

NOVEMBER 2018

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between the United States and Japan*

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## About API

Asia Pacific Initiative (API) is a non-profit, independent, Tokyo-based think tank aiming to draw up a vision for constructing the liberal international order in the Asia-Pacific region in pursuit of peace and prosperity in the region. The organization was formerly known as the Rebuild Japan Initiative Foundation (RJIF), which was founded in September 2011. Using over five years of activities by RJIF as a base, API restructured and started its second stage of development in July 2017.

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# Acknowledgments

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CSIS and API held a series of joint and individual roundtables with experts in Washington and Tokyo. These experts brought a wealth of experience and insights from across both the public and private sectors, as well as deep regional expertise. We are grateful to all of them.

A joint team from CSIS and API traveled to Myanmar and Vietnam for a study tour in March 2018. We met with a range of government officials, business people, and civil society representatives in both countries and garnered a wealth of insights from them. We thank all of these individuals for giving so generously of their time and wisdom.

A number of CSIS and API scholars and researchers, current and former, contributed to the production of this report. David Parker and Kay Kitazawa played a critical role in conceptualizing and launching the project. Toshihiro Kudo provided vital expertise and insight in Myanmar. A dedicated team of researchers, administrative staff, and interns in both Washington and Tokyo, listed in the biographical section of the report, made the success of the project possible.

We would also like to thank the many experts on both sides of the Pacific who provided thoughtful comments on various drafts of the report or contributed through interviews and roundtables. These include Wendy Cutler, Abigail Friedman, Yukiko Fukagawa, Murray Hiebert, Ryo Ikebe, Keiko Ito, Scott Miller, Derek Mitchell, Erin Murphy, Ted Osius, Rick Rosso, Amy Searight, Stephanie Segal, Troy Stangarone, Heizo Takenaka, Jim Wallar, Rikako Watai, and Jim Zumwalt. API would like to extend special thanks to Takashi Terada for his time and invaluable insights. Any mistakes or omissions are those of the authors and not those who offered comments.

This project was made possible by the generous support of the Japan Foundation's Center for Global Partnership (CGP) and the U.S.-Japan Foundation (USJF). We believe the collaborative spirit and search for consensus displayed by CSIS and API scholars, as well as the constructive results of the project, validate the mission of both sponsoring organizations to strengthen U.S.-Japan ties.

*The Parties will contribute toward the further development of peaceful and friendly international relations by strengthening their free institutions, by bringing about a better understanding of the principles upon which these institutions are founded, and by promoting conditions of stability and well-being. They will seek to eliminate conflict in their international economic policies and will encourage economic collaboration between them.*

- *Article II of the Treaty of Mutual Cooperation and Security between Japan and the United States of America*

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# Executive Summary

The alliance between the United States and Japan has been a force for peace and prosperity around the world for nearly 60 years. Economics has been at the heart of the U.S.-Japan alliance from the outset: Article II of the Treaty of Mutual Cooperation and Security mandates that the two allies “seek to eliminate conflict in their international economic policies and ... encourage economic collaboration between them.”

Nowhere are U.S. and Japanese strategic interests more closely aligned than in the Indo-Pacific region. Both Washington and Tokyo seek to ensure regional security and stability, expand trade and other economic opportunities, and support universal democratic norms. The two countries have worked constructively together for many decades to shape regional economic rules and norms through institutions such as the Asian Development Bank and the Asia-Pacific Economic Cooperation (APEC) forum.

Powerful forces are driving further strategic convergence between the United States and Japan. In the wake of U.S. withdrawal from the Trans-Pacific Partnership (TPP), China has launched an aggressive bid for economic leadership in the Indo-Pacific region, and economic coercion has become an increasingly common tool of Chinese statecraft. The China challenge is particularly pronounced in the areas of infrastructure and technology.

A more robust and coordinated economic statecraft, jointly pursued by Washington and Tokyo, is central to advancing U.S. and Japanese interests in the Indo-Pacific region. U.S. withdrawal from TPP has neither eliminated the agreement’s underlying logic nor closed the door on further strengthening U.S.-Japan economic cooperation. By working together to advance their preferred rules and norms, Washington and Tokyo can ensure better economic outcomes for themselves and others.

To explore opportunities for greater economic cooperation between the United States and Japan in third countries, the Center for Strategic and International Studies (CSIS) in Washington and the Asia Pacific Initiative (API) in Tokyo embarked on a joint research project in the spring of 2017. The project team used a case-study approach to examine a set of key countries and institutions in which economic cooperation could be especially valuable in furthering shared interests. It selected four countries and two institutional arrangements in which Washington and Tokyo can or do play leading roles in shaping economic rules and norms: Myanmar, Vietnam, India, South Korea, the regional trade architecture, and the Group of Seven (G7). Recommendations for action in each of the countries and functional areas covered in the case studies are included at the end of each respective chapter.

Key findings from the project included the following:

- The underlying strategic interests and goals of the United States and Japan in the Indo-Pacific region are highly aligned, transcending today’s bilateral trade tensions.
- China’s growing influence and assertive behavior in the region pose a substantial challenge for the United States and Japan.
- There remains a strong demand in the region for U.S. and Japanese economic engagement and leadership in rule-making and norm-setting.
- Washington and Tokyo have complementary skills in economic statecraft and should work to better coordinate their economic policies in the region.

The report offers 10 crosscutting recommendations for individual and joint action by the United States and Japan in the Indo-Pacific:

**1. Resolve bilateral trade tensions to clear the way for third-country cooperation.**

The increase of trade tensions between the two countries has been an unfortunate distraction. The United States should work with Japan to address impediments to trade and investment; in doing so, both sides should act within established rules, seek to resolve differences through negotiation, and focus on enhancing cooperation in third countries.

**2. Develop a joint strategic approach that plays to each country's strengths.**

The United States and Japan should work together to strengthen and operationalize the economic pillar of their respective free and open Indo-Pacific strategies and coordinate to maximize each country's unique advantages, including by establishing a new, bilateral Indo-Pacific Economic Cooperation Dialogue.

**3. Work toward a free and open digital economy.**

The United States and Japan should foster cooperation on emerging technologies and digital governance to ensure that both play a leading role in shaping the rules, standards, and norms of the future global economy. The two countries should cooperate in forums such as APEC to develop guidelines and principles for the digital economy.

**4. Cooperate on trade liberalization and rule-making.**

The true power of the U.S.-Japan economic relationship lies in the two countries' ability to shape global economic rules, standards, and norms, especially in the Indo-Pacific region. Rule-making efforts should focus on extending the disciplines agreed on in TPP in two key areas: the digital economy and state-owned enterprises.

**5. Promote trilateral cooperation with European partners.**

Europe has shown an intention to play a more active role in Indo-Pacific regional affairs. Trilateral economic cooperation among the United States, Japan, and the European Union should be expanded. Washington and Tokyo should also work within the G7 to gain European support for their endeavors in the Indo-Pacific.

**6. Increase financing and other support for high-quality infrastructure investments to meet regional needs and enhance connectivity.**

Both Japan and the United States have critical roles to play in the historic global infrastructure build-out. The two countries can improve operations and financing from their respective government agencies, facilitate information sharing between agencies with similar mandates, and jointly promote high standards for infrastructure investment.

**7. Respond to the risk of geo-economic coercion through trade and debt.**

There is growing concern around the world about China's economic coercion. The United States and Japan should offer more support to countries that are part of the Belt and Road Initiative, through building the capacity of government staff, offering coordinated alternative financing, and improving intelligence sharing about China's economic activities.

**8. Seek an affirmative agenda with China where possible.**

Although China has diverging interests and policies, it shares a desire for a peaceful and stable Indo-Pacific region. The development needs of the region cannot be fulfilled by one country or organization

alone. Cooperation and positive market competition where possible will be in the interest of all three major powers as well as regional economies.

**9. Utilize U.S. and Japanese strength in technical assistance and human capacity building to nurture small and medium-sized enterprises.**

Know-how, human capacity development, and a healthy climate for small and medium-sized enterprises (SMEs) are key forces for market-based growth and development. The United States and Japan should step up their efforts to develop capacity and skills in third countries and enhance SME access to global financing and trade.

**10. Collaborate on anti-corruption efforts.**

Countries with high levels of corruption are unlikely to generate stable or equitable economic growth and are at risk of becoming reliant upon non-democratic countries for trade and investment.

Washington and Tokyo should enhance intelligence sharing on corruption and deepen joint work on anti-corruption in international forums.

We hope the findings and recommendations in this report will make a useful contribution to strengthening the vital U.S.-Japan alliance and making it an even more effective force for peace and prosperity in the Indo-Pacific region. There has never been a more important time for the United States and Japan to work together to fulfill the mandate of Article II.

# Introduction and Overview

The United States and Japan are the world's two largest market economies, bound together by a decades-old alliance that has become the lynchpin of stability and security in the Asia-Pacific region. But differences over economic and commercial issues have been a recurring source of strain in the relationship for over half a century and still cast a shadow over bilateral ties today. Despite this, U.S. and Japanese strategic interests in the Indo-Pacific region are substantially—and increasingly—aligned, and economic cooperation between the two countries has the potential to advance those shared interests in the region and beyond.

Trade tensions were a consistent feature of the U.S.–Japan relationship for three decades after Japan ran its first bilateral trade surplus in 1965. In the 1970s, Washington and Tokyo sparred over everything from surging exports of Japanese color televisions to Japanese purchases of Iranian oil during the 1979 hostage crisis. Tensions grew worse in the 1980s, with conflict over Japan's currency policy and growing anger over its protected domestic market. The low point came in the summer of 1987, when a scandal broke out over a Japanese company's covert sale of advanced machinery to the Soviet Union; in response, angry members of Congress took sledgehammers to a Toshiba radio on the steps of the Capitol building at a televised press conference.<sup>1</sup> The bursting of the economic bubble at the end of 1989 did little to immediately resolve trade tensions, but these gradually eased in the second half of the 1990s as Japan descended into its first “lost decade” of economic stagnation.

Even during these periods of strain in their economic relationship, Washington and Tokyo still found ways to work together constructively to advance shared economic interests around the world. They helped shape global rules and norms in international financial institutions such as the World Bank, the Asian Development Bank (ADB), and the Organization for Economic Cooperation and Development (OECD). As founding members of the Group of Seven (G7) industrialized democracies in the mid-1970s, they were leaders of the informal body that effectively served as the steering group for the global economy.<sup>2</sup> As the Cold War wound down in the late 1980s, even with bilateral trade frictions at their peak, the two countries invested significant effort in trans-Pacific economic integration when Japan asked Australia to take the lead in establishing the Asia-Pacific Economic Cooperation (APEC) forum, an initiative that Washington soon endorsed.<sup>3</sup>

Regional economic cooperation has been a centerpiece of U.S.–Japan relations in the three decades since APEC was founded, and it has deepened since Prime Minister Shinzo Abe returned to office in December 2012. Most notably, the two countries successfully negotiated a *de facto* U.S.–Japan free trade agreement under the rubric of the Trans-Pacific Partnership (TPP). Signing TPP in February 2016 brought the United States and Japan closer than ever to realizing the ambition of Article II of the U.S.–Japan Mutual Defense Treaty of 1960, an often-forgotten provision that should be resurrected: it calls for the two partners to

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<sup>1</sup> George R. Packard, “The Coming U.S.–Japan Crisis,” *Foreign Affairs* 66, no. 2 (Winter 1987/1988), <https://www.foreignaffairs.com/articles/asia/1987-12-01/coming-us-japan-crisis>.

<sup>2</sup> “From Rambouillet to Brussels: The history of the G7,” The Federal Government (Germany), [https://www.g7germany.de/Webs/G7/EN/G7-Gipfel\\_en/Geschichtlicher-Ueberblick\\_en/historical-overview\\_node.html](https://www.g7germany.de/Webs/G7/EN/G7-Gipfel_en/Geschichtlicher-Ueberblick_en/historical-overview_node.html).

<sup>3</sup> “About APEC: History,” Asia-Pacific Economic Cooperation, <https://www.apec.org/About-Us/About-APEC/History>.

strengthen their free institutions, to eliminate conflict in their international economic policies, and to encourage economic collaboration.<sup>4</sup>

The election of Donald Trump as president of the United States has presented new challenges for U.S.–Japan cooperation. During his campaign, Trump expressed frequent dissatisfaction with U.S. alliances, questioned their strategic and economic value to the United States, and emphasized their cost to the average U.S. citizen. But it is his actions as president on trade policy that have introduced the greatest uncertainty into the U.S.–Japan relationship. Within days of taking office, Trump fulfilled his campaign promise and withdrew the United States from TPP. He has repeatedly complained about the size of the U.S. bilateral trade deficit with Japan. In April of 2018, the Trump administration declined to exempt Japan from tariffs on steel imports under Section 232 of the Trade Expansion Act of 1962, which gives the president the authority to restrict imports due to national security concerns.<sup>5</sup> In late May, the U.S. Department of Commerce announced a similar investigation under Section 232 into the national security impact of automobile and auto parts imports.<sup>6</sup> These actions, as well as President Trump’s provocative stance at the G7 Leaders’ Summit in Quebec, Canada, in June 2018, raised fears that the United States had turned away from leadership of the global rules-based economic order—at a time when Japan’s Prime Minister Shinzo Abe was hoping to link arms more tightly with the United States in upholding that order.<sup>7</sup>

Nevertheless, these strains and uncertainties have not altered the powerful underlying forces that drive strategic convergence between Washington and Tokyo. These enduring forces give much reason to be optimistic about the long-term prospects for the U.S.–Japan alliance and our economic cooperation, particularly in the Indo-Pacific region, which is the focus of this study.<sup>8</sup> The United States has three core interests in the region: protecting the security of the United States and its allies, expanding trade and economic opportunities, and supporting universal democratic norms. These align closely with Japanese interests. The past 70 years have seen Japan grow into an advanced market economy, with large stocks of unique intellectual property, significant direct investment abroad, and the deepening of shared values with the United States. Ultimately, enduring strategic and economic interests are likely to drive U.S. administrations to pursue an active economic agenda in the Indo-Pacific region. Japan is a natural partner in these efforts.

Converging U.S. and Japanese interests are also driven by the evolving strategic environment in the Indo-Pacific region. China is now one of only two economies in the world with a GDP greater than \$10 trillion.

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<sup>4</sup> Article II reads in full: “The Parties will contribute toward the further development of peaceful and friendly international relations by strengthening their free institutions, by bringing about a better understanding of the principles upon which these institutions are founded, and by promoting conditions of stability and well-being. They will seek to eliminate conflict in their international economic policies and will encourage economic collaboration between them.”

“Treaty of Mutual Cooperation and Security between Japan and the United States of America,” opened for signature January 20, 1960, Ministry of Foreign Affairs of Japan, <https://www.mofa.go.jp/region/n-america/us/q&a/ref/1.html>.

<sup>5</sup> Samuel Osborne, “Donald Trump and Shinzo Abe fail to agree on US tariff exemption for Japan,” *The Independent*, April 19, 2018, <https://www.independent.co.uk/news/world/americas/us-politics/trump-shinzo-abe-us-tariff-japan-exemption-talks-mar-a-lago-florida-a8311996.html>.

<sup>6</sup> “U.S. Department of Commerce Initiates Section 232 Investigation into Auto Imports,” Office of Public Affairs, U.S. Department of Commerce, May 23, 2018, <https://www.commerce.gov/news/press-releases/2018/05/us-department-commerce-initiates-section-232-investigation-auto-imports>.

<sup>7</sup> Emre Peker, Paul Vieira, and Valentina Pop, “Behind the scenes at G-7 meetings, allies dismayed by Trump’s jabs,” *The Wall Street Journal*, June 15, 2018, <https://www.wsj.com/articles/behind-the-scenes-at-g-7-meetings-trump-jabs-left-allies-dismayed-1529064601>.

<sup>8</sup> For purposes of this report, the “Indo-Pacific region” is defined as the geographic space covered by the U.S. Indo-Pacific Command, the U.S. Defense Department’s combatant command that stretches from India to Hawaii and from Mongolia to Antarctica; see map at <http://www.pacom.mil/About-USINDOPACOM/USPACOM-Area-of-Responsibility/>.

Under the Xi Jinping administration, Beijing has not only increased repression at home but also become more assertive and nationalistic in its security and economic policies abroad. Economic coercion—against neighbors like South Korea and the Philippines, as well as distant trade partners like Norway—has become a more common tool of Chinese statecraft. In the wake of U.S. withdrawal from TPP, Beijing has launched an aggressive bid to establish economic leadership in the Indo-Pacific, part of a larger effort to convert China’s economic might into strategic influence. The Chinese geo-economic challenge is far-reaching and interconnected.

China presents the clearest challenge to U.S. and Japan geo-economic interests in two areas: infrastructure and technology. China has put forth a vision for global economic integration in the Belt and Road Initiative (BRI), Xi Jinping’s ambitious plan to connect countries on the Eurasian continent and beyond through hard and soft infrastructure. While China’s willingness to address the massive global need for infrastructure is broadly welcome, there are growing concerns that many BRI projects involve irresponsible financing, low-quality infrastructure, and undue Chinese leverage over client countries.

Less discussed but just as important is the so-called “digital silk road,” through which China plans to set new standards and norms for the digital economy, including in critical emerging technologies such as 5G, the fifth generation of wireless technology. China’s preference for a closed internet, data protectionism, and social controls contrasts sharply with the U.S. and Japanese vision of an open internet and free data flows based on a foundation of consumer privacy. A huge data gap has emerged between China and other countries, with Chinese corporations already holding 10–15 times the amount of data as U.S. companies.<sup>9</sup> If these issues are not properly addressed, the United States and Japan risk losing their advantage as technological leaders and as shapers of rules, standards, and norms for the digital economy.

Central to addressing the challenge of China is joint pursuit by Washington and Tokyo of a more robust and coordinated economic statecraft in the Indo-Pacific region. Home to over half the world’s population and many of the world’s most dynamic economies, the Indo-Pacific region will do more than any other to shape U.S. and Japanese growth and prosperity in the future. By working together to advance their preferred rules and norms in the region, Washington and Tokyo can ensure better economic outcomes for themselves and others.

Recent experience has shown the power of U.S.–Japan economic cooperation. Together, the United States and Japan represent roughly 80 percent of the total economic activity covered by the original TPP agreement. This combined economic heft helped motivate leaders from Taiwan to Indonesia, economies with vastly different levels of development, to line up to join the agreement well in advance of its ratification. U.S. withdrawal from TPP dealt a significant setback to joint economic statecraft, but it neither eliminated the underlying logic of the agreement nor closed the door on further strengthening of U.S.–Japan cooperation. Indeed, it is more important than ever that Washington and Tokyo actively seek creative and effective ways to wield their comparative advantages in the service of shared strategic interests.

Article II of the bilateral security treaty provides both a framework and a mandate for enhanced U.S.–Japan economic cooperation along these lines. Its call for strengthening free institutions and enhancing economic cooperation is timely: as strategic competition in the Indo-Pacific continues to intensify,

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<sup>9</sup> Kai-Fu Lee, *AI Superpowers: China, Silicon Valley and the New World Order* (Boston, New York: Houghton Mifflin Harcourt, 2018), 79.

strengthening the economic dimensions of the U.S.-Japan alliance is critical to securing U.S. and Japanese strategic interests.

This enhanced cooperation will require hard work on both sides. For Washington, it will mean recognizing that, while the United States and Japan may compete in commercial affairs, the two are not economic rivals. Rather, they are vital partners with shared interests and values, capable of playing a joint leadership role in Asia that advances high-standard economic rules, norms, and standards. Building on its free and open Indo-Pacific strategy, the Trump administration needs to develop and implement a comprehensive and cohesive strategy for constructive engagement in Indo-Pacific economic integration, one that involves close coordination with Tokyo.

Tokyo's challenge is to build out its leadership role in the Indo-Pacific in the absence of traditional U.S. engagement. Japan is the only other country with the will and capacity not only to uphold but advance a rules-based, high-standard, liberal economic order in the region. The Abe administration has shown a welcome new willingness to move beyond Japan's traditional role of merely supporting Washington's initiatives and instead to initiate measures that propel the U.S.-Japan agenda forward. This new dynamic was most clearly seen in Tokyo's efforts to secure agreement among the remaining 11 members of TPP to implement the pact, rebranded as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).<sup>10</sup> Tokyo has also signed an economic partnership with the European Union and is seeking to bring the Regional Comprehensive Economic Partnership (RCEP) to conclusion. Further efforts by Tokyo to lead global and regional rule-making should be encouraged.

It is critical for Washington to understand the fundamental drivers of the shared U.S.-Japan agenda and develop creative means to advance it. While current White House policy might limit the scope for high-level coordination in the near term, much can be done at lower levels of government, in multilateral institutions, and on the ground in the region to enhance cooperation and advance shared U.S. and Japanese interests.

### *CSIS-API Project: Objective and Methodology*

Beginning in the summer of 2017, the Center for Strategic and International Studies (CSIS) in Washington and the Asia Pacific Initiative (API) in Tokyo embarked on a joint project to explore opportunities to improve U.S.-Japan economic cooperation in third countries. We used a case-study approach to examine a set of key countries and institutions in which the United States and Japan have aligned interests and potentially complementary skills, and where economic cooperation could be especially valuable in furthering shared interests.

Based on discussions with leading scholars and practitioners of the U.S.-Japan alliance in Washington and Tokyo, we decided to conduct our country case studies on a group of fast-growing, strategically significant countries in the Indo-Pacific region. Using analysis from PricewaterhouseCoopers, McKinsey, Goldman Sachs, the International Monetary Fund (IMF), and others, we identified countries in the region that are projected to experience the fastest economic growth over the next decades. We also considered the geopolitical and geo-economic significance of these countries, as well as the extent to which the lessons of U.S.-Japan cooperation could best be applied to other countries. From this group, we selected four

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<sup>10</sup> Aurelia George Mulgan, "CPTPP a boost for Japan's regional trade leadership," East Asia Forum, February 27, 2018, <http://www.eastasiaforum.org/2018/02/27/cptpp-a-boost-for-japans-regional-trade-leadership/>.

countries for case studies—Myanmar, Vietnam, India, and South Korea—to represent a variety of issues and contexts:

- **Myanmar** has a high-growth population and enormous development potential; however, it is a fragile democracy that is both wary of China and at risk of falling under Beijing’s influence due to strong economic and institutional ties.
- **Vietnam** is a high-growth, strategically important country that seeks to be more integrated into the regional economy, as seen by its involvement in TPP; at the same time, it is a non-democratic country with a state-dominated economy.
- **India** is a democracy that will soon overtake China as the most populous country in the world. If the United States and Japan can encourage Delhi to adopt more outward-looking trade policies, India has the potential to play an important role in rule-making in the Indo-Pacific.
- **South Korea** is an advanced economy and U.S. ally, yet one that is deeply entwined with China’s economy, creating vulnerability to external shocks and influence. Reunification of the Korean peninsula—still far off but more conceivable than a year ago—could be a geopolitical game-changer, while South Korea will play a crucial role in Northeast Asian economic development.

In addition to the four country cases, we identified two institutional and functional areas in which U.S.–Japan economic cooperation is particularly compelling: regional trade architecture in the Indo-Pacific, and the G7. Both represent key arenas in which the United States and Japan play leading roles in shaping economic rules and norms. Cooperation in these forums also contributes importantly to advancing U.S. and Japanese rule-setting efforts in global institutions such as the Group of Twenty (G20) and the World Trade Organization (WTO).

As their starting point, the six case studies define and examine the key U.S. and Japanese strategic and economic interests at stake. Without a clear understanding of where U.S. and Japanese interests lie in any country or institution and, most importantly, where these interests align or diverge, policymakers in Washington and Tokyo will not be able to match means to ends effectively. Our case studies also incorporate a thorough analysis of the political and economic landscape of each country and institution. To this end, a joint delegation of CSIS and API scholars visited Myanmar and Vietnam in March 2018 and held wide-ranging interviews with government, business, and civil society representatives.

Our analysis examines the state of U.S. and Japanese economic involvement in each country: not only trade and investment flows, but also aid flows, tourism, and other economic indicators that capture the full range of economic linkages between the United States, Japan, and the third countries in question. This economic analysis is coupled with an examination of political indicators of soft power and other measures of the U.S. and Japanese presence in third countries. Finally, for each case study, we offer recommendations for the United States and Japan individually, as well as proposals for joint action.

## *Key Findings*

- **The U.S. and Japan are highly aligned in their underlying strategic interests and goals in the Indo-Pacific region.** These goals include expanding economic opportunity for companies, workers, and citizens of their own countries and for other countries in the region, and advancing high-standard rules, norms, and standards of trade and investment. While the two countries already cooperate extensively in these areas, there is significant potential for greater cooperation to advance their mutual interests.

- **These shared interests transcend today's tensions, but these tensions pose risks, and Washington and Tokyo need to work through them.** Although there is much goodwill and momentum toward strengthening economic cooperation in third countries and institutions, if the Trump administration's protectionist measures go further and cause economic pain to allies including Japan, they could make economic cooperation in third countries more challenging and less effective. The agreement between President Trump and Prime Minister Abe in late September 2018 to launch negotiations toward a bilateral trade agreement was an encouraging sign that the two sides were prepared to constructively resolve their differences on trade.
- **China's economic ties to countries in the Indo-Pacific have deepened over the past ten years, giving it growing political influence.** The United States and Japan maintain strong investment and trade ties with many countries in the Indo-Pacific, but China's geo-economic role and influence are growing rapidly, as its trade, infrastructure, and other connections expand. China's influence can be expected to continue to grow, particularly in Southeast Asia, as it makes strides in high-tech industries and digital standards.
- **There is a strong demand for U.S. and Japanese leadership in the Indo-Pacific.** Many countries in the region are aware of the risks of overdependence on China but lack the belief that there are real alternatives. At the same time, nations in the Indo-Pacific do not wish to choose between China and either the United States or Japan. Washington and Tokyo could do much more in partnership to offer new forms of financing and capacity building to these countries.
- **The United States and Japan each offers its own comparative advantage in economic engagement in the region.** The United States and Japan differ in the structure of their economic and commercial ties with third countries, lending each different advantages in fostering cooperation or exerting leverage on partners. The distinct resources and structure of Washington and Tokyo's respective systems for economic policymaking provide other potential opportunities for specialization and maximum impact. For example, Tokyo is engaged in significant infrastructure construction and the establishment of manufacturing bases across the Indo-Pacific, whereas the United States is more advanced in the areas of internet services, digital content industries, and finance. In addition, favorability ratings for the two countries in other parts of the region vary.<sup>11</sup> For example, Malaysia and Indonesia view Japan significantly more favorably than the United States, while the Philippines and South Korea are far more favorably disposed towards Washington than Tokyo. Through a comprehensive, coordinated strategy, the United States and Japan can maximize their joint impact in furthering their shared interests.
- **Despite their complementarities, coordination between the two countries is underdeveloped.** Lack of communication and coordination among relevant agencies of the U.S. and Japanese governments working in third countries is an obstacle to enhanced cooperation. In some countries, agencies may support one another's goals in principle but have different priorities in practice. In parts of Myanmar, for example, the Japan Bank for International Cooperation (JBIC) is focused on building special economic zones and infrastructure, while the U.S. Agency for

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<sup>11</sup> Bruce Stokes, How Asia-Pacific Publics See Each Other and Their National Leaders, (Washington, D.C.: Pew Research Center, September 2015), 14, <http://www.pewresearch.org/wp-content/uploads/sites/2/2015/09/Pew-Research-Center-Asian-Views-of-Each-Other-Report-FINAL-September-2-2015.pdf>.

Richard Bush and Maeve Whelan-Wuest, "How Asians view America (and China)," Brookings Institution, January 18, 2017, <https://www.brookings.edu/blog/order-from-chaos/2017/01/18/how-asians-view-america-and-china/>.

International Development (USAID) is more focused on fighting infectious diseases and agricultural development. In other instances, U.S. and Japanese agency goals are similar, but neither personnel nor overseas leadership communicates enough to enable effective cooperation. Again, in Myanmar, the Japan International Cooperation Agency (JICA) and USAID has each funded separate initiatives to promote rule of law and civil liberties, with little evidence of coordination.

- Moreover, there is little formal cooperation between Japanese and U.S. government personnel at a higher policymaking level. The U.S.–Japan Economic Dialogue between Vice President Mike Pence and Deputy Prime Minister Taro Aso has yielded few tangible results. It and other high-level interactions have been dominated by bilateral trade tensions rather than opportunities for regional economic cooperation.
- **Together, these key findings point to a need for greater cooperation, based on U.S. and Japanese comparative advantages.** Greater cooperation will serve the two countries’ economic, political, and security interests—and those of the region. Cooperation will allow both the United States and Japan to strengthen different sectors and regions of the Indo-Pacific with the ultimate goal of supporting a liberal economic and political environment. Strengthened processes of coordination are also needed. The promising progress being made in the U.S.–Japan Policy Cooperation Dialogue on the Internet Economy<sup>12</sup> could be a model for broader cooperation.

### *Crosscutting Recommendations*<sup>13</sup>

We are confident in the strength and durability of the U.S.–Japan alliance. But business as usual is not sufficient: progress toward the two countries’ shared economic goals in the Indo-Pacific region will require a comprehensive and cohesive strategy. We offer below a number of crosscutting recommendations for individual and joint action by Washington and Tokyo to deepen their third-country economic cooperation and so increase their own prosperity and security, as well as that of the Indo-Pacific region.

Recommendations for action in the each of the countries and functional areas covered in our cases studies are included at the end of the respective chapter below.

#### **1. Resolve bilateral trade tensions to pave the way for third-country cooperation.**

The increase of trade tensions between the United States and Japan since the start of the Trump administration has been an unfortunate distraction from the opportunities for third-country cooperation. The imposition of Section 232 tariffs on U.S. imports of steel from Japan on questionable national security grounds was particularly harmful. The United States should work with Japan to address remaining market access and structural impediments to trade and investment between the two countries. Both sides should act within established rules, seek to resolve their economic differences through negotiation, and focus their bilateral dialogue on areas for enhanced cooperation in third countries.

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<sup>12</sup> Office of the Spokesperson, “Joint Statement on the 9th U.S.–Japan Policy Cooperation Dialogue on the Internet Economy,” U.S. Department of State, July 27, 2018, <https://www.state.gov/r/pa/prs/ps/2018/07/284592.htm>.

<sup>13</sup> See also the complementary recommendations in the CSIS report: Michael Green, Matthew Goodman, et al, *More Important Than Ever: Renewing the U.S.–Japan Alliance for the 21st Century*, (Washington, D.C.: Center for Strategic and International Studies, October 2018), <https://www.csis.org/analysis/more-important-ever>.

In a welcome sign of a more constructive turn in U.S.–Japan trade relations, President Trump and Prime Minister Abe jointly announced in late September 2018 that the two countries would launch negotiations toward a U.S.–Japan trade agreement in goods and some services, while refraining from “taking measures against the spirit of this joint statement”—a reference to Section 232 tariffs on Japanese automobiles and auto parts. With the immediate threat of bilateral trade tensions reduced, both countries should focus more of their bilateral energies on opportunities for expanded cooperation in third countries.

**2. Develop a joint strategic approach toward the Indo-Pacific region that plays to each country’s strengths.**

The United States and Japan should work together to strengthen and operationalize the economic pillar of their respective free and open Indo-Pacific strategies. The Japanese strategy focuses on economic development through regional connectivity. India is well aligned with Japan on infrastructure development, whereas the United States and Australia see the strategy as much more of a security initiative. The strategic battle is not just in the maritime domain but also involves providing economic assistance and infrastructure to countries to keep them free and open. The recently re-established quadrilateral or “quad” forum, bringing together the United States, Japan, Australia, and India, could be a useful mechanism for coordinating regional economic initiatives.

The two countries should play to their respective comparative advantages in working in third countries and institutions. In the area of infrastructure, for example, the United States and Japan cannot match Chinese funding in Southeast Asia and beyond. However, the United States holds unique advantages in innovation and finance, whereas Japan has unique strengths in long-term planning, capacity building, and establishing manufacturing bases in the region. Washington and Tokyo can bring together these advantages in complementary ways, taking into account the needs of developing nations and the strengths of other regional powers. Energy cooperation—especially expanding export and distribution of U.S.-sourced liquid natural gas throughout the Indo-Pacific region—is a particularly promising area for greater bilateral coordination.

To enhance coordination of their regional economic strategies, Washington and Tokyo should establish a bilateral Indo-Pacific Economic Cooperation Dialogue that aims to draw up joint economic plans and projects for the region. This could meet annually on the margins of the East Asia Summit or APEC meetings, and as needed throughout the year.

**3. Work toward a free and open digital economy in the Indo-Pacific.**

Japan and the United States should engage in deeper private–public initiatives to foster cooperation on fourth industrial revolution technologies such as 5G. If the two countries do not win the development race for these technologies, they stand little chance of determining the broader rules, standards, and norms of the future global economy. Washington and Tokyo should explore joint research and development funds necessary to compete with the Made in China 2025 initiative and leverage the U.S.–Japan Policy Cooperation Dialogue on the Internet Economy to facilitate business sector-driven cooperation. The priority should be on technologies that can help to promote democratic practices and small and medium-size enterprise (SME) development. In addition, both countries should cooperate in regional and international forums such as APEC and the OECD to develop guidelines and principles for development of digital technologies.

Japan, independently and in partnership with the United States, should develop its own digital economy to become internationally competitive. Japan's lack of major digital players like Google or Tencent prevent the country from playing a larger role in the regional and global digital economy. To gain a greater competitive edge, Japan should promote domestic SME-driven digital technological development and import and partner with platforms like Grab from Southeast Asia; in turn, these will help Japan to spread rules and norms to govern the digital economy across the countries of the Association for Southeast Asian Nations (ASEAN). Tokyo should consider initiatives to facilitate controlled regulatory experimentation in countries like Indonesia, Malaysia, and Vietnam. Japan's current plans for high-quality infrastructure development should be expanded to include digital connectivity. Japan is a large player in manufacturing parts used in internet of things (IoT) devices. Through harvesting the data in devices such as medical sensors, Japan can improve its stock of assets to be competitive and an effective partner on the digital economy in the Indo-Pacific.

#### **4. Cooperate on trade liberalization and rule-making in the Indo-Pacific.**

The true power of the U.S.–Japan economic relationship lies in the two countries' ability to shape global economic rules, standards, and norms, especially in the Indo-Pacific region. Despite the U.S. withdrawal from TPP, there remains substantial scope for cooperation in this regard.

In the near term, Japan should lead on supporting trade and investment liberalization efforts in the Indo-Pacific and create incentives for the United States to reengage in multilateral frameworks. Japan should continue its work to extend trade liberalization through the CPTPP, the Japan–EU Economic Partnership Agreement, and RCEP. It should look to widen membership of the CPTPP to include additional countries, including South Korea, Thailand, and Indonesia.

Despite its withdrawal from TPP, the Trump administration has shown a willingness to engage in APEC, and the two countries should redouble their joint efforts in the regional forum. Although APEC undertakings are non-binding and voluntary, the forum still plays an important role in spreading best practices and informally setting rules and norms in the Indo-Pacific region. APEC is also important because it is one of the few international forums in which Taiwan and Hong Kong have their own seats; the United States and Japan have an economic and political interest in including the two economies in regional norm-setting efforts.

Substantively, U.S. and Japanese rule-making efforts in the region should focus on extending the disciplines agreed to in TPP/CPTPP in two key areas: the digital economy and state-owned enterprises. These are the arenas in which the economic competition of the next few decades will be fought, and both the United States and Japan have an enormous stake in ensuring that high-standard, market-based approaches to internet freedom, cross-border data flows, and a limited role for the state in the marketplace prevail.

#### **5. Promote trilateral cooperation with European partners in the Indo-Pacific.**

Europe has shown its intention to play a more important role in Indo-Pacific regional affairs. The United Kingdom and France have launched their “Pacific pivots.” Their maritime security cooperation is an important contribution to enforcing economic sanctions on North Korea, which should be continued and encouraged. The Japan–EU Economic Partnership Agreement is another important front on which Japan is cooperating with Europe. Its consequences stretch far beyond economics, since it contributed to the signing of the Japan–EU Strategic Partnership Agreement.

Trilateral economic cooperation among the United States, Japan, and the European Union should be expanded. The series of statements by U.S., Japanese, and EU trade ministers over the past year on joint cooperation to combat excessive subsidies and forced technology transfer policies is constructive;<sup>14</sup> this work should be operationalized and deepened. Washington and Tokyo should also work within the G7—the key forum in which like-minded advanced democracies can speak with a unified voice—to gain European support for their endeavors in the Indo-Pacific.

## **6. Increase financing and other support for high-quality infrastructure investments to meet regional needs and enhance connectivity in the Indo-Pacific.**

Both Japan and the United States have critical roles to play in the historic global infrastructure build-out. Japan could improve the operations of its government agencies to make their projects in developing countries more attractive. JICA could continue to improve the speed of its financing and provide loans in dollars, as requested by developing countries, to make it easier to co-finance with U.S. government agencies. JBIC could strengthen its special operations risk-taking to help meet the needs of Asian countries facing offers for large loans from China.

The passage by both houses of the U.S. Congress in early October 2018 of legislation to create a new, better-resourced development finance institution—the so-called “BUILD Act”<sup>15</sup>—is a positive step that will give the United States more firepower in the global infrastructure competition. Once the new entity is up and running, it should undertake joint and coordinated financing with JBIC. These efforts should be designed to enable both U.S. and Japanese contractors and other companies to win new opportunities.

Particularly in developing countries, the United States and Japan share similar goals, yet there is minimal communication between embassies and similar agencies such as JICA and USAID. With an eye towards improving cooperation in the long run, both countries should prioritize facilitating communication and sharing information between agencies with similar prerogatives on a regular basis.

Washington and Tokyo should also deepen their cooperation on high standards for “quality infrastructure”<sup>16</sup> through their leadership in multilateral development banks like the World Bank and ADB, as well as the G7, the G20, APEC, and other relevant organizations. CSIS has done extensive work on the subject of quality infrastructure and recently established a high-level task force to develop a global infrastructure strategy for the United States, with recommendations due out in the spring of 2019.<sup>17</sup>

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<sup>14</sup> Robert Lighthizer, Cecilia Malmström, and Hiroshige Seko, “Joint Statement on Trilateral Meeting of the Trade Ministers of the United States, Japan, and the European Union,” New York, New York, September 25, 2018, [http://trade.ec.europa.eu/doclib/docs/2018/september/tradoc\\_157412.pdf](http://trade.ec.europa.eu/doclib/docs/2018/september/tradoc_157412.pdf).

<sup>15</sup> U.S. Congress, Senate, *Better Utilization of Investments Leading to Development Act (BUILD Act) of 2018*, S 2463, 115th Cong., introduced in Senate February 27, 2018, <https://www.congress.gov/bill/115th-congress/senate-bill/2463>.

<sup>16</sup> The term “quality infrastructure” was coined by the Abe administration in Japan to refer to infrastructure that is procured transparently and according to life-cycle-cost criteria, built to the highest standards of physical quality and with appropriate social and environmental safeguards, and financed in a sustainable manner. G7 leaders agreed at their 2016 meeting in Japan to five principles for quality infrastructure, commonly referred to as the “Ise-shima Principles”; see Ministry of Foreign Affairs, “G7 Ise-Shima Principles for Promoting Quality Infrastructure Investment,” Ministry of Foreign Affairs, May 27, 2018, <https://www.mofa.go.jp/files/000196472.pdf>.

<sup>17</sup> For a further look at CSIS research on the subject of quality infrastructure, please see the following report:

**7. Respond to the risk of trade- and debt-based economic coercion.**

China's coercive economic policies—as well as policies towards developing countries that have created undue dependency on Beijing—have elicited growing concern around the world. The Hambantota port project in Sri Lanka is a widely-cited example of China's "debt-trap diplomacy."<sup>18</sup> The United States and Japan should offer more substantial support to countries faced with high-risk projects that are part of the Belt and Road Initiative. Government staff need training and capacity building to evaluate infrastructure projects on the basis of life-cycle cost, debt sustainability, and environmental soundness. Furthermore, as discussed above, Washington and Tokyo should take a more proactive and coordinated approach to offering alternative financing mechanisms for development projects.

More work also needs to be done to improve shared intelligence about China's economic activities. The headline figures for Chinese economic activities and projects are impressive but reliable data is hard to find. The United States and Japan should improve information sharing to understand China's trade and investment patterns and apply more pressure on China to make its economic activities more transparent.

**8. Seek an affirmative agenda with China where possible.**

Asian countries are deeply reluctant to choose between the United States and China or between Japan and China. Although China has diverging interests and policies in some areas, it shares a desire for a peaceful and stable Indo-Pacific. Moreover, the development needs of the region cannot be fulfilled by one country or organization alone, and this necessitates taking a cooperative stance with China where possible. Cooperation and positive market competition, particularly with regards to infrastructure, will be in the interest of all three major powers as well as regional economies.

Japan should lead the attempt to become involved in BRI projects that meet high standards of transparent procurement, social and environmental soundness, and debt sustainability. Japan's role as de facto leader of ADB powerfully positions it to accomplish this objective. Examples of Sino-Japanese cooperation will embolden decisionmakers in Asia to demand the involvement of other countries in Chinese-led projects, while making it possible to influence the standards of the projects. The Trump administration's tough stance on China trade practices arguably gives Tokyo more leeway to pursue more active—albeit clear-eyed—engagement with Beijing, for example through reciprocal summits to mark the 40th anniversary of the Japan–China friendship treaty.

