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U.S.-Japan Economic Relations: Significance, Prospects, and Policy Options

William H. Cooper
Specialist in International Trade and Finance

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Summary

Japan and the United States are two major economic powers. Together they account for over 30% of world domestic product, for a significant portion of international trade in goods and services, and for a major portion of international investment. This economic clout makes the United States and Japan potentially powerful actors in the world economy. Economic conditions in the United States and Japan have a significant impact on the rest of the world. Furthermore, the U.S.-Japan bilateral economic relationship can influence economic conditions in other countries.

The U.S.-Japan economic relationship is strong and mutually advantageous. The two economies are highly integrated via trade in goods and services—they are large markets for each other's exports and important sources of imports. More importantly, Japan and the United States are closely connected via capital flows. Japan is a major foreign source of financing of the U.S. national debt and will likely remain so for the foreseeable future, as the mounting U.S. public debt needs to be financed and the stock of U.S. domestic savings remains insufficient to meet the investment needs. Japan is also a significant source of foreign private portfolio and direct investment in the United States, and the United States is the origin of much of the foreign investment in Japan.

The *relative* significance of Japan and the United States as each other's economic partner has diminished. This trend is due in part to the rise of China and other emerging economic powers. For example, China has overtaken Japan as the largest source of foreign financing of the U.S. national debt. Nevertheless, analyses of trade and other economic data suggest that the bilateral relationship remains important, and policy leaders from both countries face the challenge of how to manage it. The trend is also due to the mediocre performance of the Japanese economy over the last two decades, which was exacerbated by the global economic slowdown beginning in 2008, and other setbacks, including the tsunami, earthquake, and nuclear accidents that occurred in March 2011. Japan is still struggling to achieve sustained economic recovery.

However, during the last decade, U.S. and Japanese policy leaders seem to have made a deliberate effort to drastically reduce the friction that prevailed in the economic relationship during the 1970s, 1980s, and the first half of the 1990s. On the one hand, this calmer environment has stabilized the bilateral relationship and permitted the two countries to focus their attention on other issues of mutual interest, such as national security. On the other hand, as some have argued, the friendlier environment masks serious problems that require more attention, such as Japan's continuing failure to resolve long-standing market access barriers to U.S. exports. Failure to resolve any of these outstanding issues could heighten friction between the two countries.

More generally, other issues regarding U.S.-Japan economic relations have emerged on the agenda of the 113th Congress. U.S. and Japanese leaders have several options on how to manage their relationship, including stronger reliance on the World Trade Organization; special bilateral discussion frameworks and agreements; or a free trade agreement such as the potential Trans-Pacific Partnership (TPP) agreement in which Japan has decided to participate. Japan's participation in the TPP has renewed concerns of some Members of Congress over a number of Japanese trade practices.

Contents

Tables

Appendixes

Contacts

Japan and the United States are among the world's largest economic powers. Together they account for over 30% of world domestic product (2012 estimate). This economic clout makes the United States and Japan powerful forces that influence each other's economies and those of other countries. Economic conditions in the United States and Japan also have a significant impact on the rest of the world. Furthermore, the U.S.-Japan bilateral economic relationship itself can influence economic conditions in other countries.

The two countries remain very important economic partners, accounting for significant shares of each other's foreign trade and investment, even though their relative significance has declined. The global financial crisis and economic downturn added another dimension to the relationship as the two countries have grappled with the severe impact of the crisis on their respective economies and simultaneously have worked with their partners in the G-20 to coordinate a multilateral response. The impact of the March 11, 2011, earthquake and subsequent tsunami and nuclear plant accidents in northern Japan added still another factor to the bilateral economic relationship.

The U.S.-Japan economic relationship is important to U.S. national interests and to the U.S. Congress. It has been the subject of oversight hearings and trade legislation, and Congress plays a critical role in shaping U.S. economic policy toward Japan.

The United States and Japan have taken perhaps the most important step in years in forging a closer economic relationship. After many months of internal political debate and changes in political leadership, Japan expressed interest on March 15, 2013, in joining the negotiations to establish the Trans-Pacific Partnership (TPP) trade agreement to which the United States is a party. On April 12, after a series of informal bilateral discussions with Japan, the Obama Administration stated that it would support Japan's participation in the TPP and, with the other 10 TPP participants, it invited Japan to join. On July 23, 2013, Japan formally became a TPP participant.

Congress must approve a TPP trade agreement in which the United States is a party before any U.S. commitments could enter into force. To help the 113th Congress in fulfilling these and other responsibilities regarding U.S.-Japan economic relations, this report explores the significance and state of U.S.-Japan economic ties, major issues in the relationship, and the possible options for managing the relationship.

An Overview of U.S.-Japan Economic Trends

The U.S. and Japanese economies remain closely intertwined through trade and capital flows. Many argue that U.S. and Japanese political leaders have not always given the U.S.-Japan relationship the priority commensurate with its economic importance; nevertheless, the data and other indicators suggest that the relationship bears attention.

The Japanese and U.S. Economies

The U.S. and Japanese economies are in some respects very similar. They are both large industrialized economies that have provided their residents with a high standard of living. However, as **Table 1** points out, they are very different in some critical ways. The U.S. economy is roughly 2½ times as large as Japan's both on a nominal and purchasing power parity (PPP) basis.[1] The Japanese standard of living is slightly lower than the U.S. standard of living measured on a nominal per capita/GDP basis and even lower when measured on a PPP per capita/GDP basis. (The latter measurement reflects the high cost in Japan for food, fuel, and other basic necessities compared to the United States.) Japan has also endured slow economic growth or even recessions during the past two decades, while U.S. economic growth had been stronger, although both economies have suffered slow growth and even recession in the wake of the 2008-2009 financial crisis. The U.S. average annual GDP growth rate during the last 10 years (2003-2012) has been almost two times that of Japan's. Nevertheless, the economic recoveries in both countries are expected to be fragile, especially in Japan.

Exports are slightly more important to the Japanese economy than are imports as measured as ratios to GDP, while imports are more significant than exports in the U.S. economy. The United States has continually incurred current account deficits. Japan had been earning current account surpluses, although the surpluses have been decreasing due to diminishing demand for Japan's exports and increasing imports of energy.

