

JAPAN ECONOMIC CURRENTS

A COMMENTARY ON ECONOMIC AND BUSINESS TRENDS

US-Japan Economic Integration: Is an FTA Needed?

BY ATSUSHI YAMAKOSHI, KEIDANREN

Over the past 20 years, the idea of a free trade agreement (FTA) between the United States and Japan has been floated. But time after time, before taking on any real traction, the suggestion is pushed aside for discussion some time in the hazy future.

The time to jump-start talks aimed at closer economic integration is now. Against the backdrop of painfully slow progress in the WTO's current round of trade talks (the so-called Doha Development Agenda), many countries have been moving ahead with bilateral and regional trade agreements, including the United States and Japan. For the most part, these patchwork agreements are WTO-consistent and will ideally contribute to freer trade across borders.

During President Bush's tenure, the US has ratified FTAs with six countries (Jordan, Singapore, Australia, Chile,

Keidanren Welcomes Our New Director

Keidanren-USA is pleased to welcome its new director, Mr. Atsushi Yamakoshi, who officially assumed his post on April 1, 2006.

Throughout his long career at Keidanren (the Japan Business Federation), Mr. Yamakoshi has been in charge of U.S. and Canadian affairs, environmental policies, Asian affairs, international cooperation, European affairs, trade and investment issues and media relations.

This is Mr. Yamakoshi's second stint in Washington, DC—he received his M.A. at Johns Hopkins University's School of Advanced International Studies (SAIS) in 1997 while serving as a Visiting Economist at the Japan Economic Institute from 1994–1997.

Further information about Keidanren and its activities in Washington, DC can be found at: <http://www.keidanren-usa.org/>

Morocco and Bahrain). During Prime Minister Koizumi's term, Japan has concluded Economic Partnership Agreements, or EPAs, with two trading partners (Singapore and Mexico). But though these agreements were backed by their respective business communities, none can be described as truly commercially meaningful.

By contrast, an agreement aimed at the economic integration between the US and Japan, the world's two largest economies, would be a powerful

complement to the bilateral defense alliance and would provide momentum toward expanding liberalized global trade.

Under the 2001 Economic Partnership for Growth, the US and Japan established a number of working groups to address thorny bilateral issues including "sound macroeconomic policies, structural and regulatory reform, financial and corporate restructuring, foreign direct investment, and open markets and by

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By Edward Graham, Institute for International Economics

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providing a structure for cooperation and engagement on bilateral, regional and global economic and trade issues.”

To achieve these goals, the Bush-Koizumi initiative set up five institutional mechanisms: a private sector/government Commission, the Regulatory Reform and Competition Policy Initiative, the Financial Dialogue Forum, the Investment Initiative, and the Trade Forum. With the exception of the private-public commission which was quietly abandoned a few years ago, the other institutions have been making progress in liberalizing trade and investment. But much is left to be done.

The Private Sector Speaks Up

Keidanren has long emphasized the fact that two economies are already

highly integrated. But in May 2005, Keidanren’s Committee on U.S. Affairs decided to review business-related problems and discuss means to further strengthen our bilateral economic relations, including the possibility of concluding an Economic Partnership Agreement (EPA).

At the 42nd Japan-US Business Conference last November, the member councils endorsed a statement:

The Councils believe that a comprehensive and strategic Economic Partnership Agreement (EPA) encompassing all aspects of bilateral economic activity will ultimately be the most effective means of enhancing economic integration. Toward this end, the Councils urge both governments

to initiate formal exploratory talks within 2006 on the outlines and strategies for such an agreement.

The statement set forth an ambitious scope of an agreement:

Such an agreement should embody all elements of a Free Trade Agreement consistent with the rules of the World Trade Organization by covering "substantially all the trade" in goods as well as "substantial sectoral coverage" in services. It must also extend, but not be limited, to major areas such as direct investment, capital markets, exchange rates, regulations and regulatory transparency, distribution, agriculture, trade remedies such as antidumping, competition policy, human resources and movement of natural persons, in order to attain the high level of coverage needed.

To be sure, comprehensive negotiations (i.e. including the sensitive sectors of agriculture and textiles and competition policy) will take considerable time and compromise. Japanese elections for Prime Minister will be held this September, so it will be up to the new Japanese government to determine about how best to proceed. As for Washington, USTR will be racing to

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complete other free trade agreements in the pipeline, including the US-Korea FTA, before the expiration of trade negotiating authority, or TPA, next July.

But there are a number of steps that can be taken now to deepen the economic integration between the US and Japan: Bilateral irritants, such as the current dispute over beef

imports, should be resolved as soon as possible. Trade negotiators from both sides should sit down to enhance and deepen other initiatives, such as further deregulation and privatization and better harmonization of standards and certification. Protection for intellectual property rights will be far more robust if the US and Japan work together in key markets. And close

bilateral cooperation would enhance IT security, increase transparency, ease business-related visa procedures, improve container security, and clear other impediments to trade.

Whether or not it takes the form of a free trade agreement, economic integration would be good for the United States and Japan. But more importantly, having the best trade and investment practices embedded in a model FTA would benefit the rest of the world.

