PROMAR CONSULTING

SPECIAL REPORT: Japan, the TPP, and Agriculture

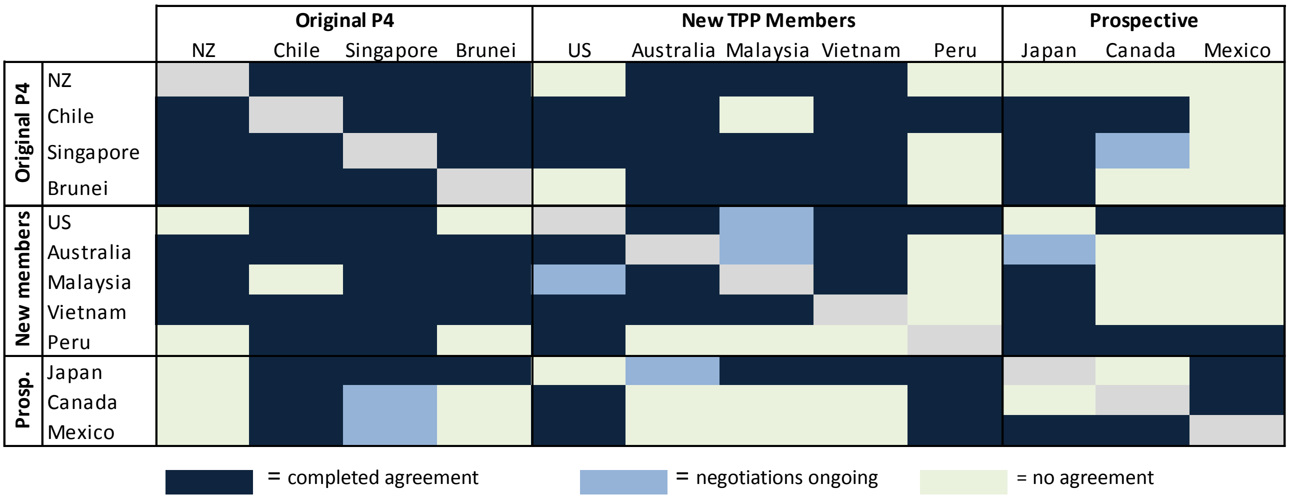
December 7, 2011 | Chris Clague, Senior Consultant Contact: cclague@promarconsulting.com

As Japan continues to take halting steps towards joining the Trans-Pacific Partnership (TPP), Promar is initiating a series of reports covering the challenges and opportunities Japan's participation creates. In this first note, we highlight five agricultural products that we believe are Japan's most sensitive and that will therefore cause the most problems for negotiators on all sides. Subsequent notes will go into greater detail on each of these products, along with others, and we will also publish occasional broader analysis of the type contained in this report.

INTRODUCTION

Over the past decade, the number of bilateral and regional Free Trade Agreements (FTAs) has increased substantially, a trend that Japan has followed by signing a host of such agreements, which it prefers to call Economic Partnership Agreements (EPAs). What it has not done, however, is complete trade negotiations outside of the WTO with a major exporter of food and agricultural products. It has started negotiations with Australia, yes, but those talks have stalled and were anyway making little progress on key outstanding issues, particularly agriculture. In agreements Japan has completed with countries like Thailand, sensitive agricultural products were either completely excluded or granted minimal amounts of increased access.

TPP MEMBERS: PRESENT, NEW, AND PROSPECTIVE AND THEIR OVERLAPPING FTAs*



*note that some of these agreements are completed but not yet in force

If it joins the TPP negotiations, Japan is going to be asked to make far more concessions in this area than it has in the past. New Zealand, for example, will certainly be pressing for Japan to open its dairy and beef markets, as will Australia and the US. The US, for its part, will seek an end to the pork import pricing system; Chile and Mexico and Canada—if the latter two join—have interests here, as well. And then there's rice. In the end, Japan may win exclusion, but not without a fight and most likely in exchange for significant concessions elsewhere.

In this introductory report, we provide an overview of Japan's current trade barriers for five key products: dairy, sugar, rice, pork, and beef. Our view is that these will be the most difficult to negotiate for Japan, although we recognize that wheat, seafood, and poultry—among others—will also present significant challenges. Should Japan eventually join the TPP negotiations, Promar will be providing regular and more in-depth reports on the products identified above.