Japan has continually exceeded the United States in terms of savings. Many economists consider the strong propensity to save in Japan relative to the United States as the primary reason why the United States has incurred current account trade deficits with Japan for many years and why Japan continues to be a major net creditor while the United States is a net debtor. At the same time, Japan has built up a huge volume of public debt, and its debt burden as a ratio of GDP is almost three times that of the United States. Japan's public debt has soared in the last several decades as it has attempted to stimulate growth with extra government spending.

Table 1. Key Comparative Economic Indicators for the United States and Japan

	Japan	United States
GDP (2012)		
- Nominal (trillions of $U.S.)	6.0	15.7
- PPP (trillions of $U.S.)	4.6	15.7
Per Capita GDP (2012)		
- PPP ($U.S.)	36,200	49,800
Real GDP Growth Rates (2012)	2.2%	2.2%
Merchandise Exports (billions of $U.S.) (2012)	793	1,612
Imports (billions of $U.S.) (2012)	857	2,357
Current Account Balance (billions of $U.S.)	85	-487
Recorded Unemployment Rates (2012)	4.4%	8.2%
Public debt/GDP (2012)	218.9%	73.6%

Source: CIA, *The World Factbook*.

Japan was hit by two economic crises in the last few years that affected U.S.-Japan economic relations. The first was the global financial crisis, which began to hit in 2008 and intensified in

[1] Purchasing power parity (PPP) measurements are the value of foreign currencies in U.S. dollars based on estimates of the purchasing power of such currency. The PPP exchange rate is then used to convert foreign economic data in national currencies into U.S. dollars.

2009. Japan was hit hard by the decline in global demand for its exports, particularly in the United States and Europe. Japan had become dependent on net export growth as the engine for overall GDP growth, as domestic consumer demand and investment lagged.

The second crisis was the March 11, 2011, earthquake, tsunami, and nuclear accidents in northeast Japan. The Japanese government has responded with a series of four supplemental fiscal packages to finance reconstruction. The implementation of the reconstruction efforts has been slower than expected, dampening the stimulus effect on economic growth. In addition, the country has had to cope with electricity shortages and search for alternative sources of power, including increased fossil fuel imports.

The two crises and the economic problems in Europe, among other factors, have adversely affected Japan's economic growth. Japan incurred growth rates of -1.1% in 2008 and -5.5% in 2009 but recovered in 2010 to expand by 4.7%. The recovery proved short-lived as Japan experienced -0.4% growth in 2011, only 1.4% in 2011, and an estimated 1.7% in 2013.

Prime Minister Abe has made it a priority of his administration to boost economic growth and to eliminate deflation, which has plagued Japan for many years. Abe is promoting a three-pronged, or "three-arrow," economic program. The first arrow consisted of a $122 billion fiscal stimulus package aimed at spending on infrastructure, particularly in areas affected by the March 2011 disaster. While the package appears to have boosted growth somewhat, its effects appear to have largely run their course and it has added to Japan's already large public debt, which at over 200% of the country's gross domestic product (GDP) is the highest of any advanced economy.

The second arrow consists of monetary stimulus to arrest deflation. As a result, under pressure from Abe, the independent central bank (Bank of Japan, or BOJ) announced in the spring of 2013 a continued loose monetary policy with interest rates of 0%, quantitative easing measures, and a target inflation rate of 2%. The Japanese yen rapidly dropped in value against the U.S. dollar and other major currencies after that announcement. Although few observers think that the BOJ will reach its target, according to a number of measures it appears that inflationary pressures have re-emerged in the economy, at least in part due to the rise in import prices resulting from the yen's depreciation.

The third arrow consists of economic reforms that are and will be aimed at restructuring the agricultural, medical services, and electricity sectors (among others) and the promotion of new services and industries. For Abe, Japan's participation in the TPP is a catalyst for those growth-promoting reforms, but many of the established economic interests are deeply entrenched, particularly within his own party, the LDP. Critics argue that Abe has pursued structural reforms cautiously, and has backtracked on many of them, such as liberalizing the sale of pharmaceuticals. Abe's government has said that in the spring of 2014 it will create a number of special economic zones (SEZs), areas that have lower taxes and fewer regulations, in order to stimulate private-sector investment.

A likely by-product of these measures will be weakening of the yen. For the past five years, the yen had exhibited unprecedented strength in terms of the dollar. In January 2007 the yen's average value was ¥120.46=$1 during the month, but after rapid appreciation, it reached as high as ¥76.65=$1 in October 2011. Since that time, it has depreciated to ¥102.3=$1 on February 7, 2014.

U.S.-Japanese Trade in Goods and Services

The growth in U.S.-Japanese bilateral trade in goods and services has been slow if not stagnant over the past two decades, reflecting, at least in part, the anemic state of the Japanese economy. Bilateral trade declined significantly in 2009 as a result of the global economic downturn. U.S.-Japan trade has picked up in 2010 and 21011 and, as **Table 2** shows, regained its pre-2009 level in 2012, but declined in 2013.

U.S. imports from Japan are concentrated within three main categories. About three-quarters of those imports have consisted of passenger cars and parts; computers and components; office machinery parts; and electrical machinery (primarily video cameras). U.S. exports to Japan are much more diverse, but a major portion of them are in computers and components; gas turbines (turbojets, turbo-propellers, etc.); office machinery parts; electrical machinery (integrated circuits and electrical apparatus for line telephone systems); optical and medical equipment; and agricultural products, such as wheat and meat.

Table 2. U.S. Merchandise Trade with Japan, 1998-2013

(billions of dollars)

Year	U.S. Exports	U.S. Imports	Trade Turnover	U.S. Balances
1998	57.9	122.0	179.9	-64.1
1999	57.5	131.4	188.9	-73.9
2000	64.9	146.5	211.4	-81.6
2001	57.5	126.5	184.0	-69.0
2002	51.4	121.4	172.8	-70.0
2003	52.1	118.0	170.1	-66.0
2004	54.4	129.6	184.0	-75.2
2005	55.4	138.1	193.5	-82.7
2006	59.6	148.2	207.8	-88.6
2007	62.7	145.5	208.2	-82.8
2008	66.6	139.2	205.8	-72.3
2009	51.2	95.9	147.1	-44.8
2010	60.5	120.3	180.8	-59.8
2011	66.2	128.8	195.0	-62.2
2012	70.0	146.4	216.4	-76.3
2013	65.1	138.5	203.6	-73.4

Source: U.S. Department of Commerce, U.S. Census Bureau.