**9. Utilize U.S. and Japanese strength in technical assistance and human capacity building to nurture SMEs in the Indo-Pacific region.**

Know-how and human capacity development are two key pillars that distinguish Japanese and U.S. development agencies as well as private-sector entities. The United States and Japan should prioritize promoting soft infrastructure in areas in which they hold comparative advantages, such as healthcare and education. The two countries should step up their efforts to develop capacity and skills in third countries, including increasing scholarships to study in the United States and Japan and establishing partner institutions to U.S. and Japanese universities in third countries. They should also pool the shared strengths of their private sectors to encourage greater corporate social responsibility and

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Daniel F. Runde and Sundar R. Ramanujam, *Financing and Implementing the Quality Infrastructure Agenda: A Report of the CSIS Project on Prosperity and Development*, (Washington, D.C.: CSIS, September 2018), [https://csis-prod.s3.amazonaws.com/s3fs-public/publication/180829\\_Financing\\_Quality\\_Infrastructure.pdf?mu2rmvHUk7hSS7u6P1Bs7F3DoMYnkmFL](https://csis-prod.s3.amazonaws.com/s3fs-public/publication/180829_Financing_Quality_Infrastructure.pdf?mu2rmvHUk7hSS7u6P1Bs7F3DoMYnkmFL).

<sup>18</sup> Maria Abi-Habib, "How China got Sri Lanka to cough up a port," *The New York Times*, June 25, 2018, <https://www.nytimes.com/2018/06/25/world/asia/china-sri-lanka-port.html>.

innovations to promote human health and development. The U.S. and Japanese private sectors can also work with their two governments to help promote the development of SMEs in the Indo-Pacific. SMEs are key forces for market-based growth and development in emerging countries of the region. Enhancing SME access to financing and to the global trading system—particularly through the digital economy—is critical. APEC and the G20 have done constructive work in this area, and Washington and Tokyo should put a renewed emphasis on SME development in these and other forums.

**10. Collaborate on anti-corruption efforts in the Indo-Pacific region.**

Much of the corruption in the Indo-Pacific is undertaken by large family-run businesses with close ties to the government, making corruption an issue that not only affects the ability to conduct business fairly, but also reaches into the heart of political governance. Countries with high levels of corruption are unlikely to result in stable or equitable economic growth, and eventually risk becoming more reliant upon non-democratic countries for trade and investment. Malaysia has been the most salient example of this phenomenon. Washington and Tokyo should enhance efforts to share intelligence on corruption, drawing on their networks of NGOs, media, and businesses in the region. They should also deepen their joint work on anti-corruption in forums like the OECD, APEC, and the G20.

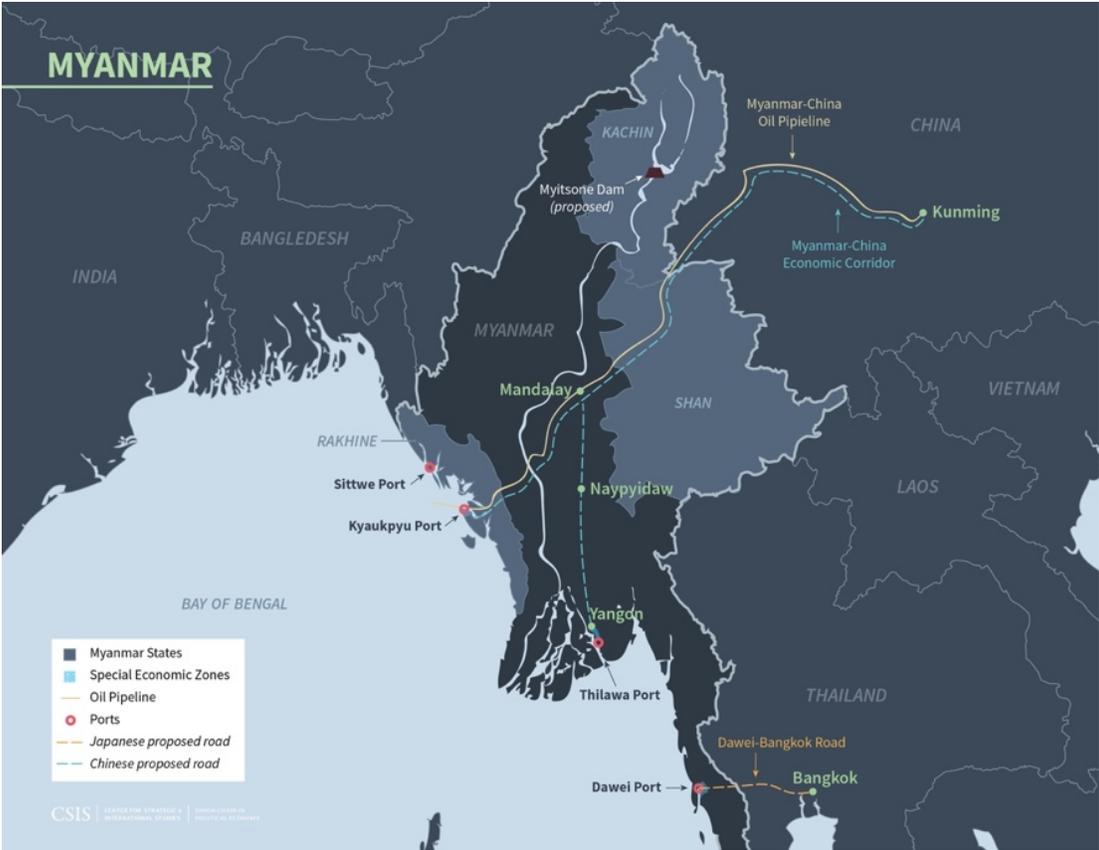
## *Conclusion*

In sum, the economic interests and objectives of the United States and Japan in the Indo-Pacific region are highly aligned. Our strengths and assets are complementary. Despite the distraction of bilateral trade tensions, we have no fundamental differences in our policy interests in the region, and there should be no political impediments to deeper, high-quality economic coordination. However, increased security and intelligence coordination between Washington and Tokyo in recent years has not been matched by a concomitant alignment of our economic policies, representing a missed opportunity. We hope the findings and recommendations in this report will make a useful contribution to rectifying this situation. There has never been a more important time for the United States and Japan to work together to fulfill the mandate of Article II.

# Case Study #1 | Myanmar

As both a fledgling democracy and an emerging economy sandwiched between India and China, Myanmar holds huge strategic importance for the United States and Japan. At the same time, Japan’s priority of deepening economic engagement and the U.S. priority on human rights are often in tension with each other. Myanmar’s political reforms, begun in 2011, along with its attempts to move away from China and embrace engagement with a broader set of partners, created a window for the United States to build its economic and diplomatic presence and for Japan to further deepen its role in Myanmar. However, with the reform process slowing down, renewed violence against the Rohingya minority, and the sham conviction of two Reuters journalists, progress toward democracy and a market economy in Myanmar have reached a critical stage.

Myanmar’s transition to democracy has been painful and fraught with human crisis. Its economic development is marked by unhealthy trends toward unsustainable debt and overdependence on China that could become entrenched. However, the United States and Japan can offer alternative economic and political forces to help Myanmar continue to democratize, grow economically, and integrate into the global community, while pushing for Myanmar to resolve its ethnic conflicts.



To do so, Washington and Tokyo must find a three-way balance that accommodates their shared economic objective of strengthening Myanmar's economy, the political objective of maintaining Myanmar's independence from China, and the human rights objective of holding the regime and military accountable for internationally recognized abuses. To meet these goals, Washington and Tokyo should encourage their companies to invest in Myanmar responsibly and transparently, offer funding and capacity-building support to meet Myanmar's infrastructure and other development needs, promote development in ethnic minority states, and cooperate on strengthening the capacity of the Myanmar government, private sector, and civil society. Strengthening bureaucratic capacity in Myanmar will have the dual benefit of ensuring a predictable and transparent climate for foreign investment and giving government officials in Naypyidaw and Yangon the ability to enact more stable, equitable governance by rule of law.

### *U.S. and Japanese Strategic Interests and Objectives*

The United States and Japan share a range of strategic interests in Myanmar, given its position in the heart of the Indo-Pacific region—in particular, an overriding geostrategic interest in preventing Myanmar from becoming overly economically dependent on China. Furthering this interest includes preventing or mitigating Chinese actions in Myanmar that may directly harm U.S. and Japanese security interests and ensuring that Myanmar's participation in Chinese institutions and initiatives, most prominently the Belt and Road Initiative (BRI), supports the country's economic and political development.

Despite their shared concerns, the United States and Japan prioritize interests in Myanmar differently, reflecting where the two nations' foreign policy approaches diverge. Although both nations value liberal governance, Japan's foreign policy focuses on creating stable rule of law practices that promote commerce and economic development, while the United States prioritizes transparent representational government, robust civil society, and human rights. With Myanmar's stalled democratization reforms and attempted ethnic cleansing of the Rohingya minority, Japan's desire to deepen economic engagement has come more visibly in conflict with the U.S. insistence on speaking out about Myanmar's governance failures.

The challenge for Washington and Tokyo will be to reconcile their divergent priorities with their shared goal of a prosperous and stable Myanmar. For the United States, securing Myanmar's continued transition from authoritarian rule to liberal democracy remains a key objective, including ensuring that human rights are respected. In contrast, Japan views its priority as keeping dialogue open with the Myanmar government regardless of its human rights situation. These different priorities mean U.S. and Japanese policy are at direct odds with one another in certain areas, such as proposed levels of economic engagement or lifting of U.S. sanctions.

The long-standing ethnic conflicts, renewed violence targeting the Rohingya minority, and the National League for Democracy (NLD) government's lack of response has drawn international media scrutiny and global condemnation, acting as a brake on investment from the United States, European Union, and other advanced economies. In 2017, through the Global Magnitsky Act, the Trump administration imposed targeted sanctions on Myanmar military officials accused of perpetrating ethnic cleansing and committing gross human rights abuses.<sup>19</sup> Though sweeping sanctions appear unlikely, the Rohingya crisis ratcheted up reputational risks for international investors, on top of an already difficult investment and regulatory

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<sup>19</sup> Patricia Zengerle, "U.S. lawmakers target Myanmar military with new sanctions," Reuters, November 2, 2017, <https://www.reuters.com/article/us-myanmar-rohingya-usa-congress/u-s-lawmakers-target-myanmar-military-with-new-sanctions-idUSKBN1D22DX>.

environment. If applied, such sanctions may push Myanmar into economic reliance on China in return for support in the UN Security Council and continued investment in the country.<sup>20</sup>

For Japan, Myanmar can play an important role as a manufacturing hub for Japanese companies, part of Japan's "Thailand-plus-one" model. The success of this model requires ensuring the continued success of the Thilawa Special Economic Zone (SEZ), a project led by Japanese companies and supported by the Japanese government. Tokyo can leverage the Thilawa SEZ as the engine for industrialization in the Yangon region and extend that model to other regions to support both Japanese businesses and Myanmar's development.<sup>21</sup>

Increasing connectivity within Myanmar and between Myanmar and its neighbors, including India and Thailand, is critical to the long-term growth of the Myanmar economy and to realizing the "free and open Indo-Pacific" strategies of the United States and Japan.<sup>22</sup> Improving in-country infrastructure, such as transportation in the economic corridor between Yangon and Mandalay, is essential to ensuring that the country is regionally competitive and that development is inclusive. The United States and Japan must actively participate in developing Myanmar's infrastructure—ensuring that infrastructure projects are transparent, accountable, financially responsible, and adhere to international standards—to prevent the establishment of networks that privilege the interests or supply chains of any one actor at the expense of the Myanmar people and other nations. Myanmar's active membership in the Association of Southeast Asian Nations (ASEAN), aided by increased regional connectivity, will help facilitate Myanmar's integration into the broader region.

## *Myanmar's Political and Economic Landscape*

### **ECONOMIC POLICY PRIORITIES**

In 2011, the government, led by Thein Sein and comprising former junta officials and retired military officers, kicked off a series of reforms that included improving relations with advanced democracies, motivated partly by the desire to avoid economic overdependence on China. Although diversification of trade, investment partners, and exports are key goals for Myanmar, China remains Myanmar's dominant trading partner under the current government.<sup>23</sup> Moreover, the Rohingya crisis and ongoing military conflict in its northern Kachin and Shan States have complicated relations with the United States and the European Union, as demonstrated when European Union refused to sign the EU-Myanmar Investment Protection Agreement and began discussing sanctioning entire sectors.<sup>24</sup> The challenge facing the United States is the question of how to uphold its core practice of responding to human rights challenges and simultaneously to prevent Myanmar's economic isolation.

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<sup>20</sup> Toshihiro Kudo, "China and Japan's Economic Relations with Myanmar: Strengthened vs. Strange," in *A China-Japan Comparison of Economic Relationships with the Mekong River Basin Countries*, ed. Mitsuhiro Kagami, (Bangkok: Bangkok Research Center, 2009): 265-289, [http://www.ide.go.jp/library/English/Publish/Download/Brc/pdf/01\\_chinaandjapan.pdf](http://www.ide.go.jp/library/English/Publish/Download/Brc/pdf/01_chinaandjapan.pdf); Beina Xu and Eleanor Albert, "Understanding Myanmar," Council on Foreign Relations, March 25, 2016, <https://www.cfr.org/backgrounder/understanding-myanmar#chapter-title-0-2>.

<sup>21</sup> Concept based upon a field trip to Myanmar and roundtables in Tokyo and Washington with personnel from academia, business, government, think tanks and trade promotion organizations.

<sup>22</sup> "Briefing on The Indo-Pacific Strategy," U.S. Department of State, April 2, 2018, <https://www.state.gov/r/pa/prs/ps/2018/04/280134.htm>; "Priority Policy for Development Cooperation FY2017," International Cooperation Bureau of Japan's Ministry of Foreign Affairs, April 2017, <https://www.mofa.go.jp/files/000259285.pdf>.

<sup>23</sup> "Burma," The Economic Complexity Observatory, <https://atlas.media.mit.edu/en/profile/country/mmr/>.

<sup>24</sup> Paul Peachy, "EU threatens economic action over treatment of Myanmar's Rohingya," *The National*, October 4, 2018, <https://www.thenational.ae/world/asia/eu-threatens-economic-action-over-treatment-of-myanmar-s-rohingya-1.777320>.

China and Myanmar continue to be strongly linked compared to Myanmar's other economic and diplomatic partners, particularly the United States and India. Military cooperation between the China and Myanmar started in 1989 under Myanmar's former military government. Unhampered by international sanctions and interested in facilitating economic growth in the name of regional stability, China was one of Myanmar's few trading partners before reforms.<sup>25</sup> Chinese goods made up approximately 20 percent of Myanmar's total imports in the late 1990s, and rose as high as 33 percent in 2003, close to the current percentage.<sup>26</sup> Many of these strategic interests from the 1990s are still held by Beijing today. Myanmar, including its access to the Indian Ocean, has featured prominently in China's People's Liberation Army geostrategic plans towards ASEAN. However, even when Myanmar was politically isolated, Myanmar-China relations were highly complex. Under the military government, Myanmar leaders were cautious of military or economic overdependence on any single external power, including China.<sup>27</sup>

Since ascending to power in 2016, State Counsellor Aung San Suu Kyi's top priority has been national reconciliation, both between the democratic forces and the military and between the Burman majority and various ethnic groups. Economic development has been a secondary concern. The table below summarizes major Myanmar economic policies in recent years.

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<sup>25</sup> Poon Kim Shee, "The political economy of China-Myanmar relations: Strategic and economic dimensions," *Southeast Asia* 19, no. 1 (1997), <https://pdfs.semanticscholar.org/9eee/5d8ebad61776cfa9834bc300f31e50e2d9c1.pdf>.

<sup>26</sup> Toshihiro Kudo, "Myanmar's Economic Relations with China: Can China Support the Myanmar Economy?" *Institute of Developing Economies (JETRO) Discussion Papers* 7, no. 66 (2006), <https://core.ac.uk/download/pdf/10843673.pdf>.

<sup>27</sup> Poon, "The political economy," 1997.

**Table 1: Myanmar Economic Policies**

Policy and Agency	Date	Purpose	Priorities
<b>National Export Strategy</b> Ministry of Commerce	2015	Guide the country's trade development and boost export competitiveness. Triple exports to \$30 billion by 2020.	Sectors and products: textiles and garments; forestry products; beans, pulses, and oilseeds; rice; fisheries; rubber; and tourism. Cross-sector: access to finance, quality management, trade facilitation and logistics, and trade information and promotion
<b>Industrial Policy</b> Ministry of Industry	Feb 2016	Guide Myanmar into being a modern industrial nation.	Electric power, oil and gas, manufacturing, mining, hotel and tourism, livestock and fisheries, transport and communication and industrial zones
<b>Economic Policy Plan</b> Ministry of Finance and Planning	July 2016	12-point plan for people-centered and inclusive development. Establish a "united federal democratic union" with economic development balanced across states, opportunities for younger generations, and positive participation of all citizens.	Reforming SOEs, increasing infrastructure and foreign direct investment, protecting intellectual property rights, and achieving financial stability, among others.
<b>Investment proposal priorities</b> Myanmar Investment Commission (MIC)	June 2017	Screening of investment in certain areas are prioritized to promote FDI in those areas. In the New Companies Bill Notification No. 13/2017, many of the industries were offered income tax exemptions.	Manufacturing, renewable energy, agriculture, export promotion industries, import substitution industries, logistic industries and construction of affordable housing
<b>Myanmar Sustainable Development Plan (2018–2030)</b> Ministry of Planning and Finance	Aug 2018	Long-term vision for national development that provides a framework for coordination and cooperation across ministries, states and regions, based on 3 pillars, 5 goals, 28 strategies and 251 action plans.	<ol style="list-style-type: none"> <li>1) Peace, national reconciliation, security and good governance</li> <li>2) Economic stability and strengthened macroeconomic management</li> <li>3) Job creation and private sector led growth</li> <li>4) Human resources and social development for a 21st century society</li> <li>5) Natural resources and the environment for the prosperity of the nation</li> </ol>

FDI = Foreign direct investment ; SOE = state-owned enterprise.

Source: Myanmar Information Management Unit, "Economic Policy of the Union of Myanmar," European Union Civil Protection and Humanitarian Aid and Canada, July 28, 2016,

[http://themimu.info/sites/themimu.info/files/documents/Statement\\_Economic\\_Policy\\_Aug2016.pdf](http://themimu.info/sites/themimu.info/files/documents/Statement_Economic_Policy_Aug2016.pdf); Myanmar Investment Commission, Notification No. 13/2017, The Republic of the Union of Myanmar (April 1, 2017),

[https://www.dica.gov.mm/sites/dica.gov.mm/files/document-files/promotedsector\\_notification\\_english-update\\_code.pdf](https://www.dica.gov.mm/sites/dica.gov.mm/files/document-files/promotedsector_notification_english-update_code.pdf); The Department of Trade and Promotion, Ministry of Commerce, *National Export Strategy: Beans, Pulses and Oilseeds, Sector Strategy, 2015-2019* (Nay Pyi Taw: Republic of the Union of Myanmar and International Trade Center, 2018),

[http://www.standardsfacility.org/sites/default/files/STDF\\_PG\\_486\\_NationalExportStrategy\\_0.pdf](http://www.standardsfacility.org/sites/default/files/STDF_PG_486_NationalExportStrategy_0.pdf); Ministry of Industry, *Industrial Policy*, (The Republic of the Union of Myanmar, 2016),

[http://moi.industry.gov.mm/sites/default/files/laws/2016/03/industrial\\_policy\\_21-3-2016english\\_version.pdf](http://moi.industry.gov.mm/sites/default/files/laws/2016/03/industrial_policy_21-3-2016english_version.pdf); Ministry of Planning and Finance, *Myanmar Sustainable Development Plan (2018-2030)*, (Nay Pyi Taw: Republic of the Union of Myanmar, 2018),

[http://themimu.info/sites/themimu.info/files/documents/Core\\_Doc\\_Myanmar\\_Sustainable\\_Development\\_Plan\\_2018\\_-\\_2030\\_Aug2018.pdf](http://themimu.info/sites/themimu.info/files/documents/Core_Doc_Myanmar_Sustainable_Development_Plan_2018_-_2030_Aug2018.pdf).

## CONSTRAINTS ON GROWTH

To sustain its high growth, Myanmar's greatest need is infrastructure, especially electric power coverage and reliability. The Myanmar National Electrification Plan calls for 100 percent electrification by 2030, up from 34 percent in 2015.<sup>28</sup> This involves increasing installed capacity to 16 gigawatts (GW), up from 4.3 GW in 2015.<sup>29</sup> ADB projects that electricity investment requirements, including distribution and transmission, will be \$40 billion through 2030.<sup>30</sup>

Despite these significant needs, power generation projects have stalled. Hydropower has been politically out-of-bounds since construction of the Chinese-led Myitsone Dam was suspended in 2011. Local groups and international NGOs have strongly opposed coal-fired power plants. Current government energy planning is considered unrealistic given the enormous and growing demand, largely from household consumption, and a poorly maintained national grid that does not service the bulk of the rural population.<sup>31</sup> In February 2018, the government announced it would proceed with four natural gas-fired power plants, three of which will be supplied with liquified natural gas.<sup>32</sup> The share of power generation owned by the state has decreased to 50 percent due to increasing private sector involvement.<sup>33</sup> However, losses from subsidizing power tariffs rose to \$400 million from 2016 to 2017.<sup>34</sup> Until tariffs are revised, no new electricity infrastructure can be built.

In addition to the power sector, Myanmar's railways, roads, and ports are vitally important to improve export competitiveness and to expand access to social services.<sup>35</sup> Domestic transportation costs are largely inefficient and much higher than other ASEAN nations. In Thailand, transportation accounts for 8 percent of product costs; in Myanmar, it accounts for 40 percent.<sup>36</sup> The lack of paved roads exacerbates the poverty trap, with 20 million people lacking access to all-season roads.<sup>37</sup> Despite the urgent need for better transportation infrastructure, investments in transportation have been low, 1.0–1.5 percent of GDP for 2005–2015 or roughly \$5 billion total, a fraction of the \$60 billion investment required for 2016–2030.<sup>38</sup>

After almost 60 years of isolation and severe underfunding by successive military regimes, the quality of education is poor and there is a significant lack of technical skills and capacity. The World Bank and other international aid groups have struggled to improve the education system, and their efforts have extended to attempts to fill the bureaucracy with capable technocrats. Currently, rank-and-file bureaucrats are either ex-military or earned their positions under the former military government; many lack specialized training and in some cases, are suspicious of business and foreign engagement. Even when reforms are not

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<sup>28</sup> Castalia Strategic Advisors, *Myanmar National Electrification Program (NEP) Roadmap and Investment Prospectus: Final Road Map and Investment Prospectus*, September 2014, [https://www.seforall.org/sites/default/files/Myanmar\\_IP\\_EN\\_Released.pdf](https://www.seforall.org/sites/default/files/Myanmar_IP_EN_Released.pdf).

<sup>29</sup> Asian Development Bank, *Myanmar: Energy Sector Assessment, Strategy, and Road Map* (Manila: Asian Development Bank, 2016), <https://www.adb.org/sites/default/files/institutional-document/218286/mya-energy-sector-assessment.pdf>.

<sup>30</sup> Ibid.

<sup>31</sup> Interview with a Myanmar expert in Tokyo.

<sup>32</sup> Thomas Kean, "Does Myanmar's LNG power plan stack up?" *Frontier Myanmar*, February 8, 2018, <https://www.frontiermyanmar.net/en/does-myanmars-lng-power-plan-stack-up>.

<sup>33</sup> Su Phyo Win, "Can LNG fill Myanmar's power gap?" *Myanmar Times*, September 15, 2017, <https://www.mmtimes.com/news/can-lng-fill-myanmars-power-gap.html>.

<sup>34</sup> Interviews with staff from the Myanmar government, multilateral institutions and Yangon embassies.

<sup>35</sup> Asian Development Bank, *Myanmar Transport Sector Policy Note: Railways*, (Manila: Asian Development Bank, 2016), <https://www.adb.org/sites/default/files/publication/189081/mya-railways.pdf>.

<sup>36</sup> Interview with officials from Myanmar's Ministry of Commerce.

<sup>37</sup> Asian Development Bank, *Myanmar Transport Sector Policy Note: Trunk Roads* (Manila: Asian Development Bank, 2016), <https://www.adb.org/sites/default/files/publication/189078/mya-trunk-roads.pdf>.

<sup>38</sup> UK-ASEAN Business Council, *Myanmar General Transport Infrastructure - Market Snapshot* (London: British Chamber of Commerce Myanmar, 2017), <http://www.ukabc.org.uk/wp-content/uploads/2017/05/Myanmar-General-Transport-April-2017.pdf>.

deliberately blocked, the reform process is plagued by bureaucratic lack of capacity or authority to make key decisions, implement laws, or recommend reforms. Additionally, government salaries are very low, making it hard to attract talent and contributing to corrupt practices.

Myanmar suffers from one of the weakest tax collection systems in the world. The government collected just 6.4 percent of GDP in revenues from 2016 to 2017, compared to an average of 12 percent in low- and middle-income countries.<sup>39</sup> Improving this system could boost the country's coffers, giving Myanmar more room to increase spending on public services, infrastructure, and civil service training. Approximately 50 percent of revenue comes from state-owned enterprises, which tend to be inefficient and crowd out more productive private sector activity, making them a high priority for reform.<sup>40</sup>

State-owned banks still account for more than half of the banking sector.<sup>41</sup> The central bank of Myanmar has imposed significant restrictions on private banks in the country, hindering their ability to grow, lend, borrow, or receive capital from abroad. Most loans are short-term, less than one year, creating a problem as businesses cannot finance capital investments on such a short timeline. The central bank also does not allow foreign banks to offer most services, which would allow for know-how and technology to spread and offer local and foreign businesses and citizens access to more reliable, higher quality services.<sup>42</sup> As a result, most foreign investments are financed offshore.

## *U.S.–Japan Economic Involvement in Myanmar*

### **TRADE RELATIONS**

China has long dominated Myanmar's trade relations, partly due to China's proximity, shared border, and strong cultural ties with Shan and Kachin provinces. Furthermore, the sanctions regimes—established by the United States, European Union, Canada, Australia in response to human rights abuses by the junta and followed by South Korea and Japan to a degree—limited Myanmar's ability to trade with other countries besides China. Other ASEAN nations, unable to compete with China's manufacturing ability, were unable to build stronger trade ties with Myanmar. China could leverage Myanmar's high level of trade dependence into political influence, especially since others like the United States and India have lower trade volumes than they should, given their economic size and proximity.<sup>43</sup> Exports to China are dominated by gemstones and increasingly by natural gas since the pipeline from Kyaukpyu was completed in 2013. In 2016, natural gas constituted a third of Myanmar's exports to China and 5 percent of China's natural gas imports.<sup>44</sup> The oil pipeline from the Kyaukpyu deep-sea port to Kunming in China began operations in 2017, allowing China to avoid relying on oil transported through the Strait of Malacca (see the section Investment Relations and Major Projects below).

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<sup>39</sup> "Myanmar Public Expenditure Review 2017: Fiscal Space for Economic Growth," The World Bank, November 21, 2017, <http://www.worldbank.org/en/country/myanmar/publication/myanmar-public-expenditure-review-2017>; "Tax revenue (% of GDP), Low & middle income," The World Bank, [https://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS?locations=XO&view=chart&year\\_high\\_desc=false](https://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS?locations=XO&view=chart&year_high_desc=false).

<sup>40</sup> San San Oo, *Fiscal Management Reform in Myanmar (lessons drawn from Japanese experiences)* (Tokyo: Japan Ministry of Finance, 2018), [https://www.mof.go.jp/pri/international\\_exchange/visiting\\_scholar\\_program/fy2016/sansan1.pdf](https://www.mof.go.jp/pri/international_exchange/visiting_scholar_program/fy2016/sansan1.pdf).

<sup>41</sup> "2018 Index of Economic Freedom, Country Rankings," The Heritage Foundation, <http://www.heritage.org/index/ranking>.

<sup>42</sup> "Myanmar and ASEAN a great unknown to Trump," *Myanmar Times*, March 16, 2017, <https://www.mmmtimes.com/business/25352-myanmar-and-asean-a-great-unknown-to-trump.html>.

<sup>43</sup> Interview with a Myanmar expert in Tokyo; , Benno Ferrarini, *Myanmar's Trade and its Potential* (Manila: Asian Development Bank, 2013), <https://www.adb.org/sites/default/files/publication/30195/ewp-325.pdf>.

<sup>44</sup> Simoes A.J.G., "What does Burma export to China?", The Observatory of Economic Complexity (OEC), 2016, [https://atlas.media.mit.edu/en/visualize/tree\\_map/hs92/export/mmr/chn/show/2016/](https://atlas.media.mit.edu/en/visualize/tree_map/hs92/export/mmr/chn/show/2016/).

**Table 2: Myanmar’s Trade with Selected Partners (in USD billion)**

Country	Exports		Imports	
	2016	%	2016	%
China	4.77	40.8	5.40	34.4
Thailand	2.24	19.2	1.99	12.7
Singapore	0.89	7.6	2.27	14.5
India	1.04	8.9	1.09	7.0
Japan	0.66	5.7	1.25	8.0
United States	0.15	1.3	0.22	1.4
Total	11.67	100	15.70	100

Source: “Myanmar Exports by Country and Region 2016,” World Integrated Trade Solution, <https://wits.worldbank.org/CountryProfile/en/Country/MMR/Year/LTST/TradeFlow/Export/Partner/all/>.

Japan has steadily increased its trade and investments in the country for a number of reasons, which include curbing the Chinese footprint in the country. In 2016, Japan was Myanmar’s fourth largest import origin location and fifth largest export destination.<sup>45</sup> Japan–Myanmar trade is slowly growing, with exports to Japan dominated by textiles. The value of garment exports—destined mainly for Japan, the European Union (which is considering trade sanctions on garments), and South Korea—rose to \$1.86 billion in 2016–17, an increase from \$1 billion in 2015–16.<sup>46</sup> In 2016, imports from Japan were dominated by transportation products, at over 80 percent of total imports, followed by machines. Ninety percent of vehicles in Myanmar are from Japan; however this dominance could be jeopardized by a ban on the import of right-hand drive vehicles.<sup>47</sup>

The ASEAN–Japan Comprehensive Economic Partnership will abolish export tariffs for 90 percent of Japanese products to Myanmar by 2026.<sup>48</sup> In 2013, Japan and Myanmar also signed a bilateral investment treaty that promotes stable and transparent conditions and establishes a dispute settlement tribunal.<sup>49</sup> Japan hopes this will help create a good investment environment and build investor confidence, key pillars of its Myanmar strategy.

Under Myanmar’s previous government, the United States had no formal diplomat in the country and instituted broad sanctions prohibiting U.S. individuals or entities from investing in the country.<sup>50</sup> Relations warmed after partial elections were held in 2010, but between the change in U.S. administration and U.S. domestic pressure to punish Myanmar for the Rohingya crisis, little to no progress has been made. The U.S.–Myanmar Partnership Dialogue between Myanmar’s Ministry of Foreign Affairs and the

<sup>45</sup> Simoes A.J.G. and Hidalgo C.A., The Economic Complexity Observatory: An Analytical Tool for Understanding the Dynamics of Economic Development, “Burma,” Workshops at the Twenty-Fifth AAAI Conference on Artificial Intelligence, <https://atlas.media.mit.edu/en/profile/country/mmr/>.

<sup>46</sup> European Chamber of Commerce in Myanmar, *Manufacturing Guide 2018*, (Yangon: European Union and EuroCham Myanmar, 2017), [https://www.ccifrance-myanmar.org/sites/ccifrance-myanmar.org/files/resources-documents/manufacturing\\_guide\\_2018.pdf](https://www.ccifrance-myanmar.org/sites/ccifrance-myanmar.org/files/resources-documents/manufacturing_guide_2018.pdf).

<sup>47</sup> AFP, “Out with the old as Myanmar restricts used car imports,” *Frontier Myanmar*, January 18, 2017, <https://frontiermyanmar.net/en/out-with-the-old-as-myanmar-restricts-used-car-imports>.

<sup>48</sup> “Japan, ASEAN agree on tariff-cutting FTA,” *Japan Times*, August 26, 2007, <https://www.japantimes.co.jp/news/2007/08/26/business/japan-asean-agree-on-tariff-cutting-fta/#.W7JHpGhKgdV>.

<sup>49</sup> Japan Ministry of Foreign Affairs, *Agreement between the government of Japan and the government of the Republic of the Union of Myanmar for the liberalization, promotion and protection of investment*, (Tokyo: Government of Japan, 2013), <https://www.mofa.go.jp/mofaj/files/000022695.pdf>.

<sup>50</sup> “Timeline: U.S.–Burma/Myanmar Relations,” *Contemporary Southeast Asia: A Journal of International and Strategic Affairs* 32, no. 3 (2010): 434–436, <https://muse.jhu.edu/article/412811/pdf>.

U.S. State Department held its first meeting in 2016 but has yet to see activity under the Trump administration.<sup>51</sup>

Despite gains made since the opening, bilateral trade between the United States and Myanmar remains low. According to the U.S. Census Bureau, total trade in goods of exports and imports between Myanmar and the United States amounted to \$436 million in 2016; by comparison Japan and China traded nearly four and thirty times as much, respectively, with Myanmar in the same year.<sup>52</sup> Major U.S. exports to Myanmar are aircraft, soybeans, machinery, and medical equipment.<sup>53</sup> Since the import ban was lifted in 2012, U.S. imports from Myanmar rose significantly: from 2010 to 2017, the total size of U.S.-Myanmar trade in goods rose from \$9.7 million to \$577.2 million.<sup>54</sup> In 2013, the U.S.-Myanmar Trade and Investment Framework Agreement was signed to develop discussions on trade and investment issues.

The United States has no free trade agreement with Myanmar, but Myanmar became a beneficiary of the U.S.'s Generalized System of Preferences (GSP) program in November 2016. Myanmar was designated as a least developed beneficiary country, allowing 5,000 products to be imported duty free into the United States. Exports of travel goods, beans and peas, aluminum, honey and preserved fruits, and vegetables to the United States have grown as a result.<sup>55</sup> Thanks to this status, exports to the United States are expected to grow further, however, Myanmar's most important export item, garments, is not included on the list. Myanmar is similarly given GSP least developed country beneficiary status by Japan, which gives duty-free and quota-free status to up to 98 percent of total tariff lines, including garments. Unlike Cambodia, Indonesia, Philippines and Thailand, Myanmar will not suffer significant harm from trade diversion resulting from Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) because its main export destinations are not CPTPP members.<sup>56</sup>

## INVESTMENT RELATIONS AND MAJOR PROJECTS

Myanmar lags behind other Southeast Asian countries in foreign direct investment (FDI) and is the third smallest recipient of FDI in the region.<sup>57</sup> Inward FDI stock equaled 38.4 percent of GDP in 2017, far below the 79.4 percent average among Southeast Asian nations.<sup>58</sup> Nonetheless, FDI contributed significantly to recent growth, accounting for 26.2 percent of gross fixed capital formation in 2017.<sup>59</sup> China is the largest investor, while the United States is far behind Asian countries in providing FDI. These numbers do not tell the whole story, as investments are often made by Japanese, U.S., and European companies via subsidiaries in Singapore, one of Myanmar's top 10 sources of FDI. India could grow to be an important provider of infrastructure, including its planned deep-sea port at Sittwe, in Rakhine State.<sup>60</sup> Government officials are

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<sup>51</sup> "U.S. Relations with Burma," U.S. Department of State, July 17, 2018, <https://www.state.gov/r/pa/ei/bgn/35910.htm>.

<sup>52</sup> United States Census Bureau, "Foreign Trade, Trade in Goods with Burma," (Suitland, MD: U.S. Census Bureau, 2018), <https://www.census.gov/foreign-trade/balance/c5460.html>.

<sup>53</sup> "Burma," Office of the United States Trade Representative, <https://ustr.gov/countries-regions/southeast-asia-pacific/burma>.

<sup>54</sup> Ibid.

<sup>55</sup> Office of the United States Trade Representative, *Myanmar and the U.S. Generalized System of Preferences (GSP) Program*, (Washington D.C.: U.S. Government, 2016), <https://ustr.gov/sites/default/files/Burma-GSP-briefer-English-November-2016.pdf>.

<sup>56</sup> Alan V. Deardorff, "Trade Implications of the Trans-Pacific Partnership for ASEAN and Other Asian Countries," *Asian Development Review* 31, no. 2 (2014): 1-20, [https://www.mitpressjournals.org/doi/pdf/10.1162/ADEV\\_a\\_00035](https://www.mitpressjournals.org/doi/pdf/10.1162/ADEV_a_00035).

<sup>57</sup> "World Investment Report: Annex Tables," United Nations Conference on Trade and Development, June, 6, 2018, <http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx>.

<sup>58</sup> United Nations Conference on Trade and Development, *World Investment Report 2018 Investment and Industrial Policies, Country Fact Sheet: Myanmar* (New York: United Nations 2018), [http://unctad.org/sections/dite\\_dir/docs/wir2018/wir18\\_fs\\_mm\\_en.pdf](http://unctad.org/sections/dite_dir/docs/wir2018/wir18_fs_mm_en.pdf).

<sup>59</sup> Ibid.

<sup>60</sup> Prime Minister Narendra Modi signaled Myanmar's importance by announcing his Act East policy on a visit there. Sittwe has encountered serious delays, and India's infrastructure projects are perceived to make slow progress. Sittwe is part of the Kaladan Multi-Modal Transport Project, connecting Kolkata, Rakhine and India's northeast.

hopeful investment will increase as Myanmar continues to liberalize and open its economy, but they maintain sober realism about the dampening effect of the Rohingya crisis, perceptions of the government’s lack of reform efforts, and dilapidated infrastructure.

**Table 3: Foreign Direct Investment Inbound Stock**

Country	FDI (in USD billion)	Percent of total
China	20.0	26.0%
Singapore	19.3	24.6%
Thailand	11.0	14.3%
Hong Kong	7.9	10.2%
Japan	1.2 (2.7*)	1.6 (3.5*)%
India	0.8	1.0%
United States	0.4	0.5%
Total	76.9	100%

\*Includes investments made through Singapore.

Source: “Data & Statistics,” Directorate of Investment and Company Administration, Ministry of National Planning and Economic Development, Republic of the Union of Myanmar, <https://www.dica.gov.mm/en/data-and-statistics>; Data as of July 2018.

One area of concern for the United States and Japan, as well as Myanmar, is the continued dominance of Chinese investment in the Myanmar economy. According to Myanmar’s Directorate of Investment and Company Administration data concerning approved investments from China, 64.6 percent went to the power sector, 22.9 percent to oil and gas, 6.5 percent to manufacturing, not including garments and agricultural processing, and 4.6 percent to mining.<sup>61</sup> Much of the groundwork for these investments—including the oil and gas pipeline that starts in Kyaukpyu and snakes across the country—came before the 2011 opening, and once again large investments from China appear to be on the rise.<sup>62</sup> In September 2018, China and Myanmar signed a memorandum of understanding for the China-Myanmar Economic Corridor, connecting Kunming, Yunnan via Mandalay to Kyaukpyu and Yangon as part of the Belt and Road Initiative, and China has separate plans to invest in the Yangon City Development Project (see maps above).

The Kyaukpyu deep-sea port is one of the most visible Chinese-backed projects and serves as a microcosm of the challenges facing not only China-Myanmar investment but U.S. and Japanese investment as well. The project is slated to be one of the “biggest infrastructure projects in Myanmar’s history,”<sup>63</sup> and originally gave China’s state-owned Citic Group a 70 percent stake.<sup>64</sup> Located in Rakhine State, the port is the terminus of a \$1.5 billion, 480-mile (770-km) parallel oil and natural gas pipeline from Kunming, China.<sup>65</sup> Once fully operational, the pipeline could supply 6 percent of China’s oil imports.<sup>66</sup> Land acquisition for

<sup>61</sup> Stephen Gelb, Linda Calabrese, and Xiaoyang Tang, *Foreign Direct Investment and Economic Transformation in Myanmar* (London: Supporting Economic Transformation, 2017), <https://set.odi.org/wp-content/uploads/2017/04/SET-Myanmar-FINAL-170404.pdf>.

<sup>62</sup> Yun Sun, “China’s Belt and Road in Myanmar,” *The Diplomat*, December 26, 2017, <https://thediplomat.com/2017/12/chinas-belt-and-road-in-myanmar/>.

<sup>63</sup> John Reed, “Myanmar reviews \$9bn China-backed port project on cost concerns,” *Financial Times*, June 3, 2018, <https://www.ft.com/content/f2f476d2-6575-11e8-90c2-9563a0613e56>.

<sup>64</sup> Ibid.

<sup>65</sup> Gregory Poling, “Kyaukpyu: Connecting China to the Indian Ocean,” Center for Strategic and International Studies, April 4, 2018, <https://amti.csis.org/kyaukpyu-china-indian-ocean/>.

<sup>66</sup> Lucy Hornby, “China and Myanmar open long-delayed oil pipeline,” *Financial Times*, April 11, 2017, <https://www.ft.com/content/21d5f650-1e6a-11e7-a454-ab04428977f9>.

the project has been criticized for potentially displacing 20,000 people, and failing to comply with Myanmar's land laws and international standards on involuntary resettlement.<sup>67</sup>

Though the Myanmar constitution legally protects the Kyaukpyu port from use by foreign militaries, there are concerns China's government could leverage port-related debt to force Myanmar to allow use by China's People's Liberation Army.<sup>68</sup> Due to these concerns, Myanmar renegotiated a scaled-down version of the project, with Citic still in the lead for construction and ownership, but with the initial price tag cut from \$7.2 billion to \$1.3 billion.<sup>69</sup> The implications of the port project present the United States with a conundrum: as Rakhine State is home to the majority of Myanmar's Rohingya population, U.S. companies investing in the region could be accused of turning a blind eye to human rights abuses, but without alternative investors, Myanmar could find itself overly indebted to Chinese state-owned conglomerates.

