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# Third Time's the Charm: Strengthening the U.S.–Japan Economic Dialogue

*Riley Walters*

The dialogue between Washington and Tokyo has become the centerpiece of U.S. economic engagement in Asia within the Administration's Indo–Pacific Strategy. It is currently the U.S.'s main economic dialogue with any Asian partner, other than the sidelined U.S.–China Comprehensive Economic Dialogue or the renegotiation of the Korea–U.S. free trade agreement. In contrast with the dialogue with China, a strengthening of the U.S.–Japan Economic Dialogue is not only important but possible given both countries' free-market principles.

While there are benefits to the dialogue, such as the inclusion of both Vice President Pence and Deputy Prime Minster Aso, some issues, such as reduction in trade uncertainty, can only be addressed through a formal agreement. For the third meeting of the dialogue, both countries should continue to pursue trade and investment liberalization, seek to protect innovation for emerging technologies and services, and examine the current investment climates brought about by each countries' tax and monetary policies.

## The Dialogue

The U.S.–Japan Economic Dialogue, crafted by President Trump and Prime Minister Abe, is built on three pillars: achieving a common strategy on trade and investment, cooperating on economic and structural policies, and building sectoral cooperation.[1] Other than the U.S. and Japan committing to a strong economic relationship, outcomes from the dialogue have mostly included commitments to transparency and reciprocity as well as the removal of regulations restricting the import of U.S. potatoes and Japanese persimmons.[2] Certainly both sides can do more to liberalize trade.

The goal of the dialogue is a continued commitment towards economic engagement. It has facilitated high levels of communication between two of the largest trading partners in the world, allowing them to address trade or investment concerns as they arise.

Special interests and political constraints in both the U.S. and Japan decrease the likelihood that the dialogue will be used as a platform to announce a bilateral agreement. However, President Trump recently signaled a willingness to entertain a multilateral trade deal with countries from the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP)—like Japan—if such a deal were advantageous for the U.S.

## The U.S. Champions in Investment, Japan Leads in Trade, but Problems Persist

As Washington continues to renegotiate existing trade deals, Tokyo is sealing new ones. In addition to the CPTPP, Japan signed an Economic Partnership Agreement with the European Union in December 2017, which liberalizes trade for a number of agricultural products like beef and cheese.[3] Japan is also currently in discussions with officials in the U.K.

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regarding the feasibility of a trade agreement following Brexit.[4]

Whatever the benefits of the agreements themselves, Japan is taking first-mover benefits by moving towards trade liberalization. Trading countries have to consider a time factor as countries race towards new trade deals. Trade regimes become institutionalized, regulations are implemented, and commercial relationships are built. Later trade deals have to cope with these realities.

While Japan is leading the charge in signing new trade deals, the U.S. continues to champion itself as a place for investment. The U.S. is the single biggest recipient of foreign direct investment with $3.7 trillion invested by 2016. Japanese investment in the U.S. is the second largest, behind the U.K., at $421 billion in 2016.

However, Japan's own inbound investments reflect one of the lowest destinations for any Organization for Economic Co-operation and Development country—receiving $227 billion in foreign investment by 2016. Of investments, total mergers and acquisitions (M&A) of Japanese firms have been on a steady decline. And of the M&A taking place, more activity is moving outside Japan. Japan now has more outbound deals than domestic deals: Cross-border deals have increased to about 63 percent of all M&A.[5] Japan has seen similar declines in firm bankruptcies.

For years, the Bank of Japan has been intervening in the stock and bond markets. This, combined with decades of low interest targeting, has created distortions in Japan's economy and labor markets.[6] These low interest rates have created artificial demand for capital, which increases short-term investment, but is ultimately an inefficient use of investment.

All this should call into question whether Japan's own policies towards building domestic growth have been working, and how much of Japan's economy is still operating with uncompetitive "zombie" firms.[7]

While the U.S. and Japan both continue to have relatively low total tariff rates, certain goods can still be expensive to import. Until March, Japan will maintain a temporary 50 percent tariff on beef imports for non-FTA partners, like the U.S. The tariff increased from the normal 38 percent in 2017 to protect its domestic industry, and could do the same in 2018. Other import restrictions on agricultural goods also remain. U.S. potatoes will still face an 8.5 percent import tariff in Japan as the U.S. has its own 2.5 percent import tariff on persimmons.