Atsushi Yamakoshi is Director of the Keidanren office in Washington, DC. The views reflected in this piece are his and do not necessarily reflect those of Nippon Keidanren. More information is available at: <http://www.keidanren-usa.org>

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Foreign Direct Investment in the United States and US National Security, Déjà Vu

BY EDWARD M. GRAHAM, INSTITUTE FOR INTERNATIONAL ECONOMICS

An issue that has confronted the United States a number of times during the past century is foreign direct investment (FDI) and national security. The salience of this issue has waxed and waned over the years. But right now, after a prolonged period of wane, the issue has again heated up. FDI represents the equity held by a foreign investor in investments under the managerial control of the investor (and hence is to be distinguished from portfolio investment, where the investor is passive).

Thus, the issue is not really about FDI *per se*, but rather over the security implications of US firms being under foreign control where, in most cases, the controlling interest is a foreign-based multinational firm, and, sometimes, one that is under the control of a foreign government.

FDI and US national security first became a major political issue during World War I. In particular, by 1914, local subsidiaries of German firms comprised much of the US chemical industry. The chemical industry was at that time amongst the most strategically important of all sectors because high explosives, combined with mechanized delivery systems, had revolutionized the conduct of war, and mostly to the advantage of the

Germans. German companies in fact dominated the new technologies of this industry. In 1917, President Wilson signed the 'Trading with the Enemy Act,' which enabled the President to seize control of assets in the United States under the control of nations hostile to the United States. German assets, most especially those in the chemical industry, were thereby seized. Following the War, and contrary to international law, most of these assets were not returned to the original owners but instead sold to US firms, where the assets included key technologies. Because US firms often lacked the expertise to work these technologies, there followed during the 1920s a series of strategic alliances between those US firms that now owned the US rights to these

technologies and the German firms that had innovated them.

Even conclusion of World War I did not end US concerns with FDI in strategic industries. Indeed, during the 1920s, there arose an assumption within the US military, and the US Navy in particular, that there might be a future conflict between the United Kingdom and the United States, nations that had been allies during the War. Accordingly, a series of laws were passed to restrict or prohibit FDI in a number of industries considered to be strategically important, including aircraft manufacture, intra-American maritime transport (the 'Jones Act'), civil air transport, telecommunications and broadcasting, and oil.

These restrictions, many of which remain in effect today, were mostly aimed towards direct investment

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from the UK. Oil industry restrictions were meant to induce British interests that then dominated Middle Eastern oil to allow US firms to obtain oil concessions there. At the time, the largest known oilfields were not in the Middle East but in the United States. While most US oilfields were under domestic control, some were under the control of the Anglo-Dutch Shell consortium. The US Navy felt that it was disadvantaged relative to the British Navy because the British had ready access to fuel oil in the Middle East whereas the Americans did not. Thus, the objective was to trade US restrictions on foreign oil companies for Middle Eastern concessions for US oil companies. Such concessions were obtained, and virtually no binding restrictions ever were actually placed on foreign oil companies operating in the United States. However, in the other sectors, the restrictions were binding and little or no FDI entered the US in the affected sectors.

The revival of Germany as a military power during the 1930s put to rest US fears of a British-US confrontation and, by the 1940s, concern once again was over German investment in the United States. The amount of this investment was in fact far less in 1941 than it had been in 1917. Nonetheless, the Trading with the Enemy Act was again invoked to nationalize German and Japanese investment in the United States. The latter was very modest in scope.

When the United States and its allies emerged victorious from World War II, a long period ensued where FDI in the United States no longer elicited any major security concerns. This non-concern was for two reasons: First, the main rival to the United States became the Soviet Union, an ally during World War II but one with whom relations quickly became antagonistic following 1946. Virtually no FDI from the Soviet Union existed. Second, by the end of World War II, US firms were at the

leading edge of technology in almost all sectors of strategic concern, so that fear of foreign technological supremacy had faded. Indeed, during the 1950s and 1960s, US firms greatly expanded their own overseas operations, so that by the late 1960s, fears were mounting in Europe and elsewhere that all leading-technology industries would become US-owned or dominated.

However, the trend towards US dominance of world industry did not continue unabated and, in the 1970s onward, fears began to reappear in the United States that foreign interests might gain control over strategic industries. Alarm grew following the oil price increases of 1973-74, and for a time there was worry that OPEC nations might use their "petrodollars" to buy out major strategic sectors in the United States. One consequence was the passage of the International Emergency Economic Powers Act in 1977, which gave the President modified powers to seize foreign assets in the United States in the event of a national emergency short of war.

Another was the creation of an inter-agency Committee on Foreign Investment in the United States (CFIUS) to monitor foreign investment in the United States and to recommend actions to counter national security

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concerns that this investment might create.