BOX 1: Basic characteristics of FTAs, the TPP, and a glossary of key terms

In speaking with clients about the TPP over the past few months, we have learned that there are some common—and not so common—misconceptions about FTAs, in general, and the TTP more specifically, as well as confusion over key trade terminology. The brief explanations and definitions in this box are meant to provide readers clarity on these issues.

- ***What is a free trade agreement (FTA)?*** It's an agreement between two or more countries designed to facilitate and liberalize trade among the signatories. In theory, all trade should become liberalized between countries party to the agreement. In practice, certain tariff lines and other trade-related measures can be—and often are—excluded from the final agreement. For this reason, and because bilateral and regional FTAs are inherently discriminatory against non-members, some trade economists use the term PTA, or 'Preferential Trade Agreement,' instead of FTA.
- ***What is the TPP and to which countries will it apply?*** The TPP, or Trans-Pacific Partnership, is a regional trade agreement and applies only to those countries that sign the agreement. The tariff reductions agreed to within the TPP framework, for example, are not applicable to countries outside the agreement, which would continue to face Most Favored Nation (MFN) tariff rates under the existing WTO agreement (provided they are a WTO member).
- ***When will my product(s) become duty-free?*** That will depend. In most agreements, a few, especially-sensitive products never become duty-free. Nearly all, however, will be placed on a tariff elimination schedule that eventually leads to the product becoming duty-free, although these schedules can extend out as far as 15-20 years from the date the agreement enters into force.

Glossary of key terms

Tariff: There are two basic types of tariffs that we will refer to in this and subsequent reports. The applied tariff is the tariff the country actually charges on imports. The bound tariff is the highest tariff that country can legally apply without violating its WTO commitments and inviting retaliation from trading partners.

Tariff-rate Quota (TRQ): A system in which a set volume of a product or product group can be imported at a reduced tariff, but any volume of that product in excess of the set volume faces a much higher—and, in some cases, prohibitively higher—tariff.

Safeguard measure: A trade barrier put in place in order to protect domestic industry from import surges, the safeguard is established based on a formula that typically takes into account either past import volumes or domestic consumption.

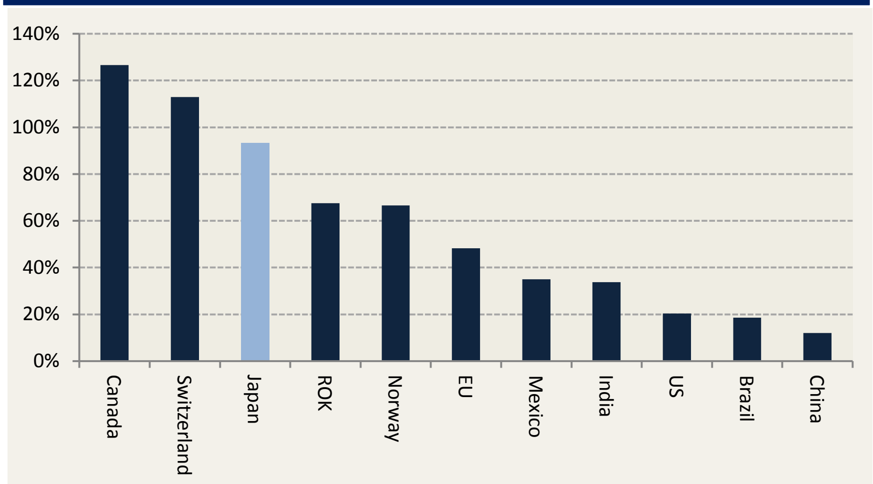
Trigger level: A safeguard measure is enacted once imports reach and surpass the set limit, known as the "trigger level." Tariffs on imports above the trigger level are levied at a higher rate than those imported below it. As with the TRQ and out-of-quota tariffs, the trigger level tariffs can be high enough so as to function as an outright barrier to further imports.

Tariff elimination schedule: Each product, or tariff line, is placed into one of the agreed upon staging categories, which are typically identified by a letter and are also called modalities. Each staging category, in turn, represents a schedule for tariff elimination in equal annual stages over a set number of years. For an example of a tariff elimination schedule, please see the beef section below.

DAIRY: Milking the bull?