Given reports from the U.S. Trade Representative's Office, U.S. officials will continue to fixate on the trade deficit (approximately $55 billion in 2016).[8] However, this number is less important than U.S.–Japan combined trade of $270 billion—especially considering that the trade deficit is only a fraction of the almost $300 billion *investment surplus* the U.S. has with Japan. The Trump Administration's push for deregulation and a competitive domestic economy will likely only attract more Japanese investment. The U.S. and Japan should focus more on the investment climate between both countries

1. News release, "Second Round of the Japan-U.S. Economic Dialogue between Deputy Prime Minster Aso and Vice President Pence of the United States of America," Ministry of Foreign Affairs of Japan, October 17, 2017, http://www.mofa.go.jp/na/na2/us/page4e_000686.html (accessed February 27, 2018).
2. Ibid.
3. News release, "Key Elements of the EU-Japan Economic Partnership Agreement-Memo," European Commission, July 6, 2017, http://trade.ec.europa.eu/doclib/press/index.cfm?id=1687 (accessed February 27, 2018).
4. Peter Walker, "Theresa May Secures Japanese Pledge on Post-Brexit Trade Deal," *The Guardian*, August 31, 2017, https://www.theguardian.com/politics/2017/aug/31/theresa-may-secures-japanese-pledge-on-post-brexit-trade-deal (accessed February 27, 2018).
5. J.P. Morgan, "Japan Cross-Border M&A: Growing and Sustainable," June 2017, p. 4, https://www.jpmorgan.com/jpmpdf/1320736622067.pdf (accessed February 27, 2018).
6. For more on this topic, see Riley Walters, "Focus for U.S.–Japan Economic Dialogue: Labor Distortions Created by Japan's Monetary Policy," Heritage Foundation *Issue Brief* No. 4758, September 7, 2017, https://www.heritage.org/jobs-and-labor/report/focus-us-japan-economic-dialogue-labor-distortions-created-japans-monetary.
7. Isabel Reynolds, Yuki Hagiwara, and Takako Tanguchi, "Zombie Hordes: Thousands of Japanese Firms Dodging Bankruptcy," Bloomberg Politics, March 12, 2017, https://www.bloomberg.com/news/articles/2017-03-12/zombie-hordes-thousands-of-japanese-firms-dodging-bankruptcy (accessed February 27, 2018).
8. Office of the United States Trade Representative, "2017 Trade Policy Agenda," March, 2017, https://ustr.gov/about-us/policy-offices/press-office/reports-and-publications/2017 (accessed February 27, 2018).

given recent changes in corporate tax policies and interest rates.

Central bankers have a greater role to play in the dialogue, besides setting interest rates. They must respond to the increased amount of government securities the banks own, central government's debts, and how each threatens the growth prospect for both countries. Respectively, the Bank of Japan holds roughly 43 percent of Japanese government bonds or the equivalent of 77 percent of Japan's gross domestic product (GDP). The U.S. Federal Reserve holds a smaller but still significant amount of U.S. Treasury security valued roughly around $2.4 trillion or 12 percent of GDP.

## U.S. and Japan Are Ready to Make the Tough Decisions

The U.S. and Japan should work to expand economic freedom while allowing for competition and innovation to build economic growth. In these sorts of dialogues, the low-hanging fruit of economic freedom is often picked first. As the dialogue continues, both countries will be called upon to liberalize industries that have had years of protection for special interests.

Going into the third dialogue, the Administration should:

- **Reduce costs for investors.** Whether through transparency and communication with regulatory agencies or by streamlining the approval processes for foreign investors, both the U.S. and Japan should find better ways to increase two-way investment by reducing regulatory costs for companies.

- **Push for trade liberalization.** Reducing restrictions on livestock and agricultural products and regulations on the trade in services is a good step toward liberalizing trade. Moreover, a bilateral free trade deal between the U.S. and Japan would be a huge step toward strengthening the economic partnership. A formal trade deal is not absolutely necessary for liberalizing trade, but absent a formal end-goal (like an agreement), the economic dialogue will become more difficult (and potentially meaningless).

- **Protect innovation.** Emerging technology and new services can have an immediate pushback from regulators. The U.S. and Japan risk losing out to other countries who are more willing to let companies take risks for innovation. The U.S. and Japan should promote innovation and new services and avoid drafting rules that inhibits growth. Both countries should reexamine their laws that effect the sharing economy.

- **Expand the role for monetary policy.** Interest rates, currency impacts, and government debt are all affected by monetary policy. As two of the leading currencies in the global financial system, the U.S. and Japan should be consulting on monetary policy in order to maintain a policy of non-intervention and fiscal responsibility.

## Conclusion

The U.S. should not rule out a bilateral or multilateral agreement with Japan. In the short term, both countries should further commit to economic freedom outside a formal bilateral agreement.

*—**Riley Walters** is a Research Associate in the Asian Studies Center, of the Kathryn and Shelby Cullom Davis Institute for National Security and Foreign Policy, at The Heritage Foundation.*