Although Japan remains important economically to the United States, its importance has slid as it has been edged out by other trade partners. In 1989, Japan was the largest source of U.S. imports and the second-largest U.S. export market. By the end of 2009, Japan was the United States's fourth-largest merchandise export market (behind Canada, Mexico, and China) and the fourth-largest source for U.S. merchandise imports (behind Canada, Mexico, and China) and remained so in 2013.

The data on merchandise trade may underestimate the relative importance of the United States to Japan's trade since a significant portion of Japanese exports to China are used as inputs to China's exports to the United States, possibly by Japanese-invested firms in China. Under a joint project, the Organization for Economic Cooperation and Development (OECD) and the World Trade Organization and (WTO) have created measurements of the value of bilateral exports and imports based on the actual value added by country, including services used in the production of those exports and imports as opposed to the final value of the exports and imports. According to the OECD-WTO database, the United States accounted for close to 20% of Japanese exports in value-added terms and was the largest market for Japanese exports, while China accounted for 15% of Japanese exports on a value-added basis, and was the second-largest export market.[2]

The emergence of China and other East Asian countries has played a role in the declining significance of the United States in Japan's trade. This trend reflects rapidly growing economies in East Asia, as well as a shift in global production and the development of regional supply chains. In the last decade, Japanese trade flows have shifted decidedly towards East Asia and away from the United States. In 1994, 38.6% of Japanese exports went to and 33.0% of Japanese imports came from nine of the largest economies in East Asia.[3] In 2013, 50.7% of Japanese exports and 40.9% of Japanese imports were with those same countries. China is the fastest-growing Japanese trade partner.[4] Similarly, the geographic pattern of U.S. trade has shifted. Mexico and China have surpassed Japan in U.S. trade, as noted above.

U.S.-Japan trade in services has increased, at least on the U.S. import side, although it remained relatively modest as of 2011 (latest data available).[5] (See **Table 3**.) The United States exports a variety of services to Japan in the form of travel services, passenger fares, and "other transportation"; royalties and licensing fees; and other private services. U.S. imports of services from Japan consisted mostly of transportation other than passenger fees, royalties and licensing fees, and other private services. The United States has realized surpluses in its bilateral trade in services with Japan.

[2] OECD-WTO Trade in Value-Added Initiative, http://www.oecd.org/valueadded.

[3] China, Hong Kong, Indonesia, South Korea, Malaysia, Philippines, Singapore, Thailand, and Taiwan.

[4] CRS calculations based on data compiled by GTIS, Inc., World Trade Atlas.

[5] The data capture "cross-border" trade in services. Because they are intangible, most services are bought and sold where the buyer and seller are located in close proximity, for example, sold by a foreign-owned company in the country of the buyer. The data, therefore, under report the volume of trade in services.

Table 3. U.S. Trade in Services with Japan, 2002-2012

(billions of dollars)

Year	U.S. Exports	U.S. Imports	Trade Turnover	U.S. Balances
2002	30.4	18.9	49.3	11.5
2003	30.1	20.0	50.1	10.2
2004	36.0	21.3	57.3	14.8
2005	42.5	23.8	66.3	18.7
2006	42.0	25.5	67.5	16.5
2007	41.2	26.2	67.4	15.0
2008	42.3	25.7	68.0	16.6
2009	41.4	22.9	64.3	18.5
2010	45.4	25.8	71.2	19.6
2011	44.9	27.5	72.4	17.4
2012	47.0	29.7	76.7	17.3

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

U.S.-Japan Bilateral Investment

Along with trade in goods and services, foreign direct investment (FDI) (investments in manufacturing facilities, businesses, and real estate) and portfolio investments (investments in government securities, corporate stocks and bonds, and bank deposits) between residents of the United States and Japan also define the economic relationship. The value of portfolio and direct investments between the United States and Japan exceeds the value of trade in goods and services. In addition, investments, particularly FDI (**Table 4**), signify a long-term financial commitment on the part of the investor.[6]

[6] Foreign direct investment (FDI) consists of investments in real estate, manufacturing plants, and retail facilities, in which the foreign investor owns 10% or more of the entity. FDI can be new establishments or mergers with or acquisitions of already established, locally based enterprises. Investors seek to take advantage of skilled labor or other resources of the local economy to produce goods or services tailored to the local market, to avoid foreign trade barriers, and for other reasons.

Table 4. U.S.-Japanese Foreign Direct Investment (FDI) Positions, 1998-2012

(historical-cost basis; billions of dollars)

	Japanese FDI in U.S.	U.S. FDI in Japan
1998	134.3	41.4
1999	153.8	55.1
2000	159.7	57.1
2001	149.9	55.7
2002	147.4	66.5
2003	157.2	57.8
2004	175.7	68.1
2005	190.3	75.5
2006	204.0	84.4
2007	229.4	85.2
2008	234.7	99.8
2009	239.3	96.0
2010	252.1	102.6
2011	291.1	126.0
2012	308.3	134.0

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Note: Figures are cumulative FDI.

The United States has consistently been the largest source of FDI in Japan. From 1998 to 2011 (latest data available), U.S. FDI in Japan has more than doubled. The sharp increase in investments was largely the result of acquisitions by U.S. firms of Japanese entities that were facing bankruptcy, rather than original or "greenfield" investments. The Japanese economy has been relatively "closed" to foreign investment, and the level of FDI in Japan consistently ranks among the lowest of industrialized countries.

Over the years, Japanese investors established a strong presence in the United States, especially in autos, where Japanese manufacturers established a commercial presence in the United States to circumvent restrictions on their exports to the U.S. market. Japanese car manufacturers have gained larger shares of the U.S. domestic market.

