



ACTION MEMORANDUM

United States Department of Innovation

Washington, DC 20590

To: U.S. Trade Representative Susan C. Schwab
From: Sherman Katz and Devin T. Stewart
Re: Comprehensive Economic Partnership Agreements (CEPA)
Date: September 1, 2006

After decades of mutual mistrust, East Asian states have begun to shape a new political-economic order. The China-ASEAN free trade agreement of July 2005 marked a watershed: China's embrace of bilateral and regional institutions means that Japan is no longer the primary driver of regional integration, and competition for leadership between China and Japan is accelerating both the pace of integration and the prospect of a harmful Sino-Japanese regional competition.

China has demonstrated considerable creativity in its economic diplomacy, not least with the promotion of an East Asian Summit this past December that excluded the United States. Although the first summit was not productive, it could lead to an East Asian community that could aid China's ascent to eventual regional hegemony. If China attains this position, it could determine both membership in a regional bloc and the values enshrined in any charter or regional governing body. One requirement to join the East Asian Summit, for example, is the acceptance of a Treaty of Amity and Cooperation (TAC), first drafted in 1976 to re-energize ASEAN, which requires neutrality among its members. The summit and any institution it produces could therefore weaken existing bilateral alliances between East Asian countries and the United States. The TAC enshrines national sovereignty, identity and territorial integrity, but it omits principles that are consistent with Asian democracy.

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If China were able to dominate a new regional bloc or build on ASEAN Plus Three, it would probably weaken other institutions, such as the Asia-Pacific Economic Cooperation (APEC). Chinese success along these lines would thus create a polarized region in which smaller countries are forced to pick sides, leading to zero-sum competitions, notably between China and Japan. This would be bad for everyone, including the United States. As Wang Jisi, dean of the School of International Studies at Peking University, wrote in the September/October 2005 Foreign Affairs, “Hard-liners in Washington may think that the United States benefits from a souring of the Chinese-Japanese relationship. In the long run, however, conflict between Beijing and Tokyo helps no one, since it could destabilize Asia’s existing economic and security arrangements, many of which benefit the United States.”

If China, aware of U.S. conventional military supremacy, is seeking advantage on other fronts such as economic diplomacy, how should the United States respond? One instrument should be Comprehensive Economic Partnership Agreements (CEPAs) with countries such as Japan and others in the region that share democratic and open-market values.

The CEPA Option

CEPAs stand on four pillars: trade liberalization, regulatory convergence, economic precedents for the international system, and trade security. A CEPA with Japan would raise the U.S. profile in East Asian economic integration and stimulate high-quality growth. An informal grouping of CEPA participants, which could include China when it is ready, would help nudge China toward transparency and accountability. In the meantime, CEPAs could blunt China’s effort to use economic diplomacy to isolate the United States in East Asia.

Trade Liberalization

The reduction of tariffs and quotas should be a major element of all bilateral CEPAs. Information technology is ripe for U.S.-Asian trade liberalization. The WTO has provided a fruitful venue for more than 66 IT-producer and consumer nations to agree to zero tariffs to facilitate trade in components and finished items. In a precedent-setting U.S.-Japan CEPA, the United States and Japan could take inspiration from that example to create a “zero baseline” of trade or regulatory barriers in the entire IT sector, including common-sizing of components, connection elements and capacities of microchips. This effort could lead to a profitable integration of several cutting-edge segments of the most dynamic industry leaders in IT.¹

¹Three IT associations, the Information Technology Industry Council (ITI), the European Information Communications and Consumer Electronics Technology Industry Association (EICTA), and the Japan Electronics and Information Technology Industries Association

According to the USTR's 2006 National Trade Estimate, U.S. exports to Japan in 2005 were up 2.2 percent from the previous year. Nevertheless, Japan maintains high tariffs and quotas on a number of U.S. products, including leather footwear, fish products, wood products, housing materials and food products such as oranges (32 percent), processed cheese (40 percent) and natural cheese (30 percent). A U.S.-Japan CEPA can and should work down Japan's barriers.