Concern with OPEC investment waned after 1979 when it became apparent that this investment was not occurring on a large scale and was quickly replaced by concerns about FDI from Japan. After 1985, this FDI began to rise substantially. In fact, beginning in about 1985, for reasons not fully understood, FDI worldwide began to grow at rates significantly greater than world economic growth, triggering what we now think of as "globalization" of the world economy. But in the late 1980s, the fact that explosive growth in FDI was a world-wide phenomenon was not yet fully appreciated and, in the United States, concern focused specifically on direct investment from Japan.

At that time, many American intellectuals were worried about erosion of American power, and some projected a burgeoning of Japanese power that would follow from the growing technological capabilities of Japanese firms. Moreover, many of these firms were now creating or acquiring US subsidiaries, and the acquisitions in particular frightened many US politicians.

A consequence was passage of the 1988 "Exon-Florio" amendment to the Omnibus Trade and Competitiveness

Act, which gave the US President authority to block any takeover of a US firm by a foreign investor if the takeover was determined "to impair or threaten to impair" US national security. Implementation of the Exon-Florio law was invested by the President in the CFIUS. However, any decision by the CFIUS to block a transaction was recommendatory only; the final decision remained that of the President alone. In 1972,

as many then asserted, but rather brings tangible economic benefits. Moreover, we documented that the majority of FDI in the United States came not from Japan but rather from Canada and the European nations, which were not seen to threaten US national security interests. Moreover, we found no evidence that Japanese direct investment posed any special security threats to the US, as was then so commonly asserted; rather, FDI

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this act was tightened by the Byrd Amendment that required CFIUS review of acquisitions of US companies where the investor was directly or indirectly state-controlled.

In 1988, Paul Krugman and I published a book where we argued that foreign direct investment in the United States does not harm the US economy,

from Japan created net benefits, just as did FDI from other countries.

Concern with Japan soon faded. The Japanese economy went into a lengthy period of recession and stagnation beginning in about 1991. And, just as fear of a confrontation with the United Kingdom had faded seventy years earlier, so did fear of rising Japanese

The Shelby bill would mandate extensive review of foreign acquisitions of US firms if these firms operated in designated "critical infrastructure" sectors, which would cover about 25 percent of the US economy.

power. And, for about the next fifteen years, US concerns over national security and FDI also largely faded.

However, these concerns have become resurrected during the past year or so. The first instance was the reaction by members of the US Congress to the proposed acquisition of the mid-sized US oil firm Unocal by the Chinese National Overseas Oil Corporation (CNOOC) in the summer of 2005. It is not clear that this takeover posed any threat to the US national security whatsoever, but the proposed acquisition nonetheless provoked such an outburst from the US Congress, where threats were made to pass bills to ban the deal, that CNOOC withdrew its bid. Some members of Congress used the occasion to argue that the Exon-Florio/CFIUS process had failed to protect US national interests. In fact, the case had not yet even been reviewed by the CFIUS.

The upset over the CNOOC bid was repeated in early 2006, when the UAE-based firm Dubai Ports World (DPW) acquired contracts to manage port terminal operations of the UK firm Peninsular and Oriental Steamship Navigation Company (P&O), which operated port facilities in six US cities. In fact, this transaction was reviewed by CFIUS and cleared in January, whereby a letter of assurances was received from DPW to adhere to security programs being implemented in the United States.

Dissatisfied, certain members of Congress raised a public outcry in March over the CFIUS clearance—in spite of the fact that DPW had accumulated an outstanding security record as manager of port terminal operations in a number of countries where security concerns were present (e.g., the UK and Israel). The objections

of these Members seemed to be simply that DPW was controlled by interests on the Arabian Peninsula, and that certain of the 9/11 terrorists originally were from that region, and not that there was any specific reason to bar DPW from managing US port terminals. Nonetheless, the controversy reached feverish levels, such that DPW eventually agreed to sell its interests in the six US ports to US investors.

In response to the DPW case, Senator Richard Shelby (R-Alabama) introduced legislation to "reform" the Exon-Florio/CFIUS process; a similar bill is expected in the US House of Representatives. The Shelby bill would mandate extensive review of foreign acquisitions of US firms if these firms operated in designated "critical infrastructure" sectors, which would cover about 25 percent of the US economy. New reporting requirements to Congress would be imposed on the CFIUS, as would a number of other requirements. In a new book coauthored by David Marchick and me¹, we note that the likely effect of this legislation, if it were to pass, would be to make the Exon-Florio clearance process lengthier, more bureaucratic,

¹*US National Security and Foreign Direct Investment*, to be published by the Institute for International Economics in mid-May, 2006.

and more susceptible to individual cases being "demagogued" by members of Congress for political purposes as happened in the CNOOC and DPW cases.

The likely outcome is that CFIUS would be inclined to become much more cautious and to block more acquisitions than in the past, if for no other reason than to avoid the demagoguery of the sort so recently witnessed. This in turn could have a chilling effect on foreign direct investment in the United States, and

this would be most unfortunate. As noted, such investment has brought tangible benefits to the US economy and, moreover, it is truly difficult to think of a case where a true national security risk has been created by this investment. The "reforms" contemplated by the US Congress thus must be judged as misguided and, indeed, likely to do the nation harm.

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