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Interview with Prof. Edward J. Lincoln

USAPC: Tokyo indicated at the conclusion of the APEC Leaders Meeting in Japan November 2010 that Japan initially would participate as an observer in the Trans-Pacific Partnership (TPP) talks before formally deciding to participate. Will Japan's agricultural interests ultimately impede its participation in the TPP?

Lincoln: I find it very sad that as we begin 2011, the Japanese government still has trouble dealing with the agricultural sector. The U.S. government and academic experts have been battering away on this issue for some 26 years.

During that period of time, Japan's agricultural sector has not done well. It continues to lose people, and the fewer and fewer remaining farmers have become older and older. I was told recently that the average age of a Japanese farmer is 65 years old. Their kids have been moving to urban centers because they do not want to be farmers. This is because farming is not a very good business in Japan due, in part, to the fact that farms remain very small.

They are so small that many farmers use rototillers to till their fields. They don't ride tractors and let the machine do the work. Farming in Japan therefore is a far more physical job than in the United States. It's no wonder that young people don't want to go into this.

But if the Japanese government doesn't do something in the coming decade, there no longer will be an agricultural sector in Japan. Tokyo needs to pursue radical reform of its agricultural sector involving a combination of two elements: (1) placing Japanese farmers under international competitive pressure, and (2) pursuing a new policy that makes the sale and transfer of agricultural land much easier in order to grow the size of farms.

The Japanese government should have pursued these policy changes about 40 years ago. As labor costs increased, this logically would have led to the creation of bigger farms. But this didn't really happen. There has been a slight increase in the size of farms, but nothing substantial because the Japanese government has been reluctant for political reasons to implement these kinds of reforms.

To be sure, Japan has opened up certain product areas in agriculture. Japan is not a particularly good place to grow wheat, for example, so for many years Japan has imported virtually all of its wheat, corn, and soybeans. More recently, there has been a big increase in the import of vegetables and certain kinds of fruit, particularly from China.

But the Japanese still do not import rice – not with a 600 percent tariff on it! There still needs to be progress on agriculture. I find it very sad that the Japanese government has yet to undertake these reforms, and once again, Tokyo is allowing agriculture to trip up its participation in the TPP. This should not be happening.

USAPC: Japan has been a regional and global economic power and regards itself as such. But, in addition to the TPP initiative, Korea, Australia, and others have been pursuing a plethora of free trade agreements (FTAs). Is Japan falling behind in Asia?

Lincoln: Part of the problem may be that the Japanese government does not appear to regard its inability to participate in TPP as being "left behind." Since about 2000, the policy of the Japanese government has been to conclude bilateral, sub-regional, and regional FTAs. To date, I believe they have concluded close to a dozen of these FTAs.

But the quality of Japan's FTAs leaves a lot to be desired. For example, agriculture is excluded. Japan can get away with that in negotiating a bilateral agreement because it is a big country and most of its FTAs are with smaller countries. Tokyo has more weight in those negotiations than it would, say, in the TPP process or talks aimed at concluding the Free Trade Area of the Asia Pacific (FTAAP) envisioned by APEC.

And it's not just agriculture that gets a pass. There are other non-agricultural products that are excluded as well as very weak agreements on services trade. These are not particularly strong FTAs. But Japan has concluded them and the count has gone up over the years. The Japanese government therefore can maintain, "Oh yes, we've concluded many FTAs with other countries. We're not being left out." But certainly Japan is being left out of quality FTAs.

USAPC: One commentator depicted Japan's participation in TPP, in effect, as a U.S.-Japan FTA because Tokyo would have to meet the U.S. standards. So, in view of your observation of Tokyo's track record on its own FTAs, at this stage Japanese officials apparently don't feel there is any great loss in not entering into the TPP process or *de facto* FTA negotiations with Washington.

Lincoln: Yes. Tokyo is not ready for what the United States wants in an FTA – and never has been.

USAPC: Yet another observer described Tokyo's decision to participate as an observer in the TPP process as a significant change in Japan's trade policy. But it sounds like you would disagree.

Lincoln: There is always the possibility that the Japanese government could surprise us. Tokyo has said it would try to make a decision about whether to formally enter the TPP talks by the summer of 2011. Prime Minister Kan has said the time is ripe for Japan to break out of its shell, deal with the agricultural issue, and participate in trade liberalizing negotiations like the TPP. But there are other cabinet officials who have been speaking out against those kinds of reforms. So who knows where the Japanese government is headed.

USAPC: So Prime Minister Kan not only is fighting traditional Liberal Democratic Party (LDP)-aligned agricultural interests but also members of his own Democratic Party of Japan (DPJ)?