Convergence of Regulatory Systems

The second pillar of every CEPA should be a convergence of regulatory systems to facilitate trade and investment. Japan's stock of FDI is just over two percent of GDP compared with 22 percent in the United States and 37 percent in the UK. President Bush and the next Prime Minister of Japan should create a small, joint cabinet-level task force to prepare for signature at the next U.S.-Japan summit a program of coordinated actions to reduce impediments to foreign investment, including regulatory and taxation measures. Both governments should take full advantage of the efforts of the Regulatory Reform Initiative under the U.S.-Japan Partnership for Economic Growth--established by Bush and Koizumi on June 30, 2001, to set a more constructive tone in the economic relationship. But both parties should acknowledge that progress to date has been inadequate and give the cabinet-level task force a mandate to promptly produce a program of specific actions.

The Japanese minister for health and the U.S. FDA commissioner for device and pharmaceutical approvals, along with legislators with oversight responsibilities for these regulatory processes, should also meet to send clear political messages to regulators in both countries: Regulators must give high priority to the impacts in each other's jurisdiction of the approval processes, and industry members in both countries should participate in the regulatory process. Moreover, given the high levels of scrutiny demanded for devices and pharmaceuticals in Japan and the United States, negotiations should begin on Mutual Recognition Agreements for regulatory approvals.

Precedents for the International System

CEPA signatories could join together to set positive precedents for broader international collaboration in the international system through cooperative action in three areas: the environment, the international economic system and global security. Examples of such collaboration might include coordination of sales of strategic petroleum reserves to stabilize oil prices; the development of new hydrogen-powered automobiles and clean, renewable sources of energy; the development of

(JEITA) recently endorsed a sectoral initiative in the Doha Round that would eliminate all tariffs on electronic products and commit countries to move toward a common regulatory system for safety and electromagnetic compatibility.

a disaster-relief coalition, and the enforcement of intellectual property-rights standards. On the security front, the Japan Atomic Energy Research Institute and its counterpart in the U.S. Department of Energy could undertake joint projects aimed at the more effective detection of low-level radiation. It may be only a matter of time until nuclear incidents, whether from military or civilian uses, threaten radiation sickness and significant loss of life.

The United States, Japan and other like-minded nations should also announce a maritime environmental initiative on oceanic transport and detection of oceanic earthquakes. As with investment and energy, this would require a small group of relevant officials to develop a program for implementation in the next 12 months.

Trade Security

CEPA accords should reduce border- and visa-security regulations for business travelers and tighten cooperation to allow for the more efficient processing of containers and business visas. Greater opening at the border would depend on governments sharing basic democratic values. A model for this level of integration is the Security and Prosperity Partnership of North America, an initiative announced in March 2005 by the leaders of Mexico, Canada and the United States.

A technology program that could serve as a model for this initiative is the e-Passport program between the United States and Australia, which began testing in June 2005. Required by the Department of Homeland Security, e-Passports will contain digital photographs and biometric information. Citizens from countries like Japan and Australia that enjoy U.S. visa-waiver privileges will need the new passports starting in October. DHS will require that all lost and stolen passports be reported, contributing to an increased flow of information among these countries. Other areas to be explored include mutual recognition of drivers' licenses and the provision of social security number databases to citizens of CEPA signatories.

The transnational flow of goods also can be improved through deepened customs cooperation and the full implementation of the Container Security Initiative (CSI), of which Kobe, Nagoya, Yokohama and Tokyo are already participating ports. The core elements of the CSI are the use of intelligence, pre-screening, detection technology and smarter containers to prevent shipping containers from being used in acts of terrorism. CEPA agreements would be an ideal means to grow the CSI.

Merits

Using CEPAs as a foreign policy tool has several merits. First, deeper economic

integration would allow the United States and its friends to influence the shape of any Asian trade bloc that comes into being. The United States and other parties to CEPAs could also join together to pressure, for instance, violators of intellectual property rights at the World Trade Organization--a notion somewhat analogous to the Cairns Group of agriculture exporting nations in the WTO and the Democracy Caucus in the United Nations.

Second, labor-abundant, democratic economic competitors of China in Asia, such as Thailand and Indonesia, would find economic liberalization with the United States and Japan--two countries rich in capital and technology--to be equally beneficial to opening up to China.

Third, U.S. companies might lose competitive advantage in large Asian markets without U.S. involvement in Asian integration. Little of the recent U.S. push toward free trade agreements has included East Asia, and China and Malaysia are proposing regional agreements that would exclude the United States. The logical strategy is for the United States to work with Japan, Australia, South Korea, India and other democracies in Asia to sign CEPAs that will form the bedrock of future East Asian integration.

