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At the Crossroads: The TPP, AIIB, and Japan's Foreign Economic Strategy

SAORI N. KATADA

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SUMMARY In 2015, two mega-initiatives took shape that will affect economic relations in the Asia-Pacific region: the US-promoted Trans-Pacific Partnership (TPP) trade agreement and the China-led Asian Infrastructure Investment Bank (AIIB). Although they address different needs, both are expected to have profound effects on Asia's economic governance in the near future, and will shape economic norms in the Asia Pacific and beyond. Japan has joined the TPP but stayed out of the AIIB, decisions that might seem counterintuitive considering its history of resisting trade liberalization and of promoting infrastructure investment. Is Japan simply favoring its US ally over rival China? Or is it that Japan's position on the TPP and AIIB aligns with its own economic priorities, and enhances its geoeconomic advantage? With a US-China competition over economic ideas and regional strategies, Japan occupies a unique position that may allow it to influence the direction of Asia-Pacific economic governance, which is now being battled out by the two "titans."

Japan's Choice

The year 2015 saw advances of two major economic initiatives, the US-promoted Trans-Pacific Partnership (TPP) trade agreement and the China-led Asian Infrastructure Investment Bank (AIIB). These two initiatives address different economic needs in the region. But the geoeconomics surrounding the initiatives are worth comparing, as they emerged from the desire of the regional superpowers to secure the rules of economic exchange. As a result, both the TPP and the AIIB are likely to have profound effects on Asia's regional economic governance in the near future, and will shape the contours of economic norms in the Asia Pacific and beyond. As the tug-of-war for international support between the United States and China proceeds, Japan has decided to join in the TPP and stay out of the AIIB, at least for now. Why is the Japanese government enthusiastic about the TPP when this agreement promotes the type of trade liberalization that Japan has resisted since the 1970s, in both repeated bilateral trade talks with the United States and in multilateral forums such as APEC (Asia-Pacific Economic Cooperation)? Why should Japan be reluctant to support the AIIB, which aims to increase infrastructure investment in Asia—the same method that Japanese foreign aid has used, for the past six decades, to build up the foundation of the region's economic development? What has Japan gained and what has it lost by taking these contrasting positions? How do Japan's positions on these matters influence the power balance surrounding economic governance of the Asia-Pacific region?

Why is the Japanese government enthusiastic about the TPP, but reluctant to support the AIIB?

At first glance, the contrasting choices appear to suggest that the Japanese government is making decisions based on security considerations, and favoring its American ally's initiative over its regional rival China. A somewhat more nuanced explanation is that the Japanese government tends to be sensitive to US preferences due to Japan's dependence on both the security umbrella of its ally and access to its market. And, because of historical and territorial tensions and the fear of a rising China, Japan would never support China's regional initiative, even though Japanese businesses would stand to gain from infrastructure projects through AIIB funding.

But the reasons behind Japan's economic policy choices are much more complex than the security or balance of power arguments. For starters, despite possible economic returns and political gains from supporting the US policy initiative, Japan was very reluctant to join the TPP, given that domestic opposition was so strong. It took the Japanese government almost three years to join the TPP negotiation after former Prime Minister Naoto Kan announced plans to do so in 2010. In addition, Japan has shown no intention of containing China or limiting China's access to the US market, particularly because an increasing number of Japanese manufacturers use China as an export platform for their products. In fact, Japan, as well as many in the United States, wants China to join the TPP in the future to make it a more widely encompassing agreement. In the area of finance, Japan once proposed an "Asia-only" alternative to the International Monetary Fund (IMF), which was called the Asian Monetary Fund at the time of the 1997 Asian financial crisis. Although this idea never materialized, it is important to note that Japan has since engaged in regional financial initiatives, such as the Chiang Mai Initiative, in collaboration with China and without the United States. The Japanese government often shares similar concerns as China about the state of the regional economy, in contrast to the argument that it always prioritizes US interests. Finally, Japan's business interests are complex, and pursuing only old-style infrastructure investments, as advanced by the AIIB, is not sufficient. Given these examples, it is important to consider Japan's own perspective, both in terms of its domestic politics and regional economic strategies, in order to understand its choices.