Japan's dairy market is among the most protected food and agriculture markets in the world and, in Promar's view, negotiating tariff reductions here could actually prove to be more difficult even than for rice, which we believe could still be excluded. The average applied tariff on dairy imports is 93.3% and the highest single tariff is 650%, according to the WTO's most recent Japan tariff profile. By comparison, the average applied dairy tariff in South Korea, another one of the world's most protected markets, is "only" 67.5% and the peak tariff is 176%.

AVG. APPLIED DAIRY TARIFFS 2010: SELECT COUNTRIES



Source: *World Trade Organization 2010 Tariff Profiles*

In addition to tariffs, Japan's imports of most key dairy commodities, such as WMP, SMP, and butter, is managed through the use of tariff-rate quotas, or TRQs. These dairy TRQs were established during the Uruguay Round as part of a compromise on market access and are divided into two large, multi-product whole milk equivalent TRQs of over 130,000 tons each and eight separate TRQs covering individual products like milk, cream, and butteroil.[1] However, MAFF/ALIC (see Box 2 below) decides the timing and volume of imports for one of the TRQs, with ALIC handling the tender and release of products into the market. Tariff rates outside of the TRQ are so high for some key products that they essentially function as nearly-complete barrriers to market access, a practice often referred to as "dirty tarrification."

Finally, Japan has the ability to invoke special safeguard measures to raise tariffs. The trigger levels on many of these safeguards are set extremely low and, as a result, the safeguards are implemented often; in fact, the majority of special safeguard measures Japan has notified to the WTO in recent years have been for dairy products.

The problem for Japan and its negotiating partners in the TPP will be the fact that the TPP now includes three of the world's largest dairy exporters—New Zealand, Australia, and the US—and they are going to expect much greater access to the Japanese market. Although the US and

[1] An example conversion weight to whole milk equivalent would be the rate of 6.48 rate used for Whole Milk Powder (WMP), which means that every ton of WMP imports uses up 6.48 tons of the TRQ.

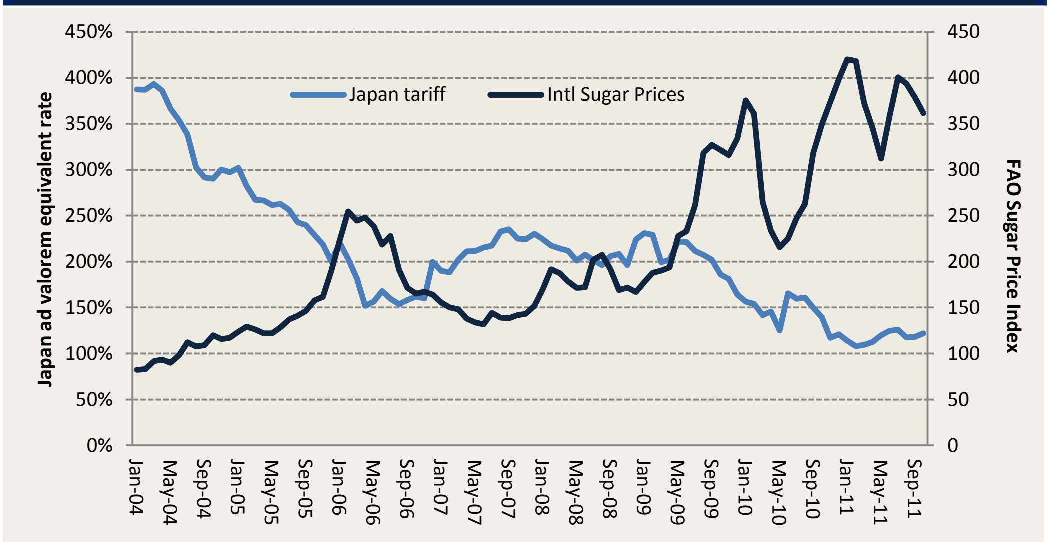
New Zealand are already at odds over Fonterra, which some in the US argue holds a monopoly over New Zealand supplies and thus has an unfair trade advantage, all three countries are likely to present something of a unified front in efforts to further open the Japanese dairy market.[2]

For its part, Japan initial offer in the TPP is likely to include an expansion of its dairy TRQs in exchange for longer and less-ambitious out-of-quota tariff elimination schedules. But countries already party to the negotiations have made it clear that other nations seeking to join the TPP should not expect to be able to exclude any products from tariff reductions. Thus, for this and other products, Japan can only buy time. And even if it does obtain a deal that allows for the temporary expansion to its TRQs, those TRQs will all need to be made available to interested buyers rather than held for the purpose of managing prices, which is how the large "designated products" TRQ is being used by ALIC now (again, see Box 2 below).