U.S. companies are hesitant to enter the market due to large reputational risks and U.S. government restrictions. The United States has continued to apply Section 312 of the USA Patriot Act to Myanmar, preventing the entry of U.S. financial institutions (see the section Political Constraints below). One of the few companies willing to enter Myanmar is General Electric, currently an important subcontractor for projects by Japanese trading houses. Myanmar government officials expressed hope that they will receive U.S. investments in the financial sector, IT and infrastructure; these dovetail with comments from the U.S. Embassy in Yangon expressing interest in encouraging U.S. investment in finance, healthcare, franchise expansion, and energy. If the Myanmar government delivers on liberalization of the insurance sector, then U.S. investment in Myanmar could grow substantially.

Japan has significant economic presence in Yangon and the nearby Thilawa SEZ, and its companies were instructed by State Counsellor Aung San Suu Kyi to focus on developing Yangon. Japanese companies have started to invest in Mandalay and southern Rakhine State as well as the Dawei SEZ in the southeast. A majority of Japanese investments are made indirectly via third countries, as seen in Figure 1 below.

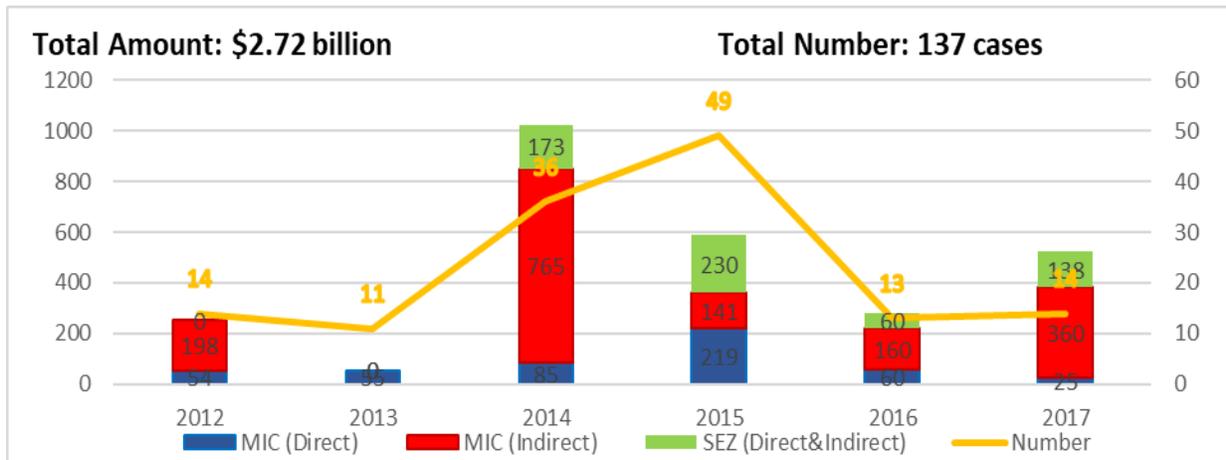
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<sup>67</sup> Sean Bain, "Kyaukpyu Special Economic Zone shows need for law reform in Myanmar," International Commission of Jurists, April 7, 2017, <https://www.icj.org/kyaukphyu-special-economic-zone-shows-need-for-law-reform-in-myanmar/>; Moe Myint, "Chinese officials push for Kyaukphyu SEZ to move forward," *The Irrawaddy*, April 25, 2017, <https://www.irrawaddy.com/news/burma/chinese-officials-push-for-kyaukphyu-sez-to-move-forward.html>; Than Tun and Trevor Wilson, "Special Economic Zone a test for better governance in Myanmar," *East Asia Forum*, June 15, 2017, <http://www.eastasiaforum.org/2017/06/15/special-economic-zone-a-test-for-better-governance-in-myanmar/>; Thiha, "MoU for Kyaukphyu SEZ to be finalized in September," Consult-Myanmar, September 13, 2018, <https://consult-myanmar.com/tag/kyaukphyu-special-economic-zone/>; Yimou Lee and Wa Lone, "China's \$10 billion strategic project in Myanmar sparks local ire," Reuters, June 8, 2017, <https://www.reuters.com/article/us-china-silkroad-myanmar-sez/chinas-10-billion-strategic-project-in-myanmar-sparks-local-ire-idUSKBN18Z327>.

<sup>68</sup> Jason Koutsoukis, "The fishing port that may become a \$10 billion Chinese debt bomb," Bloomberg, May 10, 2018, <https://www.bloomberg.com/news/articles/2018-05-10/the-fishing-port-that-may-become-a-10-billion-chinese-debt-bomb>; Poling, "Kyaukpyu," 2018.

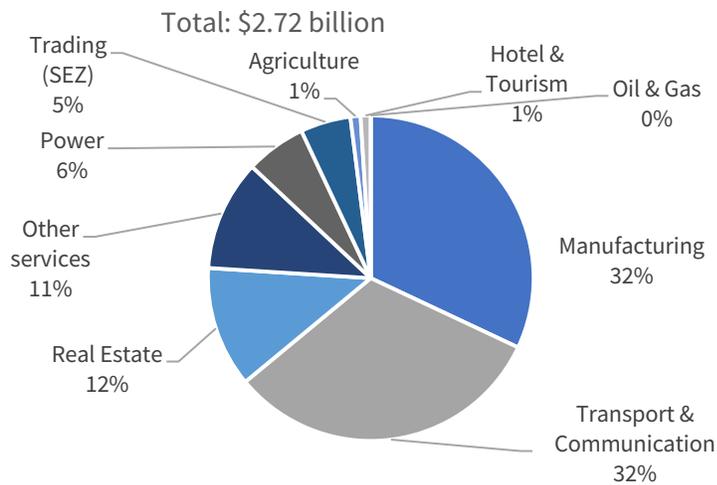
<sup>69</sup> Yuichi Nitta, "Myanmar cuts cost of China-funded port project by 80 percent." *Nikkei Asian Review*, September 28, 2018, <https://asia.nikkei.com/Spotlight/Belt-and-Road/Myanmar-cuts-cost-of-China-funded-port-project-by-80>.

**Figure 1: Japanese Approved FDI into Myanmar, 2012–Sept 2017 (in USD millions)**



Source: “Data & Statistics,” Directorate of Investment and Company Administration Japan Desk, Ministry of National Planning and Economic Development, Republic of the Union of Myanmar, <https://www.dica.gov.mm/en/data-and-statistics>.

**Figure 2: Value of Japanese FDI into Myanmar by Sector**



Source: “Data & Statistics,” Directorate of Investment and Company Administration Japan Desk, Ministry of National Planning and Economic Development, Republic of the Union of Myanmar, <https://www.dica.gov.mm/en/data-and-statistics>.

Between 2000 to 2009, Japan diversified its FDI, shifting from natural resources investment to manufacturing (comprising a third of all Japanese investment), telecommunications, logistics, and real estate. Japan has made inroads in light manufacturing and logistics but has yet to invest in power generation, oil and gas, mining, and infrastructure on the scale of China. Japan is actively seeking to facilitate further Official Development Assistance (ODA) loans to finance infrastructure and power sector investments.

Myanmar holds high expectations for Japan to provide infrastructure, along with corporate social responsibility

guidelines and transparent investment, technical assistance in legal reforms, and human capacity building. Japan is helping deliver on these hopes through the Myanmar–Japan Joint Initiative (MJJI) Investment Promotion Working Group, a bilateral dialogue started in 2013 between public and private stakeholders to help improve Myanmar’s investment climate. The first phase focused on inspection procedures, import and export policies, tax policy reforms, and improving infrastructure. In the start of its second phase in 2016, it established five currently operating working groups on industrial policy, import and export, finance and insurance, tax affairs, and investment promotion. The Japanese side systematically evaluates the progress of reforms. MJJI’s key organization, the Japanese Chamber of Commerce and Industry, Myanmar, has 372 members, a sevenfold increase since 2011. It does not share the results of MJJI with

other chambers of commerce and did not express any intention to make the dialogue less exclusive or form a group of chambers of commerce.<sup>70</sup>



Thilawa, Myanmar’s first SEZ, became operational in September 2015 after four years of preparation. The governments of Myanmar and Japan (through its Japan International Cooperation Agency or JICA) each own 10 percent, Myanmar Thilawa SEZ Holdings owns 41 percent, and the Japanese MMS Thilawa Development (backed by Mitsubishi, Marubeni, and Sumitomo) own the remaining 39 percent. Thilawa is widely considered a success and conforms to international development standards. It provides a regulatory model that can be expanded across the country. Two key factors for its success were ODA-funded infrastructure and a “one-stop service center,” where foreign investors can speak with ministry representatives and process all necessary regulatory paper work in one place.<sup>71</sup> Japan is providing up to \$176 million for the project, repayable over 40 years with 0.01 percent interest, of which \$1.14 billion was invested as of July 2017.

The Dawei SEZ—originally a joint project between Myanmar and Thailand, joined by Japan in 2015<sup>72</sup>—includes the construction of a highway and deep-sea port linking southern India, Thailand, Cambodia, and

<sup>70</sup> Interview with members of the Japanese Chamber of Commerce in Yangon.

<sup>71</sup> Interview with staff from Myanmar Japan Thilawa Development Limited

<sup>72</sup> Motokazu Matsui, “Japan tries to check China with Dawei development project,” *Nikkei Asian Review*, July 7, 2015, <https://asia.nikkei.com/Economy/Japan-tries-to-check-China-with-Dawei-development-project>.

Vietnam.<sup>73</sup> As of early 2018, the total cost of developing the Dawei SEZ was estimated at \$8.3 billion.<sup>74</sup> The project has suffered frequent delays and still faces significant obstacles before its completion. Concern and opposition to the project within Myanmar has grown, due to its excessive size, disputes over property and land rights, and compensation from investors. There are significant environmental concerns about the construction of coal power plants, destruction of mangrove forests, and coastal and maritime pollution.<sup>75</sup> The interstate highway construction project linking Myanmar and Thailand has been especially problematic both socially and ecologically.<sup>76</sup> Though journalists suggest that confidence in the Dawei SEZ project has increased since Japan's joining, spillover from international sanctions in response to Myanmar's handling of the Rohingya crisis make the project's future uncertain.<sup>77</sup>

## FOREIGN ASSISTANCE

Myanmar received over \$1.5 billion in foreign aid in 2016, with 48 percent going to economic infrastructure and services.<sup>78</sup> To align with U.S. sanctions in 2003, Japan cut off development aid, including loans, but continued grant aid and technical cooperation. In 2012, Japan restarted large-scale development assistance and provided Myanmar with significant debt relief a year later, thus removing an obstacle to dispensing further loans to Myanmar. Japan is now the largest single country donor in Myanmar, with \$429 million in aid in 2016, while India is the second largest. Myanmar was the largest and second-largest recipient of Japan's technical cooperation and grant assistance, respectively, in 2016. In 2016, Japanese Prime Minister Shinzo Abe pledged \$7.7 billion over five years as part of the Myanmar–Japan Cooperation Program. Abe agreed in a summit meeting with then-President Htin Kyaw of Myanmar at the end of 2017 to support the development of Myanmar through accelerated public and private activities in urban development in Yangon, transportation investment, and electric power infrastructure improvements.

The U.S. Agency for International Development (USAID) re-established its mission in Myanmar in 2012, after closing it in 1989.<sup>79</sup> U.S. funding peaked in 2016, when Myanmar received \$174 million through USAID, but after a slight decline to \$148 million in 2017, funds dropped to \$27 million in 2018 as of this writing in October 2018. Recent USAID assistance programming includes humanitarian assistance including emergency responses; governance assistance, including support for democratic participation and conflict prevention and resolution; and basic health and HIV/AIDS prevention.<sup>80</sup>

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<sup>73</sup> Su Phyo Win, "Construction of Dawei SEZ back on the cards," *The Myanmar Times*, December 6, 2017, <https://www.mmtimes.com/news/construction-dawei-sez-back-cards.html>.

<sup>74</sup> Matsui, "Japan tries to check China with Dawei development project," 2015.

<sup>75</sup> Brennan O'Connor, "Myanmar: The Dawei Special Economic Zone," *The Diplomat*, April 11, 2016, <https://thediplomat.com/2016/04/myanmar-the-dawei-special-economic-zone/>.

<sup>76</sup> Jared Ferrie, "Myanmar–Thailand highway branded 'ecological and social disaster,'" Reuters, August 31, 2018, <https://www.reuters.com/article/us-myanmar-development-thailand-analysis/myanmar-thailand-highway-branded-ecological-and-social-disaster-idUSKCN1LH30D>.

<sup>77</sup> Niharika Mandhana, "Sanctions risk casts shadow over Myanmar's opening to the West," *The Wall Street Journal*, April 20, 2018, <https://www.wsj.com/articles/sanctions-risk-casts-shadow-over-myanmars-opening-to-the-west-1524225603>.

<sup>78</sup> Organization for Economic Cooperation and Development (OECD) Development Assistance Committee, "Workbook: OECD DAC Aid at a glance by recipient," Tableau, [https://public.tableau.com/views/OECDDACAidataglancebyrecipient\\_new/Recipients?:embed=y&:display\\_count=yes&:showTabs=y&:toolbar=no&:showVizHome=no](https://public.tableau.com/views/OECDDACAidataglancebyrecipient_new/Recipients?:embed=y&:display_count=yes&:showTabs=y&:toolbar=no&:showVizHome=no).

<sup>79</sup> Bureau of East Asian and Pacific Affairs, "U.S. Relations with Burma," U.S. Department of State, July 17, 2018, <https://www.state.gov/r/pa/ei/bgn/35910.htm>.

<sup>80</sup> "U.S. Foreign Aid by Country: Burma (Myanmar)," U.S. Agency for International Development (USAID), [https://explorer.usaid.gov/cd/MMR?fiscal\\_year=2017&implementing\\_agency\\_id=1&measure=Obligationsf](https://explorer.usaid.gov/cd/MMR?fiscal_year=2017&implementing_agency_id=1&measure=Obligationsf).

Interviews in Yangon revealed that coordination between JICA and USAID is minimal, despite similar projects, such as JICA's Project for Capacity Development of Legal, Judicial and Relevant Sectors and USAID's Promoting Rule of Law Project.

ADB and the World Bank, of which the United States and Japan are key members, also maintain a significant presence in Myanmar. Cumulatively, ADB has contributed \$2.17 billion to 135 projects up to the end of 2017, with \$341.2 million committed in that year. ADB produced a full country partnership strategy, 2017–2021, which prioritizes infrastructure for transport, energy and urban development, education and training, and rural development, thus fitting closely with Japanese aims in Myanmar.<sup>81</sup>

The World Bank committed to lending \$617 million to Myanmar in 2017. Its focus areas for 2015–2017 were reducing rural poverty, investing in people and effective institutions, and supporting a dynamic private sector to create jobs.<sup>82</sup> However, the Rohingya crisis and other issues related to human rights abuses have slowed lending projects due to reputational and moral hazard risks. The World Bank withheld a \$200 million loan to Myanmar in October 2017, a move criticized by the Japanese Embassy. Japan argued that restricting investment would only benefit China and suggested the United States, Japan, and the World Bank cooperate to avoid such actions. The Rohingya crisis has led the World Bank to focus on high-impact projects supporting education, health services, electricity, rural roads, and inclusion of ethnic groups and religions.<sup>83</sup>

#### PEOPLE-TO-PEOPLE TIES

Japan enjoys a very strong reputation in Myanmar. According to Ipsos Indonesia, surveyed Myanmar citizens considered Japan the most important partner to Myanmar, marginally higher than China and significantly higher than the United States, as well as the most important partner for the future.<sup>84</sup> Furthermore, they also considered Japan to be Myanmar's most reliable friend, as they perceive Japan as providing solutions to global issues and developing cooperation in the international community.<sup>85</sup> Those who considered the United States or China to be its most reliable friend did so due to economic or security reasons. The United States has a growing Myanmar diaspora; between 2007 and 2015, Myanmar, along with Iraq, topped the origin of refugees consistently accepted into the United States at about 15,000 per annum.<sup>86</sup>

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<sup>81</sup> Asian Development Bank, *Asian Development Bank Fact Sheet: Myanmar* (Manila: Asian Development Bank, 2017), <https://www.adb.org/sites/default/files/publication/27782/mya-2017.pdf>.

Asian Development Bank, *Myanmar, 2017-2021: Building the Foundations for Inclusive Growth*, (Manila: Asian Development Bank, 2017), <https://www.adb.org/sites/default/files/institutional-document/237161/cps-mya-2017-2021.pdf>.

<sup>82</sup> "Country Partnership Framework for Myanmar for the Period FY15-17," International Development Association, International Finance Corporation, and Multilateral Investment Guarantee Agency, March 31, 2015, <http://documents.worldbank.org/curated/en/510151468280767634/pdf/951830CAS0IDA00OfficialUse0Only090.pdf>.

<sup>83</sup> "World Bank Group response to the situation in Myanmar," The World Bank, October 12, 2017, <http://www.worldbank.org/en/news/press-release/2017/10/12/wbg-response-to-situation-in-myanmar>.

<sup>84</sup> Ministry of Foreign Affairs (Japan), "ASEAN Official Data Spreadsheet (October 23, 2017, English-language 「ASEAN 集計表タイプ公表資料 20171023 英文」, 外務省, <http://www.mofa.go.jp/files/000304074.pdf>.

<sup>85</sup> "Japan–ASEAN Relations: Public Survey on Japan among ASEAN Citizens," Ministry of Finance (Japan), November 25, 2016, <http://www.mofa.go.jp/files/000209501.pdf>.

<sup>86</sup> "Refugee Admissions Statistics," U.S. Department of State, <https://2009-2017.state.gov/j/prm/releases/statistics/index.htm>.

**Table 4: Cross-National Human Flows**

Type of Individual		Outward from Myanmar	Inward to Myanmar
U.S.	Residents	168,000 (2015)	-
	Students	1,351	-
	Tourists	-	76,502 (2016)
Japan	Residents	23,044	2,608
	Students	4,186	-
	Tourists	22,365 (2016)	100,784 (2016)

Note: all numbers are as of 2017, unless stated otherwise.

Source: “Burmese in the U.S. Fact Sheet,” Pew Research Center, September 8, 2017, <http://www.pewsocialtrends.org/fact-sheet/asian-americans-burmese-in-the-u-s/>; “Results of 2017 academic year survey of foreign students’ enrollment status,” Japan Student Services Organization, December 2017, 「平成 29 年度外国人留学生在籍状況調査結果」, 独立行政法人日本学生支援機構, [https://www.jasso.go.jp/about/statistics/intl\\_student\\_e/2017/index.html](https://www.jasso.go.jp/about/statistics/intl_student_e/2017/index.html); “Places of Origin,” 2017 Open Doors Report, Institute of International Education, <https://www.iie.org/Research-and-Insights/Open-Doors/Data/International-Students/Places-of-Origin>; “Myanmar Tourism Statistics 2016,” Ministry of Hotels and Tourism (Myanmar), <https://tourism.gov.mm/wp-content/uploads/2017/08/Myanmar-Tourism-Statistics-2016-1.pdf>; “(Appendix 4) October 3, 2017 Detailed Results (Poll on ASEAN’s Views of Japan),” Ministry of Foreign Affairs, 「(別添 4) 20171003 詳細結果 (ASEAN 対日世論調査)」, 外務省, <https://www.mofa.go.jp/mofaj/files/000304014.pdf>; “Statistics of Foreign Residents (formerly Registered Alien Statistics) – Monthly – 2017 – December – Statistics of Foreign Residents,” Portal Site of Official Statistics of Japan, 「在留外国人統計 (旧登録外国人統計)、月次、2017 年、12 月、在留外国人統計」, 政府統計の総合窓口, <https://www.e-stat.go.jp/stat-search/files?page=1&layout=datalist&toukei=00250012&tstat=000001018034&cycle=1&year=20170&month=24101212&tclass1=00000106039>; “Annual Report of Statistics on Japanese Nationals Overseas, 2018,” Consular Policy Division, Consular Affairs Bureau, Ministry of Foreign Affairs (Japan), October 1, 2017, 「海外在留邦人数調査統計」, 外務省領事局政策課, <https://www.mofa.go.jp/mofaj/files/000394748.pdf>; “Entry and Exit Control Statistics – Annual – 2016 – Entry and Exit (Return) Count by Nationality – Foreign Entrants by Nationality and Region, By Port of Entry,” Portal Site of Official Statistics of Japan, 「出入管理統計、年次、2016 年、出入 (帰) 国者数、港別入国外国人の国籍・地域」, 政府統計の総合窓口, <https://www.e-stat.go.jp/stat-search/files?page=1&layout=datalist&toukei=00250011&tstat=000001012480&cycle=7&year=20160&month=0&tclass1=000001012481>.

## POLITICAL CONSTRAINTS

In October 2016, the United States waived most of its economic restrictions on Myanmar. It lifted both the national emergency and the subsequent nullification of the Myanmar-specific programs due to the U.S. Department of the Treasury’s Specially Designated Nationals and Blocked Persons (SDN) List. It exempted Myanmar from Section 311 of the USA Patriot Act, which had prevented U.S. banks from providing trade and investment financing in Myanmar. However, Myanmar remains subject to Section 312,<sup>87</sup> which specifies that U.S. banking institutions and non-U.S. banking institutions with operations in the U.S. can provide certain services—including trade financing, finance investment in Myanmar, and helping U.S. investors repatriate their profits—only if strict due diligence requirements regarding money laundering are met.<sup>88</sup> Only Cuba, Iran, and North Korea are also on this list.<sup>89</sup> The American Chamber of Commerce in Myanmar found that U.S. companies are reluctant to invest in Myanmar because U.S. banks refused to conduct financial transactions with local banks due to these restrictions.<sup>90</sup> Myanmar has taken steps to address money laundering concerns and the U.S. government is aware of the burden Section 312 places on

<sup>87</sup> Murray Hiebert, “Financial regulations hobble U.S. companies to Myanmar even after U.S. sanctions lifted,” Center for Strategic and International Studies, July 14, 2017, <https://www.csis.org/analysis/financial-regulations-hobble-us-companies-myanmar-even-after-us-sanctions-lifted>.

<sup>88</sup> Mizzima, “AMCHAM Myanmar encourages U.S. banks to enter Myanmar market,” August 2, 2017, <http://www.mizzima.com/business-domestic/amcham-myanmar-encourages-us-banks-enter-myanmar-market>.

<sup>89</sup> Hiebert, “Financial regulations hobble U.S. companies to Myanmar even after U.S. sanctions lifted,” 2017.

<sup>90</sup> Mizzima, “AMCHAM Myanmar encourages U.S. banks to enter Myanmar market,” 2017; U.S. Chamber of Commerce, *U.S.-Myanmar Commercial Relations: The Next Phase*, (Washington, D.C.: U.S. Department of Treasury, 2016), [https://www.uschamber.com/sites/default/files/us\\_-\\_myanmar\\_commercial\\_relations\\_-\\_the\\_next\\_phase\\_-\\_pdf](https://www.uschamber.com/sites/default/files/us_-_myanmar_commercial_relations_-_the_next_phase_-_pdf).

U.S. financial institutions. While the Treasury Department may permanently exempt Myanmar once enough progress is made to improve its anti-money laundering and corruption regimes, such a move is unlikely in the near future. President Donald Trump would have to notify Congress that the Treasury Department was permanently ending implementation of Section 312, which seems unlikely given the situation in Rakhine State. Additionally, the United States has added individuals and military divisions to the SDN list under the Global Magnitsky Act, meaning that no U.S. persons or entities can engage in any transactions with those on the list. Other Myanmar individuals and entities, including a narcotics-producing ethnic army, the United Wa State Army, are designated under the Drug Kingpin Act.

The United States and Japan have collaborated productively in Myanmar to enforce sanctions against North Korea. Both countries pressured Myanmar officials to sever ties with North Korea. However, a 2018 UN report found Myanmar purchased conventional weapons and ballistic missile systems from North Korea in violation of international sanctions.<sup>91</sup> The United States has sanctioned officials for dealing with Pyongyang, but Japan has not imposed similar sanctions.<sup>92</sup>

## *Recommendations on Myanmar*

We believe it is both vital and feasible for the United States and Japan to simultaneously advance both their economic and human rights objectives in Myanmar. By strengthening infrastructure, human capacity, and governance practices, Myanmar will become a stronger, more democratic, more stable nation, better able to negotiate relations with large neighbors, such as China, on its own terms.

### **UNITED STATES**

- 1. Create pathways towards investment and lifted sanctions that are linked to improvements in human rights and democratization.** In the early stages of Myanmar's democratization process, Myanmar was subject to financial sanctions under the USA Patriot Act, and these continue to this day. Hindered by due diligence requirements of Section 312, U.S. financial services firms cannot provide services within the country and thus are prevented from facilitating private financing, investing in the country's growing financial industry, and working with Japanese firms to cope with money laundering and corruption from within. Given the current climate, with U.S. concerns about human rights violations against the Rohingya minority and the sham conviction of two Reuters reporters, it is unrealistic to expect U.S. lawmakers to lift sanctions and other punitive economic measures at present. However, Washington can more clearly link these issues by offering the government in Naypyidaw greater access to foreign investment and other development support on condition of improved treatment of minorities, greater freedom of the press, and other steps toward more democratic governance.
- 2. Support U.S. business efforts to be a positive force for growth and better governance.** The U.S. government should encourage U.S. companies in Myanmar to do appropriate and enhanced due diligence on prospective business partners, particularly those that could have ties to the military. Unlike in previous campaigns, most human rights activists and Myanmar critics do not want to block investment in the country, recognizing the need to lift its people out of poverty and root out

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<sup>91</sup> Michelle Nichols, "Exclusive: North Korea earned \$200 million from banned exports, sends arms to Syria, Myanmar - U.N. report," Reuters, February 2, 2018, <https://www.reuters.com/article/us-northkorea-missiles-un-exclusive/exclusive-north-korea-earned-200-million-from-banned-exports-sends-arms-to-syria-myanmar-u-n-report-idUSKBN1FM2NB>.

<sup>92</sup> "Economic Sanctions and Sanctions Targets," Ministry of Finance (Japan), September 14, 2018, 経済制裁措置及び対象者リスト, 財務省, [https://www.mof.go.jp/international\\_policy/gaitame\\_kawase/gaitame/economic\\_sanctions/list.html](https://www.mof.go.jp/international_policy/gaitame_kawase/gaitame/economic_sanctions/list.html).

corruption. However, many are calling for companies to sever any links with local companies owned by or tied to the military. The American Chamber of Commerce (AmCham) in Yangon can provide valuable resources to guide U.S. companies on which local companies to avoid. The U.S. government should also work with AmCham Yangon to identify key areas preventing expanded or new investment, including legal and regulatory frameworks, infrastructure, and capacity. Working groups can be created among members of AmCham Yangon to pool expertise and potential corporate social responsibility opportunities to target capacity issues, particularly on management and employee training, drafting bills, and engaging more effectively with the Myanmar government.

## **JAPAN**

### **1. Amplify the success of Thilawa SEZ as a model for foreign investment and better governance.**

Japan's success with Thilawa stands in contrast to the slow progress of other SEZs in Myanmar, notably Kyaukpadaung in the north and Dawei in the south. Improvements in these zones could support economic development and better governance throughout the country. Japan should continue to support Thilawa as a hub for investment not only by Japanese but also U.S. and other foreign companies. Japan could also help Dawei SEZ improve its record with respect to environmental impact, social impact, and local consultations. Dawei's chances of success would be increased if the project were scaled down and priority given to constructing a port and road to Thailand to improve connectivity. Japan should also consider offering support to Indian efforts to improve connectivity in the north of the country as an alternative to China's dominant role there.

### **2. Improve information sharing with other embassies and chambers of commerce.** The Japanese government, through its embassy in Myanmar, should share information about its MJJI meetings and other government contacts on behalf of business, so that their dialogue can benefit not only Japanese companies but also U.S. and other foreign companies. Although Japan may stand in a privileged position currently, it will lose its standing if it continues to operate with a mindset of exclusivity. It is necessary to begin to gather the trust and support of other allies and partners operating in Myanmar.

## **JOINT ACTION**

### **1. Help Myanmar improve coordination of its development strategy.** There is no shortage of multilateral and bilateral agencies in Myanmar, including the World Bank, ADB, JICA, and USAID, offering assistance to support the country's economic development. However, a severe shortage of staff and skills in Myanmar's development agencies makes it difficult for them to make best use of these various offers of assistance. The United States and Japan should coordinate more closely between themselves, and with the Myanmar government, to prioritize the country's development needs and sources of assistance and more effectively implement Myanmar's own development strategy.

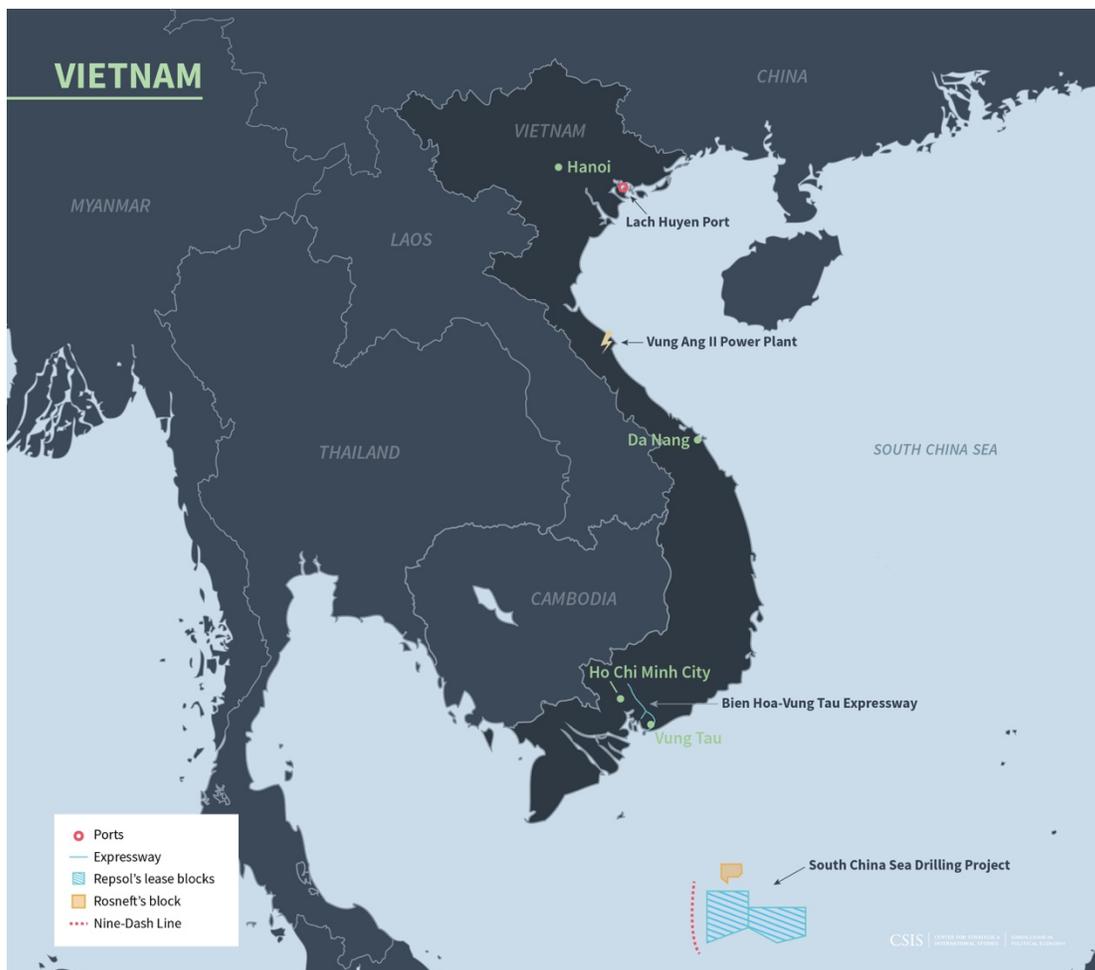
### **2. Cooperate on human capacity building and technical assistance.** Myanmar desperately needs greater human capacity. In particular, procurement officials need better ability to evaluate investment proposals to ensure they meet international standards of open and transparent bidding, social and environmental safeguards, and debt sustainability. In the financial sector, there is a pressing need for technical assistance to help local banks better manage risk and to help the central bank improve its policy functions. JICA is currently working to develop human resources in

the customs agency, and the U.S.–ASEAN Business Council is providing technical support to develop small and medium-sized enterprises. U.S. and Japanese agencies should coordinate so they can better build on and reinforce these initiatives.

- 3. Support economic development in ethnic minority states.** In the short term, Washington and Tokyo should coordinate more closely on targeted sanctions against military leaders and those instigating violence in ethnic areas. Over the long term, in addition to working on a political solution to the crisis, the United States and Japan should promote economic development in ethnic minority states, especially Rakhine and Shan states, in coordination with local communities and key stakeholders, to ensure equity, fairness, and an understanding of the concerns, needs, and complex dynamics on the ground. USAID and JICA should extend support for rural electrification and cooperate on projects to strengthen rule of law, while U.S. and Japanese representatives at ADB and the World Bank should work together to gain support for such initiatives.
- 4. Cooperate on infrastructure development.** Infrastructure—particularly roads, power, and energy facilities—is one of Myanmar’s most pressing development needs. With the creation of a new development finance corporation in the United States under the BUILD Act (see Introduction), there is greater scope for coordination with the Japan Bank for International Cooperation on infrastructure finance. U.S. firms need a mechanism to understand Japan’s two-step loans, so they can share their technology at the subcontractor level. U.S. and Japanese companies should also seek to gain a role in Chinese infrastructure projects, such as by providing the wiring, logistics, and software. A possible example of a cooperative infrastructure project would be Japanese construction of a liquified natural gas terminal to allow the import of U.S. gas, helping address the needs of both Myanmar and Japan for reliable sources of energy.
- 5. Improve coordination between the U.S. and Japanese embassies and chambers of commerce.** Communication and joint efforts between the U.S. and Japanese embassies and chambers of commerce in Myanmar are limited. Given the shared interests of the two countries in promoting Myanmar’s economic development, providing enhanced opportunities for foreign companies, and lessening Myanmar’s economic dependence on China, the two embassies and chambers of commerce should hold regular meetings—at least quarterly—to share information and policy proposals and agree on joint actions.

## Case Study #2 | Vietnam

Perhaps no country in Asia better captures the range of shared interests between the United States and Japan than Vietnam. Located at the mouth of the Mekong River, the western rim of the South China Sea, and the periphery of China, Vietnam has weathered great-power campaigns for millennia. Its history includes myriad wars of resistance against and periods of colonial domination by Chinese empires. The country's population size and its geographic position make it an important counterweight to Beijing's strategic ambitions in Asia. Strengthening Vietnam's ability to defend itself and develop a strong economy is thus the overriding strategic priority for U.S. and Japanese foreign policy towards Vietnam. That means not only providing security assistance but also supporting continued economic growth, particularly cultivating a diverse range of trade and investment partners for Vietnam and preventing overdependence on China.



## *U.S. and Japanese Strategic Interests and Objectives*

The United States and Japan both have a significant strategic and commercial interest in seeing Hanoi continue economic liberalization. Such reforms will facilitate Vietnam's transition from a command economy and investment- and export-led growth model, to a consumption-led market economy. This would put the economy on a more stable long-term trajectory and also create new opportunities for U.S. and Japanese businesses to benefit from the country's rapid growth. Measures to improve the efficiency of state-owned enterprises (SOEs)—including privatizing weak SOEs, loosening restrictions on foreign investment activity, reducing corruption, and eliminating tariffs and other trade barriers—will be key markers in Vietnam's economic progress.<sup>93</sup>

Though the United States and Japan are closely aligned on the high-level strategic and economic issues at stake in Vietnam, they have some significant differences on human rights and sectoral priorities. Historically, the United States has emphasized supporting human rights and civil society in Vietnam, in contrast to Japan's approach, which has generally been more neutral on human rights, though Japan has advocated for higher labor standards in trade agreements.

Japan and the United States have a strong mutual interest in participating in Vietnam's energy sector as major investors developing new sources of oil, gas, coal, and other power projects.<sup>94</sup> These new sources would not only meet Vietnam's growing energy needs but also provide Japan another source of imported energy in the region.<sup>95</sup>

## *Political and Economic Landscape*

### **VIETNAM'S ECONOMIC POLICY PRIORITIES**

The core priorities of the Communist Party of Vietnam (CPV) remain in many ways largely unchanged from the beginning of reforms in 1986. Domestically, this means maintaining the party's grip on power and role in the economy while promoting strong, sustainable, and inclusive economic growth.

The CPV recognizes that Vietnam must adapt its development model to continue the economy's high growth trajectory. The Vietnamese economy's tripartite structure—split between the highly productive manufacturing export sector, underpinned by foreign direct investment (FDI), and the less productive domestic services and agricultural sectors—has begun to show significant strains and is not delivering economic benefits for large segments of the population, particularly outside the Hanoi and Ho Chi Minh City metro areas. The CPV understands the economy will have to begin transitioning towards consumption, services and higher value-added advanced manufacturing, as Japan and South Korea have in the past, and China is currently seeking to do. This strategic shift is intended to avoid the middle-income trap and sustain the country's high productivity growth and manufacturing employment, even as its labor

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<sup>93</sup> World Bank Group, *Economic and Distributional Impacts of Comprehensive and Progressive Agreement for Trans-Pacific Partnership: The case of Vietnam* (Washington, D.C.: The World Bank, 2018),

<http://documents.worldbank.org/curated/en/530071520516750941/pdf/124022-WP-8-3-2018-9-59-18-CPTPPreportMarch.pdf>.

<sup>94</sup> Atsushi Tomiyama, "Japan Returns as Top Investor in Vietnam," *Nikkei Asian Review*, December 28, 2017, <https://asia.nikkei.com/Economy/Japan-returns-as-top-investor-in-Vietnam>; "Business Activities: Vietnam," JX Nippon Oil and Gas Exploration Corp., 2018, [http://www.nex.jx-group.co.jp/english/activity/southeast\\_asia/vietnam.html](http://www.nex.jx-group.co.jp/english/activity/southeast_asia/vietnam.html); "Envision and Hitachi Zosen Enter Vietnam Renewable Energy Sector," Vietnam Investment Review, May 17, 2018, <http://www.vir.com.vn/envision-and-hitachi-zosen-enter-vietnamese-renewable-energy-sector-59268.html>.

<sup>95</sup> CSIS Vietnam Roundtable.

costs rise. To that end, the government is targeting a range of sectors for development, such as renewable energy generation.<sup>96</sup>

The country's core foreign economic policy priorities are aimed at reinforcing these domestic goals—in particular, the diversification of Vietnam's trade and investment flows and the reform of the state sector. The government sees the continued expansion and deepening of the country's trade agreements as integral to its development strategy, as well as a diplomatic hedge against overreliance on China. In a speech to the Vietnam Business Summit on November 2017, Prime Minister Nguyen Xuan Phuc said the government planned to complete four more free trade agreements (FTAs) in the near future, including the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the Regional Comprehensive Economic Partnership (RCEP), along with bilateral FTAs with Cuba and Israel.<sup>97</sup> The Ministry of Industry and Trade's Strategy on Exports and Imports for 2011–2020, with Visions to 2030 identifies clear goals of consolidating the country's economic partnerships and diversifying its export and import markets.<sup>98</sup> These goals are paired with the objective of supplying the growing Chinese consumer market as Chinese labor costs rise.

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<sup>96</sup> “Prime Minister Nguyen Tan Dung on June 9, 2014 signed Decision No. 879/QĐ-TTg to approve the Industrial Development Strategy through 2025, vision toward 2035,” Socialist Republic of Vietnam Government Portal, June 9, 2014, <http://www.chinhphu.vn/portal/page/portal/English/strategies/strategiesdetails?categoryId=30&articleId=10054959>.

<sup>97</sup> “APEC 2017: Prime Minister's Speech at Vietnam Business Summit 2017,” Vietnam Law and Legal Forum, August 11, 2017, <http://vietnamlawmagazine.vn/apec-2017-prime-ministers-speech-at-vietnam-business-summit-2017-6065.html>.

<sup>98</sup> “Strategy on Exports and Imports for 2011–2020 with Visions to 2030,” Socialist Republic of Vietnam Government Portal, December 28, 2011, <http://www.chinhphu.vn/portal/page/portal/English/strategies/strategiesdetails?categoryId=30&articleId=10051303>.