The power dynamics among Asia-Pacific economies have been in flux, particularly since the 2008 global financial crisis. To reengage with Asia, the Obama administration's "rebalance" is poised to use multiple foreign policy instruments, with the TPP serving as the most important economic policy. There is also competition over who sets the rules in the areas of trade and investment in the region, with China's rapid economic expansion having distressed many rules of economic engagement—from the protection of intellectual property rights to the role of state-owned enterprises.[1] The Chinese leadership has been frustrated not only by the perceived economic containment imposed by the TPP, but also by the continuing supremacy of US power. Not only is the US dollar dominant in the region, but also economic development strategies—set by global financial institutions such as the IMF and the World Bank—are controlled by Western powers. As the neoliberal economic model was called into question by the 2008 global financial crisis, China grew ready and willing to challenge global and regional economic governance priorities with its alternative strategies challenging the dollar's dominance and emphasizing infrastructure investment.

For Japan, the TPP negotiation was an entirely new ball game

The Japanese government is positioned to use these emerging economic arrangements in its favor, to support both its economic growth strategy and geoeconomic goals. If the strategy is successful, not only would Japan gain economic advantage, but it would also gain more influence in the region. Japan could achieve a leadership role, leveraging its unique position between the two major powers of the United States and China, who are competing to determine the future of Asia-Pacific economic governance.

The TPP

On October 5, 2015, the TPP's final agreement was reached at its ministerial meeting in Atlanta, Georgia, following a five-day marathon negotiation among the trade ministers and five years of negotiating rounds among the original TPP members. The TPP is a mega–trade deal whose 12 member countries around the Pacific Rim produce 40 percent of global gross domestic product (GDP).[2] The TPP is also path-breaking, as it pursues a high standard of market liberalization and a comprehensive, rule-based free trade regime among the members. The agreement was signed by its 12 members on February 4, 2016, and currently awaits ratification by the members to come into effect. [3]

After several years of false starts due to strong domestic opposition, Prime Minister Shinzō Abe announced in March 2013 that Japan would join the TPP negotiations. After getting approval by the 11 members, Japan began participating in the negotiation process in July 2013, becoming the twelfth and last negotiating member of the TPP. Following the February signing, deliberation on the TPP ratification and associated domestic legislation began in Tokyo on April 6, 2016. Despite strong criticisms from TPP opposition groups, the Japanese government, with a solid Liberal Democratic Party majority in both houses of the Diet, is expected to ratify the TPP.

For Japan, the TPP negotiation was an entirely new ball game. The Japanese government had completed a dozen or so free trade agreements before the TPP, but only with small partner countries that did not fundamentally impact its domestic economy.[4] Given the TPP's impact, there was strong domestic opposition to the trade agreement. Japan's agricultural sector, which stands to lose from increased competition, launched skillful anti-TPP campaigns with the help of the Japanese Agricultural Cooperative (JA). Such sectoral opposition expanded into general antipathy against the TPP, spurred by uncertainty about losses that might occur from the deal's aggressive trade liberalization and rule changes.[5] The TPP also reminded people of the US-Japan trade disputes of the 1980s and 1990s, particularly the Structural Impediments Initiative, in which the US government demanded changes to Japan's economic structure. Dozens and dozens of anti-TPP books were published claiming that the TPP would abolish national medical insurance or impose mandatory English-only education in schools, thus leading Japan to ruin.[6]

Despite tough opposition, including from members of its own party who faced difficult elections in rural areas, the government leadership was keen on the TPP largely for three reasons. First, the TPP would bring the structural reform that Japan needs to achieve economic growth. Since Prime Minister Abe came into office in December 2012, his administration has put in place "three arrows" of economic growth, a strategy dubbed "Abenomics." The first arrow is bold monetary policy, which has brought monetary growth (more money in the economy); the consistent rise of the Nikkei Stock Index; and yen depreciation that advantages Japan's exports. The second arrow is implementation of flexible fiscal policy, though this has clear limitations given Japan's large government debt. In order to achieve tangible results from the third arrow, structural reform, the Japanese government sees the TPP as a useful *gaiatsu* (foreign pressure) tool. It is worthwhile to note that, this time, the pressure to change Japan has been initiated by the Japanese leadership and not imposed upon Japan by the United States. The Abe government hopes that the TPP will revitalize industry and agriculture in Japan, invite more foreign and domestic investment, spur export growth, and make Japan the hub of the global value chain.[7]

The Japanese government sees the TPP as a useful* gaiatsu *(foreign pressure) tool

The second reason that government leaders support the TPP is because Japan stands to accrue large economic gains from this mega–trade agreement. According to analysts, Japan can expect the largest economic gains among the TPP members. Estimates point to 1.9 percent GDP growth in the next ten years, thanks not only to tariff and nontariff reductions, but also to the vitalization of Japan's economy through structural reform.[8] For competitive Japanese businesses, the TPP is attractive because it opens up markets not only in the United States, but also in other member countries whose markets are still heavily protected. In addition, the agreement would establish rules such as protection of foreign direct investment and intellectual property rights, liberalization of services and government procurement, and a framework for digital trading.