SUGAR: Sweetening the deal?

Japan's sugar market is as protected—and, by some measures, even more protected—than its dairy market. Most tariffs in the sugar and confectionary chapter are levied at a specific rate[3] and during times of low international sugar prices, the *ad valorem* equivalent has reached nearly 400%[4]; tariffs are also high on starches, sugar substitutes, such as High-fructose corn syrup (HFCS), and finished goods containing sugar. Moreover, ALIC controls the country's sugar import quota, but, oddly, Japan does not have to notify the WTO of this quota, nor acknowledge ALIC's role as a state trader for sugar. Instead, it can include the sugar trade regime in its Aggregate Measure of Support (AMS) notifications as "Amber Box" support measures, i.e. trade distorting support.

AD VALOREM EQUIVALENTS RISE AND FALL DEPENDING ON INTERNATIONAL PRICES...



Source: *Japan Customs, FAO, Promar Calculations*

Note: FAO Sugar Price Index is an indexed form of International Sugar Agreement prices. HS code is 170111190

[2] That said, with New Zealand and Australia both in the TPP, dairy is also a defensive issue for the US. In its existing FTA with Australia, US dairy tariff elimination schedules were as long as 18 years for the most sensitive products. So in the TPP, the US side will find itself at once trying to open the Japanese and other markets while keeping its own market protected from competition.

[3] A specific tariff rate is a tariff rate expressed in the local currency on a per product or weight basis, as opposed to ad valorem tariffs which are expressed as simple percentages (see next footnote)

[4] For example, the specific tariff on centrifugal sugar (HS 170111190) is ¥71.8/kg and in January 2004 when the CIF price was just over ¥18/kg that worked out to ad valorem equivalent of 387% tariff per kg.

Sugar production is concentrated in three prefectures: Hokkaido (beet), Kagoshima (cane), and Okinawa (cane). Hokkaido beet sugar accounts for between 75-80% of Japan's annual sugar output, followed by Okinawa at 10-15%, and Kagoshima at around 7-8%. Considering the size of its plantations and distance from Honshu, the opening the sugar market is likely to have a disproportionate impact on Okinawa's production, at least initially. Over time, Kagoshima and Hokkaido will be affected, as well.

At present, there is just one major net exporter of sugar among TPP members and that is Australia. Its share of Japan's total centrifugal sugar imports has varied over the last four to five years, but in 2010 it was up to 42%, or 492,000 tons. The other major source of sugar imports has been Thailand, with the Philippines coming in a distant third. Peru, which is already party to the negotiations, has the potential to export more but has moved back and forth between being a net importer and a marginal net exporter in recent years.

To date, sugar has been excluded from all of Japan's EPAs, although as with rice below, Thailand was the only partner country with which sugar was an issue. More importantly, sugar was also excluded from the US-Australia FTA, which could set a precedent for the TPP and, at the very least, gives Japan an ally in the form of the US and its protected sugar sector.

BOX 2: State Trading and the TPP

The import of a number of key agricultural products into Japan is managed by the government and a quasi-governmental organization called the Agriculture and Livestock Industries Corporation (ALIC). ALIC is under the Japan MAFF and is responsible for the import of the designated dairy product TRQ, and also sugar and starch. ALIC's primary mandate is to maintain price stability and, to that end, it buys or sells stocks when prices move into and out of certain set price bands and to compensate for domestic production shortfalls.

Trade in wheat, barley, and rice is managed by the Japan MAFF. We'll leave the byzantine rice import system to the brief section below covering that commodity and for subsequent TPP reports, and instead focus here on wheat. Under the URAA Japan established separate TRQs for wheat and wheat products and for barley. Within the TRQ, the MAFF sets its own internal import quota through a process of consulting with domestic end-users to estimate that year's demand for wheat, for example, and then subtracting the forecast domestic production volume from that figure. The MAFF then marks-up the wheat for sale to domestic end-users and pockets the difference, which has added-up to as much as $400 million in revenue in certain years.