Lincoln: Yes. In recent years, the DPJ discovered that Japanese rural voters appeared willing to abandon the LDP, so the Democrats actively courted their vote. Consequently, the DPJ now finds itself proposing a policy that is not all that different from what the former ruling LDP had advocated, that is, providing subsidies to farmers. This would be the DPJ's way of saying, "We'll give you a subsidy so you won't be hurt when we open up to international trade."

Unfortunately, it appears that this subsidy would be tied to production levels. Ideally, the government would tell a farmer, "We'll give you an income subsidy, so whether you produce vegetables or rice or not, your livelihood and your income will be protected somewhat." But if the government tied a farmer's subsidy, say, to every kilo of rice he produced, then the government simply would be encouraging the farmer to stay in highly inefficient rice production rather than creating conditions more conducive to market opening. That's not a good way to go.

USAPC: Let's continue this discussion about domestic politics. During the early months of former Prime Minister Yukio Hatoyama's administration in the fall of 2009,

there were reports that the political appointees of the newly ruling DPJ and the long-time government bureaucrats did not work together effectively. Has that dynamic changed as the DPJ has gained a bit more leadership experience?

Lincoln: I'm not sure. You are correct that when the DPJ first entered office, one of its major campaign themes was to shift power from the bureaucracy to the politicians. Many people have been making that intellectual proposition for the last 20 years. They have proposed that while a strong bureaucracy may have been good for Japan when it was a developing country and the policy issues were largely technical, now that Japan is a major developed country, the issues confronting the nation shouldn't be decided by bureaucrats. That is because the issues are fundamentally political, related to the allocation of resources or the promotion of various kinds of activities. It is logical to argue that there should be such a transition in power.

In reality, though, it is very difficult to accomplish that transition. If the system has a strong bureaucracy and weak politicians, then the politicians, indeed, are weak. They don't possess the sort of policy skills that we typically associate with members of the US Congress. While we have our share of less-than-competent politicians in Congress, we also have a group of very impressive lawmakers who spend a great deal of time examining real policy questions in a way that very few Japanese politicians do. So, for starters, that situation must be remedied in order to implement the transition in power.

At least initially, it was not clear to me that there were many DPJ members who were inclined to delve deeply into policy. So on the one hand, the DPJ announced plans to take power over policymaking, but on the other hand, the Democrats did not explain clearly to bureaucrats how that would change the rules of the game. The bureaucrats didn't know how to play by these new rules and they had – and continue to have -- contempt for politicians because the politicians generally don't know the issues.

It's hard to say to what extent this dynamic has improved. It has settled down at least a little owing, in part, to indications from Prime Minister Kan that he is willing to go half-way back to the former system to enable bureaucrats to play more of a lead role in policymaking. But will that last? We don't know.

When I was in Tokyo during the week of December 13, everyone was telling me that Prime Minister Kan was not going to last more than a few months. The political scuttlebutt was that the DPJ would force Kan to resign after the regular budget is passed in late March 2011.

I found that rather distressing because my read on Kan is that he's at least somewhat better than former Prime Minister Yukio Hatoyama. Hatoyama, to me, typified the Japanese politician – he had plenty of ideas, but no policy sense. So if Kan is forced out and replaced by someone from the more “hopeful, intellectual” side of the DPJ that doesn't have a lot of policy sense, then once again we could see more confrontation between the politicians and the bureaucrats. That could have important ramifications for U.S.-Japan relations going forward.

USAPC: Throughout the global economic crisis, Japan was in the midst of political upheaval that ultimately propelled the DPJ and Prime Ministers Hatoyama and Kan to power. How did those political changes affect the government's ability to respond to the crisis? Or, was Japan better prepared to weather the storm owing to reforms instituted following its earlier banking crisis?

Lincoln: In one sense, Japan was better prepared, but the numbers indicated that, in reality, Japan got hit by the recession even worse than the United States. The U.S. economy shrank by a little over 3 percent from peak to trough, while the Japanese economy shrank by 5

percent. In terms of a decline in GDP, this was by far the worst recession Japan has experienced since the end of World War II.

But by the same token, I think you can argue that the Japanese were somewhat better prepared because the nature of this recession was different in Japan than it was in the United States. In the United States, the recession was driven by a 1990s Japanese-like collapse of the stock market and the real estate market, with consequent reverberations in the financial sector and ultimately in the so-called real sector of the economy.

That did not Japan. In the summer of 2008, the Japanese seemed pretty confident that, at worst, they would have a very mild recession. Their optimism stemmed from the fact that Japanese financial institutions didn't buy American toxic assets, unlike the European banks. They thought it unlikely that a severe recession would transfer from the United States to Japan.