Japanese FDI in the United States surged in the 1980s and continued to increase in the 1990s. In the 1980s, Japanese investors acquired such high-profile U.S. assets as Columbia Pictures, Rockefeller Center, and Pebble Beach Golf Course. These investments followed surges in Japanese investments in the United States by Japanese consumer electronics firms and auto producers. (Many of these acquisitions were not profitable for Japanese investors.) The rapid increase of the investments and their high visibility generated concerns in the United States of Japan "buying up the United States." By 2000, the level of Japanese FDI in the United States rose to $159.7 billion but declined to $147.4 billion by 2002. The level of Japan's FDI in the United States has increased since, reaching $308.3 billion in 2012. In the 1980s, Japan became the largest source of FDI in the United States, surpassing the United Kingdom, the traditional leader. By 2002, Japan had dropped to the fourth-largest source of FDI, far behind the United Kingdom and

France, and slightly behind the Netherlands. However, in 2004, its ranking reached number two behind the United Kingdom and remained there at the end of 2012.[7]

In addition to FDI, substantial amounts of capital flow between the United States and Japan in the form of portfolio investments. At the end of 2012 U.S. investors held $429.4 billion in Japanese corporate stocks and $45.7 billion in Japanese bonds. Japanese investors held $319.8 billion in U.S. corporate stocks and $337.3 billion in U.S. corporate bonds.[8]

Japanese investors are major private foreign holders of U.S. Treasury securities that finance the U.S. national debt, and their importance has soared over the last few years. By the end of May 2013, Japanese residents held $1,1111.1 billion in U.S. securities. At one time, Japanese investors were the largest foreign holders of U.S. Treasury securities; however, beginning in September 2008, China surpassed them, but Japanese investors are catching up. As of the end of November 2012, Chinese investors held $1,315.9 billion in U.S. Treasury securities.[9]

Japanese holdings of U.S. Treasury securities underscore the debtor/creditor link between the United States and Japan. The U.S. government continues to incur budget deficits and the United States as a whole maintains a low national savings rate; as a result, the United States has had to rely increasingly on foreign creditors to finance the rising national debt. This has some potentially problematic implications for U.S. interest rates. For example, if Japanese investors decided to switch their foreign investment from U.S. Treasury securities to euro-denominated securities, or if Japan's savings rate should decline as older Japanese citizens spend down their savings, and capital begins to flow back to Japan, U.S. interest rates would likely rise, all other factors remaining unchanged.

The Bilateral Economic Relationship and Shifting U.S. and Japanese Policy Priorities

By necessity, the United States and Japan have long given their bilateral economic relationship high priority. For Japan the importance of the relationship has been rooted in the emergence of the United States as the world's largest economic power; Japan's dependence on the United States for national security, especially during the Cold War; the dependence of Japanese manufacturing industries—autos, consumer electronics, and others—on exports to the United States; and the reliance of reform-minded Japanese political leaders on U.S. pressure, *gaiatsu*, to press for economic reforms in a political system that strongly protects the status quo.

For the United States, the significance of the economic relationship with Japan has been grounded in its reliance on Japan as a critical ally; the emergence of Japan in the post-World War II period as an economic power in East Asia and, until recently, the second-largest economy (now the third-largest economy) in the world; the advancing competition from Japanese manufacturers in industries, for example autos and steel and high tech industries, including semiconductors and computers, which employ large numbers of U.S. workers; the rising trade deficits with Japan; Japan's emergence as a major source of investment in the United States; and Japanese

[7] Department of Commerce, Bureau of Economic Analysis.

[8] *Survey of Current Business.* July 2013, pp. 18,19,21.

[9] U.S. Department of the Treasury, http://www.ustreas.gov/tic/.

government policies that have protected vulnerable sectors and assisted exporters, often at the expense of U.S. competitors.

For many years, the bilateral economic relationship was the centerpiece of U.S. and Japanese foreign economic agendas, and Japanese trade strongly influenced the making of overall U.S. trade policy. Many scholarly and popular books and journals were written on the subject.[10]

One reason for the shift in priorities may be the rise of China as a trade power. Since 2000, the U.S. bilateral trade deficit with China has exceeded the deficit with Japan, and the gap between the two deficits continues to grow. In 2013, the U.S. trade deficit with Japan was $73.4 billion; the deficit with China was $318.4 billion. The growing deficit with China has induced U.S. policymakers to address Chinese actions and policies that U.S. companies have asserted are unfair. These include barriers to U.S. exports, inadequate protection of intellectual property rights, an arguably undervalued exchange rate, and sales of products in the United States at less than fair value. Also, the relative economic decline of Japan and its economic problems has meant that Japan is not viewed as much as the "competitive threat" that it once was in the 1980s and early 1990s. For Japan, China has emerged both as a major economic competitor and partner in the region requiring more attention.

Other possible reasons for the shift in policy priorities might include the following:

- Foreign policy and national security concerns, for example, the increasing instability on the Korean peninsula caused by North Korea's nuclear ambitions and the territorial disputes with China, have tended to trump commercial concerns in U.S.-Japan alliance matters.
- The establishment in 1995 of the World Trade Organization (WTO) and a restructured dispute settlement body has lessened the scope for U.S. unilateral trade pressures to open Japan's market further.
- The United States and Japan have been forging economic relations with other countries and regions through free trade agreements (FTAs), which have reduced the focus on their own bilateral relations.

Bilateral Trade Issues

While U.S.-Japan economic ties have been fairly calm over the last two decades, a number of issues remain the source of friction from time to time. In addition, the United States and Japan are pursuing various options to tighten that relationship.

Japanese Import Restrictions on U.S. Beef

The issue first arose in December 2003 when Japan imposed a ban on imported U.S. beef (as did some other countries) in response to the discovery of the first U.S. case of bovine spongiform encephalopathy (BSE or "mad cow disease") in Washington State. In the months before the diagnosis in the United States, nearly a dozen Japanese cows infected with BSE had been

[10] For example, Clyde V. Prestowitz, *Trading Places: How We Allowed Japan to Take the Lead,* New York: Basic Books, 1988.

discovered, creating a scandal over the Agricultural Ministry's handling of the issue (several more Japanese BSE cases have since emerged). Japan had retained the ban despite ongoing negotiations and public pressure from Bush Administration officials, a reported framework agreement (issued jointly by both governments) in October 2004 to end it, and periodic assurances afterward by Japanese officials to their U.S. counterparts that it would be lifted soon.

In December 2005, Japan lifted the ban after many months of bilateral negotiations, but re-imposed it in January 2006 after Japanese government inspectors found bone material among the initial beef shipments. The presence of the bone material violated the procedures U.S. and Japanese officials had agreed upon. The then-U.S. Secretary of Agriculture Johanns expressed regret that the prohibited material had entered the shipments.

In July 2006, Japan announced it would resume imports of U.S. beef from cattle 20 months old or younger. The first shipments arrived in August 2006. Members of Congress had pressed Japan to lift restrictions on imports of U.S. beef from even older cattle. U.S. officials met with Japanese agricultural officials September 14-15, 2010, for technical discussions but produced no clear indication of resolution of the issue. On August 4, 2011, a bipartisan group of Senators sent a letter to Secretary of Agriculture Vilsack and to USTR Ron Kirk, urging them to press Japan (and China) to end restrictions on imports of U.S. beef. In December 2011 Japan announced that it was reassessing its BSE-related restrictions with the objective to raise the maximum age of cattle from which U.S. beef can be exported to Japan.