Finally, the Japanese government would immediately gain the power to influence other Asian countries, particularly China, in their respective commercial policies. For China, being excluded from the TPP incurs costs and challenges beyond just the economic costs of trade and investment diversion. Once the TPP rules become the commercial standard in East Asia, Chinese businesses will face multiple challenges, from competition policies to rules governing intellectual property to restrictions on state-owned enterprises. As a result, it is possible that China's leading role in regional trade could weaken. "Losing" Japan—the third-largest economy in the world, with advanced technology and abundant capital—to the TPP is damaging to China. In response, the Chinese government has become more conciliatory toward Japan, as the two major powers in the region negotiate to define the contours of East Asian trade integration.[9] For example, China had long insisted on establishing a regional free trade area among the ASEAN+3 (China, Japan, and South Korea) members, while Japan has wanted to include these 13 countries plus Australia, New Zealand, and India (ASEAN+6). As Japan approached the TPP negotiation, China compromised with Japan concerning its membership preference in the East Asia free trade area. In this manner, Japan has obtained the power to spur other mega–free trade agreements in the region, including the Regional Comprehensive Economic Partnership (RCEP) negotiations and the trilateral agreement among China, Japan, and South Korea. In terms of the United States' Asia-Pacific economic strategy, Japan is also a vital partner. This important position has allowed the Japanese government to protect five "sacred" sectors of agriculture (rice, wheat, pork and beef meat products, dairy, and sugar) from full liberalization and to negotiate significantly lower tariff liberalization—95 percent—than the more than 98 percent other TPP negotiating members have committed to.[10]

The AIIB

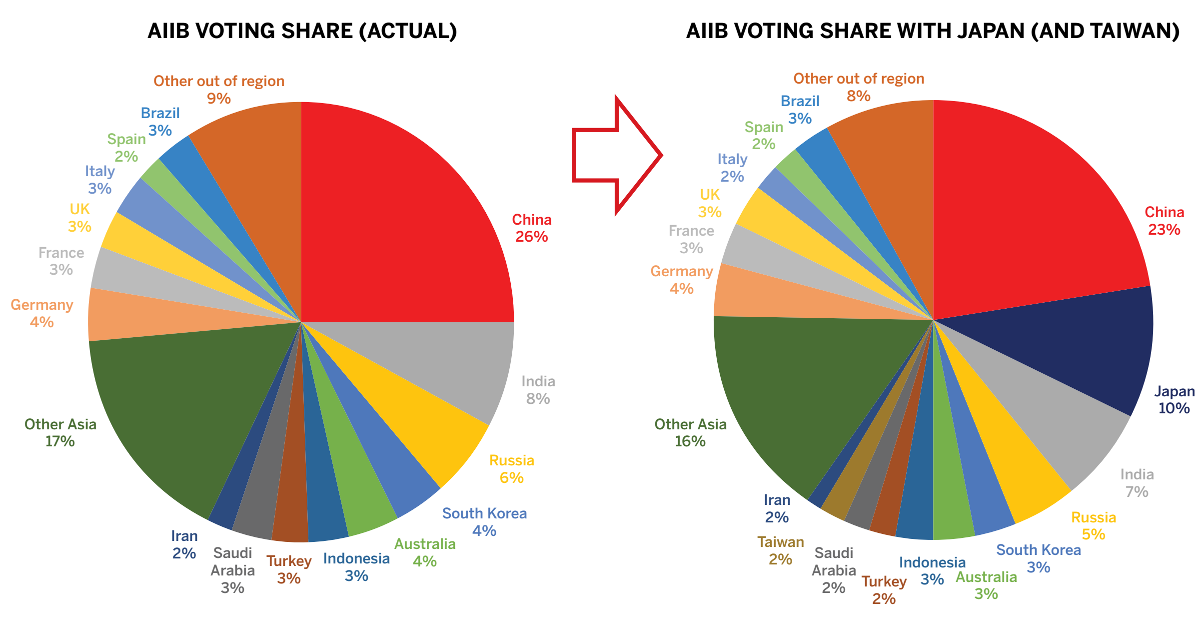
The story of Japan's position on the AIIB contrasts with the one on the TPP. On March 31, 2015, as the deadline to become a prospective founding member of the newly proposed bank came and went, the Japanese government sat on the sidelines with the US government, while 57 countries around the world—including many US allies—jumped on the bandwagon. Although Japanese politicians and officials discussed Japan's possible entry even after the March deadline had passed, the government has so far stayed out. On January 16, 2016, the AIIB was officially inaugurated with a few concrete investment projects proposed. Despite the Bank's smooth start, the Japanese government is still concerned about the quality of its governance.[11] In addition, there are no domestic supporters pushing for the Japanese government to participate in the AIIB. Two major actors, the Ministry of Finance and the Japanese business sector (supported by the Ministry of Economy, Trade, and Industry)—the actors most likely to lead Japan's entry in the AIIB—are either opposed or indifferent for several reasons discussed below.