Fourth, promoting democracy through CEPA agreements is consistent with U.S. foreign policy goals. Strong economic and security relationships among democratic nations can become development models for other East Asian countries. The spread of democratic governance and transparency promotes political stability, while the spread of market institutions will promote economic growth.

Fifth, CEPAs can help keep the United States anchored as a stabilizer in East Asia and hedge against Chinese challenges. A world is possible in which states follow China's path to economic growth without the constraints of democratic institutions--a "Beijing consensus", as it were. The "Washington consensus" in support of free markets and free trade, meanwhile, faces widespread criticism within Asia. Successful CEPA agreements could help revive a consensus based on political and economic openness.

Feasibility

Four factors make concluding a U.S.-Japan CEPA as a first step eminently feasible. First among these is the historically low level of trade friction between the United States and Japan, and second is the momentum created by the conclusion of other free trade agreements by the governments of the United States and Japan. In 2002 Japan abandoned a policy of only considering multilateral agreements, signing its first bilateral free trade agreement with Singapore and then a second in 2004

with Mexico. Japan has also held talks with Korea on a bilateral agreement and is pursuing an agreement with ASEAN Plus Three. Meanwhile, the United States signed agreements with Australia, Bahrain and Morocco in 2004 alone, completed talks with Oman in January, and will do so with the UAE and perhaps Colombia soon. The Administration has used free trade agreements to reward allies, one of which surely is Japan. The U.S. Chamber of Commerce wants the United States to sign more agreements, and the National Association of Manufacturers includes Japan in a list of potential free-trade partners.

Third is a growing sense of the political utility of CEPA agreements. The strongest case for concluding a U.S.-Japan CEPA is the prospect that China could soon rival the United States and Japan in terms of political influence, market power and military strength in Asia. The United States and Japan should respond to China's rise in a way that does not alienate China or polarize the region and creates incentives for China to move in a cooperative direction. A U.S.-Japan CEPA can do that. The story of China's WTO accession shows that China will participate in U.S.-sponsored organizations if it deems doing so to be in its interest, even if it means committing itself to economic and political reform.

A fourth factor suggesting the feasibility for CEPAs is that two groupings already exist that can provide a pool of candidates: the Community of Democracies and the tsunami-relief coalition of the United States, Japan, Australia and India. Both groups include members that uphold democratic values and the rule of law and recognize the mutual relationship between development, peace, stability and human rights. The disaster coalition comprises states with capabilities to act globally on behalf of those principles.

Obstacles

Strong pushback regarding a U.S.-Japan CEPA can be expected from two quarters: Congressmen whose constituents are parties to ongoing trade litigation in dumping cases, and industrialists frustrated by the lack of access to the Japanese market. Although China has overtaken Japan's place as the number-one unfair-trade culprit in the eyes of U.S. media--a title that is conferred automatically on the country with which the United States has the largest trade deficit--Japan continues to occupy a strong second place. Many Americans think of Japan as a country that does not play fairly, not only because of Japan's extensive penetration of the U.S. market but also because Japan, unlike China, is relatively closed to foreign investment. Such opposition can be overcome, however, once people see that a CEPA will address the very problems at issue.

If China perceives CEPAs as an exclusionary multilateral grouping, it may try to

tighten its relationship with ASEAN, and competition for alignment in East Asia could ensue. To minimize opposition from China, CEPAs therefore should not be presented as a cohesive multilateral organization, but rather as an ad hoc grouping like the tsunami-relief coalition. The experience with China in the ASEAN Regional Forum, a group China originally rejected, suggests that China could work within a new CEPA grouping.

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A U.S.-Japan CEPA should be one of many layers of Asia-Pacific integration. The United States and Japan should contribute to the proliferation of free trade agreements in the region while advancing principles of good governance, free markets, and economic and political liberty as essential components of new CEPAs across the region.

Simply adding new CEPAs after an initial U.S.-Japan agreement offers no overarching regional architecture, but Asia is not ready for a more highly integrated regional framework. The United States and Japan should contribute their own ingredients to a regional stew in the hope that these elements will become the predominant flavors when the stew is fully cooked.

Above all, the United States is well advised to reinvigorate its alliance with Japan in order to ease regional concerns about Japan's growing political profile. Creating a network of CEPAs that is attractive to all democratic countries in Asia is one way to do this. Such a network would liberalize the flow of capital and technology, and place democratic governance in the foreground as the basis for deeper integration.