On February 1, 2013, the Japanese government loosened its restrictions on beef imports from the United States to allow beef from cattle 30 months or younger for the first time since December 2003. According to a joint press release from the Office of the United States Trade Representative and the Department of Agriculture, the Japanese government's Food Safety Commission would continue to monitor shipments of U.S. beef and would consider the possibility of allowing U.S. beef from cattle of any age to be imported into Japan.

Insurance, Express Delivery, and Japan Post

Japan is the world's second-largest insurance market, next to the United States. U.S.-based insurance providers have found it difficult to access the market especially in life and annuity insurance. They have been concerned about favorable regulatory treatment that the government gives to the insurance subsidiary of Japan Post, the national postal system that holds a large share of this market. For example, they cite subsidies to the insurance operations from revenues from other Japan Post operations. Also, Japan Post-owned insurance companies are not subject to the same regulations as other, privately owned insurance providers, both domestic and foreign-owned. On October 1, 2007, the Koizumi government introduced reforms as part of a privatization process. However, the successor government, led by the Democratic Party of Japan (DPJ,) took steps to roll back the reforms. On April 27, 2012, the Diet passed legislation that would appear to loosen regulatory requirements, according to U.S. industry sources.[11] The bill is reportedly a compromise package by the lawmakers from the DPJ, the LDP, and the Komeito Party.[12] The United States is also concerned about insurance sold by cooperatives that, they claim, are regulated more leniently than private firms.

[11] *Inside U.S. Trade,* April 27, 2012.

[12] *World Trade Online,* April 5, 2012.

Similarly, the United States has also raised concerns about express delivery services and banking services that Japan Post subsidiaries provide that may receive preferential regulatory and financial treatment giving them an unfair advantage to privately owned domestic and foreign providers.[13] The United States considers Japan's treatment of insurance and the other services to be a confidence building measure that must be addressed as part of Trans-Pacific Partnership (TPP). (See discussion below.)

Market Access in Japan for U.S. Autos and Auto Parts

Auto and auto-parts-related trade and investment have been a very sensitive set of issues in the U.S.-Japan economic relationship. The issue has its roots in the late 1970s and early 1980s, when U.S. imports of Japanese-made vehicles surged as a result of the increase in U.S. consumer demand for smaller vehicles, largely in response to the rapid increase in gasoline prices, while demand for U.S.–manufactured cars plummeted. Facing pressure from the U.S. auto industry and pressure from Congress in the form of limits on imports of Japanese made cars, the Reagan Administration persuaded Japan to agree in 1981 to voluntary export restraints. Japanese manufacturers responded to the restraints by establishing manufacturing facilities in the United States and exporting high-valued, passenger cars. U.S. manufacturers asserted that Japan employed various measures to restrict sales of foreign-made cars in Japan and the use of U.S.-made parts in Japanese cars manufactured in the United States. These issues were the subject of bilateral negotiations and agreements through the 1990s. The agreements were mostly in the form of Japanese government pledges to ensure that government regulations did not impede the sale of U.S.-made cars in Japan and voluntary efforts on the part of Japanese manufacturers to increase the use of U.S.-made auto parts in cars made in the United States. The U.S. government pledged to implement programs to promote the export of U.S.-made cars in Japan.

The intensity of the issue had subsided somewhat but has regained attention in the context of Japan's possible participation in the TPP negotiations. (See TPP discussion below.) The three Detroit-based car manufacturers—Chrysler, Ford, and General Motors—charge that Japanese government regulations continue to prevent them from obtaining their fair share of Japanese domestic vehicle sales. They cite the traditionally small share of total cars sales in Japan that consist of imported cars—around 6.7%.[14]

Japan and the Trans-Pacific Partnership Agreement (TPP) and Its Other FTA Initiatives

The TPP is an evolving regional free trade agreement (FTA). Originally formed as an FTA among Singapore, New Zealand, Chile, and Brunei (the P-4), the TPP is now an agreement under negotiation among the original four countries plus the United States, Australia, Canada, Japan, Mexico, Peru, Malaysia, and Vietnam. The current 12 TPP partners have conducted a number of rounds of negotiations and envision a comprehensive arrangement to liberalize trade and to cover broad range of trade and trade-related activities. But they also envision the TPP to be a "21st century" framework for conducting trade within the Asia-Pacific region and, therefore, addressing

[13] U.S. Mission to the World Trade Organization, Geneva, *U.S. Statement on the Trade Policy Review of Japan,* February 19, 2013, http://www.geneva.usmission.gov.

[14] CRS calculations based on data in Japan Automotive Manufacturers Association, *Motor Vehicle Statistics for Japan—2013,* http://www.jama.org/pdf/MIJ2013.pdf.

cross-cutting issues that are relevant now and will be in the future. These issues include regulatory coherence; competitiveness and business facilitation, also known as transnational supply and production chains; issues pertaining to small and medium-sized companies; economic development; and the operations of state-owned enterprises. Therefore, while the 12 TPP countries negotiate the agreement, they expect other economies in the region will seek to join in those negotiations or will accede to the agreement after it has been concluded.[15]

Japan's participation in the TPP was the subject of debate within the Japanese political leadership and among other Japanese stakeholders. On March 15, 2013, Prime Minister Abe announced that Japan would formally seek to participate in the negotiations to establish the Trans-Pacific Partnership (TPP). In making the decision he had to confront influential domestic interests that argued against the move. Among the most vocal have been Japanese farmers, especially rice farmers, and their representatives. They have argued that Japanese agriculture would be severely harmed by foreign competition as Japan would have to negotiate away high tariffs and other protective measures on imports of agricultural products. Some Japanese health providers have argued that Japan's national health insurance system would be adversely affected because, they claimed, the TPP would force Japanese citizens to buy foreign-produced pharmaceuticals and medical devices. In his March 15 statement, Prime Minister Abe acknowledged those domestic sensitivities, but also insisted that Japan needed to take advantage of "this last window of opportunity" to enter the negotiations, if it is to grow economically. Other Japanese business interests, including manufacturers, strongly support the TPP.