**Table 1: Vietnam’s Economic Policies**

Policy	Date	Purpose	Objectives
Master Plan on Economic Restructuring	2013	Improve efficiency of resource allocation to increase economic growth and productivity.	<ol style="list-style-type: none"> <li>1. Restructure and privatize state-owned enterprises and commercial banks.</li> <li>2. Eliminate unnecessary regulations and barriers to integration with international markets.</li> </ol>
Vietnam 2035	2015	A long-term joint initiative of the World Bank and Vietnam’s Ministry of Planning and Investment that aims to sustainably modernize and industrialize Vietnam’s economy. Also hopes to facilitate and support a higher standard of living for Vietnamese citizens.	<ol style="list-style-type: none"> <li>1. Support an economy with a GDP per capita of at least \$18,000 in 2011 Purchasing Power Parity.</li> <li>2. 90 percent of GDP should come from industry and services.</li> <li>3. 80 percent of GDP should come from the private sector.</li> <li>4. Maintain 6 percent annual growth rate.</li> <li>5. Improve public infrastructure including health care and education.</li> <li>6. Encourage diversity and inclusivity in Vietnamese economy.</li> <li>7. Create more opportunities for innovation and entrepreneurship.</li> <li>8. Establish a modern rule of law and democratic society</li> </ol>
Five Year Socio-Economic Development Plan (2016–2020)	2016	Sets immediate goals for Vietnam’s economic development using traditional economic indicators to measure progress.	<ol style="list-style-type: none"> <li>1. Make major improvements to the growth rate of Vietnam’s GDP, and restructure Vietnam’s growth model.</li> <li>2. Actively improve welfare and standards of living for Vietnamese citizens.</li> <li>3. Effectively manage climate change and natural resources, and improve environmental protections.</li> <li>4. Insure social and political stability and address national security issues.</li> <li>5. Encourage Vietnam’s economic integration into international markets and institutions.</li> </ol>

**CONSTRAINTS ON GROWTH**

Vietnam today is butting up against the limits of its development model, and experiencing new constraints on growth. Despite significant progress in recent decades, the country’s infrastructure needs are still massive. Electricity generation will need to expand to meet the demands of the industrial sector and increasingly wealthy consumers.<sup>99</sup> Despite a high density of roads, Vietnam must continue to improve its transportation systems between and within its major population centers, in particular mass transit systems.<sup>100</sup> Vietnam allocated 5.8 percent of GDP to infrastructure in 2016, but will need to target spending

<sup>99</sup> Marco Breu et al, *Sustaining Vietnam’s Growth: The Productivity Challenge* (New York: McKinsey and Company, 2012), [https://www.mckinsey.com/~media/McKinsey/Global%20Themes/Asia%20Pacific/Sustaining%20growth%20in%20Vietnam/MGI\\_Sustaining\\_growth\\_in\\_Vietnam\\_Full\\_Report.ashx](https://www.mckinsey.com/~media/McKinsey/Global%20Themes/Asia%20Pacific/Sustaining%20growth%20in%20Vietnam/MGI_Sustaining_growth_in_Vietnam_Full_Report.ashx).

<sup>100</sup> Asian Development Bank, *Vietnam, 2016–2020: Fostering More Inclusive and Environmentally Sustainable Growth* (Manila: Asian Development Bank, September 2016), <https://www.adb.org/sites/default/files/institutional-document/199661/cps-vie-2016-2020.pdf>.

judiciously to support growth and manage urbanization in the coming years.<sup>101</sup> Public aversion against increasing public debt beyond a 65 percent ceiling has caused infrastructure projects to be delayed, with no macro solutions in sight.<sup>102</sup> The government has even begun to divest SOEs because of fiscal pressures. The country will also need to build out its financial services infrastructure; the economy is still largely cash-based, and only 21 percent of adults have access to formal financial services, one of the lowest rates in Southeast Asia.<sup>103</sup>

To take advantage of IT opportunities, Vietnam must also overcome its low internet usage, with only 52.1 million users (about half the population) in 2016, and projected to rise to a mere 59 million users by 2022.<sup>104</sup> Broader, more reliable, higher-bandwidth connectivity is key to developing high-tech industries, especially if Vietnam aims to become a leader in business outsourcing.<sup>105</sup> Although the country is recognized for its strong basic education, Vietnam will need further advances to train workers in high-skilled professions to participate in the emerging technology and advanced manufacturing sectors. Completion rates for high school and university are low on average, and even lower for poor and rural populations. Vietnam will need to increase access to tertiary education and provide students with the science, technology, engineering and mathematics (STEM) skills needed for employment, rather than focus instruction on Marxist political doctrine.<sup>106</sup>

In the long term, Vietnam faces significant challenges from an aging population, environmental damage, including the threat from climate change, and lingering public health issues. Although Vietnam has a relatively low median age of 27.4, the share of the population age 5–19 is projected to fall from 27 percent in 2010 to 22 percent by 2020. This demographic shift is expected to be among the fastest in the world.<sup>107</sup> Vietnam will not be able to rely on a youth bulge to drive growth as it has in past decades, and the social security system remains small relative to expected needs.<sup>108</sup> Finally, HIV and AIDS continue to plague Vietnam, with 250,000 people living with the virus, the 22nd highest number in the world. The country is also vulnerable to infectious diseases such as hepatitis A, typhoid fever, malaria, dengue fever, and bacterial diarrhea.<sup>109</sup> Addressing these health issues will require significant investments in the country's public health infrastructure; Vietnam has just 2.6 hospital beds per 1,000 people in 2014 compared to Japan's 13.4 beds per 1,000 people in 2012.<sup>110</sup>

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<sup>101</sup> PricewaterhouseCoopers, *Spotlight on Viet Nam: The Leading Emerging Market* (London: PricewaterhouseCoopers, 2017), <https://www.pwc.com/vn/en/publications/2017/spotlight-on-vietnam.pdf>.

<sup>102</sup> Interviews in Hanoi with officials from the U.S. and Japan embassies and multilateral institutions.

<sup>103</sup> International Finance Corporation, *Responsible Finance in Vietnam* (Washington, D.C.: International Finance Corporation, World Bank Group, 2014), [https://www.ifc.org/wps/wcm/connect/62dc148045270d65b271bec66d9c728b/IFC+Responsible+Finance+Diagnostic\\_FINAL.pdf?MOD=AJPERES](https://www.ifc.org/wps/wcm/connect/62dc148045270d65b271bec66d9c728b/IFC+Responsible+Finance+Diagnostic_FINAL.pdf?MOD=AJPERES).

<sup>104</sup> "Number of Internet Users in Vietnam from 2015 to 2022," Statista, 2018, <https://www.statista.com/statistics/369732/internet-users-vietnam/>.

<sup>105</sup> Breu et al., *Sustaining Vietnam's Growth*, 2012

<sup>106</sup> "Vietnam: Country partnership framework for the period FY18–FY22," The World Bank, 2017, <http://documents.worldbank.org/curated/en/173771496368868576/Vietnam-Country-partnership-framework-for-the-period-FY18-FY22>.

<sup>107</sup> Marco Breu, Richard Dobbs, and Jaana Remes, "Taking Vietnam's Economy to the Next Level," McKinsey and Co., February 2012, <https://www.mckinsey.com/featured-insights/asia-pacific/taking-vietnams-economy-to-the-next-level>.

<sup>108</sup> Ibid.

<sup>109</sup> "Vietnam," *Central Intelligence Agency World Factbook*, Central Intelligence Agency, September 26, 2018, <https://www.cia.gov/library/publications/the-world-factbook/geos/vn.html>.

<sup>110</sup> Ibid.

## U.S.–Japan Economic Involvement in Vietnam

### TRADE RELATIONS

While the United States has been Vietnam’s primary export destination over the past two decades, China has arguably surpassed it; official statistics are inconclusive.<sup>111</sup> China was Vietnam’s primary import origin in 2016, followed by South Korea. Imports from China were primarily capital goods at 47 percent and intermediate goods at 39 percent. The foremost import sector is electrical machinery at 45 percent, led by telephone components at 11 percent, a major input for Vietnamese consumer electronics exporters.<sup>112</sup>

Trade with the United States remains critical to Vietnam. As of 2015, consumer goods, at 66 percent, dominate Vietnam’s exports to the United States.<sup>113</sup> The top product categories are textiles and clothing at 35 percent, electrical machinery (e.g. broadcasting equipment, integrated circuits, and computers) at 22 percent, and footwear at 13 percent.<sup>114</sup> Vietnam’s imports from the United States indicate the two countries’ relative positioning in regional supply chains:<sup>115</sup> 43 percent are capital goods, and intermediate goods and raw materials each account for 23 percent.<sup>116</sup> The top imported product, integrated circuits, is a major input for Vietnamese exports of computers and other consumer electronics. Similarly, the second-largest import category from the United States, raw cotton, is a key input for textiles.<sup>117</sup> These trade dynamics reflect U.S. prowess in more advanced manufacturing and agriculture and Vietnam’s role as a major assembler of finished goods.

**Table 2: Vietnam’s Trade with Selected Partners (in USD billion)**

Country	Exports		Imports	
	2017	%	2017	%
United States	42.7	20.3	7.2	3.3
China	30.7	14.6	57.0	25.9
Japan	16.8	8.0	17.3	7.9
Total	210.3		220.3	

Source: International Monetary Fund DOTS Table for Vietnam. Direction of Trade Statistics database, International Monetary Fund, <http://data.imf.org/?sk=9D6028D4-F14A-464C-A2F2-59B2CD424B85&sid=1409151240976>.

<sup>111</sup> According to Vietnamese statistics, the United States is Vietnam’s top export destination, but China reports a higher volume of imports from Vietnam (\$50 billion) than does the United States (\$47 billion).

<sup>112</sup> “Preliminary Exports and Imports of Goods by Main Countries and Territories in 2017,” General Statistics Office (Vietnam), [http://www.gso.gov.vn/default\\_en.aspx?tabid=626&ItemID=18318](http://www.gso.gov.vn/default_en.aspx?tabid=626&ItemID=18318); “Trade in Goods with Vietnam,” U.S. Census Bureau, 2018, <https://www.census.gov/foreign-trade/balance/c5520.html>; “December 2017 Goods Import and Export Totals by Major Country (Region),” General Administration of Customs, People’s Republic of China, January 12, 2018, (4) 2017 年 12 月进出口商品主要国别 (地区) 总值表 (美元值), 中华人民共和国海关总署, <http://www.customs.gov.cn/customs/302249/302274/302275/1416426/index.html>.

<sup>113</sup> “Product Imports by Vietnam from China 2015,” World Integrated Trade Solution, <https://wits.worldbank.org/CountryProfile/en/Country/VNM/Year/2015/TradeFlow/Import/Partner/CHN/Product/All-Groups>.

<sup>114</sup> “Product Exports by Vietnam to United States 2015,” World Integrated Trade Solution, <https://wits.worldbank.org/CountryProfile/en/Country/VNM/Year/2015/TradeFlow/Export/Partner/USA/Product/All-Groups>.

<sup>115</sup> “What does Vietnam export to the United States? (2015),” The Economic Complexity Observatory, [https://atlas.media.mit.edu/en/visualize/tree\\_map/hs92/export/vnm/usa/show/2015/](https://atlas.media.mit.edu/en/visualize/tree_map/hs92/export/vnm/usa/show/2015/).

<sup>116</sup> “Product Imports by Vietnam from India 2015,” World Integrated Trade Solution, <https://wits.worldbank.org/CountryProfile/en/Country/VNM/Year/2015/TradeFlow/Import/Partner/IND/Product/all-groups>.

<sup>117</sup> Ibid.

<sup>118</sup> “What does Vietnam,” The Economic Complexity Observatory.

Vietnam's exports to Japan mirror those to the United States in the major categories—in 2015, consumer goods constituted 58 percent, capital goods 16 percent, electrical machinery 24 percent, and textiles and clothing 22 percent—with some notable differences in smaller sectors.<sup>118</sup> Most significantly, Vietnam exported \$580 million in crude petroleum to Japan in 2015, highlighting Vietnam's role in regional energy trade and Japan's large demand;<sup>119</sup> however, raw materials are only 4 percent of Vietnam's imports from Japan overall. The statistics indicate a close relationship between Japanese and Vietnamese manufacturers: 54 percent of Vietnam's imports are capital goods, 47 percent electrical machinery, and 28 percent intermediate goods.<sup>120</sup> Moreover, while Vietnam has a large surplus with the United States, its trade with Japan is much more balanced, primarily due to Vietnam's energy exports to Japan.<sup>121</sup>

Despite the United States' importance to Vietnam's trade balance, the U.S. lacks an FTA with Vietnam, and following the U.S. withdrawal from the Trans-Pacific Partnership (TPP), there is presently no proposed agreement on the table. Vietnam was expected to make significant gains from U.S. membership in TPP, and lost over a quarter of forecasted income gains from the pact due to the U.S. withdrawal, according to analysis from the Peterson Institute for International Economics.<sup>122</sup> Nevertheless, Vietnam is expected to see income gains, relative to baseline growth, of over \$11 billion through 2030 from CPTPP,<sup>123</sup> which includes disciplines on SOEs, reinforcing Vietnam's goal of reforming the state sector, and labor agreements, advocated by Japan at the request of the United States.<sup>124</sup>

Washington's ability to persuade Hanoi fell significantly after U.S. withdrawal from TPP. CPTPP includes provisions in the original agreement such as enhanced labor rights, but without incentives from TPP or reprisals from the Trump administration, there have been troubling signs of backsliding by Hanoi on treatment of labor and environmental activists.<sup>125</sup> Similarly, in the area of digital governance, Hanoi is adopting more protectionist policies despite U.S. diplomatic protests.<sup>126</sup>

U.S.-Vietnam trade relations are currently discussed under the U.S.-Vietnam Trade and Investment Framework Agreement (TIFA), first adopted in 2007.<sup>127</sup> During TPP negotiations, the two countries addressed bilateral issues as part of that initiative but resumed TIFA meetings after the US withdrew from TPP. In the most recent TIFA meeting, in March 2018, the United States urged Vietnam to address a range

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<sup>118</sup> "Product Exports by Vietnam to Japan 2015," World Integrated Trade Solution, <https://wits.worldbank.org/CountryProfile/en/Country/VNM/Year/2015/TradeFlow/Export/Partner/JPN/Product/all-groups>.

<sup>119</sup> "What does Vietnam," The Economic Complexity Observatory.

<sup>120</sup> "Product Imports by Vietnam from Japan 2015," World Integrated Trade Solution, <https://wits.worldbank.org/CountryProfile/en/Country/VNM/Year/2015/TradeFlow/Import/Partner/JPN/Product/all-groups>.

<sup>121</sup> "Product Exports by Vietnam to Japan 2015," World Integrated Trade Solution, <https://wits.worldbank.org/CountryProfile/en/Country/VNM/Year/2015/TradeFlow/Export/Partner/JPN/Product/all-groups>.

<sup>122</sup> Peter A. Petri, Michael G. Plummer, Shujiro Urata, and Fan Zhai, "Going it Alone in the Asia-Pacific: Regional Trade Agreements Without the United States," Peterson Institution for International Economics, October 2017, <https://piie.com/publications/working-papers/going-it-alone-asia-pacific-regional-trade-agreements-without-united>.

<sup>123</sup> "CPTPP Brings Vietnam Direct Economic Benefits and Stimulate Domestic Reforms, WB Report Says," The World Bank, March 9, 2018, <https://www.worldbank.org/en/news/press-release/2018/03/09/cptpp-brings-vietnam-direct-economic-benefits-and-stimulate-domestic-reforms-wb-report-says>.

<sup>124</sup> Interviews in Hanoi with officials from the U.S. and Japanese embassies.

<sup>125</sup> Simon Denyer and David Nakamura, "How a Trump decision on trade became a setback for democracy in Vietnam," *Washington Post*, October 11, 2018, [https://www.washingtonpost.com/graphics/2018/world/how-a-trump-decision-on-trade-became-a-setback-for-democracy-in-vietnam/?utm\\_term=.21a7885fb713](https://www.washingtonpost.com/graphics/2018/world/how-a-trump-decision-on-trade-became-a-setback-for-democracy-in-vietnam/?utm_term=.21a7885fb713).

<sup>126</sup> Matthew Goodman, "From Rule Maker to Rule Taker," *Global Economics Monthly* VII, no. 7 (July 2018), Center for Strategic and International Studies, <https://www.csis.org/analysis/rule-maker-rule-taker>.

<sup>127</sup> Office of the United States Trade Representative, *Vietnam* (Washington D.C.: U.S. Government, 2018), <https://ustr.gov/countries-regions/southeast-asia-pacific/vietnam>.

of barriers in the bilateral relationship.<sup>128</sup> Some of the most significant non-tariff barriers to U.S. exports include regulations on food safety, financial services, and digital trade. Recently, Vietnam has increased tariffs on several food and agricultural products, including sweeteners, tomato products, and shelled walnuts. These tariffs remain below levels prescribed by the World Trade Organization, but concerns remain that protectionism is rising in Vietnam.<sup>129</sup>

Unlike the United States, Japan does have an FTA with Vietnam: the Agreement between Japan and the Socialist Republic of Viet Nam for an Economic Partnership, which took effect in 2009. Aside from clear advantages to both countries due to their respective complementary comparative advantages, Vietnam has shown a careful but pragmatic approach to balancing trade and security relations between Japan, the United States and China. This approach towards balancing trade between great powers to achieve non-alignment was further solidified through Vietnam's inclusion first in TPP, then CPTPP.

### INVESTMENT RELATIONS AND MAJOR PROJECTS

Within Southeast Asia, Vietnam is one of the major recipients of FDI, which has contributed significantly to the country's export and investment-led growth. Foreign investment accounted for 28 percent of gross fixed capital formation in 2017,<sup>130</sup> and 70 percent of exports were supported by FDI.<sup>131</sup> But the United States still lags behind Asian states in FDI in Vietnam, ranking 13th in total registered capital for foreign direct investment projects licensed in 2016.<sup>132</sup> The majority of both U.S. and Japanese FDI in Vietnam is in manufacturing.<sup>133</sup>

There are some early signs that U.S. investment in Vietnam is expanding and changing. From 2007 to 2014, the number of U.S.-based multinational enterprises in Vietnam tripled from 17 to 50.<sup>134</sup> U.S.-based electronics companies are following the lead of their competitors in Japan and South Korea by establishing operations in Vietnam: Intel now produces 80 percent of its PC central processing units in the country, and Microsoft has recently moved in. Meanwhile, Hilton has agreed to a hotel management contract in Hanoi with BRG Group, a Vietnamese conglomerate.<sup>135</sup> U.S. companies have also moved into Vietnam's agriculture sector; Cargill recently developed a tenth aqua feed line in the country.<sup>136</sup> Notably, these new ventures follow the projections for major growth industries in Vietnam: advanced manufacturing, tourism, and agriculture. Much of this initial uptick likely occurred in anticipation of TPP, and it is possible that FDI growth will slow due to U.S. withdrawal. On the other hand, U.S. investment in Vietnam could continue to

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<sup>128</sup> Office of the United States Trade Representative, *United States and Vietnam Renew Trade Dialogue During Trade and Investment Framework Agreement (TIFA) Meetings* (Washington D.C.: U.S. Government, 2017), <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2017/march/us-and-vietnam-renew-trade-dialogue>.

<sup>129</sup> Office of the United States Trade Representative, *2017 National Trade Estimate Report on Foreign Trade Barriers* (Washington D.C.: U.S. Government, 2017), <https://ustr.gov/sites/default/files/files/reports/2017/NTE/2017%20NTE.pdf>.

<sup>130</sup> United Nations Conference on Trade and Development, *World Investment Report 2018: Investment and New Industrial Policies: Country Fact Sheet: Viet Nam* (New York: United Nations, 2018), [http://unctad.org/sections/dite\\_dir/docs/wir2018/wir18\\_fs\\_vn\\_en.pdf](http://unctad.org/sections/dite_dir/docs/wir2018/wir18_fs_vn_en.pdf).

<sup>131</sup> PricewaterhouseCoopers, *Spotlight on Viet Nam*, 2017.

<sup>132</sup> General Statistics Office, "Foreign Direct Investment Projects Licensed in 2017 by Main Counterparts" (Hanoi: Government of Vietnam, 2018), <https://www.gso.gov.vn/SLTKE/pxweb/en/04.%20Investment/-/E04.16.px/table/tableViewLayout1/?rxid=5a7f4db4-634a-4023-a3dd-c018a7cf951d>.

<sup>133</sup> Bureau of Economic Analysis, U.S. Department of Commerce, *U.S. Direct Investment Abroad: Balance of Payments and Direct Investment Position Data* (Washington D.C.: U.S. Government, 2018), <https://www.bea.gov/international/di1usdbal.htm>; "Balance of Payments (Data Based on BPM5)," Bank of Japan, <http://www.boj.or.jp/en/statistics/br/bop/index.htm/>.

<sup>134</sup> Organization for Economic Cooperation and Development (OECD), "Outward Activity of multinationals by Country of Location- ISIC, Rev 3," OECD.stat, October 10, 2018, [https://stats.oecd.org/Index.aspx?DataSetCode=AFA\\_OUT3\\_PARTNER#](https://stats.oecd.org/Index.aspx?DataSetCode=AFA_OUT3_PARTNER#).

<sup>135</sup> PricewaterhouseCoopers, *Spotlight on Viet Nam*, 2018.

<sup>136</sup> "Cargill in Vietnam inaugurates new aquaculture feed line," Cargill, May 3, 2017, <https://www.cargill.com/2017/cargill-vietnam-inaugurates-new-aquaculture-feed-line>.

grow as U.S. industries and firms in China seek new destinations in reaction to the recent U.S. Section 301 tariffs on Chinese imports.

**Table 3: FDI Inflows into Vietnam from Selected Counterparts**

Cumulative (2002–2016)			2016		
Country	FDI (USD million)	Percent of total	Country	FDI (USD million)	Percent of total
South Korea	50,554	17%	South Korea	7,965	30%
Japan	42,434	14%	Japan	3,036	11%
China	10,528	4%	China	2,137	8%
United States	10,142	3%	United States	430	2%
<b>Total</b>	<b>293,700</b>	<b>100%</b>	<b>Total</b>	<b>26,891</b>	<b>100%</b>

Source: Total registered capital. General Statistics Office (Vietnam), “Foreign Direct Investment Projects Licensed by Main Counterparts (Accumulation of Projects Having Effect as of 31/12/2017)” (Hanoi: Government of Vietnam, 2018), <https://www.gso.gov.vn/SLTKE/pxweb/en/04.%20Investment/-/E04.13.px/?rxid=5a7f4db4-634a-4023-a3dd-c018a7cf951d>.

Unlike the United States, Japan is already a substantial investor in Vietnam, second only to South Korea and well ahead of China.<sup>137</sup> Japan has been a major factor in Vietnam’s emergence as a center of manufacturing activity in Asia, concentrating its investment in transportation equipment, electric machinery, and metalworking, as well as finance and insurance.<sup>138</sup> According to the Japan External Trade Organization (JETRO), 1,700 Japanese companies have entered the Vietnamese market, and 70 percent of Japanese firms operating in Vietnam plan to expand their business.<sup>139</sup> Vietnam hosts a significant number of Japanese electronics companies that do simple assembly and basic research and development in the country, including Canon, Fujitsu, Tokyo Micro, Fuji Xerox, and Panasonic.<sup>140</sup> In the event that Thailand does not join CPTPP, Vietnam is poised to become a more important manufacturing hub in Southeast Asia for Japanese companies.

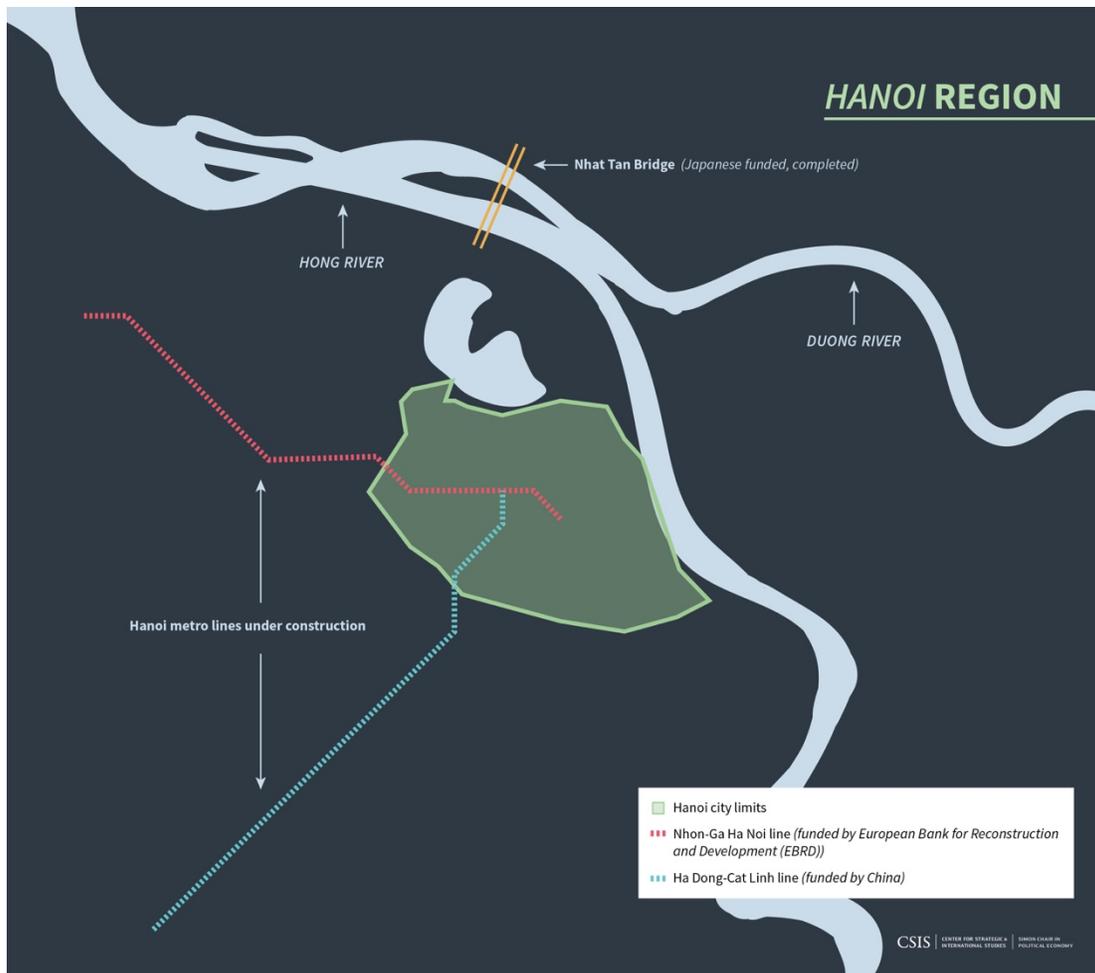
Japanese companies’ role in infrastructure investment is equally important to their role in manufacturing. Japan continues to outrank China as Vietnam’s largest source of infrastructure investment.<sup>141</sup> Unlike their U.S. counterparts, Japanese companies have effectively leveraged support from their government to secure contracts and finance major projects. Japanese companies have also been involved in urban infrastructure and in larger consortiums including non-Japanese entities, and Vietnam is looking to Japan for high-speed rail infrastructure development.

<sup>137</sup> Total registered capital. General Statistics Office (Vietnam), “Foreign Direct Investment Projects Licensed by Main Counterparts (Accumulation of Projects Having Effect as of 31/12/2017)” (Hanoi: Government of Vietnam, 2018), <https://www.gso.gov.vn/SLTKE/pxweb/en/04.%20Investment/-/E04.13.px/?rxid=5a7f4db4-634a-4023-a3dd-c018a7cf951d>.

<sup>138</sup> “Balance of Payments,” Bank of Japan.

<sup>139</sup> “Vietnam Attracts Foreign Investors,” Electronic Information Page Foreign Investment, <http://fdi-vietnam.com/foreign-investment-activities-in-vietnam/vietnam-attracts-foreign-investors.html>.

<sup>140</sup> Breu et al, *Sustaining Vietnam’s Growth*, 2012.



Japan has been particularly active in supporting energy projects. One project that suggests both the promise and pitfalls for these efforts is the private sector-led Vung Ang II power plant project. Jointly sponsored by Mitsubishi and a Hong Kong-based holding company, financed by the Japan Bank for International Cooperation (JBIC), involving General Electric as a prime engineering, procurement and construction contractor, the project aims to build a 1,200-megawatt coal-fired power plant in Ha Tinh province. Though the plant will help meet rising electricity demand in Vietnam, coal is increasingly regarded with suspicion by Vietnamese officials and citizens who are aware of the environmental impact.

In recent years, Japanese investment has begun to diversify out of manufacturing and infrastructure. JETRO reports that in 2016, half of new direct investment was not in the manufacturing sector, but in education, IT, hotels, and restaurants. Japanese firms also invest in Vietnam’s agricultural sector, with 43 high-tech agricultural projects recorded.<sup>142</sup> Kubota, for instance, has signed contracts worth over \$46.5 million to develop clean agriculture technology in Vietnam.<sup>143</sup> The JETRO Hanoi office places a clear

<sup>142</sup> Mizuho Research Institute, “Trends in Japan’s Foreign Direct Investment Toward Asia,” *Mizuho Economic Outlook & Analysis*, November 16, 2016, <https://www.mizuho-ri.co.jp/publication/research/pdf/eo/MEA171221.pdf>; “Vietnam Hi-tech Farming Needs Systemic Development,” Viet Nam News, September 6, 2017, <http://vietnamnews.vn/economy/393050/viet-nam-hi-tech-farming-needs-systemic-development.html#7bzTlozRPxmZE2yL.97>.

<sup>143</sup> PricewaterhouseCoopers, *Spotlight on Viet Nam*, 2017.

strategic focus on introducing Japanese investments into agricultural processing in Vietnam.<sup>144</sup> Recently, Japanese companies have also been jointly investing and cooperating with Korean companies. For example, Sumitomo and CJ Group are engaged in a joint venture to produce flour, and Swing Water and Hanshin jointly constructed a sewage treatment plant.<sup>145</sup> Therefore, Korean and Japanese investments are not necessarily exclusive, and more opportunities remain for future collaboration.

## FOREIGN ASSISTANCE

Though no longer a low-income country, Vietnam still receives a significant amount of official development aid. In 2016, Vietnam received \$2.9 billion in foreign aid, with 63 percent going to infrastructure and related services.<sup>146</sup> As suggested by the prominent roles of JICA and JBIC in supporting infrastructure investment in Vietnam, Japan is the largest aid donor, providing nearly \$1.6 billion.<sup>147</sup> Vietnam is Japan's second-largest aid beneficiary, following India.<sup>148</sup> Japan has provided aid worth over \$1 billion to Vietnam every year since 2012, a jump from the previous threshold of around \$600 million.<sup>149</sup> This aid is conducted through JICA, which sends over 100 experts in the country.<sup>150</sup> Most aid to Vietnam is in infrastructure and human resources, particularly in transport and communications.<sup>151</sup>

As with most Japanese investments, aid to Vietnam has focused on Hanoi, Ho Chi Minh City, and adjacent areas. The most recently announced project, and largest in 2017 by value, is a public sanitation project in Bien Hoa City, which was funded through Official Development Assistance loans provided by JICA worth \$247 million.<sup>152</sup> Many JICA projects in Vietnam like this one focus on soft infrastructure such as environmental management and private sector development, but few of its projects are service-based only, without a physical infrastructure component.<sup>153</sup>

In contrast, aid from the United States tends to focus on health and social infrastructure, as well as strengthening governance, access to education, gender equality, increased competition, environmental protection, legacies of war, and transparency. The United States disbursed \$138 million worth of foreign assistance to Vietnam in 2016, a significant increase over \$9 million in 2002,<sup>154</sup> albeit only a tenth of Japan's foreign aid towards Vietnam. Nearly all of this aid is in the form of grants.<sup>155</sup> The U.S. Agency for

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<sup>144</sup> Interview with JETRO Hanoi staff.

<sup>145</sup> Hung Le, "CJ, Sumitomo Cooperate in Flour Production," *The Saigon Times*, March 5, 2014, <http://english.thesaigontimes.vn/33341/CJ-Sumitomo-cooperate-in-flour-production.html>; "Hanshin E&C Lands 38 Bil. Won Wastewater Treatment Center Project in Vietnam," *The Korea Economic Daily*, June 22, 2015, <http://english.hankyung.com/business/2015/06/22/1534341/hanshin-ec-lands-38-bil-won-wastewater-treatment-center-project-in-vietnam>.

<sup>146</sup> OECD Development Assistance Committee, "Workbook: OECD DAC Aid at a glance by recipient," Tableau, [https://public.tableau.com/views/OECDDACAidataglancebyrecipient\\_new/Recipients?:embed=y&:display\\_count=yes&:showTabs=y&:toolbar=no&:showVizHome=no](https://public.tableau.com/views/OECDDACAidataglancebyrecipient_new/Recipients?:embed=y&:display_count=yes&:showTabs=y&:toolbar=no&:showVizHome=no).

<sup>147</sup> "Aid statistics by donor, recipient and sector: Recipient view," OECD, <https://www2.compareyourcountry.org/aid-statistics?cr=701&cr1=oeecd&lg=en&page=1>.

<sup>148</sup> "Aid statistics by donor, recipient and sector: Donor view," OECD, <https://www2.compareyourcountry.org/aid-statistics?cr=625&cr1=oeecd&lg=en&page=0>.

<sup>149</sup> "Aid (ODA) disbursements to countries and regions [DAC2a]," OECD, <http://stats.oecd.org/Index.aspx?DataSetCode=Table2A>.

<sup>150</sup> "Viet Nam: Japan's ODA (2015), JICA's Technical Cooperation (FY2015), JICA's ODA Loan, JICA's Grant Aid," Japan International Cooperation Agency (JICA), <https://www.jica.go.jp/vietnam/english/c8h0vm0000bkm9yp-att/vietnam.pdf>.

<sup>151</sup> "Aid (ODA) disbursements to countries and regions [DAC2a]," OECD, <http://stats.oecd.org/Index.aspx?DataSetCode=Table2A>.

<sup>152</sup> "Signing of Japanese ODA Loan Agreement with Vietnam: Supporting improvements to public sanitation through the provision of drainage and wastewater systems," JICA, August 31, 2017, [https://www.jica.go.jp/english/news/press/2017/170831\\_02.html](https://www.jica.go.jp/english/news/press/2017/170831_02.html). JICA provided loans worth ¥24.7 billion, or \$247 million as of the time of writing in October 2018.

<sup>153</sup> "Activities in Viet Nam," JICA, <https://www.jica.go.jp/vietnam/english/activities/index.html>.

<sup>154</sup> "U.S. Foreign Aid by Country: Vietnam," U.S. Agency for International Development (USAID), [https://explorer.usaid.gov/cd/VNM?fiscal\\_year=2002&measure=Disbursements](https://explorer.usaid.gov/cd/VNM?fiscal_year=2002&measure=Disbursements).

<sup>155</sup> "Aid (ODA) disbursements to countries and regions [DAC2a]," OECD, <http://stats.oecd.org/Index.aspx?DataSetCode=Table2A>.

International Development (USAID) provides the vast majority of this aid, accounting for \$83 million spent on Vietnam in 2017. The USAID mission in Vietnam is fairly large, with 41 employees, many of whom are focused on HIV/AIDS and infectious diseases. This reflects USAID’s strategy of prioritizing healthcare, articulated in 2014 when it listed governance strengthening, healthcare, and environmental remediation through dioxin cleanup as its key areas of focus.<sup>156</sup> USAID’s Provincial Competitiveness Index has become an important aspect of national economic policy. However, the planned budget for 2018, though it still allocates the largest share to healthcare and other social services, also includes significant funding for security related projects.



Also unlike Japan, USAID has indicated that its priority regions are the Central Highlands, Northern Highlands, and Mekong Delta, largely rural areas outside major population centers.<sup>157</sup> Aid there focuses on HIV/AIDS care, conflict and security, and general environmental protection, with \$97 million spent on those three areas alone in 2016.<sup>158</sup> USAID has also done significant work on environmental sustainability

<sup>156</sup> “United States Country Development Cooperation Strategy (CDCS) for Vietnam USAID Assistance 2014-2019,” USAID, [https://www.usaid.gov/sites/default/files/documents/1861/USAID\\_Vietnam\\_CDCS\\_2Page\\_Fact\\_Sheet\\_Eng.pdf](https://www.usaid.gov/sites/default/files/documents/1861/USAID_Vietnam_CDCS_2Page_Fact_Sheet_Eng.pdf).

<sup>157</sup> “Vulnerable Populations,” USAID, <https://www.usaid.gov/vietnam/vulnerable-populations>.

<sup>158</sup> “U.S. Foreign Aid by Country: Vietnam,” USAID.

and cleanup as a legacy of war, including assisting with dioxin decontamination around the Da Nang Airport and conducting studies on dioxin remediation at Bien Hoa.<sup>159</sup>

**Table 4: Selected Donors’ Aid to Vietnam**

Donor	Priority Sectors	Priorities	Funding (2016, net, in USD million) <sup>160</sup>
Japan	Economic infrastructure, transport and communications	Hanoi, Ho Chi Minh City, and adjacent areas	1,166 (mostly loans)
USA	Healthcare, including HIV/AIDS, environmental cleanup, governance	Northern and Central Highlands, Mekong Delta (rural)	104 (mostly grants)
World Bank	Poverty alleviation, Infrastructure	Hanoi and Ho Chi Minh City areas and central coastline	621 (mostly loans)
ADB	Transportation, energy, poverty alleviation/social services	Domestic and regional connectivity, Central Highlands	271 (mostly loans)

#### PEOPLE-TO-PEOPLE TIES

The United States and Japan hold significant advantages in public opinion in Vietnam. Pew Research shows an impressive 86 percent of surveyed Vietnamese people held a favorable opinion of U.S. citizens in 2017. Though confidence in the U.S. president has declined from 71 to 58 percent since the election of Donald Trump, this has not translated into a more negative opinion of the United States more broadly.<sup>161</sup> There are some lingering differences by age group in perceptions of the United States, but the long-term trend is favorable. Almost 90 percent of 18- to 29-year-olds had a positive opinion of the United States, while just 60 percent of those over 50 did.<sup>162</sup>

Opinion of Japan is also highly positive, with 90 percent saying the Japan–Vietnam relationship was friendly, and 45 percent saying Japan is Vietnam’s most reliable friend.<sup>163</sup> There is also evidence that Japan’s development assistance is helping shape this favorable opinion, with 95 percent of survey respondents in a 2017 poll saying that aid from Japan is helpful to Vietnam’s development.

<sup>159</sup> “Vietnam Country Profile,” USAID, <https://www.usaid.gov/vietnam/documents/country-profile-2018>.

<sup>160</sup> “Aid (ODA) disbursements to countries and regions [DAC2a],” OECD, <http://stats.oecd.org/Index.aspx?DataSetCode=Table2A>.

<sup>161</sup> “Build your own chart: Tracking U.S. favorability and confidence in the U.S. president, 2002 to 2018,” Pew Research Center, October 1, 2018, <http://www.pewglobal.org/interactives/us-image/>.

<sup>162</sup> “40 years after fall of Saigon, Vietnamese see U.S. as key ally,” Pew Research Center, April 30, 2015, <http://www.pewresearch.org/fact-tank/2015/04/30/vietnamese-see-u-s-as-key-ally/>.

<sup>163</sup> “ASEAN Official Data Spreadsheet (October 23, 2017, English-language),” Ministry of Foreign Affairs (Japan) 「ASEAN 集計表タイプ公表資料 20171023 英文」, 外務省, <http://www.mofa.go.jp/files/000304074.pdf>.

**Table 4: Vietnamese Ties with the United States and Japan<sup>164</sup>**

Vietnamese Immigrants in Country		Vietnamese's Feelings Towards Country		
Country	Vietnamese Immigrants	Country	Favorable	Unfavorable
U.S.	1,343,000	U.S.	84%	11%
Japan	199,990	Japan	82%	15%

Sources: Migration Policy Institute, Statistics Japan, & Pew Research Center. See footnote for detail.

Including both native-born and foreign-born U.S. residents, Pew estimates that there are about 2 million Vietnamese in the United States.<sup>165</sup>

Educational ties between the United States and Vietnam have also grown significantly in recent years. Vietnam was the sixth largest source of foreign exchange students in the United States in the 2016–2017 school year, with over 20,000 Vietnamese students attending U.S. institutions at the undergraduate and graduate level, or enrolled in optional practical training programs. Of these students, 68 percent studied at the undergraduate level, with the largest contingent studying business and management.<sup>166</sup> Over 2,500 Vietnamese students attended intensive English language programs in 2017, the ninth largest cohort by country.<sup>167</sup>

After China, Japan is the second largest destination for Vietnamese students studying abroad, with over 61,000 students in 2017.<sup>168</sup> Additionally, over 26,000 Vietnamese students were in Japanese language institutes in 2017, and in a recent public opinion poll 58 percent of Vietnamese respondents reported interest in learning Japanese.<sup>169</sup>

Party-to-party ties with China are very strong and the three pillars of power in Vietnam—the party, the military, and security services—all hold deep suspicions of the United States. However, Vietnam public opinion of China is fairly negative, holding at a 10 percent approval rate in 2017,<sup>170</sup> and the Vietnam public's confidence in the Chinese leader has dwindled from 31 percent in 2014 to 20 percent in 2015 and 18 percent in 2017.<sup>171</sup> These negative views act as a major brake on the Vietnamese government pulling closer to China.

<sup>164</sup> Estimate for Vietnamese in Japan as of end of 2016. Estimate for Vietnamese immigrants to U.S. as of 2017. Poll of Vietnamese's feelings about Japan dates to 2015. Poll of Vietnamese's feelings towards the U.S. dates to 2017. Elijah Alperin and Jeanne Batalova, "Vietnamese Immigrants in the United States," Migration Policy Institute, September 13, 2018, <https://www.migrationpolicy.org/article/vietnamese-immigrants-united-states>; "Chapter 2: Demography/Households: 2-8: Foreign Residents by Nationality," Statistics Japan, 「国籍別在留外国人数」, 総務省統計局, <http://www.stat.go.jp/data/nihon/02.html>; Bruce Stokes, "How Asia-Pacific Publics See Each Other and Their National Leaders," Pew Research Center, September 2, 2015, <http://assets.pewresearch.org/wp-content/uploads/sites/2/2015/09/Pew-Research-Center-Asian-Views-of-Each-Other-Report-FINAL-September-2-2015.pdf>.

<sup>165</sup> "Vietnamese in the U.S. Fact Sheet," Pew Research Center, <http://www.pewsocialtrends.org/fact-sheet/asian-americans-vietnamese-in-the-u-s-fact-sheet/>.