The actors most likely to lead Japan's entry into the AIIB are either opposed or indifferent

From the Ministry of Finance's standpoint, the costs of achieving a successful AIIB vastly outweigh the potential benefits that Japan would receive. First, Japan worries about the AIIB diluting the influence of post-WWII Bretton Woods institutions such as the IMF and the World Bank, as well as the Asian Development Bank (ADB). With the emergence of a competing funding institution with a different emphasis, the AIIB could potentially weaken social and environmental protections. Japan's own political influence in these institutions is also at stake. Japan now holds the second-largest voting share in both the IMF and the World Bank, a status it received after challenging its low share for the last 40 years.[12] The Japanese government argued that it had diligently worked within the system, where the incumbent powers from Europe and the United States have had, in the newcomers' view, an "unfairly" large power share, to achieve its secondary position. As for the ADB, this regional multilateral development bank was initiated by the Japanese government in 1966, and remains Japan's important contribution to Asia's economic development. The Japanese government holds 15.7 percent of the bank's voting share, basically the same amount as the United States. In addition, it has been the convention that retired, formerly high-ranking officials from the Ministry of Finance are named as ADB presidents.

Second, the Ministry of Finance does not foresee a positive return on investment if Japan were to join the AIIB. Because of the AIIB's capital subscription and voting shares that favor regional members, Japan, as an Asian country, is estimated to receive the fairly high voting share of 9.8 percent, with its subscription set at $10.6 billion (Figure 1).[13] There has also been talk that Japan could expect to receive the vice president position at the AIIB. However, despite these advantages, the concern is that Japan's participation would be used to mask the AIIB's governance problems. For example, if Japan participates, it could lead to a higher credit rating for the AIIB, as well as more legitimacy and credibility.[14] Hence, the Japanese government's wait-and-see attitude could contribute

Figure 1. **The AIIB Voting Share without and with Japan.**



Source: Kawai (2015;16).

to greater efforts on the part of the AIIB to implement transparency and robust governance, with the goal of achieving solid ground in the financial markets.

From a business perspective, the AIIB is not necessarily an attractive entity to Japan. Even if (as insisted by the AIIB's president Jin Liquin) the AIIB would make the infrastructure contract-bidding process open to all nationalities and use transparent procedures, there is very little likelihood that Japanese companies would benefit much from these projects. According to the Ministry of Finance, in recent years only 0.5 percent of infrastructure contracts have been awarded to Japanese companies from the ADB, an institution over which Japan has dominant power. Even into the twenty-first century, the Japanese government has capitalized on infrastructure development as an integral component of Asia's economic growth strategy, to the extent that 44.6 percent of Japan's bilateral aid was geared toward economic infrastructure in 2013–14.[15] With the high quality of Japan's construction, however, the cost of Japanese projects tends to be very high, causing Japan to lose contracts to competitors from countries like India and China. In addition, despite the often-quoted figure of $8 trillion in infrastructure needs in Asia over the next ten years, the risk and difficulty of the bulk of these projects are quite high.