Prior to Japan's entering the TPP negotiations, The Obama Administration had identified three issues that Japan needed to address as "confidence building measures" if the United States were to support Japan's entry into the TPP: Japanese restrictions on imports of U.S. beef; market access for U.S.-made cars; and insurance and express delivery issues.

The beef issue appears to have been addressed with the February 1, 2013, Japanese action to allow imports of U.S. beef from cattle younger than 30 months. Regarding the auto issue, Japan agreed to increase the number of U.S.-made vehicles that can be imported under its Preferential Handling Procedure (PHP) from 2,000 per vehicle "type" to 5,000 per vehicle "type." In addition, the two countries agreed to address in parallel negotiations issues regarding non-tariff measures (NTMs) pertaining to auto trade, including transparency in regulations, standards, certification, "green" and other new technology vehicles, and distribution. The parallel auto negotiations are also to address the establishment of a special "safeguard" provision to deal with injurious surges in auto imports and of a special tariff "snap-back" mechanism to deal with a partner's failure to fulfill the commitments on auto trade. Japan agreed that under the proposed TPP, U.S. tariffs on imports of Japanese motor vehicles will be phased out over a period equal to the longest phase-out period in the agreement.

The activities of the government-run Japan Post, subsidiaries of which sell insurance and express delivery services, were the main focus of USTR's agreement with Japan on insurance. Japan announced that the government would not approve new or modified cancer insurance products or stand-alone medical insurance products for sale by Japan Post until it has been determined that a "level-playing field" has been established in competition between private insurers and Japan Post.

[15] For more information on the TPP, see CRS Report R42694, *The Trans-Pacific Partnership (TPP) Negotiations and Issues for Congress*, coordinated by Ian F. Fergusson.

The countries agreed to address additional "level-playing field" issues regarding insurance in the actual TPP negotiations.

Furthermore, the two sides agreed to hold negotiations parallel to the TPP negotiations to address issues regarding non-tariff measures (NTMs) in insurance, government procurement, competition policy, express delivery, and sanitary and phytosanitary (SPS) measures. The parallel negotiations are to achieve "tangible and meaningful" results by the completion of the main TPP negotiations and will be legally binding at the time a TPP agreement would enter into force.

A large segment of the U.S. business community supports Japanese participation in the TPP, if Japan can resolve long-standing issues on access to its markets for U.S. goods, services, and agriculture. However, the Detroit-based U.S. auto industry, the United Autoworkers union, and Members of Congress with a large auto-industry presence in their districts, have expressed strong opposition. Other segments of the U.S. business community have expressed support for Japan's entry into the TPP negotiations, although some have conditioned their support on Japan's willingness to address long-standing issues.

Along with the TPP, Japan is pursuing or considering other regional trade arrangements. On November 20, 2012, Japanese, Chinese, and South Korean trade ministers announced the launching of negotiations on a trilateral free trade agreement. The negotiations began in early 2013. The scope of the possible agreement remains undefined but would not likely match the ambition of the TPP. Market access for agricultural products will likely be a point of contention as the small but vocal agriculture interests in South Korea and Japan confront the possibility of increased rice imports from China under an FTA arrangement.[16]

In addition, Japan, along with the 10 members of the Association of Southeast Asian Nations (ASEAN), China, South Korea, Australia, New Zealand, and India, announced on November 20, 2012, their intention to begin negotiations to form a trade arrangement—the Regional Comprehensive Economic Partnership (RCEP). While not ostensibly in conflict with the TPP, some have suggested the RCEP could be an alternative to the more comprehensive TPP. While RCEP would include some TPP partners, it is noteworthy for the absence of the United States and the inclusion of China.[17] Japan has also launched FTA negotiations with the European Union.

The Doha Development Agenda

Japan and the United States have been major supporters of the Doha Development Agenda (DDA), the latest round of multilateral trade liberalizing negotiations in the WTO. Yet, the two countries had taken divergent positions in some critical areas. For example, the United States, Australia, and other major agricultural exporting countries pressed for the reduction or removal of barriers to agricultural imports and subsidies of agricultural production, a position strongly resisted by Japan and the European Union. At the same time, Japan and others have argued that national antidumping laws and actions that member countries have taken should be examined during the DDA, with the possibility of changing them, a position that the United States has opposed.

[16] *International Trade Reporter,* May 31, 2012.

[17] See, for example, Pakpahan, Beginda, Will RCEP Compete with the TPP?, *EastAsiaForum,*www.eastasiaforum.org.

In July 2006, WTO Director-General Pascal Lamy suspended the negotiations because, among other reasons, the major participants could not agree on the modalities that negotiators would use to determine how much they would liberalize their agricultural markets and reduce agricultural subsides. Negotiators had been meeting from time to time to try to resuscitate the talks. However, Lamy's attempt to hold a ministerial meeting in December 2008 failed when the major parties to the negotiators could not resolve their differences over establishing modalities in agricultural and non-agricultural negotiations.[18]

Various groups of WTO members have been meeting to try to establish a foundation for completing the negotiations without success to date. Smaller groups of WTO members have been meeting to explore options other than a comprehensive agreement, such as a plurilateral services agreement—the Trade in Services Agreement (TISA)—a d expansion of the information technology agreement. In 2013, WTO members reached an agreement on improving trade facilitation. Japan and the United States are major participants in those discussions.

Overarching Issues

For more than a decade, U.S.-Japanese bilateral economic discussions have concentrated less on the specific issues and more on fundamental factors that cut across many aspects of the U.S. and Japanese economies, such as government regulations, intellectual property rights, competition policies, and pharmaceutical and medical devices pricing practices. Given the complexity of many of these issues, they have been the basis of discussion, negotiation, and disputes for many years. The United States and Japan have addressed these issues within various frameworks over the years with mixed results. (See discussion in the **Appendix**, "Managing the U.S.-Japan Economic Relationship—A Brief History.")

Prospects and Policy Options to Deepen Economic Ties

Although the relative significance of the U.S.-Japan economic relationship has been diminished somewhat with the rise of China and other emerging economic powers and Japan's stagnant economic performance, it remains important to the respective companies and the Asia-Pacific region as a whole. As Japan and the United States continue to manage their economic relationship, they have several options on how to deepen the relationship. These options are not necessarily mutually exclusive but could be employed more or less in tandem.