<sup>166</sup> "Open Doors Fact Sheet: Vietnam," Institute of International Education, 2017, <https://p.widencdn.net/mpk0cg/Open-Doors-2017-Country-Sheets-Vietnam>.

<sup>167</sup> Institute of International Education, "Places of Origin," Intensive English Programs, <https://www.iie.org/Research-and-Insights/Open-Doors/Data/Intensive-English-Programs/Places-of-Origin>.

<sup>168</sup> "International Students in Japan 2017," Japan Student Services Organization, December 2017, [http://www.jasso.go.jp/en/about/statistics/intl\\_student/data2017.html](http://www.jasso.go.jp/en/about/statistics/intl_student/data2017.html).

<sup>169</sup> Japan Student Services Organization, "International Students," 2017; Ministry of Foreign Affairs (Japan), "ASEAN Official," 2017.

<sup>170</sup> "Global Indicators Database, Vietnam: Opinion of China," Pew Research Center, <http://www.pewglobal.org/database/indicator/24/country/239/>.

<sup>171</sup> Ibid.

## Recommendations on Vietnam

Other than Singapore, Vietnam is arguably the most important partner for the United States and Japan in Southeast Asia when it comes to advancing a rules-based economic order in the Indo-Pacific. The country's historic suspicion of China and acceptance of higher standards in TPP negotiations makes Hanoi open to proposals from Washington and Tokyo for domestic economic reform and joint action in regional rule-making and norm-setting. Washington and Tokyo should enhance their individual and collective efforts to promote a more open, engaged Vietnam.

### UNITED STATES

- 1. Use the U.S.–Vietnam Trade and Investment Framework Agreement (TIFA) to address market access and structural problems in Vietnam's economy.** After the U.S. withdrawal from TPP, the TIFA remains the best venue to address key sticking points between the two countries on trade policy. U.S. officials should use the TIFA to establish clear goals and recommended actions for change in Vietnamese policies, such as those listed in the Office of the U.S. Trade Representative's annual National Trade Estimate Report on Foreign Trade Barriers. Progress on these issues would not only increase U.S. commercial opportunities in Vietnam but also strengthen the country's economy and make it a more capable partner.
- 2. Work to build Vietnam's administrative capacity.** Vietnam suffers from under-developed trade, regulatory, and tax management systems. The United States should step up its existing capacity-building efforts in the country. In 2001 and 2010, USAID initiated the Support for Trade AcceleRation (STAR) projects to help Vietnam open its economy, encourage growth, and fulfill its bilateral trade agreement with the United States.<sup>172</sup> STAR's second iteration in 2010–2012 primarily focused on preparing Vietnam for TPP requirements. Its final report deemed STAR successful at addressing Vietnam's regulatory and legal infrastructure and lending technical support toward Vietnam's entrance into the World Trade Organization and the U.S.–Vietnam Bilateral Trade Agreement.<sup>173</sup> STAR's success provides both a reason to be optimistic about the possibilities of a new program, and, potentially, a model for future capacity-building programs. Vietnam's weak tax administration system creates bottlenecks for public investment and financial vulnerabilities. The United States should commit to further technical assistance and capacity building in tax administration in Vietnam. In this regard, the U.S. Department of the Treasury should appoint a financial attaché to the U.S. Embassy in Hanoi.
- 3. Strengthen ties between the U.S. business community and government.** Though the United States maintains a robust business presence in Vietnam, the American Chamber of Commerce (AmCham) in Hanoi and Ho Chi Minh City remain under-utilized resources to coordinate concerns among business leaders and convey them to officials in Washington and Hanoi. AmCham should align initiatives between the two chapters and create a new structure to coordinate all U.S. business promotion in Vietnam.

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<sup>172</sup> "Vietnam—Support for Trade Acceleration Project (STAR I, II, Plus)," DAI, <https://www.dai.com/our-work/projects/vietnam-support-trade-acceleration-project-star-i-ii-plus>; USAID, *Performance Evaluation of the USAID/Vietnam Support for Trade Acceleration (STAR) Project: Final Report*, (Washington, D.C.: USAID, May 2011), [https://pdf.usaid.gov/pdf\\_docs/pdacs486.pdf](https://pdf.usaid.gov/pdf_docs/pdacs486.pdf).

<sup>173</sup> USAID, *Performance Evaluation*, 2011.

## JAPAN

- 1. Support investment in energy and include U.S. companies.** Vietnam's sizeable energy needs will continue to grow to meet the demands of a rapidly growing economy. Japanese companies, in partnership with JICA and JBIC, have the expertise and experience to help Vietnam use its resources effectively and produce sufficient power. However, some energy sources, notably coal, hydropower, and oil, face significant political constraints, either due to environmental damage or the maritime dispute with China in the South China Sea. The Japanese government needs to propose energy projects that contribute to the sound development of natural resources and produce sufficient power to help meet Vietnam's future needs.
- 2. Invest in healthcare.** Japanese businesses and the Japanese government have significant advantages in healthcare but have not been correspondingly active in providing health support through development assistance and new investments, especially given Vietnam's rapidly aging population and ongoing public health needs. Given the Vietnamese government's stretched budget, new public-private partnership frameworks need to be set up to exploit the huge demand. Japan should encourage U.S. involvement in supplying modern medical equipment and IT solutions for new facilities.

## JOINT ACTION

- 1. Support Vietnam's capacity to meet CPTPP commitments.** While negotiating TPP, Vietnam agreed to compromise with the United States on issues including intellectual property, customs, and labor standards. Had the United States not dropped out of TPP, it would likely have worked with Japan and other nations to build Vietnam's human capital and administrative capacity, enabling Vietnam to implement its TPP commitments. Though the United States is not a party to CPTPP, follow-through for Vietnam on these points would still serve U.S. interests and those of CPTPP member Japan. Tokyo and Washington should coordinate to provide technical know-how and human capacity building to Vietnam's government to help Vietnam to meet its commitments in CPTPP and other trade agreements.
- 2. Coordinate on major projects in energy and infrastructure.** Few Japanese-funded projects in this study—except the Vung Ang 2 plant—feature U.S. partners or subcontractors, despite significant potential gains from incorporating U.S. technical expertise, financing, and political support. This lack of collaboration in many cases stems from U.S. company representatives and embassy officials being unaware of new projects and loans. Energy and infrastructure are two key needs for Vietnam's economic development that could be better serviced through Japanese-U.S. collaboration, and where JBIC, JICA, Export-Import Bank of the United States, USAID, and other agencies can commit more resources.
- 3. Establish a trilateral business forum.** While both Japanese and U.S. businesses engage with Vietnamese government officials in the Vietnam Business Forum, this venue is also open to business representatives from other countries, often with competing interests and visions for economic development in Vietnam. A trilateral, multi-stakeholder forum between Vietnamese, U.S., and Japanese private and public-sector officials will ensure that U.S. and Japanese core commercial interests are addressed, for example when Suntory and Pepsi mobilized the local embassies to cooperate in addressing a tax issue.<sup>174</sup>

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<sup>174</sup> Interview with the Japanese Embassy in Hanoi.

- 4. Expand support for education.** Vietnam urgently needs stronger educational institutions to improve governance and meet the demand for high-skilled labor due to its shift from low value-added manufacturing. The United States should build on the success of Fulbright University Vietnam by expanding funding and support for educational institutions, particularly in the Hanoi area. Given significant Vietnamese demand for STEM skills and study in Japan, the Japanese government should commit more development assistance and work with Japanese businesses to support technical education in Vietnam.

# Case Study #3 | India

As the world’s most populous democracy, its seventh-largest economy, and a nuclear power, India holds pivotal importance for U.S. and Japanese regional ambitions. Though past U.S. and Japanese administrations have struggled to forge a lasting partnership with India, the increasing strategic convergence between Washington, Tokyo, and New Delhi promises prospects for renewed engagement over shared interests. U.S. and Japanese businesses already have a significant presence in the country but continue to face significant barriers to entry and expansion that in turn impede the growth and development of the Indian economy. If India can improve the ease of doing business for foreign and domestic firms—through both domestic reforms and increased infrastructure—increased trade should naturally follow.

The Japanese government and Japanese development agencies have also been actively involved in initiatives such as the Delhi–Mumbai Industrial Corridor and the Mumbai–Ahmedabad High Speed Rail line. The Trump and Abe administrations should continue to support India’s reform and market opening while working with the Modi government to strengthen subnational economic cooperation between U.S. states, Japanese prefectures, and Indian states, particularly in energy and connective infrastructure.



## *U.S. and Japanese Strategic Interests and Objectives*

India's economic size, its status as a great power with significant naval as well as nuclear capabilities, and its geographic location make the country a critical strategic partner for the United States and Japan. Washington and Tokyo have a strong interest in seeing New Delhi continue to play the role of a counterweight to Beijing, particularly in South Asia where China has cultivated closer diplomatic, economic, and security relationships with India's neighbors. U.S. Deputy Assistant Secretary for East Asian and Pacific Affairs Alex Wong has observed that as a liberal democracy, India "can bookend and anchor the free and open order in the Indo-Pacific region, and it's our policy to ensure that India does play that role, does become over time a more influential player in the region."<sup>175</sup>

The United States and Japan also have a significant interest in the continued growth of the Indian economy, as well as in ensuring access to what may one day be the largest consumer market in the world. India has the potential to be a major destination for U.S. and Japanese exports and investment. In addition, much like Japan's emergence as a major advanced democracy during the Cold War, India's transition to a stronger, more outward-focused economy could also make it an important player in regional rule-making and norm-setting.

Priorities for the U.S. and Japan include fostering closer business ties, encouraging continued economic reforms and market opening, and creating the environment for a more robust set of bilateral trade and investment relationships. Moreover, China's attempts to finance new infrastructure projects with military dual-use potential in Pakistan, Sri Lanka, and Bangladesh present an opportunity for Washington and Tokyo to engage with New Delhi in supporting high-standard infrastructure investment.<sup>176</sup>

Both the United States and Japan have pursued increased engagement with India, and the Indian government has sought increased engagement in return. India is central to the "free and open Indo-Pacific" strategy, an Abe government initiative adopted by the Trump administration to promote freedom and openness for nations in the Indo-Pacific: domestic political freedom as well as freedom from coercion and corruption; openness to communication, maritime trade, and foreign investment as well as open logistics through infrastructure improvements.<sup>177</sup> The Abe government has wedded its Indo-Pacific strategy to India's Act East policy through the Asia-Africa Growth Corridor, which aims to enhance connectivity between Japan, India, and several African countries.<sup>178</sup>

In line with the Indo-Pacific strategy, the Department of Defense recently renamed the U.S. Pacific Command the U.S. Indo-Pacific Command.<sup>179</sup> Moreover, a quadrilateral forum among nations with implicit interests in preventing Chinese regional hegemony—the United States, Japan, India, and Australia, also known as the "quad"—has gradually stepped up security cooperation and relaunched an official security

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<sup>175</sup> Alex Wong, "Briefing on the Indo-Pacific Strategy," U.S. Department of State (April 2, 2018), <https://www.state.gov/r/pa/prs/ps/2018/04/280134.htm>.

<sup>176</sup> PTI, "India, U.S., Japan to work together in Indo-Pacific for 'projects that make economic sense,' to oppose China's economic behavior," *First Post*, April 20, 2018, <https://www.firstpost.com/india/india-us-japan-to-work-together-in-indo-pacific-for-projects-that-make-economic-sense-to-oppose-chinas-economic-behaviour-4439019.html>.

<sup>177</sup> Wong, "Briefing," 2018.

<sup>178</sup> International Cooperation Bureau, *Priority Policy for Development Cooperation* (Tokyo: Japan Ministry of Foreign Affairs, 2017), 9, <https://www.mofa.go.jp/files/000259285.pdf>.

<sup>179</sup> Scott Neuman, "In Military Name Change, U.S. Pacific Command Becomes U.S. Indo-Pacific Command," *National Public Radio*, May 31, 2018, <https://www.npr.org/sections/thetwo-way/2018/05/31/615722120/in-military-name-change-u-s-pacific-command-becomes-u-s-indo-pacific-command>.

dialogue in November 2017.<sup>180</sup> Japan has already joined the U.S.–India Malabar naval exercise;<sup>181</sup> India has not yet agreed to Australia joining the Malabar exercise,<sup>182</sup> but experts expect quadrilateral security exercises in the future,<sup>183</sup> with freedom of navigation as an objective.<sup>184</sup>

Terrorism was a major topic of the 2017 quadrilateral summit,<sup>185</sup> and the United States and Japan both have bilateral counter-terrorism working groups with India.<sup>186</sup> At the U.S.–India 2+2 Dialogue in September 2018, the United States and India agreed to deepen ties at the United Nations and Financial Action Task Force regarding counterterrorism. The countries also signed an agreement to help India obtain critical defense technologies from the United States and access communication networks that would ensure interoperability between U.S. and Indian armed forces.<sup>187</sup>

## *Political and Economic Landscape*

### **INDIA'S ECONOMIC POLICY PRIORITIES**

India is one of the fastest-growing economies in the world, with an average annual growth rate of 7.3 percent since Prime Minister Modi took office in 2014.<sup>188</sup> India is projected to grow between 4 and 8 percent per year through mid-century, which would make it the world's third-largest economy in nominal terms and second-largest economy in purchasing power parity by 2050.<sup>189</sup>

Despite impressive headline growth, India remains a relatively poor country, with significant structural issues impeding growth. India's GDP per capita was \$1,749 in 2016, only 22 percent of China's.<sup>190</sup> This low GDP in part reflects India's ongoing struggles in economic management and inclusive growth, expressed in the country's poverty rate: an estimated 73 million Indians live in extreme poverty.<sup>191</sup>

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<sup>180</sup> Jesse Barker Gale and Andrew Shearer, "The Quadrilateral Security Dialogue and the Maritime Silk Road Initiative," Center for Strategic and International Studies, April 2, 2018, <https://www.csis.org/analysis/quadrilateral-security-dialogue-and-maritime-silk-road-initiative>.

<sup>181</sup> Ankit Panda, "U.S., Japan, India Hold Trilateral Ministerial Meeting on UN Sidelines," *The Diplomat*, September 19, 2017, <https://thediplomat.com/2017/09/us-japan-india-hold-trilateral-ministerial-meeting-on-un-sidelines/>.

<sup>182</sup> Emanuele Scimia, "Malabar 2018: India deals a blow to Australia and 'the quad'," *Asia Times*, May 1, 2018, <http://www.atimes.com/malabar-2018-india-deals-a-blow-to-australia-and-the-quad/>.

<sup>183</sup> "U.S., India, Japan, Australia to Plan Actions on South China Sea," Voice of America Learning English, February 7, 2018, <https://learningenglish.voanews.com/a/us-india-japan-australia-to-plan-actions-on-south-china-sea/4241884.html>.

<sup>184</sup> Indrani Bagchi, "India, U.S., Japan, Australia hold first meet; to work for open Indo-Pacific zone," *The Times of India*, November 13, 2017, <https://timesofindia.indiatimes.com/india/quadrilateral-coalition-india-us-japan-and-australia-hold-first-meeting-of-officials-on-indo-pacific-cooperation/articleshow/61617951.cms>.

<sup>185</sup> Jesse Barker Gale and Andrew Shearer, "The Quadrilateral Security Dialogue and the Maritime Silk Road Initiative," Center for Strategic and International Studies, April 2, 2018, <https://www.csis.org/analysis/quadrilateral-security-dialogue-and-maritime-silk-road-initiative>.

<sup>186</sup> "Joint Statement on the 15th Meeting of the India–U.S. Working Group on Counterterrorism," U.S. Department of State, March 27, 2018, <https://www.state.gov/r/pa/prs/ps/2018/03/279587.htm>; "The 5th Meeting of the Japan–India Joint Working Group on Counter-Terrorism," Ministry of Foreign Affairs (Japan), November 8, 2017, [https://www.mofa.go.jp/fp/is\\_sc/page23e\\_000490.html](https://www.mofa.go.jp/fp/is_sc/page23e_000490.html).

<sup>187</sup> PTI, "2+2 talks: India, U.S. ink critical defense pact; discuss cross-border terror, H-1B visa issue," *The Times of India*, September 6, 2018, <https://timesofindia.indiatimes.com/india/22-talks-india-us-ink-critical-defence-pact-discuss-cross-border-terror-h-1b/articleshow/65702426.cms>.

<sup>188</sup> The World Bank, "India, GDP growth (annual %)" (Washington, D.C.: World Bank 2017), <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2017&locations=IN&start=1990>; Aprameya Rao and Kishor Kadam, "25 years of liberalization: A glimpse of India's growth in 14 years," *First Post*, July 7, 2016, <https://www.firstpost.com/business/25-years-of-liberalisation-a-glimpse-of-indias-growth-in-14-charts-2877654.html>.

<sup>189</sup> PricewaterhouseCoopers, *The Long View: How will the global economic order change by 2050?* (United Kingdom: PricewaterhouseCoopers LLP, 2017), 4, <https://www.pwc.com/gx/en/world-2050/assets/pwc-the-world-in-2050-full-report-feb-2017.pdf>.

<sup>190</sup> "GDP per capita, current prices, U.S. dollars per capita," International Monetary Fund, <http://www.imf.org/external/datamapper/NGDPDPC@WEO/OEMDC/ADVEC/WEOORLD/IND?year=2018>.

<sup>191</sup> Homi Kharas, Kristofer Hamel and Martin Hofer, "The start of a new poverty narrative," Future Development (blog), The Brookings Institution, June 19, 2018, <https://www.brookings.edu/blog/future-development/2018/06/19/the-start-of-a-new-poverty-narrative/>.

Though India's fiscal situation has improved in recent years, large deficits are still common: India's federal budget deficit has averaged 3.8 percent of GDP under Prime Minister Modi. The ratio of government debt to GDP has remained stable at about 69 percent, and the annual current account deficit has remained below 2 percent of GDP.<sup>192</sup> However, persistent fiscal and trade deficits constitute external vulnerabilities, and an oil shock would worsen the country's terms of trade. The financial system remains fragile, with high levels of non-performing loans held by state-owned banks that are saddled with weak governance.<sup>193</sup> Moreover, following several years of relatively high investment, India's investment rate has declined to 30 percent of GDP in 2017, which may presage a more sustained slowdown in growth overall.<sup>194</sup>

India's trade policy has also turned more protectionist in recent years. Modi's government removed India from trade talks with the European Union, Canada, and Australia; slowed talks on the Regional Comprehensive Economic Partnership (RCEP); and adopted a new Model Bilateral Investment Treaty, thus re-opening over 70 existing bilateral investment treaties.<sup>195</sup> Additionally, the United States has raised concerns over increased local content requirements in key sectors tied to Modi's Make in India policy.<sup>196</sup>

There have been some notable policy successes: among 30 reforms pending when Prime Minister Modi took office, the government has completed nine and made progress on 14 more.<sup>197</sup> Inflation has declined from 5.8 percent in fiscal 2014 to an estimated 3.6 percent in fiscal 2018, owing not only to the global decline of commodity prices but also to the Reserve Bank of India's move toward a more conventional monetary policy under former Reserve Bank Governor Raghuram Rajan and his successor Urjit Patel.<sup>198</sup> The Modi government has undertaken several new structural reforms that could boost growth over the

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<sup>192</sup> International Monetary Fund, *India: 2018 Article IV Consultation – Press Release; Staff Report; And Statement by the Executive Director for India*, (Washington, D.C.: International Monetary Fund 2018), 7, <https://www.imf.org/en/Publications/CR/Issues/2018/08/06/India-2018-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-Executive-46155>.

According to the IMF's most recent external debt stability framework, India's debt-stabilizing non-interest current account threshold is a deficit of 3.5 to 3.7 percent of GDP.

<sup>193</sup> International Monetary Fund, "India: 2017 Article IV, Consultation – Press Release; Staff Report; And Statement by the Executive Director for India," (Washington, D.C.: International Monetary Fund 2017), <https://www.imf.org/en/Publications/CR/Issues/2017/02/22/India-2017-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-Executive-44670>; International Monetary Fund, "India: 2018 Article IV Consultation – Press Release; Staff Report; And Statement by the Executive Director for India," (Washington, D.C.: International Monetary Fund 2018), 7, <https://www.imf.org/en/Publications/CR/Issues/2018/08/06/India-2018-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-Executive-46155>.

<sup>194</sup> Martin Wolf, "Modi's India is on course to top China for growth," *Financial Times*, February 6, 2018, <https://www.ft.com/content/e4998ab2-0a73-11e8-839d-41ca06376bf2>.

<sup>195</sup> Prabhash Ranjan, Harsha Vardhana Singh, Kevin James, and Ramandeep Singh, "India's model bilateral investment treaty: Are we too risk averse?" The Brookings Institution, August 1, 2018, <https://www.brookings.edu/research/indias-model-bilateral-investment-treaty-are-we-too-risk-averse/>; Arun S., "India's concerns slowing RCEP talks," *The Hindu*, July 25, 2017, <https://www.thehindu.com/business/Indias-concerns-slowing-rcep-talks/article19359808.ece>

<sup>196</sup> "United States raises concerns over local content requirement in India," *Economic Times*, February 9, 2016, <https://economictimes.indiatimes.com/news/economy/foreign-trade/united-states-raises-concerns-over-local-content-requirement-in-india/articleshow/50918939.cms>.

<sup>197</sup> "The Modi Government's Reform Program: A Scorecard," Center for Strategic and International Studies, <http://indiareforms.csis.org/>.

<sup>198</sup> Associated Press (AP), "Reserve Bank of India raises key lending rate to 6.25 percent," *India West*, June 6, 2018, [http://www.indiawest.com/news/india/reserve-bank-of-india-of-raises-key-lending-rate-to/article\\_f4e2f166-69bd-11e8-b4d6-5368495974c3.html](http://www.indiawest.com/news/india/reserve-bank-of-india-of-raises-key-lending-rate-to/article_f4e2f166-69bd-11e8-b4d6-5368495974c3.html); International Monetary Fund, *India: 2018 Article IV Consultation – Press Release; Staff Report; And Statement by the Executive Director for India* (Washington, D.C.: International Monetary Fund 2018), 7, <https://www.imf.org/en/Publications/CR/Issues/2018/08/06/India-2018-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-Executive-46155>.

The Indian fiscal year begins in April and ends in March, so "fiscal 2018" refers to April 2017 to March 2018.

medium to long term as well. Most significant is a national goods and services tax, implemented in July 2017, that is expected to reduce barriers to trade among India’s states and promote growth.<sup>199</sup>

Beneath these policy changes, the Indian economy has experienced some structural transformation along with fast growth. The value added by agriculture, forestry, and fishing has declined from 41.6 percent of GDP in 1973 to 15.5 percent in 2017, while services’ value added has risen from 28.8 percent to 48.9 percent of GDP over the same period.<sup>200</sup> Yet manufacturing value added has fallen from 17.4 percent of GDP in 2006 to 15.0 percent in 2017.<sup>201</sup> These numbers lag behind historical examples of industrial and post-industrial economies in East Asia, raising fears that India will not experience the same kind of productivity growth. The central challenge to India’s future economic performance is ensuring the high growth of recent years continues given the relatively low amount of export-oriented manufacturing.

Since his election as prime minister in 2014, Narendra Modi has launched several economic initiatives to create an advanced, competitive India; the main ones are outlined in the following table.

**Table 1: India’s Economic Policies**

Policy or Initiative	Date	Purpose	Priorities
<b>Make in India</b>	Sep 2014	Make India a manufacturing hub and major exporter.	<ol style="list-style-type: none"> <li>1. Create 100 million jobs and increase the manufacturing segment of GDP from 16 percent to 25 percent by 2022.</li> <li>2. Attract foreign investment in export sectors.</li> <li>3. De-license and de-regulate industries to improve efficiency.</li> <li>4. Improve intellectual property regulation and innovation registration systems.</li> </ol>
<b>Smart Cities Mission</b>	June 2015	Construct the infrastructure to accommodate rapid urbanization and facilitate productivity gains.	<ol style="list-style-type: none"> <li>1. Develop 100 smart cities and make improvements in 500 traditional cities, utilizing big data and digital technology to improve citizens’ quality of life.</li> </ol>
<b>Digital India</b>	July 2015	Connect citizens from rural areas to high-speed internet networks.	<ol style="list-style-type: none"> <li>1. Create sustainable electronic infrastructure, particularly analytics and e-commerce payment platforms.</li> <li>2. Provide government services online, such as voter ID card and school certificate distribution.</li> <li>3. Create an entirely digitally literate society.</li> </ol>

Sources: “Major Initiatives,” Prime Minister’s Office (India), [http://www.pmindia.gov.in/en/major\\_initiatives/make-in-india/](http://www.pmindia.gov.in/en/major_initiatives/make-in-india/); Amit Shanbaug, “Make in India: Employment generation to get a boost,” *The Times of India*, October 7, 2017, <https://timesofindia.indiatimes.com/india/make-in-india-employment-generation-to-get-a-boost/articleshow/60979303.cms>; “Make in India: The Vision, New Processes, Sectors, Infrastructure and Mindset,” Make in India, 2016, <http://www.makeinindia.com/article/-/v/make-in-india-reason-vision-for-the-initiative>; S. Chandra Kala, A. Sivarana, and S. Soundarya, “Impact of digitalization on business and profession in India,” *International Research Journal of Management Science and Technology* 9, no. 4 (2018): 242-246, [http://www.irjmst.com/article\\_pdf.aspx?id=6762.pdf](http://www.irjmst.com/article_pdf.aspx?id=6762.pdf).

<sup>199</sup> The World Bank, *India Development Update: India’s Growth Story* (Washington D.C.: The World Bank, 2018), <http://documents.worldbank.org/curated/en/814101517840592525/pdf/123152-REVISED-PUBLIC-MARCH14-IDU-March-2018-with-cover-page.pdf>.

<sup>200</sup> “Agriculture, forestry, and fishing, value added (% of GDP), India,” The World Bank, (<https://data.worldbank.org/indicator/NV.AGR.TOTL.ZS?locations=IN>); “Services, value added (% of GDP), India,” The World Bank, <https://data.worldbank.org/indicator/NV.SRV.TOTL.ZS?locations=IN>.

<sup>201</sup> “Manufacturing, value added (% of GDP), India,” The World Bank, <https://data.worldbank.org/indicator/NV.IND.MANF.ZS?locations=IN>.

Major obstacles currently hinder India's economic transition, and the government has inefficiencies at both the national and subnational level. Corruption is perhaps the single biggest constraint on India's achieving rapid, sustained, and inclusive growth. India is ranked 100th on the World Bank's Ease of Doing Business Survey and 81st on Transparency International's corruption perceptions index.<sup>202</sup> Transparency International's 2017 survey indicated that 69 percent of Indians had paid a bribe in exchange for public services within the past 12 months; over 60 percent reported paying bribes for IDs or registration, public schools, public hospitals, utilities, or police.<sup>203</sup>

High-quality infrastructure—critical for India to receive proper investment and increase its economic output—is in short supply. Despite large public expenditure on infrastructure investment (about 35 percent of GDP), India's government still expects to need investment of nearly \$1.5 trillion over the next decade to meet economic demand; this figure may underestimate demand and meet capacity only in the short term. The current infrastructure deficit amounts to 5 percent of total GDP.<sup>204</sup> Power is one sector with manifest room for improvement. Fewer than four of five Indians have access to electricity, and among rural households with electricity, only 7 percent report having no power outages.<sup>205</sup> Unreliability of electricity supply is in turn associated with a lower probability of villages adopting electricity where it is available.<sup>206</sup>

Centralized reforms and infrastructure development are further complicated by India's decentralized federal government system. India's constitution grants states the power to form and execute policies concerning energy, health, law and order, and environmental regulation, among others. As a result, state governments are powerful political agents in their own right. The federal government helps make democratic governance of India's large diverse population possible; however, decentralized power also means states vary widely in their policy agendas, willingness to work with New Delhi's priorities, and thoroughness in enacting reforms such as tackling corruption or environmental regulation.

## U.S.–Japan Economic Involvement in India

### TRADE RELATIONS

India primarily exports intermediate and consumer goods to Japan, such as chemicals and petroleum products, and imports capital and intermediate goods from Japan, especially machinery and metals.<sup>207</sup> In 2011, Japan and India signed the Comprehensive Economic Partnership Agreement, which covers both trade and services and aims to reduce or eliminate tariffs on over 94 percent of items traded between the

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<sup>202</sup> "Rankings & Distance to Frontier," *The World Bank: Doing Business, Measuring Business Regulations*, The World Bank, 2018, <http://www.doingbusiness.org/rankings?region=south-asia>; "Corruption Perceptions Index 2017," Transparency International, February 21, 2018, [https://www.transparency.org/news/feature/corruption\\_perceptions\\_index\\_2017](https://www.transparency.org/news/feature/corruption_perceptions_index_2017).

<sup>203</sup> Coralie Pring, "People and Corruption: Asia-Pacific – Global Corruption Barometer," Transparency International, March 7, 2017, [https://www.transparency.org/whatwedo/publication/people\\_and\\_corruption\\_asia\\_pacific\\_global\\_corruption\\_barometer](https://www.transparency.org/whatwedo/publication/people_and_corruption_asia_pacific_global_corruption_barometer).

<sup>204</sup> Abhishek Dangra, "The Missing Piece in India's Economic Growth Story: Robust Infrastructure," August 2, 2016, *S&P Global*, <https://www.spglobal.com/our-insights/The-Missing-Piece-In-Indias-Economic-Growth-Story-Robust-Infrastructure.html>.

<sup>205</sup> "India's economy: Why the time for growth is now," McKinsey Global Institute, September 2016, <https://www.mckinsey.com/featured-insights/india/indias-economy-why-the-time-for-growth-is-now>; Noor Mohammad and Anuj Srivas, "Modi announces 100% electrification – but that doesn't mean everyone has power," *The Wire*, April 29, 2018, <https://thewire.in/government/narendra-modi-government-rural-electrification-power>; Sudeshna Gosh Banjeree, Douglas Barnes, Bipul Singh, Kristy Mayer, and Hussain Samad, *Power for All: Electricity Access Challenge in India*, (Washington, D.C.: The World Bank, 2015), 2, <https://openknowledge.worldbank.org/handle/10986/20525>.

<sup>206</sup> *Ibid.*, 30.

<sup>207</sup> World Integrated Trade Solution, "Product Exports to India by Japan 2016," The World Bank, <https://wits.worldbank.org/CountryProfile/en/Country/IND/Year/2016/TradeFlow/Export/Partner/JPN/Product/all-groups>; World Integrated Trade Solution, "Product Exports by Japan to India 2016," The World Bank, <https://wits.worldbank.org/CountryProfile/en/Country/JPN/Year/2016/TradeFlow/Export/Partner/IND/Product/all-groups>.

two nations within a decade of enactment.<sup>208</sup> However, bilateral trade volume, particularly Indian exports to Japan, has steadily declined since then. In 2017, reported exports to Japan totaled \$3.85 billion, while its imports from Japan amounted to \$9.63 billion.<sup>209</sup>

**Table 2: India’s Trade with Selected Partners (USD billion)**

Country	Exports		Imports	
	Fiscal 2018	%	Fiscal 2018	%
United States	46.1	15.8	26.6	5.7
China	12.5	4.4	76.4	16.4
Japan	4.5	1.6	10.9	2.4
Total	303.5	-	465.6	-

Note: sources used were from the government of India. Other national reports may reflect different numbers. “F2018” is fiscal 2018. Sources: India Export Import Data Bank, “Total Trade, Country-wise, China,” India Department of Commerce, October 10, 2018, <http://commerce-app.gov.in/eidb/>; India Export Import Data Bank, “Total Trade, Country-wise, USA,” India Department of Commerce, October 10, 2018, <http://commerce-app.gov.in/eidb/>; India Export Import Data Bank, “Total Trade, Country-wise, Japan,” India Department of Commerce, October 10, 2018, <http://commerce-app.gov.in/eidb/>

U.S. trade with India increased by 5.6 percent annually from 2011 to 2016. The United States was India’s top export market and second-largest import source, but India is not a top-10 import or export partner of the United States.<sup>210</sup> According to the Office of the U.S. Trade Representative, bilateral trade volume in 2016 amounted to \$115 billion, with the United States importing \$72.8 billion from India and exporting \$42.0 billion to India.<sup>211</sup> Major U.S. goods exports to India in 2017 were precious metal and stone, mineral fuels, and aerospace. Major import sectors were precious metal and stone, pharmaceuticals, mineral fuels, machinery, and miscellaneous textile articles.<sup>212</sup> While the United States is important to mitigating India’s trade deficit, the U.S. does not have a free trade agreement with India. In his first speech as U.S. Ambassador to India, Ken Juster recognized that economic relations have failed to keep up with the strategic relations when he said “a strategic view of our economic relationship could eventually lead to a roadmap for a U.S.-India Free Trade Agreement.”<sup>213</sup> However, RCEP appears the more likely trade mechanism to engage India in liberalization (see the chapter Regional Trade Architecture below).

### INVESTMENT RELATIONS AND MAJOR PROJECTS

Japan is India’s third-largest source of foreign direct investment (FDI). From 2006 to 2017, Japan’s net outward FDI to India was \$27.9 billion.<sup>214</sup> India’s share of Japan’s total outward FDI is minor but likely to increase, as India and Japan are complementary markets with great prospects for more trade and

<sup>208</sup> Masanori Kondo, “Japan–India Economic Relationship: Trends and prospects,” The Research Institute of Economy, Trade and Industry, August 2012, <https://www.rieti.go.jp/publications/pdp/12p016.pdf>.

<sup>209</sup> “India-Japan Economic Relations,” The Embassy of India in Tokyo, Japan, 2015, [https://www.indembassy-tokyo.gov.in/india\\_japan\\_economic\\_relations.html](https://www.indembassy-tokyo.gov.in/india_japan_economic_relations.html).

<sup>210</sup> India Export Import Data Bank, “Total Trade, Country-wise, USA,” India Department of Commerce, October 10, 2018, <http://commerce-app.gov.in/eidb/>; Office of the U.S. Trade Representative, *U.S.-India Bilateral Trade and Investment* (Washington D.C.: U.S. Government, 2018), <https://ustr.gov/countries-regions/south-central-asia/india>.

<sup>211</sup> Ibid.

<sup>212</sup> Ibid.

<sup>213</sup> Raymond Vickrey, “Is it finally time for a U.S. –India Free Trade Agreement?” Center for Strategic and International Studies, February 26, 2018, <https://www.csis.org/analysis/it-finally-time-us-india-free-trade-agreement>.

<sup>214</sup> Japan External Trade Organization (JETRO), “Japanese Trade and Investment Statistics” (Tokyo: JETRO, 2018), <https://www.jetro.go.jp/en/reports/statistics.html>.

investment. In 2014, Prime Minister Abe pledged \$35 billion of investment in India's public and private sectors by 2020,<sup>215</sup> and members of the India–Japan Business Cooperation Committee stated in January 2018 that FDI from Japan into India is likely to double by 2025.<sup>216</sup>

Japan has also partnered with India's manufacturing industry and supported Prime Minister Modi's Make in India and Skill India initiatives. Over the next decade, Japan hopes to train 30,000 Indian people at the Japan–India Institute for Manufacturing.<sup>217</sup> There are some signs that private Japanese investment in India is expanding. As of October 2016, over 1,300 Japanese companies have registered in India, an increase of 6 percent compared to 2015.<sup>218</sup>

According to a 2017 Japan Bank for International Cooperation (JBIC) survey, India is the second most preferred investment destination by Japanese manufacturing companies over both the medium and long term. However, as of 2016 India did not rank among the top five Asian countries in terms of resident overseas subsidiaries of Japanese corporations. The 2017 JBIC survey shows that the top three hurdles for Japanese companies are unclear execution of the legal system, underdeveloped infrastructure, and a complicated tax system.<sup>219</sup>

The Japan–India Information and Communication Technology (ICT) Comprehensive Cooperation Framework was launched in October 2013, but the Japanese government is proposing to replace this with a Japan–India Digital Partnership, which would aim to connect Japanese hardware and tech firms to India's software and start-ups in order to address cyber, ICT infrastructure, submarine cable, and biometric security concerns. The Japan–India Startup Hub was also formed in 2017 to encourage the entry of start-ups into each other's markets, tech incubators in India, and the transfer of know-how, with the aim of creating a new hub of innovation in Bangalore.<sup>220</sup>

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<sup>215</sup> Embassy of India in Tokyo, Japan, "India–Japan Economic Relations," (Tokyo: Embassy of India, 2018), [https://www.indembassy-tokyo.gov.in/india\\_japan\\_economic\\_relations.html](https://www.indembassy-tokyo.gov.in/india_japan_economic_relations.html).

<sup>216</sup> Arshad Khan, "Foreign Direct Investment inflows from Japan are set to double by 2025," *The New Indian Express*, January 24, 2018, <http://www.newindianexpress.com/business/2018/jan/24/foreign-direct-investment-inflows-from-japan-set-to-double-by-2025-1762502.html>.

<sup>217</sup> Ministry of Foreign Affairs (Japan), "Japan–India Relations (Basic Data)" (Tokyo: Japanese Government, 2018), <https://www.mofa.go.jp/region/asia-paci/india/data.html>.

<sup>218</sup> Embassy of India, "India–Japan Economic Relations," 2018.

<sup>219</sup> "FY2017 Survey (the 29th) Report on Overseas Business Operations by Japanese Manufacturing Companies," Japan Bank for International Cooperation (JBIC), November 22, 2017, <https://www.jbic.go.jp/en/information/press/press-2017/1122-58812.html>.

<sup>220</sup> "Joint Statement Between Ministry of Economy, Trade and Industry of Japan, and Ministry of Commerce and Industry, Government of India," opened for signature May 1, 2018, *Japan Ministry of Economy, Trade and Industry Press*, <http://www.meti.go.jp/press/2018/05/20180507005/20180507005-1.pdf>.

**Table 3: FDI Inflows into India from Selected Counterparts (USD million)**

Cumulative (April 2000 to June 2018)			Fiscal 2018		
Mauritius	129,073	33%	Mauritius	15,941	36%
Singapore	73,289	19%	Singapore	12,180	27%
Japan	28,160	7%	Japan	1,610	4%
United States	22,765	6%	United States	2,095	5%
China	2,058	0.5%	China	350	0.1%
<b>Total</b>	<b>355,758</b>	<b>100%</b>	<b>Total</b>	<b>44,857</b>	<b>100%</b>

Note: The Government of India's FDI statistics measure investments from the point of last departure. Mauritius and Singapore have historically had tax agreements with India that encouraged third-country investors to go through them to channel FDI into India. Sources: India Department of Industrial Policy and Promotion, *FDI Statistics*, (New Delhi: India Ministry of Commerce and Industry, 2018), <http://dipp.nic.in/publications/fdi-statistics>. India Department of Industrial Policy and Promotion, *Quarterly Fact Sheet: Fact Sheet on Foreign Direct Investment (FDI) From April, 2000 to March, 2018* (New Delhi: India Ministry of Commerce and Industry, 2018), [http://dipp.nic.in/sites/default/files/FDI\\_FactSheet\\_29June2018.pdf](http://dipp.nic.in/sites/default/files/FDI_FactSheet_29June2018.pdf); India Department of Industrial Policy and Promotion, *Quarterly Fact Sheet: Fact Sheet on Foreign Direct Investment (FDI) From April, 2000 to March, 2017* (New Delhi: India Ministry of Commerce and Industry, 2017), [http://dipp.nic.in/sites/default/files/FDI\\_FactSheet\\_January\\_March2017.pdf](http://dipp.nic.in/sites/default/files/FDI_FactSheet_January_March2017.pdf); Suraj Jaiswal, "Netherlands becoming FDI 'round tripping' haven like Mauritius, Singapore?" *Business Standard*, April 21, 2018, [https://www.business-standard.com/article/economy-policy/netherlands-becoming-fdi-round-tripping-haven-like-mauritius-singapore-118042100148\\_1.html](https://www.business-standard.com/article/economy-policy/netherlands-becoming-fdi-round-tripping-haven-like-mauritius-singapore-118042100148_1.html).

The United States is the sixth-largest foreign investor in India, with over \$22 billion in FDI from April 2000 to June 2018, accounting for 6 percent of India's total FDI inflows.<sup>221</sup> Prime Minister Modi's economic stimulus initiatives and efforts to improve the nation's Ease of Doing Business Ranking will likely encourage U.S. companies to enter India; however, India's market still imposes many barriers to entry for foreign investors, with high tariffs, local content requirements, and varying state-level policies cited as key deterrents.<sup>222</sup>

Both the United States and Japan have bilateral energy cooperation agreements with India. In 2016, Japan signed a deal to export nuclear technology, equipment, and material to India.<sup>223</sup> The United States reached a civil nuclear agreement with India in 2008 but it has been stalled for a decade; stumbling blocks include India's 2010 legislation making suppliers liable for any accident and the bankruptcy of Westinghouse, one of the planned suppliers.<sup>224</sup> Prime Minister Modi and President Trump reportedly discussed how to move forward in 2017,<sup>225</sup> and the matter was further discussed during the 2+2 Dialogue in September 2018.<sup>226</sup>

<sup>221</sup> India Department of Industrial Policy and Promotion, *Quarterly Fact Sheet: Fact Sheet on Foreign Direct Investment (FDI) From April, 2000 to March, 2018*, (New Delhi: India Ministry of Commerce and Industry, 2018), [http://dipp.nic.in/sites/default/files/FDI\\_FactSheet\\_29June2018.pdf](http://dipp.nic.in/sites/default/files/FDI_FactSheet_29June2018.pdf)

<sup>222</sup> "India-Market Challenges," U.S. Department of Commerce, October 10, 2018, [www.export.gov/article?id=India-Market-Challenges](http://www.export.gov/article?id=India-Market-Challenges).