Next Steps

The TPP has been called the trump card of the Abenomics growth strategy

With the expectation that the TPP will come into effect, the Abe administration announced the "Comprehensive TPP Related Policies Charter (TPP Charter)" on November 25, 2015, crystalizing Japan's strategy to most effectively utilize the TPP to its advantage. Calling the TPP the "trump card" of the Abenomics growth strategy, the Charter laid out how the TPP can bring economic gains to small and medium enterprises and to the agricultural sector in Japan through new export strategies. It also promotes an ambitious plan for Japan to become the global hub of trade and investment through innovation in global value chains.[16] Since the TPP reached basic agreement in October, nonmembers such as the Philippines, Thailand, South Korea, and Taiwan are already showing a strong interest in joining. Furthermore, the Japanese government plans to leverage the TPP in shaping regional trade architecture, and in aiding its ongoing negotiations in the RCEP and the trilateral free trade agreement with China and South Korea. It is the Japanese government's hope that not only would these intra-Asia regional free trade agreements achieve a higher liberalization level, but that they would also incorporate rules from the TPP. Of course, the largest concern now is when the United States—currently undergoing a presidential election season, and with all candidates announcing reservations to the TPP—would place the TPP ratification deliberation through the House and Senate, and whether or not the TPP will be supported by lawmakers.

In the area of development finance, the Japanese government has to seek influence in the region using its own instruments, rather than through the newly established AIIB, at least for the time being. Nonetheless, the AIIB's influence is already being felt in the reforms that the United States and Japanese governments have taken in the multilateral development banks in which they dominate. First, both the World Bank and Asian Development Bank have promised to collaborate closely with the AIIB in their financing operations through co-financing and sharing expertise. The ADB was particularly swift to react, as its president, Takehiko Nakao, has proactively engaged with the AIIB and met with Jin Liquin several times. Second, to compete with the AIIB, the funding practice of the ADB has already been modified to address criticisms and weaknesses. ADB loan amounts are to be expanded by 50 percent starting in 2017, and its loan approval process will be shortened from 21 months to 15 months. Third, the Abe administration is now keen on expanding its "quality infrastructure" investment. At the 21st International Conference on the Future of Asia in May 2015, Prime Minster Abe unveiled Japan's economic cooperation expansion through Public-Private Partnership and a 25 percent increase in funds for infrastructure investment. Furthermore, the Japanese government plans to boost the capacity of the Japan Bank for International Cooperation to fund infrastructure projects by giving the bank a financial cushion to sustain higher-risk projects and allowing it to have a longer cost-accounting time frame. The changes are not only focused on improving infrastructure financing practices, however. There has been a visible reversal in Japanese foreign aid from being mostly untied to being tied to purchase and procurement from Japan.[17]

Leadership competition in the area of development finance will continue between Japan and China

Future Paths

The economic governance structure of the Asia-Pacific region has begun to shift dramatically with these two mega-initiatives, the TPP and the AIIB. As the United States and China promote their respective economic norms and rules in the region, the Japanese government is responding to this tectonic shift. And it is moving in the direction that would benefit Japan's economy and its geoeconomic position. Japan's business interests and strategic interests have aligned to support the TPP. As for the AIIB, while the move was not supported by Japanese businesses, the government's decision to distance itself from the bank emerged from defensive concerns that it needed to maintain its position in the retreating global hierarchy.

Three points are important to consider for the future path of Asia's economic governance. First, despite domestic opposition, the rule-based trade and investment regime of the TPP would benefit Japan, and it would be an important element in restructuring the Japanese economy. The Abe administration desperately needs the TPP both domestically and regionally to revitalize Japan's economy. Meanwhile, the Japanese government could also benefit from the TPP's critical influence in defining the rules of the game for the region's trade and investment relations. Second, leadership competition in the area of development finance will continue between Japan and China. Such competition is generally a welcome dynamic for regional governance, as well as for the smaller developing countries of Southeast Asia, as the major powers compete for followers and supporters. Finally, a concerning development in Japan is the insistence that national gains and vested interests are prioritized over the common good of the region going forward. Despite the lack of direct business returns, Japan would have been an important regional player if it had taken part in the AIIB. At this point, Japan's long experience as the major aid donor in Asia and leader of the ADB will go untapped by the AIIB. By staying on the sidelines, Japan may have deprived the AIIB of its chance to be another important institution promoting the region's cooperation and development.

Notes

[1] Hence, President Obama's famous statement, "If we don't write the trade rules, China will." This was first quoted in his interview with Jerry Seib of the *Wall Street Journal* on April 26, 2015.

[2] The TPP member countries are: Chile, New Zealand, Singapore, and Brunei (original P-4 members); the United States, Australia, Peru, and Vietnam (joined negotiation in 2008); Malaysia (2010); Canada and Mexico (2011); and Japan (2013).