To date, the practice of state trading has not been banned by a bilateral or regional trade agreement, with most state-trading countries arguing that it's an issue that should be left to WTO negotiations. That may change with the TPP. A draft text on the activities of State-owned Enterprises (SOEs) was tabled by the US at the 9th round of negotiations in Peru. Whether it will apply to an organization like ALIC, however, is unclear at this point (as is whether that text will even be incorporated into the final agreement).

Regardless, how the MAFF and ALIC operate is sure to be addressed in the negotiations. The administration of the designated dairy TRQ, for instance, is likely to be altered so that imports under the TRQ are sold through auction or licensing systems rather than for use in stock maintenance and price stabilization. Related measures, such as the establishment of consultative groups to monitor the filling and administration of the TRQs, will also need to be put in place, as they were under the terms of the KORUS FTA.

RICE: The Third Rail of Japanese Trade Politics?

Knowing that any real liberalization of the rice would be politically disastrous, in every trade negotiation—whether bilateral, regional, or global—Japan has fought successfully to ensure the country's rice growers remain sheltered from import competition. The URAA, and the effort to 'tariffy' non-tariff barriers, led to Japan establishing minimum market access for rice imports, but since the MAFF Food Agency manages the imports and marks up the price, those imports very rarely make it to consumers. Furthermore, rice has been excluded from all Japan's completed EPAs (though the EPA with Thailand was the only agreement in which rice could have potentially been an issue).

The present negotiating 'broad' framework, or outline, of the TPP could spell the end of Japan's rice barriers. Released after the recent APEC meeting in Hawaii,[5] the document states that the TPP tariff schedule "will cover all goods," a phrasing which can easily be interpreted as including rice. Moreover, New Zealand's Trade Minister has been quoted publicly as saying that the talks "must include rice;" considering the thin rice trade between current TPP members, the Minister's comment was most likely intended for his audience in Tokyo.

Still, there are precedents that suggest Japan might be able to manage to keep rice out of the TPP.

Three countries currently party to the negotiations have an interest in gaining access to the Japanese rice market: the US, Australia, and Vietnam. However, in maybe the strongest precedent, the US agreed to completely exclude rice from its agreement with South Korea. The first time the US raised the issue in those trade negotiations, the Korean side walked out. When rice was brought up again, the Koreans responded by pointing to the exclusion of sugar from the US-Australia FTA as grounds for keeping rice out of the KORUS FTA (which serves as another precedent for Japan in the TPP). In the end, it was left out, reportedly on a "rice for beef" deal that granted US beef greater access to the Korean market in exchange for taking rice off the table.

Another precedent comes from Japan's EPA with Vietnam, which also excluded rice, although Vietnam might have more leverage in the multilateral TPP setting to reverse that agreement.

Promar's current view is that a deal will ultimately be struck that keeps rice out of the agreement. It will violate one of the core principles of the TPP in its present form, but even with the diminished power of the farm lobby in Japan, we feel rice still represents a political deal-breaker for Japan. Japan will therefore try to make a "rice for product-x" concession or concessions and if this is on dairy, beef, or pork (or even sugar), it will be a net-win for some combination of the US, Australia, and New Zealand. Vietnam would stand to lose the most from this result, although its status as a developing country could lead Japan to grant a small volume of additional access.