<sup>223</sup> Sharon Squassoni and Yukari Sekiguchi, "Japan-India Nuclear Cooperation Agreement," Center for Strategic and International Studies, November 21, 2016, <https://www.csis.org/analysis/japan-india-nuclear-cooperation-agreement>.

<sup>224</sup> Aman Malik, "Obama's India Visit: What can India and the U.S. do about the civil nuclear deal?" *International Business Times*, January 21, 2015, <https://www.ibtimes.com/obamas-india-visit-what-can-india-us-do-about-civil-nuclear-deal-1789416>; Indrani Bagchi, "Westinghouse capable of delivering India nuclear reactors: Rick Perry," *The Times of India*, April 17, 2018, <https://timesofindia.indiatimes.com/india/westinghouse-capable-of-delivering-india-nuclear-reactors-rick-perry/articleshow/63804113.cms>.

<sup>225</sup> PTI, "PM Modi-Trump talks: Civil nuclear deal to figure, no pact on reactors," *The Times of India*, June 25, 2017, <https://timesofindia.indiatimes.com/india/pm-modi-trump-talks-civil-nuclear-deal-to-figure-no-pact-on-reactors/articleshow/59311335.cms>.

<sup>226</sup> "India U.S. '2+2' dialogue live updates," *The Times of India*, September 6, 2018, <https://timesofindia.indiatimes.com/india/india-us-2-2-dialogue/liveblog/65689119.cms>.

India is a world leader in the global outsourcing market, and several U.S. firms have availed themselves of opportunities there. IBM, for instance, now employs more Indians than Americans.<sup>227</sup> Japan is also brainstorming on prospects for cooperation with India, such as how to integrate Japanese firms with Indian engineers to create an industrial base comparable to China's.<sup>228</sup> Gaining access to the Indian tech consumer market may prove more difficult; Indian regulators are reportedly drafting rules to protect their homegrown firms from U.S. tech behemoths like Amazon, Apple, Google, and Facebook.<sup>229</sup>

## FOREIGN ASSISTANCE

India received \$1.8 billion in official development assistance from Japan in 2016, more than it received from any other country, and more than any other country received from Japan.<sup>230</sup> Loans account for the vast majority of this assistance.<sup>231</sup> Japan's foreign aid policy focuses on improving the country's strategic relationship with members of the Indo-Pacific region, and its aid to India is conducted through the Japan International Cooperation Agency (JICA). From fiscal 2008 to fiscal 2017, JICA extended \$22 billion of loans to India: 62 percent in transport infrastructure, 14 percent in water and sanitation, 12 percent in energy, and 6 percent in forestry and agriculture.<sup>232</sup>

Investment priorities for Japan include power, transportation, and environmental projects such as the Ahmedabad–Mumbai High Speed Rail, the Delhi–Mumbai Industrial Corridor, and the Delhi Metro Project. Japan has become a major player in connectivity infrastructure in India, focusing on railways, highways, and power to remove key bottlenecks to growth and interstate trade. The most ambitious such project is the \$17 billion Mumbai–Ahmedabad high speed railway project, which broke ground in 2017 and, officials hope, will generate 20,000 jobs.<sup>233, 234</sup>

Although JICA and USAID have begun collaboration on development assistance in India, USAID's more limited resources and focus on grants have limited its scope. USAID disbursed \$123 million of aid to India in 2016, primarily in health: the two leading aid activities were the President's Emergency Plan for AIDS Relief and the Maternal and Child Survival Program.<sup>235</sup>

India continues to rely heavily on grant and loan assistance from the World Bank and ADB. The World Bank will help fund Prime Minister Modi's Skill India initiative by providing \$250 million to develop

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<sup>227</sup> Vindu Goel, "IBM now has more employees in India than in the U.S.," *The New York Times*, September 28, 2017, <https://www.nytimes.com/2017/09/28/technology/ibm-india.html>.

<sup>228</sup> Shusuke Murai, "Professionals from Japan and India brainstorm on future IT ties at Tokyo tech event," *Japan Times*, April 20, 2018, [https://www.japantimes.co.jp/news/2018/04/20/business/professionals-japan-india-brainstorm-future-ties-tokyo-tech-event/#.W5a2\\_UZKgdU](https://www.japantimes.co.jp/news/2018/04/20/business/professionals-japan-india-brainstorm-future-ties-tokyo-tech-event/#.W5a2_UZKgdU).

<sup>229</sup> Newley Purnell, "India looks to curb U.S. tech giants' power," *The Wall Street Journal*, August 13, 2018, <https://www.wsj.com/articles/india-looks-to-curb-u-s-tech-giants-power-1534178721>.

<sup>230</sup> Compare Your Country, "Gross disbursements of Official Development Assistance (ODA) in 2016," Organization for Economic Cooperation and Development, 2018, <https://www2.compareyourcountry.org/aid-statistics?cr=701&lg=en&page=20>.

<sup>231</sup> "India ODA," Ministry of Finance (Japan), 2016, <https://www.mofa.go.jp/mofaj/gaiko/oda/files/000142555.pdf>.

<sup>232</sup> Dollar amount converted from 2.46 trillion yen;

<sup>233</sup> "Operations and Activities in India," Japan International Cooperation Agency (JICA), March 2017, [https://www.jica.go.jp/india/english/office/others/c8h0vm0004cesxi-att/brochure\\_12.pdf](https://www.jica.go.jp/india/english/office/others/c8h0vm0004cesxi-att/brochure_12.pdf).

<sup>234</sup> "Mumbai–Ahmedabad High-Speed Link," *Railway Technology*, 2018, <https://www.railway-technology.com/projects/mumbai-ahmedabad-high-speed-link/>; ET Online, "India's first bullet train manages to drive through land acquisition deadlock," *The Economic Times*, July 6, 2018, <https://economictimes.indiatimes.com/industry/transportation/railways/indias-first-bullet-train-manages-to-drive-through-land-acquisition-deadlock/articleshow/64880783.cms>.

<sup>235</sup> Aashish Chandorkar, "Mumbai to Ahmedabad on the bullet train," *The Hindu Business Line*, September 12, 2017, <https://www.thehindubusinessline.com/opinion/mumbai-to-ahmedabad-on-the-bullet-train/article9856326.ece>.

<sup>235</sup> U.S. Agency for International Development (USAID), "U.S. Foreign Aid by Country, India," January 23, 2018, [https://explorer.usaid.gov/cd/IND?measure=Disbursements&fiscal\\_year=2016](https://explorer.usaid.gov/cd/IND?measure=Disbursements&fiscal_year=2016).

training programs at a local and national level.<sup>236</sup> The World Bank has also provided loans to improve various infrastructure projects in India such as the Rural Road Initiative. India has been the largest borrower of ADB’s sovereign lending since 2010. ADB provided India \$2.76 billion of loans in 2017, focusing on transportation, energy, urban infrastructure, and agriculture and natural resources; its 209 loans to India since 1986 total \$35.9 billion.<sup>237</sup>

### PEOPLE-TO-PEOPLE TIES

As of late 2016, there were about 9,000 Japanese nationals living in India and 31,000 Indian nationals living in Japan.<sup>238</sup> During Prime Minister Modi’s visit to Japan in 2016, Modi and Abe declared 2017 the Year of Japan–India Friendly Exchanges to improve people-to-people ties between the two nations. Indians and Japanese already have warm opinions of each other. According to a 2016 Pew Research Center poll, 54 percent of surveyed Japanese have a favorable view of India, while 24 percent have an unfavorable view; likewise, 44 percent of surveyed Indians have a positive view of Japan, while 22 percent have an unfavorable view.<sup>239</sup>

**Table 4: Indian Citizens’ Ties with the United States and Japan**

Indian Citizens Living in Country		Indians’ Feelings Towards Country		
Country	Indian Residents	Country	Favorable	Unfavorable
U.S.	1,280,000	U.S.	49%	9%
Japan	28,047	Japan	42%	15%

Sources: “Non-resident Indians and Persons of Indian Origin,” India Ministry of External Affairs, December 2016, <https://www.mea.gov.in/images/pdf/NRIs-and-PIOs.pdf>; Bruce Stokes, Dorothy Manevich and Hanyu Chwe, “Three Years in Modi Remains Very Popular: India and the World,” Pew Research Center, November 15, 2017, <http://www.pewglobal.org/2017/11/15/india-and-the-world>.

In a 2017 Pew poll, nearly half of surveyed Indians reported a positive view of the United States, with only 9 percent claiming an unfavorable view.<sup>240</sup> The United States is home to some four million people of Indian heritage, 1.28 million of them non-resident citizens of India.<sup>241</sup> Changes by the Trump administration to the H1-B visa for highly skilled immigrants, 75 percent of whom are Indian, caused the issue to be raised in the 2+2 ministerial dialogue in September 2018.<sup>242</sup> From 2007 to 2017, the number of Indian students in the United States doubled; India is the second-most common origin for international students in the United States, accounting for 17.3 percent of all international students. Of these students, 56 percent are

<sup>236</sup> “New World Bank project to give impetus to India’s skill’s agenda – to provide over 8 million youth with market-relevant training,” The World Bank, June 23, 2017, <http://www.worldbank.org/en/news/press-release/2017/06/23/new-world-bank-project-give-impetus-india-skills-agenda-to-provide-over-8mn-youth-with-market-relevant-training>.

<sup>237</sup> “Asian Development Bank Member Fact Sheet: India,” Asian Development Bank, 2017, <https://www.adb.org/sites/default/files/publication/27768/ind-2017.pdf>.

<sup>238</sup> “Japan–India Relations (Basic Data),” Japan Ministry of Foreign Affairs, September 25, 2017, <https://www.mofa.go.jp/region/asia-paci/india/data.html>.

<sup>239</sup> Bruce Stokes, “Hostile Neighbors: China vs. Japan,” Pew Research Center, September 13, 2016, <http://assets.pewresearch.org/wp-content/uploads/sites/2/2016/09/Pew-Research-Center-China-Japan-Report-FINAL-September-13-2016.pdf>.

<sup>240</sup> Ibid.

<sup>241</sup> “Indians in the U.S. Fact Sheet,” Pew Research Center, September 8, 2017, <http://www.pewsocialtrends.org/fact-sheet/asian-americans-indians-in-the-u-s/>; India Ministry of External Affairs, “Population of Overseas Indians, Non-resident Indians and Persons of Indian Origin” (New Delhi: Government of India, 2016), <https://www.mea.gov.in/images/pdf/NRIs-and-PIOs.pdf>.

<sup>242</sup> Dilsher Dhillon, “Indians accounted for 75% of all H1B visas in the U.S. in the last two years,” Business Insider, May 8, 2018, <https://www.businessinsider.in/indians-accounted-for-75-of-all-h1b-visas-in-the-us-in-the-last-two-years/articleshow/64079333.cms>; “2+2 Dialogue: COMCASA Signed; Iran Oil Import, H1B Visa Discussed,” The Quint, September 2018, <https://www.thequint.com/news/india/two-plus-two-dialogue-sushma-swaraj-nirmala-sitharaman>.

graduate students.<sup>243</sup> International tourism has also increased between India and the United States. In 2016, the United States had nearly 1.2 million tourist arrivals from India, and India had nearly 1.3 million tourist arrivals from the United States.<sup>244</sup> Indians spent an estimated \$13.6 billion on travel and tourism in the United States in 2016.<sup>245</sup>

## POLITICAL CONSTRAINTS

While the United States and India have a positive strategic partnership, frictions exist, particularly with trade. In 2018, the United States challenged Indian export subsidies at the World Trade Organization, claiming these subsidies hurt U.S. companies by unfairly allowing Indian exporters to sell cheaper goods.<sup>246</sup> It also initiated a review of India's eligibility for the Generalized System of Preferences, the United States' oldest and largest preferential trade program, due to compliance concerns.<sup>247</sup> The United States has formally denied India a blanket exemption from Section 232 tariffs on steel and aluminum exports, although it is open to a conditional waiver; the 25 percent steel duty hike coincided with a 42 percent year-on-year drop in Indian steel exports to the United States in the second quarter of 2018.<sup>248</sup> Moreover, the U.S. Department of the Treasury added India to its Monitoring List as of the April 2018 Foreign Exchange Report, citing India's purchases of foreign exchange and significant bilateral goods trade surplus with the United States.<sup>249</sup>

India has been the second-biggest importer of Iranian oil, reportedly accounting for 27 percent of Iran's oil exports for 2018 as of September 25.<sup>250</sup> News reports around that date indicated Indian firms will cease to import oil from Iran in November, when the U.S. sanctions on Iran are scheduled to be reinstated.<sup>251</sup> It is unclear whether the threat of secondary sanctions by the U.S. will likewise dissuade India from its plans to

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<sup>243</sup> Aditi Gyanesh, "Twelve percent increase in Indians studying in the U.S. in 2017," *The Times of India*, November 13, 2017, <https://timesofindia.indiatimes.com/home/education/news/12-increase-in-indians-studying-in-the-us-in-2017/articleshow/61630177.cms>.

<sup>244</sup> International Trade Association National Travel and Tourism Office, "India Profile: Arrivals to the U.S.," 2016, [http://tinet.ita.doc.gov/outreachpages/download\\_data\\_table/2016%20India%20Final.pdf](http://tinet.ita.doc.gov/outreachpages/download_data_table/2016%20India%20Final.pdf); India Ministry of Tourism Market Research Division, *India Tourism Statistics, 2017* (New Delhi: India Ministry of Tourism 2017), <http://tourism.gov.in/sites/default/files/Other/INDIA%20TOURISM%20STATISTICS%202017.pdf>.

<sup>245</sup> Ed Fuller, "How India has become a booming supplier of outbound tourists," *Forbes*, March 14, 2017, <https://www.forbes.com/sites/edfuller/2017/03/14/ignore-india-at-your-peril/#1f8d3d0e4225>.

<sup>246</sup> David Alexander and Tom Brown, "U.S. challenges Indian export subsidies at WTO-official," Reuters, March 14, 2018, <https://www.reuters.com/article/us-usa-trade-india/u-s-challenges-indian-export-subsidies-at-wto-official-idUSKCN1GQ2LZ>.

<sup>247</sup> Office of U.S. Trade Representative, "USTR Announces New GSP Eligibility Reviews of India, Indonesia, and Kazakhstan" (Washington D.C.: U.S. Government, 2018), <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/april/ustr-announces-new-gsp-eligibility>; Office of U.S. Trade Representative, "Generalized System of Preferences (GSP)" (Washington D.C.: U.S. Government, 2018), <https://ustr.gov/issue-areas/trade-development/preference-programs/generalized-system-preference-gsp>.

<sup>248</sup> Amiti Sen, "U.S. says no to unconditional withdrawal of penal tariff on India's steel, aluminum," *The Hindu Business Line*, September 27, 2018, <https://www.thehindubusinessline.com/news/us-says-no-to-unconditional-withdrawal-of-penal-tariff-on-indias-steel-aluminium/article25060485.ece>; Nidhi Verma and Malini Menon, "U.S. willing to exempt Indian steel, aluminum exports from high tariff with riders," Reuters, September 18, 2018, <https://www.reuters.com/article/us-usa-trade-steel/u-s-willing-to-exempt-indian-steel-aluminum-exports-from-high-tariff-with-riders-et-now-tv-channel-idUSKCN1LYOU4>; Asit Ranjan Mishra, "U.S. duty hikes begin to hurt as steel exports plunge 42 percent," *Live Mint*, September 4, 2018, <https://www.livemint.com/Industry/9BXk8pQSvYJXpku1mmMHYN/US-duty-hikes-begin-to-hurt-as-steel-exports-plunge-42.html>.

<sup>249</sup> U.S. Department of Treasury Office of Internal Affairs, *Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States* (Washington D.C.: U.S. Government, 2018), <https://home.treasury.gov/sites/default/files/2018-04/2018-04-13-Spring-2018-FX-Report-FINAL.pdf>.

<sup>250</sup> Debjit Chakraborty, Dhvani Pandya, and Javier Blas, "India is cutting imports of Iranian oil to zero in November," Bloomberg, September 26, 2018, <https://www.bloomberg.com/news/articles/2018-09-25/india-is-said-to-cut-imports-of-iranian-oil-to-zero-in-november-jmhy95z8>.

<sup>251</sup> Ibid; Bloomberg, "With U.S. sanctions set to kick in, India may not import Iranian oil in November," *The Times of India*, September 26, 2018, <https://timesofindia.indiatimes.com/business/india-business/as-us-sanctions-dawn-india-may-import-no-iranian-oil-in-november/articleshow/65960150.cms>.

procure the S-400 missile defense system from Russia.<sup>252</sup> Russia has supplied India with 62 percent of its arms between 2013 to 2017, despite major increases in U.S. arms exports to India in recent years.<sup>253</sup> Japan reached a memorandum of understanding in April 2018 after drawn-out negotiations to supply India with the US-2 amphibious aircraft produced by ShinMaywa Industries, which could be Japan's first arms export since the ban was lifted.<sup>254</sup>

India's Chabahar port project in Iran is another delicate issue for India-U.S. ties. India has agreed to invest over \$500 million in the port and its northbound rail connection, intended to allow Indian goods to bypass Pakistan on the way to Afghanistan and Central Asia.<sup>255</sup> Japan's officials have suggested they could participate in the project, including via development assistance.<sup>256</sup> While U.S. officials have been verbally supportive of the Indian project, they have also re-imposed economic sanctions that will penalize Indian companies doing business in Iran.<sup>257</sup> Indian delays and half-measures on the project have in turn triggered the Iranian government to threaten to end "special privileges" it extended to India.<sup>258</sup>

## Recommendations on India

As three of the largest democracies in the Indo-Pacific, the United States, Japan, and India have clear overlapping interests in promoting high-standard economic rules and norms and preventing regional overdependence on China. To this end, the United States and Japan should encourage India to become a more constructive player in regional economic rule-making and norm-setting.

### UNITED STATES

- 1. Engage with regional as well as national leadership.** Current U.S. policy focuses on New Delhi; however, within India's democratic federal government, the ability to enact on the ground reform and development requires active involvement from state governments. The United States should expand economic engagement with India's powerful state leaders and channel senior U.S. private sector engagement with India's state leaders to discuss reform priorities directly.<sup>259</sup>

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<sup>252</sup> PTI, "S-400 deal a 'significant transaction,' may lead to sanctions on India: U.S.," *The Times of India*, September 21, 2018, <https://timesofindia.indiatimes.com/india/s-400-a-significant-purchase-with-potential-caatsa-implications-says-us/articleshow/65897582.cms>; Daniel Cebul, "India to U.S.: Sanctions won't stop Russian air-defense system purchase," *Defense News*, June 7, 2018, <https://www.defensenews.com/global/asia-pacific/2018/06/07/india-to-us-sanctions-wont-stop-russian-air-defense-system-purchase/>.

<sup>253</sup> "Asia and the Middle East lead rising trend in arms imports, U.S. exports grow significantly, says SIPRI," Sipri, March 12, 2018, <https://www.sipri.org/news/press-release/2018/asia-and-middle-east-lead-rising-trend-arms-imports-us-exports-grow-significantly-says-sipri>.

<sup>254</sup> "Mahindra defence and Shinmaywa Industries Limited Join Hands for U.S.-2 Amphibious Aircraft," Mahindra Group, April 11, 2018, <http://www.mahindra.com/news-room/press-release/mahindra-defence-and-shinmaywa-industries-limited-join-hands-for-us-2-amphibious-aircraft>.

<sup>255</sup> Waslat Hastat-Nazimi, "Can India challenge China with new Iranian Chabahar Port?" DW, 2018, <https://www.dw.com/en/can-india-challenge-china-with-new-iranian-chabahar-port/a-41659083>.

<sup>256</sup> Sachin Parashar, "Japan interested in Chabahar project," *The Economic Times*, July 12, 2018, <https://economictimes.indiatimes.com/news/defence/japan-interested-in-chabahar-project/articleshow/54166416.cms>.

<sup>257</sup> Christopher Woody, "Trump is trying to increase the pressure on Iran, but that means 'threading the needle' with major ally," *Business Insider*, July 2, 2018, <https://www.businessinsider.com/us-backs-india-plan-for-chabahar-port-amid-increasing-pressure-on-iran-2018-7>.

<sup>258</sup> PTI, "Iran criticizes India for not making promised investments in Chabahar port," *The Times of India*, July 11, 2018, <https://timesofindia.indiatimes.com/business/india-business/iran-criticises-india-for-not-making-promised-investments-in-chabahar-port/articleshow/64937334.cms>.

<sup>259</sup> Wadhvani Chair in U.S. -India Policy Studies, "U.S. -India State and Urban Initiative," Center for Strategic and International Studies, 2018, <https://www.csis.org/programs/wadhvani-chair-us-india-policy-studies/us-india-state-and-urban-initiative>.

2. **Resolve trade issues and expand trade opportunities through active dialogue.** While the United States and India have grown closer on a diplomatic and security level, less attention has gone towards strengthening economic relations. Initiatives such as Modi's Make in India aim to foster innovation through tariff protections of key industries. The United States should use the existing U.S.–India Bilateral Trade Policy Forum to address differences at the World Trade Organization, and if possible explore the possibilities for expanded trade or a bilateral free trade agreement.<sup>260</sup>

## JAPAN

1. **Invest and develop high quality infrastructure and energy resources.** India's infrastructure and energy needs continue to grow exponentially as standards of living rise. A major constraint on further growth is lack of reliable infrastructure, including energy and transportation. Further development of energy sources and reliable energy grids are also essential. Through partnerships with JICA and JBIC, Japanese companies should explore projects such as railways, roads, and bridges that increase connectivity. In addition to pursuing energy grids, Japanese public–private partnerships should pursue creative means of providing energy to different regions, such as through renewable resources and energy storage.
2. **Remove obstacles and encourage investments in the manufacturing sector.** The demographic bonus can benefit India only if the young population is employed and contributing to productive economic activity. Expanding manufacturing, which provides mass employment opportunities, is imperative. At the same time, Japanese companies need to explore opportunities in overseas markets because demand and the labor force will struggle to grow in Japan, hence Indian manufacturing investments offer a mutually beneficial opportunity. Japan should provide technical assistance to help remove obstacles to investment such as an unclear legal system, underdeveloped infrastructure and complex tax system. Japan should also make efforts to create facilities for local technical training.

## JOINT ACTION

1. **Coordinate on major projects in energy and infrastructure.** As in other case studies, we found some evidence of bilateral cooperation but little evidence of Japanese–U.S. partnerships in India, though each would benefit from the other's expertise and financing. The United States and Japan should make sure that their companies are fully apprised of opportunities in India's energy sector—in hydrocarbons, renewables, distribution, and thermal generation—and have the information they need to pursue deals. Likewise, JBIC, JICA, Export-Import Bank of the United States, USAID and other agencies can commit more resources to encouraging private companies to meeting urgent infrastructure needs.
2. **Cooperate with India to develop and adopt infrastructure investment norms.** As the largest developing democracy in the world, India has a pressing need to develop infrastructure and a core interest in providing regional leadership. With these two interests in mind, the United States and Japan should work with India through bilateral and trilateral dialogues, as well as in regional and multilateral forums, to gain acceptance for a set of high-standard principles governing

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<sup>260</sup> Raymond Vickrey, "Is it finally time for a U.S. –India Free Trade Agreement?" Center for Strategic and International Studies, February 26, 2018, <https://www.csis.org/analysis/it-finally-time-us-india-free-trade-agreement>.

infrastructure investment in the region. These principles could be advanced through the G20, which Japan will host in 2019 and India in 2021.

3. **Advocate for greater competitiveness and trade in trilateral dialogues.** The United States and Japan share many common regional concerns with India and should use those concerns as a springboard towards more positive engagement on trade. Regular trilateral dialogues will also give the United States and Japan a better platform to discuss shared concerns over India's ease of business and domestic policies that impact U.S. and Japanese businesses, such as local content requirements. If talks are approached in a constructive, proactive manner, all three nations can find ways to satisfy their respective and shared long-term interests.
4. **Collaborate on the establishment of an innovation hub in India.** The Indian government is keen to capitalize on its strengths in ICT, and Japan is attempting to turn Bangalore into a center for innovation through its Japan-India Startup Hub. Japan also has major plans to deepen ICT cooperation from a national security perspective. The United States should reinforce both of these Japanese efforts with its know-how and funds. For example, Washington and Tokyo should establish frameworks to promote joint ventures or venture capital funds in India, as well as facilitating the free movement of Indian entrepreneurs.
5. **Encourage the export of Japanese military technology to India.** The Indian defense establishment purchases over half of its equipment from Russia. This creates difficulties for interoperability of the quad countries—the United States, Japan, India and Australia. The United States should create a list of technologies that it encourages Japan to export to India, with a particular focus on strengthening India's capabilities in the maritime domain.

## Case Study #4 | South Korea

A key U.S. ally, advanced economy, and democracy strategically located in Northeast Asia, South Korea is of enormous geopolitical importance to both the United States and Japan. The 2017 THAAD<sup>261</sup> incident, when China retaliated economically against Seoul for agreeing to house a U.S. missile-defense system in the country, illustrates South Korea's foreign policy dilemma: how should it balance its security alliance with the United States against its economic dependence on China? Facing fast-moving developments in North Korean diplomacy, a range of strategic initiatives and trade deals in the region, and an economy weighed down by demographic and other challenges, South Korea will face difficult choices in the years ahead. The United States and Japan must make efforts to put aside trade gripes and overcome history in order to deepen economic collaboration and increase South Korea's economic resilience. Washington and Tokyo should encourage Seoul to accede to the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), collaborate on development and rule-making for industries of the future, and push back against Chinese economic coercion.



### *U.S. and Japanese Strategic Interests and Objectives*

The United States and Japan share many strategic goals regarding South Korea. Foremost is maintaining a strong U.S.–South Korea alliance. In addition to helping deter North Korean aggression and manage the

<sup>261</sup> Terminal High Altitude Area Defense.

rise of China, the strength of the U.S.–South Korea alliance has an enormous impact upon the credibility of the U.S.–Japan alliance and U.S. regional security guarantees. The two alliances are critical to security, prosperity, and non-proliferation in Northeast Asia.

Another shared priority is reducing Beijing’s leverage over Seoul’s diplomatic and national security policy by promoting a diverse range of economic options for Seoul and narrowing the perception gap on China’s role and actions in the region. Beijing’s retaliation against Seoul’s deployment of the THAAD system was a clear example of China leveraging its economic influence into coercive power. South Korea’s support of and participation in coalitions of like-minded democratic countries is vital. At the same time, the United States and Japan must recognize that South Korea does not wish to alienate China.

Occupation and wartime legacies including the comfort women issue are the major obstacle to furthering economic cooperation between Japan and South Korea, let alone trilaterally; politics usually comes first, leaving economics behind. In the view of Japanese government officials interviewed for this study, historical issues close the door for government-led initiatives to improve Japan–South Korea business relations. The United States and Japan have a vital strategic interest in improved Japan–South Korea political relations, which would allow for closer trilateral cooperation, including in economics.

The United States and Japan diverge on some issues that affect South Korea. Washington has declined to take a position on sovereignty over the Takeshima/Dokdo Islands, which both Japan and South Korea claim as part of their territory. Additionally, while Seoul and Washington have actively engaged Pyongyang in public, high-level diplomacy, Tokyo has taken a more cautious posture. In addition to its unique concerns over Japanese abductees in North Korea, Tokyo sees denuclearization and disarmament as inseparable issues, differing from Washington.<sup>262</sup>

## *Political and Economic Landscape*

South Korea is the 11th largest economy in the world, with a GDP of roughly \$1.5 trillion and some of the most competitive industries in the world. However, the country faces many severe challenges. The economy remains dominated by *chaebol*, or large, family-run conglomerates, leaving little room for innovative small and medium-sized enterprises to develop. Youth unemployment is high at 10.3 percent, and inequality is growing. The country faces the challenge of moving from an export- and investment-oriented economy to one driven by domestic consumption and high-productivity service industries.<sup>263</sup> Raising the percentage of the economy constituted by services is vital to raise incomes and reduce vulnerability to external shocks. The services sector was targeted for reforms under the Park administration but has received less attention under the Moon administration.<sup>264</sup>

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<sup>262</sup> Demetri Sevastopulo and Simon Mundy, “U.S. leaves South Korea in limbo over contested Dokdo Islands,” *Financial Times*, February 18, 2018, <https://www.ft.com/content/bdaa3820-987b-11e3-a32f-00144feab7de>; Kurt M. Campbell, U.S. Senate Committee on Foreign Relations Subcommittee on East Asian and Pacific Affairs, “Maritime Territorial Disputes and Sovereignty Issues in Asia,” 112th U.S. Congress, September 20, 2012, <https://2009-2017.state.gov/p/eap/rls/rm/2012/09/197982.htm>.

<sup>263</sup> “Korea, South,” *Central Intelligence Agency World Factbook*, Central Intelligence Agency, September 26, 2018, <https://www.cia.gov/library/publications/the-world-factbook/geos/ks.html>.

<sup>264</sup> Stephen S. Roach et al., “South Korea: Finding its Place on the World Stage,” McKinsey and Company, April 2010, [East Asia Forum, August 26, 2015, \[https://www.adb.org/sites/default/files/publication/30081/economics-wp324.pdf\]\(http://www.eastasiaforum.org/2015/08/26/south-korea-must-confront-structural-problems-in-the-economy/; Donghyun Park and Kwanho Shin, <i>Performance of the Service Sector in the Republic of Korea: An Empirical Investigation</i>, ADB Economics Working Paper Series, no. 324 \(Manila: Asian Development Bank, 2012\), <a href=\).](https://www.mckinsey.com/featured-insights/asia-pacific/south-korea-finding-its-place-on-the-world-stage; Suk-yeo Jung, “Productivity of Korea’s Business Service Sector Stands at Low Level,” <i>BusinessKorea</i>, August 2, 2017, <a href=)

South Korea's demographics are a major structural constraint on growth. The country has one of the lowest fertility rates in the world, at around 1.05 children per woman. People over age 65 account for 12.2 percent of the population, which, while low by the standards of the Organization for Economic Co-operation and Development (OECD), is growing at the fastest pace in the advanced world.<sup>265</sup> Some 37.3 percent of the population is predicted to be elderly by 2050, according to the Korea National Statistical Office projection.<sup>266</sup> South Korea is set to overtake Japan as the most aged country in the world by 2060.<sup>267</sup> The need to increase social protection systems will increase taxes, decrease economic growth and widen inter-generational inequality.

Chinese industrial policies present challenges for future South Korean growth. China's climb up the value chain in sectors like shipbuilding and automotive has made it a competitor in many key industries.<sup>268</sup> The Mercator Institute named South Korea the country most vulnerable to Made in China 2025 policies due to its high dependence on manufacturing and high-tech industries.<sup>269</sup>

The geo-economic coercion from China over the THAAD deployment underscored the need for Seoul to diversify its economic relations in order to avoid excessive Chinese influence in foreign policy. The Hyundai Research Institute estimated that China's unofficial THAAD sanctions cost South Korea about \$7.5 billion, or 0.5 percent of GDP.<sup>270</sup> According to the Korea Tourism Organization, Chinese tourists to South Korea fell by 48 percent last year; estimates of the resulting losses range from \$4.7 billion to \$7.7 billion.<sup>271</sup>

In response, the Moon administration is diversifying its foreign economic relations, especially towards the Association of Southeast Asian National (ASEAN), as part of its New Southern Policy announced in November 2017. The goal is to elevate Korea's relationship with ASEAN to the level of its relations with China, Japan, Russia and the United States.<sup>272</sup> South Korea is also implementing a New Northern Policy, which aims to build economic connections among South Korea, North Korea, and Russia.<sup>273</sup>

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<sup>265</sup> "South Korea has fastest-aging population in OECD, study shows," IZA World of Labor, September 29, 2014, <https://wol.iza.org/news/south-korea-has-fastestaging-population-in-oecd-study-shows>.

<sup>266</sup> Hyun-sook Yoon, "Korea: Balancing Economic Growth and Social Protection of Older Adults," *The Gerontologist* 53, no. 3 (June 1, 2013), <https://academic.oup.com/gerontologist/article/53/3/361/838477>.

<sup>267</sup> "Deep Dive: The Challenges of an Aging Population-South Korea," Coresight Research, <https://www.funglobalretailtech.com/research/deep-dive-%E2%80%A8the-challenges-aging-population-south-korea/>.

<sup>268</sup> "Why South Korea is growing wary of China," *The Economist*, February 1, 2018, <https://www.economist.com/asia/2018/02/01/why-south-korea-is-growing-wary-of-china>.

<sup>269</sup> Jost Wübbeke, Mirjam Meissner, Max J. Zenglein, et al, *Made in China 2025*, Merics Papers on China, no. 2 (December 2016), [https://www.merics.org/sites/default/files/2017-09/MPOC\\_No.2\\_MadeinChina2025.pdf](https://www.merics.org/sites/default/files/2017-09/MPOC_No.2_MadeinChina2025.pdf);

<sup>270</sup> "Assessment and Countermeasure for the Recent ROK-China Economic Loss," 기계, 건설 공학연구정보센터, 최근 한중 상호간 경제 손실 점검과 대응 방안, Mechanical, Architectural, and Traffic Engineering Research Information Center (MATERIC), [http://materic.or.kr/community/board/content.asp?idx=126970&page=1&board\\_idx=1017&s\\_kinds=&s\\_word=&s\\_gubun=&listCnt=](http://materic.or.kr/community/board/content.asp?idx=126970&page=1&board_idx=1017&s_kinds=&s_word=&s_gubun=&listCnt=;); Voice of America, "South Korea tries to ease effects of China's trade sanctions," September 7, 2017, <https://www.voanews.com/a/south-korea-china-trade-sanctions/4047667.html>.

<sup>271</sup> "S. Korea still smarting from China's THAAD retribution," Yonhap News, March 14, 2018, <http://english.yonhapnews.co.kr/national/2018/03/14/51/0302000000AEN20180314002700320F.html>; Troy Sangarone, "South Korean losses from China's THAAD retaliation continue to grow," Korea Economic Institute of America, January 16, 2018, <http://blog.keia.org/2018/01/south-korean-losses-chinas-retaliation-continue-grow/>.

<sup>272</sup> Ji-Ae Sohn and Kyongmi Lee, "With President Moon's New Southern Policy announcement, South Korea's cooperation with ASEAN to expand," Consulate General of Republic of Korea in Yokohama, Japan, November 10, 2017, ソン・ジェ、イ・ギョンミ, 「文大統領、 「新南方政策」 宣言で韓国と ASEAN の協力拡大」, 横浜大韓民国総領事館, [http://overseas.mofa.go.kr/jp-yokohama-ja/brd/m\\_952/view.do?seq=759997&srchFr=&srchTo=&srchWord=&srchTp=&multi\\_itm\\_seq=0&itm\\_seq\\_1=0&itm\\_seq\\_2=0&company\\_cd=&company\\_nm=&page=2](http://overseas.mofa.go.kr/jp-yokohama-ja/brd/m_952/view.do?seq=759997&srchFr=&srchTo=&srchWord=&srchTp=&multi_itm_seq=0&itm_seq_1=0&itm_seq_2=0&company_cd=&company_nm=&page=2).

<sup>273</sup> Darren Whiteside, "South Korea's Moon unveils new focus on Southeast Asia," Reuters, November 9, 2017, <https://www.reuters.com/article/us-indonesia-southkorea/south-koreas-moon-unveils-new-focus-on-southeast-asia-idUSKBN1D90OC>; Ji-Ae Sohn, "President Moon unveils New Southern Policy for ASEAN," Korean Culture and Information Service,

**Table 1: South Korea’s Economic Policies**

Policy or Initiative	Date	Purpose	Priorities
<b>Objectives of the National Administration for Five Years</b>	July 2017	A five-year roadmap for the Moon administration that sets 5 major policy objectives, 20 major strategies and 100 major tasks.	<ol style="list-style-type: none"> <li>1. Popular sovereignty</li> <li>2. Accelerating economic democratization, including <ul style="list-style-type: none"> <li>• growing SMEs</li> <li>• harnessing the fourth industrial revolution</li> <li>• creating employment opportunities</li> <li>• establishing a fair economy</li> <li>• public economy for the middle class</li> </ul> </li> <li>3. Better social safety measures</li> <li>4. Equally developed regions</li> <li>5. Peaceful and prosperous Korean peninsula</li> </ol>
<b>The Five-Year Economic Plan</b>	July 2017	Economic policies to achieve 3 percent growth by shifting the economy’s paradigm from export-driven to income- and consumption-led growth and shift the drivers of economic growth from businesses to people	<p>Domestic: Raise minimum wage and offer subsidies to businesses and low income earners to mitigate the negative impact of that policy on workers; reduce economic dependence on large businesses; develop SMEs; reduce living costs; lower social service use costs; increase public servants; and decrease temporary workers.</p> <p>Foreign: Respond to protectionism by signing FTAs with Mercosur and Eurasian Economic Union; negotiate expansions of respective FTAs with China, ASEAN, and India; and focus on economic cooperation with India, ASEAN, Japan and Russia.</p>
<b>Presidential Fourth Industrial Revolution Committee</b>	Oct 2017	Secure growth engine technologies, create industrial infrastructure and ecosystem, and make preparations for future social change.	<p>Boost investment in IoT, big data and 5G wireless internet</p> <p>Leading sectors: autonomous vehicles, smart factories and drones</p> <p>Innovation subcommittee: science and technology, industry and economy, and social system</p> <p>Special subcommittees: smart cities and healthcare</p>

*Abbreviations:* ASEAN = Association of Southeast Asian Nations; FTA = free trade agreement; IoT = internet of things; Mercosur = Southern Common Market; SME = small and medium-sized enterprise.

*Sources:* Interview with a South Korea expert in Tokyo; Ji-Ae Sohn, “President emphasizes ‘People-Centered Fourth Industrial Revolution,’” Korean Culture and Information Service, October 12, 2017, <http://www.korea.net/NewsFocus/policies/view?articleId=149973>; Yung-sil Yoon, “4th Industrial Revolution Committee to promote Smart City as export models,” *BusinessKorea*, November 8, 2017, <http://www.businesskorea.co.kr/news/articleView.html?idxno=19747>; Yonhap, “Korea eyes lead in ‘4th industrial revolution,’” *The Korea Herald*, October 12, 2017, <http://www.koreaherald.com/view.php?ud=20171012000741>.

<http://www.korea.net/NewsFocus/policies/view?articleId=151092>; Prashanth Parameswaran, “Questions remain over Moon’s new Southern Policy,” *The Straits Times*, December 9, 2017, <https://www.straitstimes.com/opinion/questions-remain-over-moons-new-southern-policy>.

## U.S. and Japanese Economic Engagement

### TRADE RELATIONS

South Korea is highly dependent on trade for economic growth, with exports equivalent to approximately half of its GDP.<sup>274</sup> According to a projection by the South Korea-based Institute for International Trade, tariff hikes of 10 percent by the United States, China, and Europe would decrease South Korean exports by 6.4 percent, amounting to a \$36.7 billion GDP loss.<sup>275</sup> Historically, South Korea has placed a high value on regional free trade agreements (FTAs) and is currently a signatory to 15 FTAs encompassing 52 countries.<sup>276</sup>

**Table 2: South Korea's Trade with Selected Partners (USD billion)**

Country	Exports		Imports	
	2017	%	2017	%
China	141.2	25.1	97.0	20.5
United States	68.7	12.2	49.8	10.5
Japan	26.5	4.7	54.4	11.5
Total	562.0	-	472.6	-

Source: Direction of Trade Statistics database, "Exports, FOB to Partner Countries," International Monetary Fund, <http://data.imf.org/regular.aspx?key=61013712>.

China has been South Korea's largest trading partner since 2007. Its 22.8 percent share of South Korea's trade is larger than the sum of U.S. and Japanese trade. Like South Korea, Germany depends on trade for economic growth, but its exports are distributed more equally across its top five trading partners.<sup>277</sup> China-South Korea trading relations are asymmetric: China, including Hong Kong, purchases 32 percent of Korean exports, centering on semiconductors, electrical devices and parts, LCDs and chemicals, whereas South Korea only purchases 4.5 percent of Chinese exports.<sup>278</sup> Nevertheless, Korean trade with China has a degree of resilience as three-quarters of trade is processing trade, so the market demand lies outside of China.<sup>279</sup>

South Korea's FTA with China, effective in December 2015, was prompted by Seoul's fear of negative consequences to Korean electronics companies due to China's Economic Cooperation Framework Agreement with Taiwan.<sup>280</sup> Under the FTA, South Korea and China will eliminate tariffs on 92 and 91

<sup>274</sup> "Why a big slump in South Korea's exports matters," *The Economist*, September 1, 2015,

<https://www.economist.com/news/2015/09/01/why-a-big-slump-in-south-koreas-exports-matters>.

<sup>275</sup> Jaewon Kim, "U.S.-China trade war seen hitting South Korea hard," *Nikkei Asian Review*, April 10, 2018,

<https://asia.nikkei.com/Economy/US-China-trade-war-seen-hitting-South-Korea-hard>.

<sup>276</sup> "Korea Country Commercial Guide: Korea - Trade Agreements," U.S. Department of Commerce, Last Published September 6, 2018,

<https://www.export.gov/article?id=Korea-Trade-Agreements>.

<sup>277</sup> "Germany," The Economic Complexity Observatory, <https://atlas.media.mit.edu/en/profile/country/deu/>.

<sup>278</sup> "Exports, FOB to Partner Countries," Direction of Trade Statistics.

<sup>279</sup> Kyle Ferrier, "Just how dependent is South Korea on trade with China?" Korea Economic Institute of America, <http://keia.org/just-how-dependent-south-korea-trade-china>.