[3] If all 12 governments do not ratify the TPP agreement within two years, the requirements are that 85 percent of the TPP GDP and at least six countries must ratify the TPP agreement for it to come into effect. That means the legislatures of both the United States and Japan (which, combined, account for approximately 78 percent of the TPP GDP) have to ratify the agreement, as well as any four other countries among the remaining ten.

[4] The bilateral and multilateral free trade agreements that Japan had signed by early 2013 are with Singapore, Mexico, Malaysia, Chile, Thailand, Indonesia, Brunei, ASEAN, the Philippines, Vietnam, Switzerland, India, and Peru.

[5] Naoi and Urata (2013) argue that the protectionist coalition emerged from the convincing campaign organized by the JA. Megumi Naoi and Shujiro Urata, "Free Trade Agreements and Domestic Politics: The Case of the Trans-Pacific Partnership Agreement," *Asian Economic Policy Review* 8.2 (2013): 326–349.

[6] The most popular book of this genre was Takeshi Nakano, *TPP Boukoku-ron* (*Prophecy of How TPP Ruins Japan*) (Tokyo: Shueisha, 2011).

[7] These are the goals set by the Abe cabinet in its TPP Charter announced in November 25, 2015.

[8] Peter A. Petri and Michael G. Plummer, "The Economic Effects of the Trans-Pacific Partnership: New Estimates," Peterson Institute for International Economics Working Paper 16-2 (2016). Japan's cabinet office estimates that the TPP will contribute an additional ¥14 trillion ($140 billion) in the next ten years (December 24, 2015).

[9] See Solis and Katada (2015) on how Japan's announcement to join the TPP in 2010 had already triggered a cascade effect on other free trade agreements in Japan's favor. Mireya Solis and Saori N. Katada, "Unlikely Pivotal States in Competitive Free Trade Agreement Diffusion: The Effect of Japan's Trans-Pacific Partnership Participation on Asia-Pacific Regional Integration," *New Political Economy* 20.2 (2015): 155–177.

[10] C. Freund, T. Moran, and S. Oliver, *Tariff Liberalization: Assessing the Trans-Pacific Partnership*, Vol. 1: Market Access and Sectoral Issues (Washington, DC: Peterson Institute for International Economics, 2016): 31–40.

[11] The president designate of the AIIB, Jin Liquin, has promoted the institution as "lean, clean, and green." For the argument about Japanese concerns, see Masahiro Kawai, "Asian Infrastructure Investment Bank in the Evolving International Financial Order," in *Asian Infrastructure Investment Bank: China as Responsible Stakeholder?* (Washington, DC: Sasakawa Peace Foundation USA, 2015): 5–26.

[12] Japan's second-ranking position has remained after the US Congress agreed in December 2015 to support the 2010 IMF quota reform, an agreement that was long pending due to a delay in the increase of US contributions. The new voting share allocation places China at 6.39 percent, a very close third to Japan's 6.46 percent.

[13] Calculation based on Kawai, see note 11.

[14] Masato Kanda, "Infura shi-en ni tsuite (About Infrastructure Support)," *Fainasu,* July 2015, 7. It was particularly the case prior to March 2015, before many advanced industrial countries joined.

[15] OECD DAC report 2015, at http://www.oecd.org/dac/stats/statisticsonresourceflowstodevelopingcountries.htm. The average amount of bilateral aid allocated to economic infrastructure by the entire OECD DAC donors during the same period was 18.9 percent.

[16] TPP Charter; http://www.cas.go.jp/jp/tpp/tppinfo2.html.

[17] Japanese aid was traditionally tightly tied to procurement and contracts with Japanese businesses, which tends to increase the costs and was considered to be mercantilist. The Japanese government, however, responded to international norms by severing the links during the 1990s and through the 2000s. The result was that Japanese aid became virtually untied to procurement and contracts, until recently.

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For information, please contact:

Publications Office
East-West Center
1601 East-West Road
Honolulu, Hawai'i 96848-1601

Tel: 808.944.7145 | Fax: 808.944.7376
EWCBooks@EastWestCenter.org
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About the Author

Saori N. Katada *is associate professor at the School of International Relations at the University of Southern California. She was an Asian Studies Fellow at the East-West Center in Washington in 2015. Katada is the author of several books and numerous articles on trade, financial and monetary cooperation in East Asia, and foreign aid. She has her PhD from the University of North Carolina at Chapel Hill (political science) and BA from Hitotsubashi University (Tokyo). Before joining USC, she served as a researcher at the World Bank in Washington, DC, and as international program officer at the UNDP in Mexico City.*

She can be reached at: skatada@usc.edu