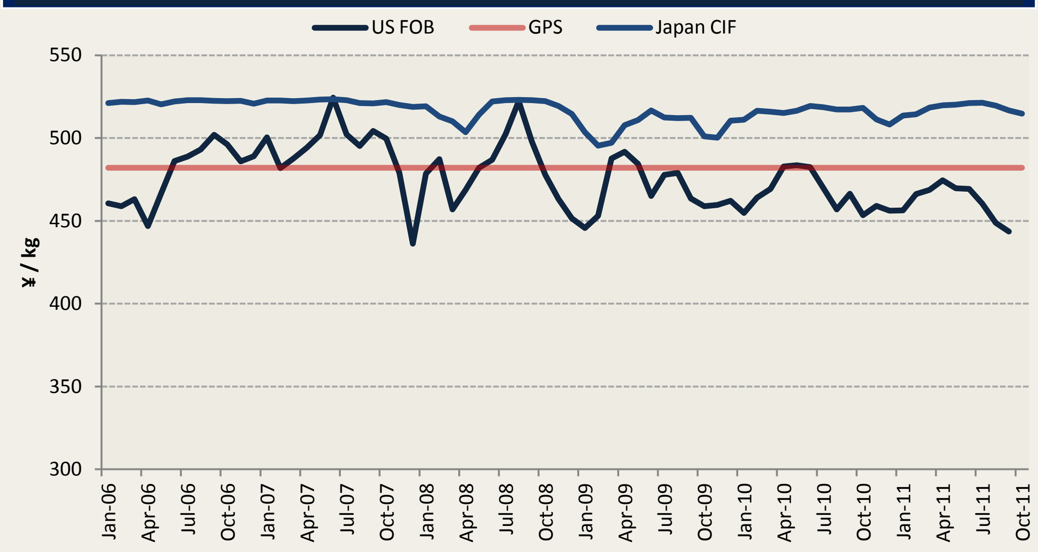
[5] Available at http://www.dfat.gov.au/trade/tpp/TPP_broad_outlines%20.pdf, among other trade ministry websites.

PORK: Taking a broom to the system?

Japan is the world's largest importer of pork, taking in over 750,000 tons in 2010 and the US has long been its dominant supplier, accounting for around 40% of the total volume in most years. Among the other countries currently party to the TPP, only Chile ships significant amounts to Japan (24,500 tons in 2010), although Canada and Mexico—the second and fourth-largest import sources for Japan—have expressed interest in joining the agreement in recent months.

Japan's domestic pork industry is protected behind a unique tariff called the Gate Price System (GPS). Under the GPS, imports are taxed based on whether the per kilogram price is below or above the price set by the Japanese government.[6] Imports that are below that price are taxed at a rate that brings the per kilogram price up to the government-set price, with an additional duty of 4.3% levied on top of that. Imports that are above the gate price only face the 4.3% duty.

GAMING THE SYSTEM: US PORK EXPORT V. JAPAN IMPORT PRICES



Source: *Japan Customs, USDA FAS Global Agricultural Trade System, US Federal Reserve*
Note: US FOB prices converted to JPY using that month's average dollar-yen rate. Product is fresh/chilled pork cuts (HS 020319).

At least that is the way the system is designed to work. How it actually functions is quite different. Traders on both sides can and do collude to put together mixed shipments that shelter pork cuts that would otherwise be below the gate price and thus face the equalizing tariff (plus the 4.3% tariff applied to all pork imports). This practice explains why, in the chart above, Japan CIF prices manage to stay just above the gate price even though there is considerable fluctuation in the US FOB price (shown converted to yen for illustrative purposes).

Japan has stated in the past that it would only negotiate the GPS at the WTO, but It's unlikely the other TPP parties will accept this position, particularly the US and to a lesser extent Chile. To date, the only bilateral trade agreement Japan has completed with a major exporter of pork

[6] The gate price is currently set at ¥361/kg for whole and half carcasses and ¥482/kg for cuts; the GPS price for processed pork products, such as ham and bacon, is ¥ 1,035/kg.

has been its Economic Partnership Agreement (EPA) with Mexico. In that agreement, Japan gave Mexico a country-specific TRQ that increases annually and now stands at 83,000 tons. Imports within the TRQ are still subject to the GPS, but the additional tariff has been reduced to 2.2% and Mexican pork is no longer included in the special safeguard, should it be triggered; out-of-quota Mexican pork faces the GPS and the full additional tariff of 4.3%.

The GPS, and the fact that it's being gamed, also creates a problem for Japan and its prospective negotiating partners. Normally, tariff elimination schedules start from a baseline tariff, as with beef below, for example. But there is no baseline tariff for pork outside of the 4.3% that is levied on top of imports below the GPS price or levied alone on those above the GPS price. Japan is not going to agree to use 4.3% as the starting point for tariff elimination and we doubt its potential TPP negotiating partners hold illusions to the contrary. Were the system not being manipulated, one option could have been to start from, say, the five-year average GPS tariff required to bring the relevant tariff lines up to the GPS price. That is not an option, however, and some other equivalent measure to determine a starting point will need to be agreed upon.

BEEF: How old and how much?