<sup>280</sup> Ministry of Commerce (People's Republic of China), "China-ROK, China-Australia FTA to take effect on December 20" (Beijing: Government of the People's Republic of China, 2015),

[http://fta.mofcom.gov.cn/enarticle/enkorea/enkoreanews/201601/30417\\_1.html](http://fta.mofcom.gov.cn/enarticle/enkorea/enkoreanews/201601/30417_1.html).

percent of products, respectively, over the course of 20 years.<sup>281</sup> China views the FTA as an important response to the Trans-Pacific Partnership (TPP) and an instrument to pressure Japan to seriously consider a trilateral FTA with China and South Korea, because Japanese companies would be disadvantaged in the Chinese market. A trilateral arrangement could be a step toward a regional trade architecture under China-preferred rules.<sup>282</sup> The United States supported South Korea's efforts to conclude a high-quality FTA with China, believing it would move China closer to international standards on trade, investment and market access. However, the degree of liberalization fell short of expectations, and negotiations to lower barriers for services and investment are ongoing.<sup>283</sup>

Though it now lags behind China, the United States remains South Korea's second-largest trading partner. The United States accounts for 12 percent of South Korean exports, down from 50 percent in the late 1960s.<sup>284</sup> The U.S.–South Korea Free Trade Agreement (KORUS) came into effect in 2012, reinforcing the alliance through economic ties. In the initial five years of KORUS, trade in goods and services increased by approximately \$25.7 billion, driven by automobiles, semiconductors, software, and agriculture products.<sup>285</sup> South Korean exports, mostly in goods, accounted for three-fifths of the growth, aided by a weak won and strong dollar, which made KORUS a renegotiation target for the Trump administration. U.S. goods exports to South Korea have grown more slowly, widening the bilateral trade deficit, while the U.S. trade surplus in services has grown. Leading services exports from the U.S. are travel, intellectual property, and transport.<sup>286</sup> Additionally, the U.S.–South Korea Information and Communications Technology Policy Forum is an important dialogue to coordinate policy and cooperation on the digital economy and cybersecurity.

An agreement on KORUS revision was reached in March 2018. The Trump administration attempted to use the pressure of North Korean negotiations to draw concessions from South Korea, but the agreement represented a willingness to keep the alliance on a good footing. South Korea was exempted from the Trump administration's steel tariffs because it accepted conditions in the renegotiation of KORUS to place quotas on steel exports to the United States. It was signed at the end of September 2018, although as of this writing in October 2018, the specter of possible Section 232 automobile tariffs continue to put ratification of the agreement by the Korean National Assembly in doubt.

Despite nearly doubling in volume in the twenty-first century, Japan–South Korea trade has declined as a share of South Korea's total trade.<sup>287</sup> South Korea's largest bilateral trade deficit is with Japan, with many South Korean firms relying on imported Japanese intermediary goods and materials for production or assembly. However, that deficit narrowed slightly in the 2010s, signifying lower dependence on imported

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<sup>281</sup> Reuters/AFP, "South Korea passes free-trade bill with China," *Deutsche Welle*, December 30, 2011, <https://www.dw.com/en/south-korea-passes-free-trade-bill-with-china/a-18883892>.

<sup>282</sup> Takashi Terada, "Northeast Asia's Realism: Fated External Influences on Trilateral Economic Integration," *East Asian Community Review* 1, no. 1–2 (August 2018), <https://link.springer.com/article/10.1057/s42215-018-0006-4>.

<sup>283</sup> Troy Stangarone, "Three questions about the Korea–China FTA," Korea Economic Institute of America, <http://keia.org/three-questions-about-korea-china-fta>; Jeffrey J. Schott, Euijin Jung, and Cathleen Cimino-Isaacs, "An Assessment of the Korea-China Free Trade Agreement," Peterson Institute for International Economics, Policy Brief no. PB15-24 (December 2015), <https://piie.com/sites/default/files/publications/pb/pb15-24.pdf>.

<sup>284</sup> "Exports, FOB to Partner Countries," Direction of Trade Statistics.

<sup>285</sup> "Fact Sheet: Four Year Snapshot: The U.S.–South Korea Free Trade Agreement," March 15, 2016, Office of the United States Trade Representative, <https://ustr.gov/about-us/policy-offices/press-office/fact-sheets/2016/March/Four-Year-Snapshot-KORUS>; "U.S. International Trade in Goods and Services: South Korea," Bureau of Economic Analysis, U.S. Department of Commerce, <https://www.bea.gov/international/factsheet/factsheet.cfm?Area=626>.

<sup>286</sup> "Korea," Office of the United States Trade Representative, <https://ustr.gov/countries-regions/japan-korea-apec/korea>.

<sup>287</sup> "Exports, FOB to Partner Countries," Direction of Trade Statistics.

Japanese goods, increased production within South Korea by Japanese companies, and supply chain diversification strategies by Korean companies.<sup>288</sup>

Japan and South Korea started negotiations on a bilateral trade deal in 2003, but made little progress. Instead, they have focused on concluding the Regional Comprehensive Economic Partnership (RCEP) and a trilateral FTA with China, with Tokyo spurred on by the bilateral trade deal between China and South Korea.<sup>289</sup> TPP and protectionism are key sources of external pressure for progressing with RCEP and the trilateral FTA to deepen Northeast Asian integration, as China and South Korea worry about economic isolation.<sup>290</sup> South Korea first expressed interest in joining TPP in 2013 and is now debating whether to accede to CPTPP.<sup>291</sup> A government investigation determined that membership would benefit the economy overall, despite concerns about a worsening of its trade imbalance with Japan due to an inflow of manufacturing goods and components, particularly automobiles, and damage to its domestic agriculture and fishing industries.<sup>292</sup> Additionally, South Korea has concerns about trade diversion and damage to Korea's economic and strategic interests if it stays out of CPTPP. Seoul has approached the Japanese government on the administrative levels to express interest and gauge feasibility in joining CPTPP,<sup>293</sup> and many experts believe they will join eventually.<sup>294</sup>

## INVESTMENT RELATIONS AND MAJOR PROJECTS

South Korea's stock of inward foreign direct investment (FDI) stood at \$231 billion in 2017, while the outward stock totaled \$356 billion, representing one quarter of Korea's GDP. Inflows grew from \$3.3 billion in 1997 to \$17.1 billion in 2017.<sup>295</sup> Japan and the United States are the first- and second-largest foreign direct investor countries in South Korea, with \$52.5 billion and \$38.8 billion of FDI stock, respectively. Outflows were \$31.7 billion, almost double inflows, reflecting the country's current account surplus. Major investment destinations are China, the United States, and Vietnam.

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<sup>288</sup> Internal document dated January 2018, received from JETRO.; Direction of Trade Statistics, "Exports, FOB to Partner Countries."

<sup>289</sup> Jeffrey J. Schott, "Korea's FTA conundrum," *JoongAng Ilbo*, November 10, 2003, <https://piiie.com/commentary/op-eds/koreas-fta-conundrum?ResearchID=273>.

<sup>290</sup> Terada, "Northeast Asia's Realism," 2018.

<sup>291</sup> Kye-wan Cho, "South Korean government consults with various industries about its accession to CPTPP," *Hankyoreh*, August 17, 2018, [http://english.hani.co.kr/arti/english\\_edition/e\\_business/858098.html](http://english.hani.co.kr/arti/english_edition/e_business/858098.html).

<sup>292</sup> Kazuhiro Momomoto, "The Park Geun-hye Administration's FTA Policy, with a Focus on the Responses to the Korea-China FTA and TPP," Institute for International Trade and Investment, April 2016: 14, 百本和弘, 「朴槿恵政権の FTA 政策：韓中 FTA と TPP への対応を中心に」, 国際貿易投資研究所, [http://www.iti.or.jp/report\\_29.pdf](http://www.iti.or.jp/report_29.pdf); Suk-ye Jung, "S. Korea decides to join CPTPP," *BusinessKorea*, August 16, 2018, <http://www.businesskorea.co.kr/news/articleView.html?idxno=24344>.

<sup>293</sup> Kye-wan Cho, "South Korea and U.S. discuss joint entry to Trans-Pacific Partnership," *Hankyoreh*, April 15, 2018, [http://english.hani.co.kr/arti/english\\_edition/e\\_business/840591.html](http://english.hani.co.kr/arti/english_edition/e_business/840591.html).

<sup>294</sup> Interviews in Tokyo with Korea experts.

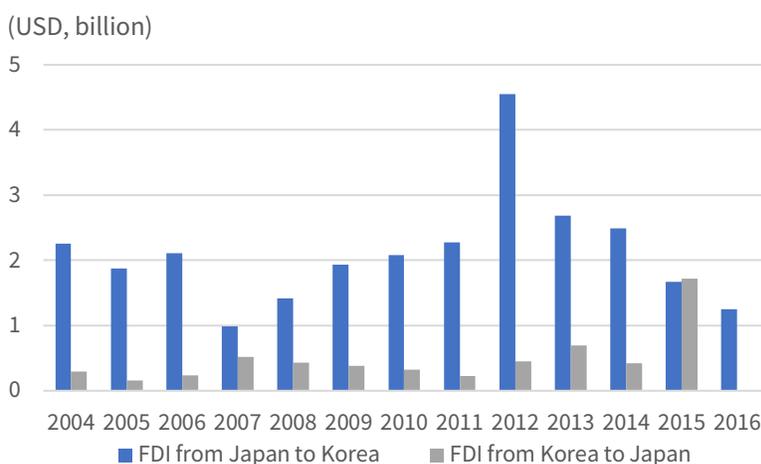
<sup>295</sup> United Nations Conference on Trade and Development, *World Investment Report 2018: Investment and New Industrial Policies: Country Fact Sheet: Korea, Republic of* (New York: United Nations, 2018), [https://unctad.org/sections/dite\\_dir/docs/wir2018/wir18\\_fs\\_kr\\_en.pdf](https://unctad.org/sections/dite_dir/docs/wir2018/wir18_fs_kr_en.pdf).

**Table 3: South Korean FDI Positions with Selected Counterparts, 2017 (USD million)**

Direct Investment Liabilities (Inbound)			Direct Investment Assets (Outbound)		
Total Inward	230,597	100%	Total Outward	355,758	100%
EU	82,561	36%	China	80,476	23%
Japan	52,510	23%	United States	80,123	23%
United States	38,845	17%	Southeast Asia	67,541	19%
Southeast Asia	27,397	12%	EU	45,593	13%
China	9,186	4%	Japan	6,259	2%

Source: Korean Statistical Information Service, “International Investment Position for Nations” (Dunsan: Statistics Korea, 2014), [http://kosis.kr/eng/statisticsList/statisticsList\\_01List.jsp?vwcd=MT\\_ETITLE&parentId=N#SubCont](http://kosis.kr/eng/statisticsList/statisticsList_01List.jsp?vwcd=MT_ETITLE&parentId=N#SubCont).

**Figure 1: FDI flows between Japan and South Korea**



Source: <http://www.mofa.go.jp/mofaj/files/000005986.pdf>

Japan–South Korea investment is asymmetric with many inbound Japanese investments and little flow in the other direction. South Korea’s FDI stock in Japan was just \$6.3 billion, in contrast to \$80 billion of investment assets in both China and the United States. FDI inflows from Japan peaked in 2012, dropping because of the weak yen and worsening business environment in South Korea.<sup>296</sup>

Roughly 82 percent of Japanese firms in Korea reported profits in

2017—the highest proportion of profitable Japanese firms in an Asian economy—and only 3.4 percent reported losses.<sup>297</sup> Japanese parts and materials companies invest to supply Korean manufacturers, such as Japanese glass for Korean LCD televisions. Top sectors for Japanese investments are chemical products, finance, services, and electrical machinery. SoftBank Group is one of the biggest Japanese investors in South Korea, and has invested heavily in e-commerce since 2015, when it placed \$1 billion in leading e-commerce company Coupang.<sup>298</sup> Japanese investor concerns about South Korea include strict regulations on chemical products, a rise in wages, a possible rise in electricity costs, strengthening tax collection, and

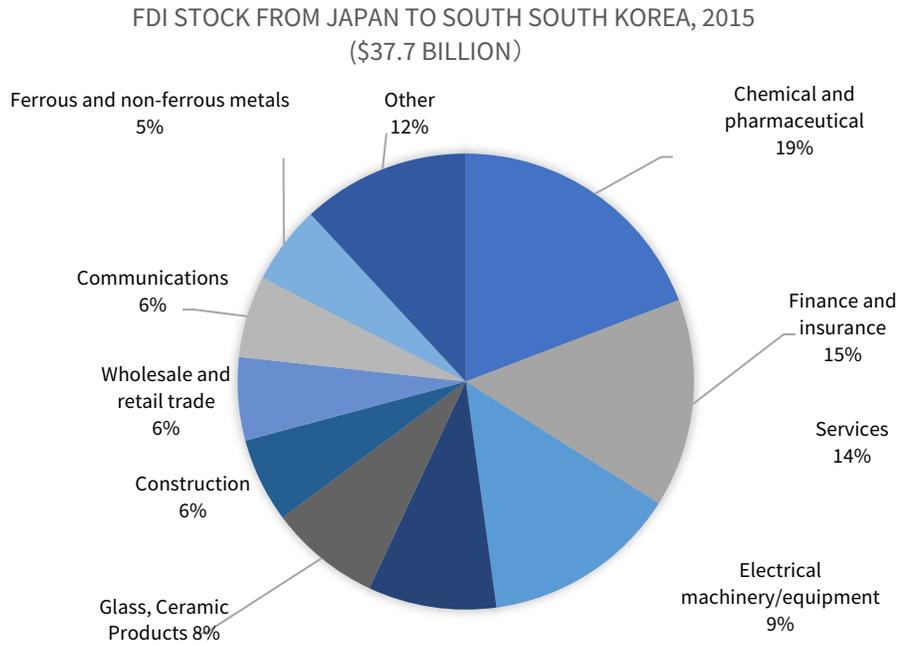
<sup>296</sup> Suk-yeo Jung, “Japan’s investment in S. Korea hit 57-month high in Q3,” *BusinessKorea*, November 16, 2017,

<http://www.businesskorea.co.kr/news/articleView.html?idxno=19836>.

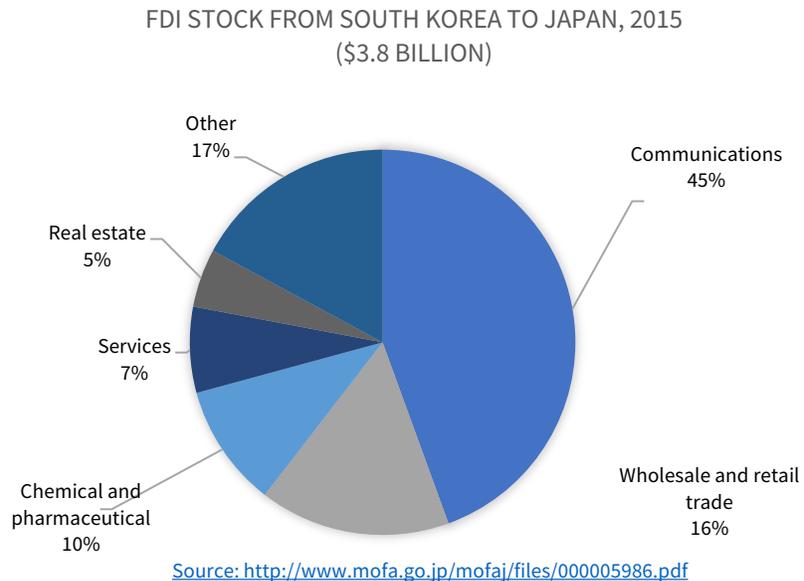
<sup>297</sup> Internal document dated January 2018, received from JETRO; Willem Thorbecke and Nimesh Salike, “Foreign Direct Investment in East Asia,” RIETI Policy Discussion Paper Series 13-P-003 (March 2013), <https://www.rieti.go.jp/publications/pdp/13p003.pdf>.

<sup>298</sup> “SoftBank to invest \$1 billion in Coupang, Korea’s largest online retailer,” SoftBank Corp., June 3, 2015, [https://group.softbank/en/corp/news/press/sb/2015/20150603\\_02](https://group.softbank/en/corp/news/press/sb/2015/20150603_02).

unbalanced customs and corporate tax.<sup>299</sup> The Japan External Trade Organization (JETRO) encourages Korean investments into Japan's ICT, healthcare, and tourism industries.<sup>300</sup>



**Figure 2: FDI Stock from Japan to South Korea, 2015 (\$37.7 billion)**



**Figure 3: FDI Stock from South Korea to Japan, 2015 (\$3.8 billion)**

<sup>299</sup> Internal document dated January 2018, received from JETRO.

<sup>300</sup> Hiroyuki Ishige, Keynote remarks at a symposium on large-scale investment in Japan, Japan External Trade Organization, September 26, 2017, 「ソウル「大型対日投資シンポジウム」基調講演」, [https://www.ietro.go.jp/invest/speech/speech\\_20170926.html](https://www.ietro.go.jp/invest/speech/speech_20170926.html).

In recent years, Japanese and Korean companies have made several joint investments, many of which are large-scale energy infrastructure projects based in Asia, the Middle East, and Africa, as well as collaborating on electricity production, food processing, chemicals, and waste treatment projects.<sup>301</sup> Additionally, the Korea International Cooperation Agency, Korea's development agency, has been holding annual meetings with the Japan International Cooperation Agency (JICA) since 2010 to explore cooperation opportunities, with a recent focus on public-private partnerships.

The investment chapter of KORUS encouraged bilateral FDI, and since 2011 South Korean direct investment in the United States has close to doubled. Nevertheless, some U.S. manufacturing investments have struggled. For example, General Motors's Korea operations have faced high costs and low productivity.<sup>302</sup> In May 2018 the company reached a deal with South Korean labor unions allowing the establishment of a new Asia-Pacific regional headquarters in South Korea, but General Motors's losses in South Korea have previously forced a plant closure and the layoffs of nearly 3,000 employees.<sup>303</sup>

### PEOPLE-TO-PEOPLE TIES

South Koreans view the United States positively, while historical issues with Japan are the cause for negative feelings that limit the range of possible political action. Cultural ties and fading attachment to colonial history by young people gives hopes for the improvement of Japan-South Korea relations.<sup>304</sup> A 2018 Asan survey found that if the United States and China "continued their rivalry," 68 percent of Koreans would favor strengthening ties with the United States over China.<sup>305</sup>

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<sup>301</sup> Documents received from the Ministry of Economy, Trade and Industry dated October 2017 and Jetro Seoul dated January 2018.

<sup>302</sup> Makoto Kajiwara, "GM plant closure threat serves as warning for Seoul," *Nikkei Asian Review*, March 6, 2018, (<https://asia.nikkei.com/Economy/GM-plant-closure-threat-serves-as-warning-for-Seoul>) Song Jung-a, "GM to shut South Korea plant in restructuring drive," *Financial Times*, February 13, 2018, (<https://www.ft.com/content/e248acdc-106f-11e8-8cb6-b9ccc4c4dbbb>)

<sup>303</sup> Reuters, "GM to locate new Asia-Pacific headquarters in South Korea, government says," CNBC, May 10, 2018, <https://www.cnbc.com/2018/05/10/gm-to-locate-new-asia-pacific-headquarters-in-south-korea-government-says.html>.

<sup>304</sup> "Despite diplomatic rows, Japan and South Korea are growing closer," *The Economist*, January 18, 2018, <https://www.economist.com/asia/2018/01/18/despite-diplomatic-rows-japan-and-south-korea-are-growing-closer>.

<sup>305</sup> "South Koreans and Their Neighbors 2018," Asan Institute of Policy Studies, May 2, 2018: 24, <http://en.asaninst.org/contents/south-koreans-and-their-neighbors-2018/>.

**Table 4: People-to-People Ties: South Korea–U.S. and South Korea–Japan**

Relevant Nation and Sector of Society		Outward from South Korea	Inward to South Korea
U.S.	Favorable view	75%	75%
	Unfavorable view	25%	23%
	Residents	1,800,000	140,000
	Students	58,663 (2016/2017)	1,119
	Tourists	2,000,000 (2016)	900,000
Japan	Favorable view	27%	27%
	Unfavorable view	56%	68%
	Residents	450,000	53,000
	Students	15,000	2,464
	Tourists	7,100,000	2,300,000

Note: All numbers are as of 2017, unless stated otherwise.  
 Source: Author’s compilation; see footnote for further details.<sup>306</sup>

<sup>306</sup> “President Trump’s State Visit and Perceptions of Neighboring Countries: The Effects of the ROK–U.S. Summit and Its Implications,” 아산정책연구원, 트럼프 방한과 주변국 인식: 한미 정상외교 효과와 그 시사점, The Asan Institute for Policy Studies, <http://www.asaninst.org/contents/%ED%8A%B8%EB%9F%BC%ED%94%84-%EB%B0%A9%ED%95%9C%EA%B3%BC-%EC%A3%BC%EB%B3%80%EA%B5%AD-%EC%9D%B8%EC%8B%9D-%ED%95%9C%EB%AF%B8-%EC%A0%95%EC%83%81%EC%99%B8%EA%B5%90-%ED%9A%A8%EA%B3%BC%EC%99%80-%EA%B7%B8/>; Chul-soo Kim, “Number of US citizens living in South Korea rises 30 percent in 10 years,” *The Korea Times*, July 2, 2015, <http://www.koreatimesus.com/number-of-us-citizens-living-in-south-korea-rises-30-percent-in-10-years/>; “The 5th Japan-South Korea Joint Public Opinion Poll (2017) Analysis Report on Comparative Data,” Genron NPO, July 20, 2017, [http://www.genron-npo.net/en/opinion\\_polls/archives/5363.html](http://www.genron-npo.net/en/opinion_polls/archives/5363.html).  
 “Number of foreign tourists to Japan (totals) in 2018,” 日本政府観光局, 2018 年訪日外客数 (総数), Japan National Tourism Organization, [https://www.jnto.go.jp/jpn/statistics/since2003\\_tourists.pdf](https://www.jnto.go.jp/jpn/statistics/since2003_tourists.pdf); “Statistics (foreigners visiting Japan and Japanese going abroad),” 日本政府観光局, 「統計データ (訪日外国人・出国日本人)」, Japan National Tourism Organization, [https://www.jnto.go.jp/jpn/statistics/visitor\\_trends/index.html?tab=block1](https://www.jnto.go.jp/jpn/statistics/visitor_trends/index.html?tab=block1); “Results of 2017 academic year survey of foreign students’ enrollment status,” Japan Student Services Organization, December 2017, 独立行政法人日本学生支援機構, 「平成 29 年度外国人留学生在籍状況調査結果」, [https://www.jasso.go.jp/about/statistics/intl\\_student\\_e/2017/index.html](https://www.jasso.go.jp/about/statistics/intl_student_e/2017/index.html); “Korea, Monthly Statistics of Tourism,” Korea Tourism Organization, <http://kto.visitkorea.or.kr/eng/tourismStatics/keyFacts/KoreaMonthlyStatistics/eng/inout/inout.kto>;  
 “Current Status of International Students,” 통계청, 유학생 관련 현황, Korean Statistical Information Service, [http://kosis.kr/statHtml/statHtml.do?orgId=111&tblId=DT\\_1B040A14&vw\\_cd=MT\\_OTITLE&list\\_id=111\\_11104&scrId=&seqNo=&lang\\_mode=ko&obj\\_var\\_id=&itm\\_id=&conn\\_path=E1#](http://kosis.kr/statHtml/statHtml.do?orgId=111&tblId=DT_1B040A14&vw_cd=MT_OTITLE&list_id=111_11104&scrId=&seqNo=&lang_mode=ko&obj_var_id=&itm_id=&conn_path=E1#); “Change in the number of resident foreigners by country and region,” Table 1, 法務省, 「国籍・地域別在留外国人数の推移, 第 1 表」, Ministry of Justice (Japan), <http://www.moj.go.jp/content/001238032.pdf>;  
 “Monthly Korea Immigration Policy Internal Statistics,” 법무부, 출입국,외국인 정책 내부용 통계 월보, Ministry of Justice (Korea), [http://www.moj.go.kr/doc\\_html/viewer/skin/doc.html?fn=f3e439d5def4137b8bab63c4e3da17c5&rs=/doc\\_html/viewer/result/201804/](http://www.moj.go.kr/doc_html/viewer/skin/doc.html?fn=f3e439d5def4137b8bab63c4e3da17c5&rs=/doc_html/viewer/result/201804/); “Non-Resident Arrivals to the United States: Overseas, Canada, Mexico & International,” National Travel and Tourism Office, International Trade Administration, U.S. Department of Commerce, <https://travel.trade.gov/view/m-2017-I-001/index.asp>; “South Korea: Opinion of Americans,” Pew Research Center, Global Indicators Database, <http://www.pewglobal.org/database/indicator/2/country/116/>; “Koreans in the U.S. Fact Sheet,” Pew Research Center, September 8, 2017, <http://www.pewsocialtrends.org/fact-sheet/asian-americans-koreans-in-the-u-s/>; “Views of the U.S. vary across regions,” Pew Research Center, June 23, 2017, [http://www.pewglobal.org/2017/06/26/u-s-image-suffers-as-publics-around-world-question-trumps-leadership/pg\\_2017-06-26-us\\_image-01-0/](http://www.pewglobal.org/2017/06/26/u-s-image-suffers-as-publics-around-world-question-trumps-leadership/pg_2017-06-26-us_image-01-0/); “Places of Origin,” 2017 Open Doors Report, Institute of International Education,

## *Recommendations on South Korea*

The United States and Japan have a compelling interest in a South Korea that is economically strong, militarily secure, and free from coercion by China or other countries. As an advanced economy with a similar stake in an open, rules-based order in the Indo-Pacific, Korea is an important partner in updating and upholding that order. Washington and Tokyo should do more to bolster Korea's economic strength and independence and to encourage Seoul to join in collaborative economic endeavors in the region.

### **UNITED STATES**

- 1. Fully implement the revised KORUS agreement and look for new areas of proactive cooperation.** KORUS has acted both as an important economic arrangement deepening integration of the U.S. and Korean economies, and as an important strategic underpinning of the bilateral alliance. Both governments should fully implement the new agreement, then build on it by looking for areas of expanded cooperation in trade, such as in shaping regional rules around digital commerce and state-owned enterprises.
- 2. Cooperate with South Korea to develop services with high levels of productivity.** The high reliance of the Korean economy upon exports in goods is one of its major economic vulnerabilities, as South Korea services industries fall short of OECD averages. The United States should facilitate strengthening South Korea's services industry by encouraging more market access for U.S. companies to increase competition. Joint research on digital industries and work on standards and rules for the digital economy could give a boost to Korea's services sector and enhance cooperation on regional economic rule-making.

### **JAPAN**

- 1. Encourage South Korean accession to CPTPP.** Without the United States in the deal, the risk to South Korea of a Chinese backlash for joining CPTPP has fallen. If Tokyo's aim is to bring the United States back to TPP, it should seek to bring developed economies that can meet high standards into CPTPP. South Korean accession could also improve the standards of a potential China-Japan-South Korea trilateral trade deal by pressuring Beijing to agree to further trade liberalization to avert trade diversion.
- 2. Expand tourist relations.** Tourism was the South Korean industry hardest hit by THAAD retaliatory action. More could have been done to promote Japanese citizens to visit South Korea. Furthermore, people-to-people exchange is a hugely important and powerful form of grassroots diplomacy that will contribute to resolving historical issues over the long-term. The Japan Tourism Agency should cooperate with Korea's Ministry of Foreign Affairs to find ways to encourage more Japanese to travel to Korea.
- 3. Cooperate on measures to deal with an aging society and labor market rigidity.** In response to its ageing population and labor shortage, the Japanese labor market has become more flexible over the past few years, and Tokyo is enacting policies to try to improve productivity. Seoul could learn from Japan's experience; in comparison to other OECD nations, Japan's situation is far more culturally relatable and applicable to South Korea. Both countries share a rising set of workers on non-permanent contracts and are pushing forward with initiatives to make employment more inclusive

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<https://www.iie.org/Research-and-Insights/Open-Doors/Data/International-Students/Places-of-Origin>; Statistical Database, Korean Statistical Information Service.

for women and senior citizens in conservative societies. In addition, Japan has a successful ecosystem of small and medium-sized enterprises that broadens employment opportunities. There is potential to formalize the exchange of advice and policymaking experience between Japan and South Korea on how to reform their labor markets and cope with aging societies.

#### **JOINT ACTION**

- 1. Deepen trilateral cooperation on regional economic rule-making.** The United States, Japan, and Korea all have a stake in an open, rules-based economic order in the Indo-Pacific. They should enhance their existing work through regional trade agreements and institutions such as APEC and ADB to ensure high-standard rules and norms of trade, finance, infrastructure investment, and other areas of economic integration. These efforts should put a particular emphasis on rule-making in the areas of digital commerce and state-owned enterprises.
- 2. Create mechanisms for trilateral research and development funding and information exchange on industries of the future.** South Korea is the country with the highest level of vulnerability to Beijing's Made in China 2025 strategy. Rapid Chinese technological gains in electric vehicles, sensors, and big data risk making South Korea's economy subordinate to China's. Rather than go it alone in the race for artificial intelligence and other high-end technologies, trilateral U.S.-Japan-South Korea collaboration that includes the public and private sectors in each country would accelerate research to develop technologies of the future and the rules and standards that govern them. This should include a focus on blockchain, which facilitates decentralization and has applications for key sectors such as finance and healthcare.
- 3. Enhance trilateral energy cooperation.** Like Japan, South Korea relies highly on imports of energy. Diversifying sources by relying more on U.S. liquified natural gas would enhance the energy security of all three countries and make them less vulnerable to external supply shocks. In addition, companies in the United States, Japan, and Korea are working to develop renewable technologies, and each has comparative advantages in certain areas. For example, Korea in battery storage, Japan in sea-based wind power, the United States in solar. By working in tandem, the three countries can not only find development synergies but also mitigate the risk of overproduction and dumping by Chinese producers of renewables.
- 4. Work together to push back against Chinese economic coercion.** Washington and Tokyo were slow and tepid in their response to China's economic pressure against South Korea during the THAAD crisis. At a minimum, they should have corralled their G7 partners into issuing a forceful statement of condemnation. In future, Washington and Tokyo should do more to mobilize international support against Chinese coercion and be prepared to take proportionate retaliatory actions against Chinese economic interests.

## Case Study #5 | Regional Trade Architecture

Since the founding of the Asia-Pacific Economic Cooperation (APEC) forum in 1989, the United States, Japan, and other economies of the Indo-Pacific region have been engaged in building an architecture of regional economic integration. Over the last three decades, this architecture has evolved, its progress shaped by the elevation of APEC to the leaders' level, including heads of state, in 1993; the conclusion of scores of bilateral free trade and investment agreements between countries of the region; and the launch of two large plurilateral trade negotiations, the Trans-Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership (RCEP). The United States and Japan have participated in many though not all of these arrangements, and both have a strong interest in how the region's trade architecture takes shape in the years ahead. This is particularly true as China offers its own vision for regional integration and as other economies in the region make decisions about which rules and norms of trade and investment they will adopt.

### *U.S. and Japanese Strategic Interests and Objectives*

Both the United States and Japan have a compelling strategic interest in creating a free, open, and fair trade architecture in the Indo-Pacific region. Increased flows of trade and investment, as well as high-standard rules in trade agreements, promote economic growth, job creation, and domestic reform in the economies of the region. Economic integration also supports strengthened diplomatic and security ties between the United States and Japan and the countries of the Indo-Pacific, as well as granting those countries the ability to chart an independent foreign policy course.

The United States and Japan are in a competition with China to determine the rules, standards, and norms of trade and investment in the Indo-Pacific. Given that roughly half of the world's population and economic weight lies in the Indo-Pacific, this competition will ultimately shape the rules and norms that apply in the global economy. At the same time, it is equally crucial for the United States and Japan to develop positive, mutually beneficial economic relations with China by cooperating where possible, including in the building of a common regional architecture.

Three areas in which rule-making is particularly important for the United States and Japan, each of which is addressed in this case study, are state-owned enterprises (SOEs), the digital economy, and trade in services. Each presents its own set of challenges:

- State-owned enterprises challenge free-market principles through state-backed subsidization, inefficient and often excessive investment and production, poor corporate governance, and discriminatory regulation.
- China's social surveillance and closed digital-governance model, globalization of China's own digital standards (especially to other authoritarian regimes), and the Great Firewall all challenge U.S. and Japanese strategic interests.
- Services present a unique set of challenges in rule-making, but are both an expanding sector of the global economy and a sector that the U.S. and Japan excel in. It would thus serve both nations' domestic interests to play a lead role in shaping global rules.

Through economic initiatives like RCEP and the Belt and Road Initiative (BRI), China aims to spread its model of governance in these three key areas throughout the Indo-Pacific region and beyond.

Japan, without natural resources of its own, depends on trade. Given its high volume of maritime trade, it is vital for Japan to maintain open passage and freedom of navigation, especially with respect to energy security—interests that the United States shares. It is in Japan’s national interest to uphold and further develop the multilateral trading system and trade liberalization. Japan’s strategic interests in furthering an open, rules-based regional trade architecture are two-fold: to propel domestic structural reforms (the so-called “third arrow” of the Prime Minister’s economic strategy, commonly known as Abenomics), and to vitalize regional economies, benefiting Japanese businesses in the process.

The United States has an underlying strategic interest in furthering free trade and determining the rules in the Indo-Pacific region. The current bilateral trade approach of the Trump administration, particularly when backed by unilateral tariffs and other measures to protect the U.S. market, is unlikely to produce as substantial economic and political gains for the United States as a multilateral or plurilateral approach. Building broader economic ties in the region reinforces the U.S. security presence. The December 2017 National Security Strategy rightly highlights the importance of distinguishing economic competition between countries that follow fair and free market principles from that with countries that do not respect those principles. Furthermore, the United States is a global leader in technological innovation and advanced services industries, meaning that it has a particular interest in influencing the direction of global rules and standards for these emerging industries.

To achieve their vision of regional trade architecture, the United States and Japan will need to engage productively with two key entities in the region: India and the Association of Southeast Asian Nations. Domestic reforms to make India more open and less protectionist, as well as policies to incentivize India to join the emerging regional trade architecture, are strongly in the U.S. and Japanese interest. Economic integration between the countries of ASEAN is also important policy goal for the United States and Japan to keep the Indo-Pacific free and open, maintain economic growth, and protect the independence of individual members.

The regional trade architecture is also embedded in the wider framework of international trade rules and institutions. New bilateral and plurilateral arrangements must remain consistent with the rules of the World Trade Organization (WTO). Reforming the WTO to make it more effective and legitimate is in the essential strategic interest of both the United States and Japan.

## *Regional Trade Strategies of Japan, the United States, and China*

### **JAPAN’S TRADE STRATEGY**

Japan’s regional trade architecture strategy is to establish an open and rules-based multilateral system. Tokyo set a goal in its 2013 Revitalization Strategy to expand the coverage of its trade through free trade agreements (FTAs) to 70 percent by 2018 and to double the stock of inward foreign direct investment (FDI) by 2020.<sup>307</sup> The Ministry of Foreign Affairs (MOFA) identifies in its Diplomatic Bluebook 2017 “the emergence of protectionist and inward-looking trends” to be one of the four major threats to its vision for

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<sup>307</sup> “Fiscal 2017 Report on Priority Measures to Strengthen Industrial Competitiveness,” Headquarters for Japan’s Economic Revitalization, 「平成 29 年度産業競争力強化のための重点施策等に関する報告書」, 日本経済再生総合事務局, [https://www.kantei.go.jp/jp/singi/keizaisaisei/pdf/houkoku\\_honbun\\_180206.pdf](https://www.kantei.go.jp/jp/singi/keizaisaisei/pdf/houkoku_honbun_180206.pdf).

the regional order, the wider international order and Japanese national security.<sup>308</sup> The backlash against globalism presents a risk to the economic order based upon rules, and it is in Japan's vital interest to maintain trade liberalization efforts and the multilateral trading system with the ultimate aim of tiding the system over until the U.S. trade policy agenda is once again multilateral and internationalist. In an attempt to do so, Japan is set to ratify the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP), finalize the Japan–EU Economic Partnership Arrangement (EPA), and conclude RCEP negotiations. It is also engaged in talks on a trilateral FTA with China and South Korea.



Japan's Participation in Goods & Services Trade Agreements

- Signatory of Trade Agreement with Japan
- Non-signatory of Trade Agreement with Japan, but WTO member
- Non-signatory of Trade Agreement with Japan, WTO non-member

Source: World Trade Organization, [https://www.wto.org/english/tratop\\_e/region\\_e/rt\\_a\\_participation\\_map\\_e.htm](https://www.wto.org/english/tratop_e/region_e/rt_a_participation_map_e.htm)

Japan's trade strategy has evolved through several stages over the past 20 years. Before its first FTA in 2002, Japan was seen as a staunch multilateralist that emphasized the negative effects of bilateral, and sometimes even regional, deals. Japan feared the creation of a trading system with “discriminatory effects” as well as bilateral FTAs requiring the elimination, rather than reduction, of tariffs—an unacceptable consequence for Japan's agricultural sector.<sup>309</sup> With the negotiation of its first FTA—

with Singapore in 2002—Japan's trade strategy evolved into a multi-layered one that pursued both bilateral and regional trading arrangements, in order to complement but not replace the multilateralism of the General Agreement on Tariffs and Trade and the WTO.<sup>310</sup> As trade negotiations in the WTO bogged down, and with APEC's non-binding norm-setting seen as insufficient, Japan saw bilateral FTAs as means to widen regional integration and eventually contribute to global trade liberalization.<sup>311</sup>

For a decade, Japan focused primarily on FTAs with Asian partners, based upon the Singapore model, because the highest barriers for Japanese trade and investment lay within Asia. After Prime Minister Abe returned to office in late 2012, the targets for Japan's FTAs shifted to the United States and Europe. The reasons for this were threefold: the WTO's inability to agree on new rules; the need for new measures to

<sup>308</sup> Ministry of Foreign Affairs (Japan) (MOFA), *Diplomatic Bluebook 2017* (Tokyo: MOFA, 2017) <https://www.mofa.go.jp/files/000287676.pdf>.

<sup>309</sup> MOFA, *Diplomatic Bluebook 1995* (Tokyo: MOFA, 1995) <https://www.mofa.go.jp/policy/other/bluebook/1995/index.html>; Yoichi Suzuki, “Japan's Trade Strategy in an Age of Rising Protectionism,” Weatherhead Center Program on U.S.-Japan Relations presentation, November 7, 2017, at Harvard University.

<sup>310</sup> Takashi Terada, “The Making of Asia's First Bilateral FTA: Origins and Regional Implications of the Japan-Singapore Economic Partnership Agreement,” *Pacific Economic Papers* 354 (2006), <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.1020.9642&rep=rep1&type=pdf>.

<sup>311</sup> The bilateral FTAs maintained complementarity with WTO through GATT Article 24, which stipulates that an FTA should liberalize trade in all products substantially; this is thought to mean removing tariffs on over 90 percent of imports from the FTA partner.

tackle non-tariff, “behind-the-border” barriers; and the growing influence of emerging economies over global trade in ways that the WTO was unprepared to handle.

TPP—amounting to a *de facto* bilateral FTA with the United States—was first and foremost supposed to address these issues. This represented a radical evolution from MOFA’s FTA 2002 strategy, which had evaluated FTAs with the United States or Europe as a “very difficult task.” Tokyo was pushed into action by South Korea’s FTAs with the United States and Europe (see the South Korea case study) and China’s development of an FTA network.<sup>312</sup> TPP became a centerpiece of the Abe administration’s economic strategy, with three aims: expanding Japanese trade and investment overseas, advancing domestic reforms, and increasing leverage in other trade negotiations.<sup>313</sup> The agreement established high-standard rules in the Indo-Pacific with regard to the digital economy, services, state-owned enterprises, and labor and environmental regulations.

U.S. withdrawal from TPP marked a turning point for Japanese trade strategy and its position in the regional trade architecture. As the largest remaining economy in the group, Japan took the lead in persuading the other 11 members to agree to a modified CPTPP. In part, Tokyo was motivated by concerns that Mexico, Chile, and Peru would pursue economic integration through the Pacific Alliance framework, a Latin American free trade network that China could potentially dock onto.<sup>314</sup> In an effort to facilitate an eventual U.S. return to TPP, Tokyo successfully encouraged other members to suspend only 22 of the original agreement’s thousands of provisions.

From the outset of the Trump administration, Japan has resisted entering into formal bilateral FTA negotiations, fearing this would disincentivize the United States from returning to TPP and risk legitimizing Trump’s bilateral, zero-sum approach. However, some in Japan argued that a bilateral deal could have appeal if it built on the standards of TPP. This may have played into the decision by Prime Minister Abe to agree with President Trump in late September 2018 to launch negotiations toward a U.S.–Japan trade agreement. However, other factors were clearly at play. Abe values the U.S.–Japan alliance above all else and wanted to put trade issues on the back burner. He also wanted to forestall the prospect of Section 232 tariffs on automobiles and auto parts, something he appears to have achieved, at least for the time being.

Japan has pursued other initiatives to uphold trade liberalization since the advent of the Trump administration, despite the agricultural lobby remaining a domestic obstacle to Japanese leadership on free trade. Tokyo accelerated negotiations on the Japan–EU EPA in order to counter U.S. protectionism, give impetus to TPP-11 negotiations, and remain competitive against South Korean firms in the EU market following signing of an EU–South Korea FTA. Negotiations that had been held up for four years were wrapped up in four months, and a final deal was signed in July 2018. The Japan–EU agreement is significant as a free trade deal between two large economic entities that value market-based democracy, rule of law, and human rights. It also establishes a model for high-standard rule-making that offers an alternative to China’s approach. It ventured into areas not yet covered by FTAs, going beyond TPP in some cases, such as harmonization of food safety regulations, the handling of data, corporate governance and incorporating the Paris Climate Accord. Europe and Japan had just recently concluded the Strategic

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<sup>312</sup> “Japan’s FTA Strategy (Summary),” MOFA, October 2002, <https://www.mofa.go.jp/policy/economy/fta/strategy0210.html>.