The TPP

The TPP issue presents opportunities and challenges for the United States and Japan. On the one hand, if successful, it could reinvigorate an economic relationship that has remained steady but stagnant, by forcing the two countries to address long-standing, difficult issues, and allowing them to raise their relationship to a higher level. On the other hand, failure to do so could indicate that the underlying problems are too fundamental to overcome and could set back the

[18] For more information on the DDA, see CRS Report RL32060, *World Trade Organization Negotiations: The Doha Development Agenda*, by Ian F. Fergusson.

relationship. It could signify the failure of the United States and/or Japan to deal with domestic opposition to a more open trade relationship.

Reliance on the WTO

With or without the TPP, the United States and Japan could continue to use the WTO and its dispute settlement mechanism to resolve issues that come under the WTO's aegis. This option could help to promote stability in the bilateral relationship by containing political friction like that which erupted in the 1980s and 1990s. In addition, it could lessen the perception that many Japanese have had that the United States was acting unilaterally in making its demands on Japan to open up its markets and in threatening to limit market access to Japanese exporters in retaliation. The WTO provides at the least the semblance of neutrality where both countries could anticipate impartial treatment by their peers.

A potentially major constraint on the use of this option is the limited scope of the WTO's coverage and also the lack of progress in the DDA negotiations. A number of long-standing issues in U.S.-Japan economic ties pertain to competition policy, that is, how governments use their authority to ensure fair competition among producers. In addition, except for the completion of the agreement on trade facilitation, the failure of the WTO members, to complete the DDA round of negotiations may indicate the inability of the 159-member body to expand its coverage, constraining its future relevance. Nevertheless, the United States and Japan might continue to use the WTO process to resolve those issues that come under its purview.

Special Frameworks

A second option would be to discuss economic ties through a special framework and/or sector-specific agreements. These frameworks allow each country to raise and negotiate on issues that are not subject to international rules, such as regulatory policies and competition policies, but nevertheless have caused problems in the bilateral relationship. In addition, they provide a forum for officials to address issues before they emerge as full-fledged disputes. However, the record with respect to special frameworks, such as the Market-Oriented Sector-Selective (MOSS) talks, and the Structural Impediments Initiative (SII) (see **Appendix**) is mixed. While the United States and Japan have achieved some successes, a number of issues seem to have lingered over the years, such as government regulatory practices. Similarly, the record of sector-specific discussions, such as on autos and auto parts trade and construction services, reflects only partial success. The current Economic Harmonization Initiative (EHI) appears dormant for the time-being, and its relevance may be overtaken if Japan joins the TPP.

Appendix. Managing the U.S.-Japan Economic Relationship—A Brief History

For the United States and Japan, managing their economic relationship has meant cooperating in areas of mutual agreement and addressing problems in a manner that meets the national interest of each country while maintaining the integrity of the alliance. While the two countries have succeeded in doing this, by and large, trade frictions became heated at times, making relations difficult.

The United States dominated the economic relationship with Japan for many years after World War II. The United States was by far the largest economy in the world, and Japan was dependent on the United States for national security. The United States set the agenda, and the issues on the agenda were driven by the U.S. demands for Japan to reform its economic and trade policies, eliminate industrial policies, and boost domestic consumption. Sometimes these efforts led U.S. policymakers to force Japan to curb exports of certain products, such as cars, to the United States and/or to remove barriers to U.S. exports and investment.

Until recently, the United States and Japan, largely at the initiative of the United States, had used special bilateral frameworks and agreements to conduct their government-to-government economic relations. Some of these mechanisms were designed to address trade and investment barriers in Japan that were product-specific—for example, semiconductors and autos—and others were designed to address "generic" barriers that affected many sectors, such as the Japanese retail distribution system.

The Reagan Administration introduced the first multi-sector negotiating framework—the Market-Oriented Sector-Specific (MOSS) talks—with Japan in March 1985. The process resulted from discussions between President Reagan and Prime Minister Nakasone to find a way to deal with trade issues that had been clouding the relationship for some time. The initial set of negotiations covered four sectors: telecommunications; medical equipment and pharmaceuticals; forestry products; and electronics. The two countries added auto parts later. The sectors were selected because of the potential for U.S. companies to increase exports to the Japanese market if the barriers were removed. They were also sectors in which multiple Japanese government barriers to imports existed. The United States and Japan reached agreement in all of the MOSS sectors. A 1988 General Accounting Office (GAO) study concluded that U.S. exports in each of the selected sectors except auto parts increased, but that improved market access does not necessarily guarantee huge increases in exports.[19] Macroeconomic trends and other factors also play a role that could trump market access.

In March 1989, President George H. W. Bush with Prime Minister Uno launched the Structural Impediments Initiative (SII) that targeted a broad range of Japanese macroeconomic policies and practices and structural factors that served as nontariff trade barriers and that prevented U.S. exporters and investors from penetrating or increasing their presence in the Japanese market. The SII was a pioneering effort in that U.S. negotiators targeted Japanese barriers that were cited by not only American exporters and investors, but also by Japanese academics, business leaders, and

[19] U.S. General Accounting Office, *U.S.-Japan Trade: Evaluation of the Market-Oriented Sector-Selective Talks,* GAO/NSIAD-880205, July 1988. p. 57.

politicians. In so doing, the U.S. side sought to increase the possibility of a successful outcome if it had a domestic constituency in Japan that would be working to achieve the same goal. In addition, the targeted policies and practices were ones that were fundamental to Japanese economic life and had not been subject to bilateral negotiation. These targets were Japan's high savings-low investment imbalance, to which many economists attribute its perennial current account surpluses; the Japanese retail distribution system, particularly its Large-Retail Store Law that favored small "mom and pop" enterprises at the expense of larger operations, such as Toys R Us; land use policies that inhibited the market entry of new firms and kept land prices high; the *keiretsu* business conglomerates that both Japanese and U.S. experts blamed as a barrier to the entry of new Japanese and foreign firms to the Japanese market; exclusionary business practices, such as the formation of cartels to limit competition; and business pricing practices under which Japanese companies would sell products at a premium in Japan so that they could undersell their competitors in the U.S. market.