Japan is the second largest beef importer after Russia and Australia, the US, and New Zealand have long been the country's main suppliers. However, the US's share dropped to zero or near zero in 2004 and '05 following the BSE discovery. US imports have been recovering since it reached agreement for Japan to allow in beef from cattle under 20-months of age at slaughter, but volumes were still just one-third of pre-BSE levels in 2010.

Japan has been holding talks with the US for years over relaxing the BSE-related restrictions, with the US arguing that Japan should follow the World Organization for Animal Health (OIE) in recognizing that the US is now only a controlled risk for BSE, the same designation the OIE currently assigns to Japan. Reportedly, the two sides made progress when the US Secretary of Agriculture visited Japan last summer, but there's has been little mention in the press since then.

Word from the US industry in Washington is that they expect Japan to lift the restrictions as a pre-condition to joining the TPP negotiations. With the next negotiating round fast approaching, however, we expect the issue will be need to either be addressed on the TPP sidelines and/or perhaps even in the context of the negotiations themselves.

On the trade and tariff side, Japan will need to make concessions on beef tariffs and also make adjustments to the safeguard measures now in place with a view towards abolishing them altogether. Under the current system, the beef tariff is set at 38.5%, but Japan has the option of raising that tariff to as high as 50% if quarterly imports exceed the safeguard trigger level, which is calculated as 117% of the total volumes for the same quarter the previous year.[7] It has, however, been 8-plus years since the last time the safeguard was triggered.

The final agreement on beef for Japan will probably follow a three-track approach covering the base rate, safeguard trigger level, and safeguard tariff rate. For example, the base rate would be eliminated in 10 equal annual stages (3.85% per year), becoming duty-free in the 10th year,

[7] Quarters are based on Japan's fiscal year, which runs from April to March.

while the safeguard trigger level is increased by 2-3% per year until the 10th year, when beef imports would become duty-free. At the same time, the safeguard duty would also be reduced in equal annual stages. For example of how this might look, see the table below.

JAPAN: POSSIBLE TREATMENT FOR BEEF IN THE TPP

	Current	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Base rate	38.50	34.65	30.80	26.95	23.10	19.25	15.40	11.55	7.70	3.85	Duty Free
Trigger (vol.)	117%	120%	123%	126%	129%	132%	135%	138%	141%	144%	
Trigger (tariff)	50	45	40	35	30	25	20	15	10	5	

CONCLUDING REMARKS

Even without Japan's participation, the TPP would still have been one of the most ambitious trade-related undertakings ever pursued outside of the GATT/WTO framework. Japan's potential presence in the negotiations takes that ambition even further, increasing both the prospective benefits and, consequently, the complications of reaching an agreement.

Foremost among those complications will be food and agriculture. That Japan's trade barriers are among the highest in the world for the products it deems most sensitive is a fairly well-known fact. What is less known, let alone understood, is that the structure of these barriers—which are a legacy of the Uruguay Round compromises—are somewhat unique and thus defy customary solutions used in most bilateral and regional trade agreements. That does not make them impossible to negotiate, but it does mean they will be unusually difficult, as we are sure the Australian negotiators can attest to from their years of bilateral FTA negotiations with Japan.

To reiterate, the five products covered in this report—dairy, sugar, rice, pork, and beef—are the five that we believe will prove most divisive for Japan in the TPP negotiations.

- For **dairy**, with New Zealand, Australia, and the US all in the agreement, there will be strong pressure on Japan to dismantle its current system of barriers, which is substantial and could make the dairy negotiations even more difficult than rice.
- **Sugar** will likewise prove hard, although the presence of only one major sugar exporter, Australia, will lessen the pressure here and Japan will have common cause with the US in resisting greater market access.
- **On rice,** our view is that including it in the final agreement is, for Japan, a political dealbreaker, but that the KORUS FTA and the Australia-US FTA provide Japan with useful precedents for exclusion.
- **Pork** negotiations, to start, will need agreement on a reasonable baseline tariff from which to begin tariff eliminations on Japan's imports (we assume the GPS will be eliminated); the US and Chile will be pushing for a low number here, along with exemptions from the pork safeguard measures.
- **Beef** negotiations may not truly start until the Japan-US dispute over BSE restrictions is resolved, but then they will focus on tariff elimination, gradual removal of the safeguard measures, and probably codifying beef-related SPS standards.