. Critics argue that trade agreements have produced massive job losses and exacerbated economic disparities, that they empower multinational corporations to erode regulatory sovereignty, and that secret negotiations alienate democratic oversight. Addressing these concerns must be a central task for policymakers to show that trade liberalization has not produced higher rates of unemployment, nor has it mortally wounded manufacturing or been a main contributor to income inequality; that the investor-state dispute settlement (ISDS) mechanism has not resulted in the onslaught of regulatory regimes; and that proper oversight over trade negotiators exists through legislatively approved procedures.

The critics are right on two fronts. The circle of consultation with different groups in society needs to expand in tandem with the greater domestic reach of trade negotiations, and the current policy framework has come woefully short in dealing with the adjustment costs for displaced workers. The key here is that we should care not just about what happens to workers affected by trade agreements but to all workers unable to navigate difficult economic transitions.

POLITICAL VIABILITY

At the end of the day, only trade agreements that make it to the finish line, that get ratified, matter in the realization of anticipated economic and geopolitical gains.⁶ Negotiating an ambitious trade agreement with little chance of securing domestic approval is not sound policy. Hence, a

dose of political pragmatism is necessary to secure the yes vote in ratification. This requires galvanizing the support of likely winners and neutralizing the opposition of potential losers. When opponents to a trade agreement operate as veto players in the political system (that is, they have the clout to derail the negotiations or deny approval of the final deal), it requires making accommodations for them: scaling-down liberalization commitments and/or extending side payments.

The Dilemmas of Trade Governance

Delivering on each of these objectives is a tall order for policymakers, but the complexities of trade policy design are only fully appreciated by factoring in “interaction effects.” In other words, there are unavoidable trade-offs when negotiating ambitious trade agreements that can both generate support from large groups in society and get clearance from veto players so as to be enacted. The simultaneous pursuit of core trade objectives creates two fundamental dilemmas: decisiveness versus inclusiveness and reform versus subsidization.⁷

DECISIVENESS VERSUS INCLUSIVENESS

This dilemma captures the tension between executive efficiency and responsiveness to civil society. Negotiation of ambitious trade agreements requires departure from the status quo, as far-reaching liberalization commitments will cut into the vested interests of powerful producers. But political systems with multiple veto players who agree on little (that is, where there is wide separation of power and purpose) are prone to gridlock and will be unable to launch significant trade initiatives.⁸ Hence the shift to a proactive trade policy will be predicated on centralizing decisionmaking to avoid policy capture. However, excessive centralization of decisionmaking can undermine legitimacy if trade policy formulation becomes exclusionary. The risks are to encourage the formation of an unlikely coalition among excluded groups (vested economic interests fearing loss of economic rents and civil society groups mobilized by value-driven campaigns) and/or to provoke a significant amount of social contestation of trade liberalization efforts.

REFORM VERSUS SUBSIDIZATION

This dilemma captures the tension between politically expedient subsidization and desirable economic reforms. Because trade has distributional consequences, compensation to sectors disadvantaged by liberalization

has long been a task of trade policy formulation. However, compensation can be given for different reasons. If used as a side payment, we should expect targeted benefits that aim to preserve the status quo, but if deployed to consolidate reforms, we should expect general safety nets and adjustment programs that favor exit from contracting sectors. The political viability of trade agreements may dictate targeted compensation, but political pragmatism could sidetrack economic reforms. The risks are that side payments to producer groups will prolong the status quo, negating the reform benefits of liberalization, and that targeted compensation programs may come at the expense of genuine adjustment for displaced workers, hollowing out support for free trade.⁹

Crafting trade policy is not for the fainthearted; it demands hard choices. Accomplishing a desirable goal means sacrificing other cherished objectives to some extent. Trade policy is comprised of myriad balancing acts to reconcile competing interests, and it is sorely contested because different groups in a society will have clashing preferences on the acceptable trade-offs. For Japan and the United States the Trans-Pacific Partnership trade negotiations represented a critical investment to advance national interests, deepen the alliance, and provide much-needed international governance at a time of stress in the international order. But the traction of the anti-trade message in U.S. politics (which culminated in the United States withdrawal from TPP) not only put those ambitious goals on hold, it underscored the centrality of a domestic policy framework to support the middle class as a precondition to sustain internationalism. If there is one message this book seeks to convey, it is that the future of a rules-based economic architecture hinges on the ability of these countries to spur on domestic renewal.