<sup>313</sup> Mireya Solís and Shujiro Urata, “Abenomics and Japan’s Trade Policy in a New Era,” *Asian Economic Policy Review* 13, no. 1 (January 2018): 106-123, <https://onlinelibrary.wiley.com/doi/full/10.1111/aepr.12205>.

<sup>314</sup> Takashi Terada, “How and Why Japan has Saved the TPP,” The Asan Forum, February 19, 2018, <http://www.theasanforum.org/how-and-why-japan-has-saved-the-tpp-from-trump-tower-to-davos/>.

Partnership Agreement in April 2018, showing that economic cooperation can go hand-in-hand with cooperation in other domains. The Japan–EU EPA is also a geopolitically important contribution by Japan to help the solidarity and unity of Europe in the face of Brexit.

Meanwhile, Japan along with other RCEP members set a goal to wrap up the negotiations by the end of 2018, despite the deal’s standards being lower than TPP’s.<sup>315</sup> If this ambitious deadline is not reached, an agreement could be complicated by domestic political developments in ASEAN, including Thai and Indonesian elections in 2019. However, RCEP is seen as the best chance for a trade agreement that locks China in and commits it to reforms, as well as engages India in regional trade architecture.

It is in Japan’s strategic interest for CPTPP to be signed, so that a coalition of seven member states in both agreements can be formed to promote rule-making negotiations within RCEP, going beyond merely lowering tariffs.<sup>316</sup> Japan should also look to expanding CPTPP to include other regional economies such as Korea and Indonesia, as discussed elsewhere in this report.



U.S. Participation in Goods & Services Trade Agreements

- Signatory of Trade Agreement with the U.S.
- Non-signatory of Trade Agreement with the U.S., but WTO member
- Non-signatory of Trade Agreement with the U.S., WTO non-member

Source: World Trade Organization, [https://www.wto.org/english/tratop\\_e/region\\_e/rt\\_a\\_participation\\_map\\_e.htm](https://www.wto.org/english/tratop_e/region_e/rt_a_participation_map_e.htm)

### U.S. TRADE STRATEGY

U.S. trade policy has undergone a dramatic shift in the Trump administration. Unlike all of his predecessors since World War II, who broadly endorsed the multilateral trading system and pursued liberalization and strengthening of trade rules, President Trump views trade as essentially a zero-sum game of winners and losers, in which the United States has been one of the losers. The measure of this failure, in Trump’s view, has been large bilateral trade deficits. The remedy is to seek bilateral

deals with measurable gains for U.S. exporters and to eschew process-oriented multilateral initiatives, while putting up protectionist barriers at home. Emphasis is placed on the reshoring and renationalization of manufacturing, particularly traditional industries like steel and automobiles.

The actions of the Trump administration on trade do not align well with its rhetoric of a “free and open Indo-Pacific.”<sup>317</sup> The Trump administration’s withdrawal from TPP is widely seen as a strategic error, opening the door for economic integration in the Indo-Pacific that excludes the United States and creating

<sup>315</sup> Walter Sim, “RCEP ministerial meeting kicks off in Tokyo, leaders express hope for major progress,” *The Straits Times*, July 1, 2018, <https://www.straitstimes.com/asia/east-asia/rcep-ministerial-meeting-kicks-off-in-tokyo-leaders-express-hope-for-major-progress>.

<sup>316</sup> Terada, “How and Why,” 2018.

<sup>317</sup> Takashi Terada, “The Competing U.S. and Chinese Models for an East Asian Economic Order,” *Asia Policy* 3 no. 2 (April 2018), 15-19.

a vacuum for China to pursue its lower-standard, less market-oriented model of regional economic integration.

The Trump administration has prioritized tough action against China for its massive subsidies, forced technology transfer, intellectual property theft, and market access barriers. Renegotiating the North American Free Trade Agreement (NAFTA) was another priority. Neither Japan nor TPP has been high on the economic agenda. As noted above, President Trump and Prime Minister Abe agreed in late September 2018 to launch talks toward a bilateral trade agreement, but it remains unclear how those talks will unfold. Meanwhile, in January and again in April 2018, Trump hinted publicly at the possibility of U.S. reentry into TPP, but these statements were reversed within days. Furthermore, President Trump's decision not to attend the East Asia Summit and APEC Leaders' Meeting in November 2018 was widely viewed in the region as a sign of lack of interest in the Indo-Pacific affairs.

Nevertheless, the Trump administration has shown a willingness to join forces with Japan and other allies to tackle common trade challenges. U.S. Trade Representative Robert Lighthizer has issued several joint statements over the past year with his Japanese and European counterparts in which the three allies agreed to join forces to take on global overcapacity and forced technology transfer policies—a joint strategy clearly aimed at China. In their latest statement at the UN General Assembly meetings in late September 2018, the three ministers agreed to pursue WTO reform together.

These steps, as well as the progress concluding U.S.–South Korea Free Trade Agreement (KORUS) and a revised NAFTA (dubbed the U.S.–Mexico Canada Agreement, or USMCA) and launching bilateral trade talks with Japan, suggest that the Trump administration may be slowly moving back toward a more constructive position on trade in the Indo-Pacific region. However, the White House has yet to articulate a comprehensive trade strategy for the region to fill the large hole left by its TPP withdrawal.



China's Participation in Goods & Services Trade Agreements

- Signatory of Trade Agreement with China
- Non-signatory of Trade Agreement with China, but WTO member
- Non-signatory of Trade Agreement with China, WTO non-member

Source: World Trade Organization,  
[https://www.wto.org/english/tratop\\_e/region\\_e/rta\\_participation\\_map\\_e.htm](https://www.wto.org/english/tratop_e/region_e/rta_participation_map_e.htm)

### CHINA'S TRADE STRATEGY

China's trade strategy in the Indo-Pacific region has a number of motives. Beijing has sought to:

- Improve its export competitiveness and strengthen China's role in production networks by expanding access to regional trade networks for its companies.
- Enhance its resource security through FTAs with resource-rich countries such as Australia, Chile, Iceland, New Zealand, and Peru.
- Gather support for China's status as a market

economy in the WTO by requiring FTA partners to recognize China's market economy status before entering.

- Secure its regional political and security interests by enlarging economic ties with various regional powers. Beijing concluded an FTA with ASEAN out of fear of economic isolation driven by Japanese FTA policy.<sup>318</sup> It also concluded FTAs with Australia and South Korea in part to drive a wedge in the U.S. alliance system in the Indo-Pacific.

Having initially focused on bilateral deals, China's trade strategy shifted with the progress of TPP negotiations. Beijing backed the launch of RCEP negotiations in 2012, re-started negotiations on a China-Japan-South Korea FTA, and in 2016 endorsed the Free Trade Area of the Asia-Pacific, a pan-Pacific arrangement within APEC.<sup>319</sup>

Whether China will make the concessions necessary to conclude RCEP or a trilateral FTA with Japan and South Korea is an open question. China is likely to attempt to keep RCEP low-standard with minimal political intervention and slow liberalization to protect its state-led economic model. China remains wary of opening up its own market and prefers to engage in FTAs with friendly countries. The unwillingness to open up is a serious barrier to China's regional and global trade and investment ambitions. However, Beijing continues to rely on its investment power through BRI and on its market power as a top trading partner for most countries in the region.

### *Priority Issues for Cooperation*

There are many potential areas for productive cooperation between the United States and Japan to strengthen the regional economic architecture. Three functional areas should be prioritized: strengthened disciplines on state-owned enterprises (SOEs); open, high-standard rules for the digital economy; and enhanced rules on trade in services.

#### **STATE-OWNED ENTERPRISES**

The United States and Japan have a strategic interest in ensuring that their businesses and workers can compete fairly with SOEs in the Indo-Pacific. All countries have SOEs, and none support their total elimination. However, SOEs can create serious market distortions, as they often receive heavy subsidies and preferential tax and regulatory treatment compared to privately-held firms. Thus, the United States and Japan have an interest in rules that govern the behavior of SOEs in the marketplace.

Before TPP, there were few international disciplines on SOEs beyond non-binding guidelines by the Organization for Economic Cooperation and Development (OECD) and International Monetary Fund, guidelines primarily designed to ensure greater transparency. TPP for the first time established binding regional rules on SOEs, putting constraints on non-commercial government subsidies, cheap loans, and preferential regulatory treatment, and making SOE ownership and financing more transparent.<sup>320</sup>

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<sup>318</sup> Takashi Terada, "Constructing an East Asian Concept and Growing Regional Identity: From EAEC to ASEAN + 3," *The Pacific Review*, 16(2) December 2010, 251-277.

<sup>319</sup> Bryan Mercurio, "China's Trade Strategy: Work in Progress," *The Asia Dialogue*, November 17, 2016, <http://theasiadialogue.com/2016/11/17/chinas-trade-strategy-work-in-progress/>.

<sup>320</sup> "State-Owned Enterprises and Competition Policy," Office of the U.S. Trade Representative, <https://ustr.gov/trade-agreements/free-trade-agreements/trans-pacific-partnership/tpp-chapter-chapter-negotiating-7#>; Thi Anh Nguyet Le, "State-owned Enterprise Reforms in the TPP Negotiation: Is it a win-win for Vietnam?" RIETI Discussion Paper Series 15-E-092 (July 2015), <https://www.rieti.go.jp/jp/publications/dp/15e092.pdf>.

However, the rules in TPP did not cover sub-central SOEs, which account for 40 percent of SOE revenue in China. Moreover, 70 percent of Chapter 17 on State-Owned Enterprises and Designated Monopolies was dedicated to exceptions. It also did not address all aspects of preferential regulatory treatment, investment behavior, corporate governance, and transparency of SOEs.<sup>321</sup> Thus there is much room for the United States and Japan to further develop the rules set in TPP, extend them to other trade deals, and strengthen enforcement mechanisms. The Japan–EU EPA is also introducing similar high-standard rules on SOEs. Japan is offering capacity-building support to Vietnam in APEC to internalize the OECD’s SOE guidelines.

There is now momentum on the part of Japan and the United States alongside the European Union to act multilaterally on SOEs. September’s Trilateral Meeting of the Trade Ministers of the United States, Japan, and the European Union resulted in a joint statement which included an agreement to intensify discussions on SOE market distortions and aim to negotiate more effective multilateral rules addressing said challenges. This is a positive initial step towards tackling this widely recognized problem.

Even without the benefit of binding solutions on SOEs, there are creative actions the United States, Japan, and allies can take. There are a number of parallels between the distortions created by SOEs with those created by agricultural subsidies. Like SOEs, all countries subsidize agriculture, and none support their total elimination. Yet in the past two decades progress has been made in understanding and combating agricultural subsidies in a way that can provide useful precedent for handling SOEs.

Rather than tackle agricultural subsidies directly, in the WTO Agreement on Agriculture in the Uruguay Round of trade negotiations (which entered into force in 1995), signatories agreed to list each nation’s respective agricultural subsidies. Subsidies were then grouped according to degrees of market distortion. Countries then had a public image incentive to change policies from the distortionary “amber box” grouping to the benign “green box” grouping. This cooperative, non-coercive approach could easily be adapted to SOEs, allowing countries to reach common definitions and share information without the threat of punishments.

## **THE DIGITAL ECONOMY**

The United States and Japan have a shared interest in an open, interoperable, reliable, and secure internet, supporting innovation, communication, and inclusivity while protecting consumer privacy. This contrasts sharply with China’s vision of a closed internet, control of data, and negligible privacy protections. The digital challenge from China is multifaceted, with the risk of digitally driven authoritarianism being supported in the region. First, Beijing is planning mass social control through digital surveillance technologies facilitated by artificial intelligence and big data in a social credit system. Second, the state is deeply entwined with the digital economy, and Beijing is deploying technologies of the fourth industrial revolution to support its broader economic planning. Third, cybersecurity is used by Beijing as an excuse for disguised protectionism, such as requiring the construction of local data centers. Fourth, the dual-use nature of digital technologies creates the risks of military applications and gray-zone uses by China. Finally, Beijing wishes to create a digital sphere of influence through the use of technologies and platforms

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<sup>321</sup> Sean Miner, “Commitments on State-Owned Enterprises,” in *Trans-Pacific Partnership: An Assessment*, ed. Cathleen Cimino-Isaacs and Jeffrey J. Schott (Peterson Institute for International Economics, July 2016), 335-348, [https://piie.com/publications/chapters\\_preview/7137/19iie7137.pdf](https://piie.com/publications/chapters_preview/7137/19iie7137.pdf); Mitsuo Matsushita, “State-Owned Enterprises in the TPP Agreement,” in *Paradigm Shift in International Economic Law Rule-Making*, ed. J. Chaisse, H. Gao, and C. Lo, (Singapore: Springer, 2017), [https://link.springer.com/chapter/10.1007/978-981-10-6731-0\\_11](https://link.springer.com/chapter/10.1007/978-981-10-6731-0_11); Tsuyoshi Kawase and Masahito Ambashi, “Disciplines on State-Owned Enterprises under the Trans-Pacific Partnership Agreement: Overview and Assessment,” ERIA Discussion Paper Series DP-2017-13, Economic Research Institute for ASEAN and East Asia (ERIA), February 2018, <http://www.eria.org/uploads/media/ERIA-DP-2017-13.pdf>.

with close links to the government. Through the “digital silk road,” a key element of BRI, platforms with close links to the government are monopolizing markets and the collection of data in surrounding countries. This worry is particularly acute in Southeast Asia.

It is in the digital arena that the global competition for the rules, standards, and norms governing the future economy is most forcefully being played out. FTAs negotiated by the United States and Japan to date include important disciplines on the digital economy. The TPP and the Japan–EU EPA both include provisions against imposing customs duties on electronic transmissions and against forced access to source codes. In three years, the Japan–EU EPA will review the necessity of rules on the free flow of data.<sup>322</sup> TPP goes further with provisions on freedom of cross-border data flows and against data localization requirements.<sup>323</sup>

Under the Obama administration, Washington and Tokyo agreed to set up a U.S.–Japan Policy Cooperation Dialogue on the Internet Economy; the Trump and Abe administrations agreed to continue the forum. At its eighth meeting in September 2017, the two sides discussed a wide range of topics, including coordination in the Group of Seven, Group of Twenty, OECD, APEC, and other international forums; promotion of cross-border flows under APEC’s Cross-Border Privacy Rules (CBPR) system; cybersecurity; and challenging third-country restrictions on digital trade, such as data localization measures, and violations of intellectual property rights.<sup>324</sup> The European Union and Japan are also engaged in regular and intense cooperation on the digital economy.

Such bilateral policy coordination efforts, on top of multilateral initiatives, are examples of constructive steps that the United States and Japan can take to realize their joint vision for the internet and counter China’s attempts to establish a closed digital economy that can be spread to other parts of the Indo-Pacific region.

## **GLOBAL TRADE IN SERVICES**

As the world develops beyond hard manufacturing into technology and information-driven industries, the need to govern global trade in services is growing. Among APEC member countries, services account for over 50 percent of GDP in developing economies and approximately 70 percent in developed economies, including Japan (72.6 percent) and the United States (78.1 percent).<sup>325</sup> Liberalizing global trade in services therefore is a key domestic interest for both Japan and the United States and would positively impact both developed and developing third-country economies.

Current trade in services is governed by the General Agreement on Trade in Services (GATS), which came into force in 1995 at the conclusion of the Uruguay Round. GATS was important in setting out definitions for sectors covered under the broad umbrella of services, and in defining the four modes of supply (cross-border, consumption abroad, commercial presence, and presence of a natural person).<sup>326</sup> Where GATS fell

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<sup>322</sup> Vrijsschrift, “EU–Japan trade agreement not compatible with EU data protection,” European Digital Rights (EDRi), January 10, 2018, <https://edri.org/eu-japan-trade-agreement-eu-data-protection/>.

<sup>323</sup> “The Digital 2 Dozen,” Office of the U.S. Trade Representative, 2016, <https://ustr.gov/sites/default/files/Digital-2-Dozen-Final.pdf>.

<sup>324</sup> Office of the Spokesperson, “Joint Press Statement for the Eighth U.S.–Japan Policy Cooperation Dialogue on the Internet Economy,” U.S. Department of State, September 25, 2017, <https://www.state.gov/r/pa/prs/ps/2017/09/274410.htm>.

<sup>325</sup> Asia-Pacific Economic Cooperation (APEC), *APEC Economic Policy Report 2016: Structural Reform and Services* (Singapore: APEC, 2016), 5, <https://www.apec.org/Publications/2016/11/2016-APEC-Economic-Policy-Report>.

<sup>326</sup> General Agreement on Trade in Services, Part 1, Article 1 (Uruguay Round Agreements, Annex 1B, 285–286), [https://www.wto.org/english/docs\\_e/legal\\_e/26-gats.pdf](https://www.wto.org/english/docs_e/legal_e/26-gats.pdf).

short was in liberalizing trade in services beyond the level already prescribed in most major economies' domestic laws. Though it was an important legal step forward, it did little to open markets.

To tackle services trade barriers, 23 WTO members began negotiating the Trade in Services Agreement (TiSA) agreement in March 2013. The TiSA parties account for approximately 70 percent of global trade in services and include Japan, the United States, the European Union, and half the members of APEC. Negotiations currently do not include China.<sup>327</sup> Though talks potentially hold great promise and include discussion of digital commerce and data protection,<sup>328</sup> there is at present little momentum towards reaching a deal.

Given the expanded coverage of services in both CPTPP and USMCA, the current administrations in both Japan and the United States have shown a clear interest and initiative in further liberalizing global trade in services. Both countries should therefore capitalize on shared interests to advocate on the world stage for rules that will open pathways for greater services trade.

### *Recommendations on Regional Trade Architecture*

With the current U.S. administration skeptical about multilateral trade, Japan has been pursuing a commendable role as a leader of trade liberalization and rule-making efforts in the Indo-Pacific. However, it cannot uphold this position alone; engagement by the United States, the world's largest economy and traditional leader on Indo-Pacific economic integration, is needed to support Tokyo's efforts. We offer recommendations below for individual and joint action by the two countries to move back onto the path of coordinated leadership on building an open, free, and fair regional trade architecture.

#### **UNITED STATES**

- 1. Avoid unilateral trade actions that harm allies and partners.** The Trump administration's unilateral trade actions on steel and aluminum, and prospectively on automobiles and auto parts, have not only harmed the U.S. economy and undermined the rules-based order but also alienated allies from Canada to Japan. Tough trade actions may occasionally be necessary to deal with deeply entrenched policies and practices, but these actions should not be done in a way that creates fissures with allies and partners who are vital both to strengthening the regional trade architecture and to taking on unfair practices in China and elsewhere.
- 2. Build on the conclusion of the USMCA to extend high standards in trade throughout the Indo-Pacific.** While the new trade agreement with Mexico and Canada may not be the radical overhaul of NAFTA promised by President Trump, it did represent a constructive step toward high-standard rule-making which could be extended to the Indo-Pacific. The digital commitments in the USMCA are arguably an improvement over TPP—for example, they include a total ban on data localization requirements, without an exception for financial services firms. The intellectual property and services chapters also include TPP-plus disciplines. The United States should seek to extend these high-standard rules to other trade agreements in the Indo-Pacific—ultimately to a multilateral, TPP-like deal involving the United States.

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<sup>327</sup> "Trade in Services Agreement Fact Sheet," European Commission, September 29, 2016, [http://trade.ec.europa.eu/doclib/docs/2016/september/tradoc\\_154971.doc.pdf](http://trade.ec.europa.eu/doclib/docs/2016/september/tradoc_154971.doc.pdf)

<sup>328</sup> *Ibid.*

- 3. Push for limited, urgent reforms of the WTO Appellate Body to preserve its ability to function.** The Trump administration’s complaints with the WTO Appellate Body echo complaints made by previous administrations and should be understood as a bipartisan U.S. complaint. Frustrations over Appellate Body practices that go beyond those stipulated by the 1994 GATT Agreement have been articulated by the United States multiple times.<sup>329</sup> Unfortunately, standard practice within the WTO is to approach problems comprehensively and thus link urgent issues with non-urgent ones, making it more difficult to convince members to vote on packages overall and producing slower reforms. The United States has withheld approvals of Appellate Body judges, which has caught the attention of other WTO members but hasn’t yet mobilized reform. A possible solution is active de-coupling of dispute settlement issues, speeding the voting process and allowing members to vote for limited, urgent issues that will keep the Appellate Body functional. The United States, with the support of Japan and possibly the European Union, can spearhead these efforts—with the expectation that once U.S. complaints are addressed, Washington will approve Appellate Body judges.

## JAPAN

- 1. Incentivize the United States to return to leadership in the multilateral trading system, starting with the WTO.** While Japan has the right objective in working for a U.S. return to TPP, this is not a realistic outcome in the short term. The Abe government deserves credit for taking the lead in holding together the remaining 11 members of TPP and upholding the multilateral system. Japan should build on its experience with CPTPP to work in other institutions, particularly the WTO, to create pathways for the United States to rejoin multilateral trade rule-making initiatives.
- 2. Place multilateral trade liberalization at the heart of the free and open Indo-Pacific strategy.** With a disengaged United States, an Australia distracted by domestic politics, and a closed, protectionist India, Japan stands in the strongest position to push for multilateral trade liberalization in the Indo-Pacific. This should be a central focus of Tokyo’s free and open Indo-Pacific strategy. Tokyo should push for high standards and high ambition in both RCEP and its trilateral negotiations with China and South Korea.
- 3. Ensure entry into force of CPTPP, upgrade rules at five-year review, and look to expand membership.** CPTPP is a vital step forward in shaping regional rules to ensure a high-standard of liberalization. The particular case of Vietnam will showcase the effectiveness of CPTPP in promoting domestic reform of SOEs. Considering TPP’s long-term goal of pushing China towards higher standards, the rules should be tightened at the five-year review. As sub-central SOEs produce 40 percent of revenue made by China’s SOEs, the expansion in the coverage of the rules is vital to ensure that TPP in its future form will hold traction vis-à-vis China. As iterated in other sections of this report, other nations such as South Korea should be strongly encouraged to join CPTPP. Expanded membership would have the additional benefit of creating more uniform regional standards, further incentivizing China to raise its standards as well.

## JOINT ACTION

- 1. Work together to extend and strengthen rules on SOEs.** The United States and Japan should work together to enhance both rule-making and enforcement with respect to SOEs. On rule-making, given

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<sup>329</sup> Tetyana Payosova, Gary Clyde Hufbauer, and Jeffrey J. Schott, “The Dispute Settlement Crisis in the World Trade Organization: Causes and Cures,” Peterson Institute for International Economics, March 2018, <https://piie.com/system/files/documents/pb18-5.pdf>.

the current legal characterization of SOEs, it can be difficult to label Chinese activity as orchestrated by the state. Coordination on broadening and sharing definitions of SOEs is necessary. The trilateral work among the U.S., Japanese, and EU trade ministers, including developing a plan to tackle industrial subsidies, is a positive start and should be expanded. Washington and Tokyo should explore lessons learned from efforts to categorize agricultural subsidies in the Uruguay Round Agreement on Agriculture to create higher-level rules, such as outlining different degrees and kinds of subsidization, demanding high levels of transparency, and addressing the macro-effects of SOEs. On enforcement, Washington and Tokyo should cooperate more closely by increasing information sharing, aligning cases against overcapacity and dumping, and exploring avenues to exchange technical assistance, such as those between Japan's Ministry of Economy, Trade and Industry, the U.S. Department of Commerce, and the U.S. International Trade Commission.<sup>330</sup>

2. **Make high-standard digital rule-making a priority in bilateral cooperation.** The United States and Japan have a critical interest in ensuring that the rules, standards, and norms of the digital economy support their commercial and strategic goals. They should step up their coordination on data policy and tackle digital protectionism, technical standard-setting, and mass data collection for new illiberal governance models. Digital regulations are managed through various forums, creating a risk of conflicting or contradictory rules. Washington and Tokyo should prioritize coordination in the digital arena through the U.S.–Japan Economic Dialogue, and in multilateral forums in which they participate, from the Group of Twenty to APEC. The U.S.–Japan Policy Cooperation Dialogue on the Internet Economy should meet more frequently to coordinate joint positions on these issues.
3. **Push for early progress in the TiSA services negotiations.** Given the weight of services in both their economies and the relatively under-developed international rules in this area, there is a clear opportunity for the United States and Japan to step up their joint efforts to bring the negotiation of a WTO Trade in Services Agreement to a rapid conclusion. They should work with like-minded countries such as Group of Seven partners, Australia, and South Korea to drive the negotiations forward.
4. **Enhance cooperation in regional organizations such as APEC and ADB and strengthen links with Europe on economic rule-making.** While APEC's commitments are voluntary and non-binding, they play an important role in shaping the future development of binding rules and norms. ADB is also a vital player in financing projects with high standards. Washington and Tokyo have disproportionate influence in APEC and ADB and should more actively coordinate their positions in these bodies on trade rule-making and infrastructure standard-setting.

The United States and Japan should also do more to coordinate with the European Union on regional economic rulemaking. For example, APEC's Cross-Border Privacy Rules (CBPR) are interoperable with the European Union's Data Transfer Mechanism, giving it greater regional and global regulatory power. More economies should be encouraged to sign onto CBPR, starting with Australia, New Zealand, and Thailand, where necessary by offering technical support. In particular, only the United States and Japan have established accountability agents for CBPR, necessary for certifying companies, and could provide support to help existing participants to CBPR to establish their own accountability agents.

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<sup>330</sup> Tsuyoshi Kawase, "Disseminating TPP SOE Chapter through New Japan-US Economic Cooperation Framework," The Brookings Institution, 2018, [https://www.brookings.edu/wp-content/uploads/2018/02/fp\\_20180129\\_tsuyoshi-kawase-presentation.pdf](https://www.brookings.edu/wp-content/uploads/2018/02/fp_20180129_tsuyoshi-kawase-presentation.pdf).

## Case Study #6 | The Group of Seven

The Group of Seven (G7) has lost much of its luster since it was first formed in response to the oil shocks of the 1970s. Bringing together leaders of the world's seven largest industrialized democracies—the United States, Japan, Germany, the United Kingdom, France, Italy, and Canada—the G7 had early success in stabilizing the global economy and setting an agenda for international economic cooperation. But over time, the forum was rendered less effective by a combination of diminishing consensus within the group, growing questions about its legitimacy as economic power in the world shifted toward new emerging markets, and, in the wake of the 2008 financial crisis, elevation of the Group of Twenty (G20) as the effective steering group for the global economy. The disruptive performance by U.S. President Donald Trump at the 2018 G7 Summit in Quebec, Canada, was widely seen as the death knell for the forum.

However, there is a case to be made that the G7 is more relevant than ever in a world in which the G20 post-crisis consensus has broken down and China poses a growing challenge to a market-oriented, rules-based order. Many of the core interests that unite the United States and Japan align with those of other G7 members—a point that even the Trump administration has effectively acknowledged by forming a common front with Japan and the European Union to take on China's problematic industrial policies.<sup>331</sup> Despite President Trump's general skepticism about multilateralism, there is an opportunity for the United States and Japan to revitalize the G7 as a force to uphold specific aspects of the rules-based economic order.

### *U.S. and Japanese Strategic Interests*

The United States and Japan share more common strategic interests in the G7 than at any time before. As advanced democracies, all members of the G7 fundamentally believe in a rules-based order and market-based economies. They value democracy and strive to promote good governance in emerging countries and regions recovering from conflict. The United States and Japan also have a growing interest in managing the problematic aspects of China's rise and ensuring free and open commerce with an emphasis on transparency and rule of law. These shared interests are stronger and more enduring than the conflicts which arose at the most recent G7 meeting in Canada.

The United States and Japan have historically used their roles as hosts of G7 summits to advance a broad agenda of global economic, security, and political goals. In the economic realm, these include growth and employment, structural reforms, development, and measures to deal with aging societies. They have also used the G7 to promote a robust global health agenda. While economic issues were the original rationale for formation of the G7, a gathering of leaders of the world's largest democracies has also inevitably been an important venue for discussing the pressing security issues of the day, from nuclear proliferation to terrorism, as well as human rights and other political concerns.

The United States and Japan have shown an interest in using the G7 to address problems not otherwise being met by other institutions of global governance. There is growing concern in both Washington and Tokyo that many of China's problematic trade practices—including massive subsidies and forced

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<sup>331</sup> Robert Lighthizer, Cecilia Malmström, and Hiroshige Seko, "Joint Statement on Trilateral Meeting of the Trade Ministers of the United States, Japan, and the European Union," New York, September 25, 2018, [http://trade.ec.europa.eu/doclib/docs/2018/september/tradoc\\_157412.pdf](http://trade.ec.europa.eu/doclib/docs/2018/september/tradoc_157412.pdf).

technology transfer policies—are not sufficiently covered by current World Trade Organization (WTO) rules. The G7 is thus a useful vehicle to coordinate U.S., Japanese, and European positions on how to address WTO reform and problematic Chinese practices.

## *Background on the G7*

The G7 was formed in 1975 in response to the 1971 Bretton Woods fixed interest rate collapse and the 1973 oil crisis.<sup>332, 333</sup> Then-President Valéry Giscard d'Estaing of France invited his counterparts from the United States, Japan, Germany, and the United Kingdom to join him for a summit in a chateau in Rambouillet outside Paris. (The Italian prime minister subsequently invited himself to the summit, and Canada joined the group the following year.) The agenda of the original meeting focused on overcoming high unemployment, deepening international economic cooperation, recommitting to principles of development of the Organization for Economic Cooperation and Development (OECD), and increasing global trade through tariff reductions and multilateral trade agreements.<sup>334</sup> The formation of the G7 also was a milestone for Japan, marking the first major recognition of the country as a global economic and political leader.<sup>335</sup>

Russia was formally added to the group in 1998 and remained a member of the newly named G8 until 2014, when the other members voted to suspend Russian membership after Moscow's *de facto* invasion of Crimea. Informally, the European Union has been a full participant in the G7 as a "non-enumerated" member since 1981; it is represented by the presidents of both the European Council and the European Commission.

The G7 is not an international organization or formal governing body, but rather a forum for members to discuss global economic, security, and political issues of the day. The G7 reaches decisions only when members reach a consensus on an initiative. The decisions and initiatives that arise from these discussions are non-binding and have no direct legal consequence. However, G7 statements have played an important role in global agenda-setting, and help signal to the world where these large industrialized democracies stand on major issues.

The G7 meets annually, and the chair of the forum rotates each year. Given that there is no G7 administrative body or permanent secretariat, the host country plays an important role in deciding which issues to include on the agenda. The host country creates an agenda for upcoming summit discussions and prepares the final communiqué, which is then approved by other nation's high-ranking officials, known as sherpas. This declaration is issued at the end of the annual summit and often includes joint initiatives and various action plans for the upcoming year. Japan was G7 host in 2016, and the United States will host in 2020. This format was emulated by the larger G20, which Japan will host in 2019.

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<sup>332</sup> Michael Bordo, "The Bretton Woods International Monetary System: A Historical Overview," in *A Retrospective on the Bretton Woods System: Lessons for International Monetary Reform*, ed. Michael Bordo and Barry Eichengreen, (Chicago: University of Chicago Press, 1993), <http://www.nber.org/chapters/c6867.pdf>.

<sup>333</sup> Greg Myre, "The 1973 Arab oil embargo: The old rules no longer apply," National Public Radio, October 16, 2013, <https://www.npr.org/sections/parallels/2013/10/15/234771573/the-1973-arab-oil-embargo-the-old-rules-no-longer-apply>.

<sup>334</sup> Robert Hormats, "Memorandum for Brent Scowcroft about the Rambouillet Summit", National Security Adviser's Memoranda of Conversation Collection at the Gerald R. Ford Presidential Library, December 2, 1975, <https://www.fordlibrarymuseum.gov/library/document/0314/1553299.pdf>.

<sup>335</sup> Hugo Dobson, "Japan and the Changing Global Balance of Power: The View from the Summit," *Politics*, Vol. 30, No. 3 (2010), 33-42, <http://eprints.whiterose.ac.uk/89039/1/Dobson,%20Politics,%202010%202.0.pdf>.

While the G7 can help identify global issues of concern, it has struggled in recent years to develop concrete action plans in response to these challenges. Members often fall short in implementing agreed actions and in mobilizing domestic support to launch new initiatives. Since the G7 lacks any real legislative authority and all decisions are non-binding, the forum has received criticism for falling short of targets and failing to address major issues. The G7 has struggled to work collectively, opting instead to act as a forum to list international commitments.

The G7 has also been criticized for excluding important emerging powers—notably China—and representing much less world economic power than in previous decades. China is now the second-largest economy in the world at official exchange rates, India is number six, and Brazil is larger than both Italy and Canada. By 2050, emerging markets are expected to grow around twice as fast, on average, as advanced G7 economies.<sup>336</sup>

In part to address this legitimacy question, in the wake of the 2008–09 financial crisis, the Obama administration endorsed the G20 as “the premier forum for international economic cooperation.”<sup>337</sup> The G20 introduced China, India, and Brazil to global economic governance, helping develop the “habits of cooperation” necessary to respond to potential future crises and address a number of structural economic challenges in the meantime.<sup>338</sup>

Yet the G20 itself has struggled with effectiveness and legitimacy in recent years. Though major emerging market economies, including China, India and Brazil, play an increasingly large role in global growth, the inclusion of more actors with divergent interests makes collaboration slower and more difficult. And just as the G7 had to develop and refine their habits of cooperation over the course of decades, the G20 members will need time to grow and practice those habits. As a smaller group of traditionally like-minded countries, the G7 should be able to reach consensus more quickly.

This is not to say that there cannot be overlap between work of the G7 and the G20. While members are loath to admit it, the G7 has on occasion acted as an informal caucus within the G20 to push for wider adoption of priority initiatives. The G7 can also serve as a pathfinder group to implement certain actions, bringing along other willing G20 countries over time. For the G7 to play these roles, close coordination between the United States and Japan within both the G7 and the G20 is essential.

In the past two decades, U.S. and Japanese stances on the G7 have occasionally diverged. Japan strongly opposed inviting Russia to join the international forum as an observer in 1997, concerned that admission of Russia to the liberal, rules-based international forum would dilute the G7’s core values of democracy and free markets. In addition, Russia’s admission would cause Japan to lose its own political clout and voice as the only non-European member. Japan preferred a smaller, more cohesive forum, as it provided members with better opportunities to create tangible change and mobilize collective action. In the end, however, Japan reluctantly agreed admit Russia to the G8 in 1998 to avoid conflict within the forum.<sup>339</sup>

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<sup>336</sup> “The World in 2050,” PricewaterhouseCoopers, 2018, <https://www.pwc.com/gx/en/issues/economy/the-world-in-2050.html>.

<sup>337</sup> Matthew Goodman, “G-ometry Test,” Center for Strategic and International Studies, Global Economics Update 1 no. 3 (May 2012), [https://csis-prod.s3.amazonaws.com/s3fs-public/legacy\\_files/files/publication/120516\\_simonchair\\_newsletter.pdf](https://csis-prod.s3.amazonaws.com/s3fs-public/legacy_files/files/publication/120516_simonchair_newsletter.pdf).

<sup>338</sup> Ibid.

<sup>339</sup> *Financial Post*, “Japan drops opposition to Russian entry to G7,” University of Toronto G8 Information Centre, May 20, 1997, <http://www.g8.utoronto.ca/fp/fp970520.htm>.

The United States historically has had no problem acting at odds with other members of the G7, including Japan. At the 1995 Halifax summit, the United States discussed auto tariffs and access to Japan's market during side talks.<sup>340</sup> The same year, other G7 members were unable to persuade the United States to change its stance on Cuba.<sup>341</sup> Despite Japan's position, Washington strongly advocated for Russia's inclusion as a symbol of the end of the Cold War.<sup>342</sup> And as mentioned, following the global financial crisis, the Obama presidency favored the G20 over the G8 as the premier forum for global economic governance.

However, these are not major divergences, and the United States and Japan could find much common ground in the G7. However, President Trump's new approaches to trade and climate change have made it harder to come together in the forum. President Trump has not shied away from criticizing what he views as G7 members' inadequate defense spending and unfairly large trade surpluses. The President's refusal to sign the 2018 communiqué in Quebec dealt a potentially fatal blow to the G7. However, since then, the Trump administration has worked out some of its differences on trade with its G7 partners and engaged in trilateral efforts with the European Union and Japan to take on problematic Chinese trade and industrial policies. This is an indication that the G7 can still resume an important role as a voice for the world's largest advanced democracies in bolstering a rules-based economic order.

### *Recommendations on the G7*

While the G7 clearly can no longer serve as steering group for the global economy, it still plays a unique role as a gathering place of leaders of the world's largest advanced democracies to discuss major global concerns. As the two largest economies in the group, the United States and Japan should combine forces to revitalize the G7 as a forum to promote a high-standard, rules-based global economic order.

#### **UNITED STATES**

- 1. Remain present and engaged in the G7.** As the Trump administration rethinks and renegotiates the U.S. role in the global order, it should not give up its seat at the G7 table. Bringing together a group of like-minded countries can be useful as a tool to advance U.S. interests. Even when the Trump administration believes G7 allies are not carrying their weight on security concerns, there is value in cooperating on geo-economic issues such as challenging Beijing's problematic trade and industrial policies, and more broadly supporting the rules-based order.

#### **JAPAN**

- 1. Harness Japan's credibility to bolster the G7's role.** As highlighted by its success in persuading the 11 remaining members of TPP to sign a modified agreement without the United States, Japan is increasingly asserting itself as a leader on the global economic stage. Japan can build on this newfound confidence and credibility to nudge its G7 colleagues toward meaningful commitments and actions on global economic priorities.

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<sup>340</sup> William J. Clinton, "The President's News Conference with Prime Minister Tomiichi Murayama of Japan in Halifax, Canada," The American Presidency Project, June 15, 1995, <http://www.presidency.ucsb.edu/ws/index.php?pid=51503>.

<sup>341</sup> Marie-Josée Drouin, "Will Clinton put Cuban-American lobby ahead of trade allies?: The U.S. should not unilaterally impose its view on the rest of the world," Financial Post, University of Toronto G8 Information Centre, July 3, 1996, <http://www.g8.utoronto.ca/fp/fp703962.htm>.

<sup>342</sup> Zachary Laub and James McBride, "The Group of Seven (G7)," Council on Foreign Relations, May 30, 2017, <https://www.cfr.org/backgrounder/group-seven-g7>.

2. **Use the G7 and G20 in tandem to reinforce policy priorities.** The annual cycle of global and regional summits—the G7, G20, APEC, etc.—provides an opportunity for host countries and like-minded partners to reinforce a policy agenda across these various forums. Japan takes over as G20 host in December 2018. Tokyo should work for consensus in the G7 on its G20 priorities, including quality infrastructure and global health, and use that consensus to drive toward agreement in the G20. Commitments agreed to in the Osaka G20 Summit can then be advanced in other international forums such as APEC.

#### JOINT ACTION

1. **Use the G7 to reinforce trilateral work on trade rules.** The trade ministers of the United States, Japan, and the European Union are doing constructive work to define a collective response to “non-market-oriented policies and practices of third countries”—a thinly veiled reference to China.<sup>343</sup> This includes an effort to develop new rules on industrial subsidies and state-owned enterprises, to push back against forced technology policies, to resist digital protectionism, and to reform the WTO. While there are differences among the three partners on these issues, especially with respect to digital governance, G7 members are nevertheless united in their fundamental commitment to a market-based, rule-of-law approach to these issues. This trilateral work should be carried into and refined by the G7, and from there taken into other forums such as the G20 in order to win broader international support.
2. **Use the G7 to spread high global standards on quality infrastructure.** The United States and Japan have enormous commercial and strategic stakes in today’s global infrastructure build-out.<sup>344</sup> They also share concerns that certain aspects of China’s ambitious Belt and Road Initiative could create economic and geopolitical risks. Both Washington and Tokyo have emphasized the importance of high-quality infrastructure investment characterized by open, lifecycle-cost-based procurement practices; transparency and lack of corruption; adequate social and environmental safeguards; and debt sustainability. Under Japan’s leadership in 2016, the G7 agreed to the “Ise-Shima Principles” for quality infrastructure. Over the coming year, the United States and Japan should work to flesh out these principles in the G7 and win broader international acceptance for them, including in the G20 during Japan’s host year in 2019.
3. **Begin collective action on limited case studies.** Collective action is like a muscle that requires training and strengthening over time. Japan and the United States should propose modest collective-action initiatives in the G7. By working together towards small successes, the G7 will be able not only to work out best practices of cooperation but also to leverage these successes when tackling larger issues.
4. **Reach out to other advanced democracies in the Pacific.** Membership of the G7 was decided in the 1970s, but since then the center of gravity in the global economy has shifted toward the Indo-Pacific. To ensure the voices of other advanced democracies in the region are heard, the United States and Japan should encourage the G7 to do more informal outreach to South Korea, Australia, New Zealand, and other like-minded countries in the region on the substantive rule-making and norm-setting issues above.

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<sup>343</sup> Robert Lighthizer, Cecilia Malmström, and Hiroshige Seko, “Joint Statement on Trilateral Meeting of the Trade Ministers of the United States, Japan and European Union, Office of the United States Trade Representative,” Office of the U.S. Trade Representative, September 25, 2018, <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/september/joint-statement-trilateral>.

<sup>344</sup> See analysis of global infrastructure developments on the CSIS Reconnecting Asia website: <https://reconnectingasia.csis.org>.

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