What did happen – and was totally unexpected – was a collapse in international trade. The U.S. economy fell by 3 percent. Imports decreased roughly 30 percent, peak to trough, from roughly the beginning of 2008 to early 2009. That's also true for world trade, which decreased by about 30 percent during that same one-year period.

But Japan's exports decreased by about 50 percent. That is colossal, almost like the Great Depression. You'd think that if the U.S. economy shrank by 3 or 4 percent, then imports would shrink by roughly that amount. No one can quite figure out why this happened.

For U.S. trade, the predominant explanation seems to revolve around trade finance. When financial markets froze up in the fall of 2008, financing for international trade was hit particularly hard. That contributed, in part, to the sharp decrease in U.S. trade, according to this argument.

But Japan's financial institutions were in very good shape to provide trade financing. So I think Japan was hit by something rather different, which actually may have been self-induced. Japanese companies, particularly the auto and electronics companies, saw inventory at their American subsidiaries rising rapidly in the summer and fall of 2008. In addition, the pundit analysis in the fall of 2008 included a fair amount of speculation that we were headed into the second Great Depression.

I think that frightened Japanese companies. And when a company is frightened, it doesn't want to see an inventory build-up. So many Japanese companies responded by cutting shipments primarily to the United States and secondarily to Europe. So, for example, Toyota Motor Company shut down factories for several weeks in early 2009 to try to get inventories back under control. The analysis hasn't been done yet, but I think what I just described will be borne out by data.

That being the case, Japan's recovery was relatively quick. Japanese exports and global trade bounced back, not to pre-recession levels, but they did rebound. The Japanese economy returned to growth in 2009. The level of growth hasn't been as strong as we'd like to see in light of the nature of its recession. Recovery from an inventory-driven recession tends to be more V-shaped than U shaped.

But there are other reasons for Japan's weaker-than-expected growth. The U.S. and European economies are not recovering very quickly, which would limit Japan's export growth. In addition, the yen has strengthened against other currencies over the past three years. That has taken some of the edge off of Japan's price competitiveness during this recessionary period.

USAPC: With respect to currency valuation, the United States has been pressuring China doggedly to reform its currency policy on grounds that it is fueling the bilateral economic imbalance. Japan also has experienced some negative economic repercussions from China's currency policy. How would you compare Tokyo's handling of this matter with Washington's?

Lincoln: Basically, the Japanese government isn't doing anything partly because it is genuinely conflicted by this issue -- and partly because I think Tokyo would rather leave this up to Washington. "Let the United States be the bad guy on this issue," may be the view of Japanese officials.

But underneath that, I think the Japanese are conflicted because over the past eight or nine years there has been a fairly aggressive level of investment by Japanese firms in China. Much of that investment, as is true for a fair amount of other foreign direct investment flowing into China, is for final assembly of products for export around the world. So it's not clear that the Japanese would benefit from a stronger Chinese yuan. The weaker yuan makes the price of the final assembled goods more competitive in the global marketplace. So I think the Japanese government has been getting mixed signals from the business community about whether they really care about this issue.

USAPC: You mentioned that the yen has been strengthening over the past three years. Why is that happening, and do you see Tokyo intervening to brake the trend?

Lincoln: Let's go back a little. The yen was extraordinarily strong in the mid-1990s. In 1995, the nominal yen-dollar rate peaked at Y80/\$1.00, and then fell to Y122/\$1.00 by 2007. It now is back to around Y83/\$1.00. That gives the appearance of wide changes, with the yen back close to its historic high.

The weakening was particularly noticeable during 2000 to 2007. But when I say the exchange rate weakened, I'm not only referring to the dollar-yen exchange rate. Rather, I am referring to the real effective exchange rate. This is the rate that matters for international trade because it is a broad measure of how price-competitive a country's exports are and how price-competitive imports into that country are.

It is an index number that is an average of the exchange rate against all currencies with which the country trades, weighted by the share of trade with each of these countries around the world, and adjusted for a differential in inflation between the home country and each of these countries. It's a fairly complicated calculation, but it gives you a very broad picture of what's happening to the price of one country's products versus the price of products in the rest of the world.

So on that basis, the yen peaked in 1995 and then fell to a low level in 2007. From 2000 to 2007, this real effective exchange rate was below the 30-year-average. But that low level was instrumental in creating very strong export growth. Basically, it was exports that brought Japan out of its "lost decade."

This time around, the yen has rebounded from that low point in 2007 to just a little bit above the average. It is not real strong, but compared to where the yen was in 2007, it has strengthened in value.