THE PLAN

The first section of this book draws primarily (but not exclusively) from the U.S. experience, to flesh out the challenges of achieving the goals of trade policy and navigating uncomfortable trade-offs. The second section uses the trade dilemma framework to illuminate breakthroughs in Japan's trade policy and reform agenda as well as its die-hard habit of subsidizing inefficient sectors. Chapter 2 underscores the ambitions behind trade policy. On the economic front, it explores the track record of high-quality trade agreements in increasing trade flows and generating higher economic payoffs, and it discusses the potential of international

commitments to leverage domestic reforms to increase productivity. On the foreign policy front, it provides an overview of the varied security externalities of trade agreements, but the thrust of the discussion is on the role of large powers in negotiating architectural trade agreements that display their global leadership ambitions.

The next three chapters address the legitimacy challenges of trade policy. Chapter 3 examines the critics' argument that trade policy militates against inclusive growth by undercutting employment and promoting income inequality. The chapter pays close attention to the problem of transitional unemployment (writ large as a result of broad economic change) and the need for a revamped policy framework to address this issue. Chapter 4 examines the argument that deep trade agreements compromise the ability of states to regulate in the public interest. It revisits long-standing debates on whether globalization has promoted a regulatory race to the bottom and whether the investor-state dispute mechanism has produced regulatory chill. The chapter notes that there is little public understanding of the reasons behind the migration of the trade agenda to regulatory matters and highlights the trend in trade agreements to adopt more explicit safeguards on prudential regulation. Chapter 5 addresses the democratic deficit debate in trade policy in the areas of transparency/oversight and consultation with stakeholders. It offers a comparison of the role of transparency in different venues of international negotiation (especially the WTO) to assess the critics' argument on exceptional levels of secrecy in the TPP. It provides an overview of the evolution of the trade advisory committee system in the United States to illustrate the challenges in expanding engagement with nongovernmental organizations (NGOs) and other civil society groups.

Chapter 6 discusses the role of political institutions in creating conditions for state decisiveness or indecisiveness, and applies these insights to trade policy formulation. Through an overview of different national cases, it discusses the balance of power between executives and legislatures and the role of bureaucratic politics in favoring (or not) narrow client interests. It notes different patterns of lobbying activity driven by anticipated losses or gains from trade initiatives and discusses the role of political compensation to mitigate opposition to trade liberalization. Chapter 7 builds on the insights from the previous chapters to elucidate the trade governance dilemmas that drive this book's analysis: decisiveness versus inclusiveness and reform versus subsidization. It offers broad strategies to tackle each dilemma: expanding the circle of consultation

to improve trade policy representativeness and developing a pro-adjustment safety net to enable workers to navigate difficult economic transitions. The chapter underscores how U.S. solutions to trade governance dilemmas have become largely ineffective, and it explains the appeal of the trade backlash in the presidential election by looking at longer-term legitimacy challenges, in particular the debate on the distributional consequences of globalization. To sustain open economic engagement, the United States needs to strengthen and revamp its social compact. (In) action on this front will shape the choices of other trading nations like Japan.

The next three chapters in the book focus on Japan's struggles to use trade policy proactively in addressing its economic transformation challenges and securing preferential access to overseas markets; these loom large over its future economic prosperity. Chapter 8 discusses Japan's evolution from a passive rule-taker to a committed rulemaker in the world of international trade negotiations. It notes the modest achievements of Japan's early forays into preferential trade deals and discusses the TPP's transformational impact on Japan's trade strategy—enabling the country to participate in four concurrent mega trade negotiations. Chapter 9 zooms in on Japan's protracted and fitful search for executive leadership to undermine the influence of vested interests hindering liberalization efforts. It discusses the eroding but still significant clout of the agricultural lobby and the redefinition of “red lines” in Japan's trade policy. The chapter analyzes the emergence of prime ministerial leadership in the Shinzo Abe administration but notes that, despite higher levels of policy-making centralization, a pattern of “negotiated decisiveness” prevailed in bringing Japan into the TPP and reforming the agricultural cooperative system. Chapter 10 addresses Japan's economic reform imperative and discusses the areas where the TPP could create positive synergy to close internationalization gaps and promote productivity. It assesses the outcomes of the TPP negotiations for the Japanese economy and points to areas of future improvement to modernize Japanese agriculture.

The conclusion identifies defining dilemmas for Japan (the search for decisiveness, the quest for reform) and the United States (the reconstruction of a domestic consensus in favor of internationalism) as trading nations in the twenty-first century. It also offers suggestions to recalibrate national choices on trade that will require critical investments at home (on human capital) and abroad (on updated rules) to forge a new Asia-Pacific economic order.