The SII also included U.S. policies and practices, such as the low U.S. savings rate, which Japanese negotiators asserted was a cause of U.S. trade deficits. This element was an attempt to make the format more balanced. However, it was generally understood that the real focus of the SII was Japanese barriers. The SII process operated throughout the four years of the George H. W. Bush Administration. U.S. and Japanese negotiators met periodically and reported annually on progress made in resolving the offensive policies and practices. The results of the SII process are mixed. On the one hand, it focused attention of policymakers of both sides on fundamental causes of problems that cut across many sectors and economic activities. The SII is also credited with placing enough pressure on Japan to change its Large-Retail Store Law. Some observers also argued that by selecting policies and practices that many Japanese themselves wanted changed, the United States lessened the unilateral thrust of previous negotiations. On the other hand, many of the problems that had plagued the U.S.-Japan relationship before the SII remain, such as the trade imbalances.

The Clinton Administration negotiated its own bilateral framework with Japan. The "United States-Japan Framework for a New Economic Partnership" borrowed elements from the MOSS and the SII processes by including some sector-specific goals along with overall structural and macroeconomic issues. These goals were included in five "baskets." This framework departed from the others in several important ways. It obligated the President and the Prime Minister to meet at least twice a year to review progress under the framework. At the insistence of the Clinton Administration, "objective criteria" were to use to determine whether Japan was fulfilling its obligations under the framework. This element proved highly controversial, and the two countries never agreed on the role the "objective criteria" would play or, for that matter, what they would be. The United States argued the criteria were to be targets Japan was to meet while Japan did not want to be bound by such criteria and argued that the criteria were to be guidelines. The differences over "objective criteria" reached the summit level and strained U.S.-Japan relations.

The United States and Japan reached agreements in most of the areas, including medical equipment procurement, intellectual property rights protection, financial services, insurance, and flat glass, among others, but not without some acrimony. For example, the United States was on the brink of imposing tariff-sanctions on Japan, and both countries were poised to take one another to the WTO before they reached agreement on Japanese imports of autos and auto parts. U.S.-Japanese trade friction reached its peak during the period of that framework that roughly corresponds to the first Clinton Administration. The friction was due in part to the long-running frustration that U.S. exporters and investors were experiencing with the same obstacles that previous agreements were supposed to have addressed. The "results-oriented" strategy was intended to provide a clear indicator of whether Japan had removed the barriers. But Japan resisted such objective indicators, because, it argued, the problems in U.S.-Japan trade stemmed from private sector practices and not government policies. The framework raised the issues to the summit level to ensure that both sides took the issues seriously. By doing so, however, the framework increased the risk that failure to achieve results would sour the entire relationship.

With the completion of the auto and auto parts agreement in 1995, most trade issues in the framework had been completed. The Clinton Administration closed the books on the framework. In its place, it got Japan to agree in June 1997 to another, more loosely shaped format, the Enhanced Initiative on Deregulation and Competition Policy (the Enhanced Initiative). This format did not have the results-oriented elements of the previous framework. It was a mechanism for exchanging views on some of the fundamental aspects of the Japanese economy that limited competition and were likely preventing Japan from emerging from the economic malaise that had set in. These issues had not received as much attention in previous negotiations. The United States focused on getting Japan to change regulations and competition policies affecting telecommunications, medical devices and pharmaceuticals, and financial services, as well as more generic issues such as competition policy and regulation transparency.[20]

On June 30, 2001, President Bush and then-Prime Minister Koizumi announced the formation of the "U.S.-Japan Economic Partnership for Growth" (The Economic Partnership). In so doing, the Bush Administration continued a tradition of creating special frameworks as mechanisms for discussing bilateral economic issues with Japan, a unique approach in U.S. trade policy.

The Enhanced Initiative marked a turning point in the overall U.S.-Japan relationship as economic relations became less prominent. While negotiators continued to meet to exchange views and monitor progress under the initiative and previous agreements, the issues did not have the importance at the summit level they once had. National security issues had become more dominant in the bilateral relationship.

The Economic Partnership consisted of several initiatives or dialogues to include participation from subcabinet-level leaders from both governments and participation from members of the business communities and other nongovernment sectors from both countries. The U.S.-Japan Subcabinet Economic Dialogue provided overall direction for the Economic Partnership. Other elements of the Economic Partnership included the Regulatory Reform and Competition Policy Initiative (with working groups on telecommunications, information technologies, energy, and medical devices and pharmaceuticals, plus a cross-sectoral working group); the Financial Dialogue, which examined such issues as banking reform; the Investment Initiative, which discussed requirements to improve the investment climate in Japan; and the Trade Forum, which operated to resolve sector-specific trade issues, to catch potential problems before they got worse, and to monitor sector-specific agreements already in effect. Each one of these elements contributed to an annual report to the President and the Prime Minister in which participants record progress and make recommendations for the coming year.

In November 2010, President Obama and then-Prime Minister Kan established the United States-Japan Economic Harmonization Initiative (EHI), a framework similar to its predecessors, to discuss these complex issues. In 2011 under the EHI, the two sides held several working-level

[20] Edward J. Lincoln, Troubled Times: U.S.-Japan Trade Relations in the 1990s (Washington, D.C., Brookings Institution Press, 1999), pp. 158-166.

and ad hoc meetings and a high-level meeting at the Deputy USTR/Deputy Minister for Foreign Affairs level. No meetings under the EHI have taken place since 2011as the TPP has become the de facto framework for addressing bilateral trade issues.

The WTO Dispute Settlement Mechanism

In addition, the United States and Japan are using the dispute settlement mechanism in the World Trade Organization (WTO) more frequently to resolve bilateral issues. In so doing, the United States and Japan have helped to depoliticize their trade disagreements, leaving it to panel members selected from trading partner nations to adjudicate the disputes. Furthermore, the WTO has provided a forum in which Japan has felt comfortable challenging U.S. trade practices.

Increased reliance on the WTO has reflected a major shift in Japan's strategy in dealing with the United States in trade. In 1995, Japan filed a dispute with the WTO as a counter-complaint against a U.S. complaint against Japan on the sale of autos and auto parts (discussed above). The two countries reached a resolution outside the WTO, but it was the first time that Japan had challenged the United States rather than acceding to U.S. demands. Japan was emboldened to shift its strategy in 1997 when the WTO ruled against the United States on its complaint against Japan regarding the marketing of Kodak and Fuji film in Japan.[21]

Author Contact Information

William H. Cooper
Specialist in International Trade and Finance
wcooper@crs.loc.gov, 7-7749

[21] Saaida M. Pekkanen, "The Politics of Japan's WTO Strategies," *Orbis,* Winter 2004, pp. 135-147.