Unfortunately, when many people think about the exchange rate, they tend to think of the dollar-yen value in the spot market today, versus last year or the year before. But that rate doesn't adjust for the difference in inflation and neither does it adjust for the fact that Japan trades with a lot of countries, many of whose currencies are not tied to the dollar. You get a very misleading picture of how strong the yen is by just focusing on the dollar-yen rate.

To put it in simple terms: for the past 15 years Japan has had mild deflation, running between 0.5 percent and 1 percent. The United States has had a modest positive inflation of between 1 percent and 2 percent. Thus, during this 15 year period, the price of Japanese products actually has decreased while the price of U.S. products has increased. At any given yen-dollar rate, Japanese products have been more price competitive.

But as I said, the tendency of many people is to focus just on the yen-dollar rate at any given moment. That's what was happening in Japan during the summer and fall of 2010. There were expressions of anxiety about the fact that this nominal yen-dollar rate would get back up to its peak of 1995. These concerns eventually caused the Japanese government to intervene in September 2010 in a pretty substantial way for a day or two. It was a surprising and large intervention. Japanese Finance Minister Yoshihiko Noda then said that Tokyo would consider doing it again.

I found that a little odd. Minister Noda attended the G-20 Finance Minister's meeting in October 2010 in South Korea, where the ministers issued a statement pledging not to manipulate currency values for trade gains. Noda endorsed the statement but then returned to Tokyo and announced that Japan would keep its options open. I find that rather contradictory.

The fact is, however, that Tokyo has not intervened since then, perhaps because the yen did not test the ¥80/\$1.00 limit. In addition, though, U.S. Treasury Secretary Timothy Geithner may have laid down the law to Minister Noda at the G-20 Finance Ministers meeting, saying something to the effect that such action would be particularly unhelpful in light of U.S.-led efforts to pressure China to allow the yuan to appreciate. In any event, I hope that that message was delivered in fairly strong terms to the Japanese government.

USAPC: You mentioned earlier that Japanese business may not necessarily welcome efforts by the U.S. and Japanese governments to pressure China to reform its currency policy. However, I'm wondering whether China's recent embargo on rare earth mineral exports to Japan has had the opposite effect and caused greater wariness about doing deals with China.

Lincoln: Yes, I think that episode has had a somewhat chilling effect on attitudes about doing business with China. Based on casual observation, I've actually found Japanese business to be more wary of China as a place to locate production and do business than American business. I think that has intensified particularly since China imposed the embargo on rare-earth mineral exports to Japan.

Over the last five years, I've listened to Japanese businessmen say they are absolutely convinced that they get mistreated more than other foreign companies in China. They think the Chinese have it out for them. For example, last year there were strikes at foreign factories in China where workers were demanding higher wages. Well, guess whose factories had the strikes – Japanese factories. These incidents cause Japanese business to be wary.

But will this wariness show up in the foreign direct investment data? I don't know. It didn't show up much in the last five years, but that could change going forward.

The flap concerning the rare-earth mineral embargo was particularly egregious. The timing of it was highly suspicious – coming as it did shortly after the Japanese Coast Guard arrested the captain of a Chinese fishing vessel operating in the waters off the Senkaku Islands. However, we cannot rule out coincidence.

The Chinese government announced a couple of years ago that it planned to reduce foreign shipments of rare earth minerals because greater quantities were needed at home. And they indicated that shipments would be reduced by 40 percent in 2010. Everyone knew the cut was coming. But to actually halt shipments was a surprise.

You can't rule out other factors. There apparently has been rising concern in the Chinese government that although Beijing announced plans to reduce rare-earth mineral shipments, there nevertheless have been unauthorized, illegal exports. Perhaps the Japanese were buying through an unauthorized source, so the ban was a way of cracking down on the illegal exports. Maybe word went out to the provincial level that they had better check the export documents and find

out whether the mines and processing firms actually are authorized to export rare-earth minerals. I offer this simply as an alternative explanation for Beijing's action.

But the fact that shipments suddenly stopped a week or so after the fishing boat incident was so curiously coincidental. I think this has the Japanese government and others, including our own government, worried. It undermines the perception of the reliability of China as a full participant in open markets. And, of course, in open markets, it shouldn't be the Chinese government that establishes a quota for the export of rare-earth minerals. It should be the market that determines the outcome.

Importantly, the rare-earth mineral embargo appears to have had political ramifications. The embargo -- combined with China's unwillingness to openly criticize and sanction North Korea for its sinking of a South Korean naval vessel in March 2010 and its shelling later in 2010 of South Korea's Yeonpyeong island -- seems to have really cooled the pro-China stance favored by the DPJ when the party first gained power 16 months ago and driven the ruling party back toward the United States.

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