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# Asia Pacific:

# PERSPECTIVES

*an electronic journal*

Volume VII · Number 1

15 July · 2007

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\* 'Asia Pacific region' as used here includes East Asia, Southeast Asia, South Asia, Oceania, and the Russian Far East.

## Cross-Regional Trade Cooperation: The Mexico-Japan Free Trade Agreement

by Sarita D. Jackson, Ph.D.

### Abstract

Latin American and Asia-Pacific countries are fervently forging economic cooperative relationships, which began with the Asia-Pacific Economic Cooperation in 1989. The two regions have shifted away from looking intra-regionally for economic stability against the forces of globalization. Rather, they have moved towards emphasizing cross-regional trade pacts. Cross-regional trade pacts present a number of advantages for member countries. The Mexico-Japan FTA, as a case study, shows us that trade and FDI between member countries increase with cross-regional free trade agreements (FTA). However, FTAs between the Latin American and Asia-Pacific regions do not have a direct impact on trade and FDI. As trade relations between Mexico and Japan show, there have been periods of expanded trade activity prior to the implementation of a cross-regional trade pact. Instead, a number of other variables play a key role in promoting trade and FDI such as the regulatory environment, fiscal policy, and physical infrastructure. Furthermore, cross-regional trade agreements present other new opportunities for the countries involved. Latin American and Asia-Pacific countries that sign onto inter-regional trade deals have access to other regional markets that may consist of larger economies, low cost producers, and more efficient production mechanisms.

### Introduction

Trade relations between the Asia-Pacific and Latin America display a cooperative commercial relationship that continues growing stronger. Asia-Pacific and Latin American countries began integrating into the global economy by sealing intra-regional trade deals with their respective regional partners. Not long after, individual countries from both regions began forging economic cooperative relationships with non-regional trading partners on the other side of the Pacific. Today, trade deals have gone into effect between Korea and Chile; Chile and Brunei, Singapore, and New Zealand; China and Chile;<sup>1</sup> Japan and Mexico; Thailand and Peru; Taiwan and Nicaragua; and Panama and Singapore. Furthermore, Japan and Chile as well as Taiwan, El Salvador, and Honduras have completed trade negotiations and signed a free trade pact. The construction of a commercial bridge across the Pacific between Latin America and Asia-Pacific countries remains underway, for example Singapore and Peru and Taiwan and the Dominican Republic are currently negotiating a bilateral cross-regional trade accord. Additionally, China and Chile began FTA talks on services trade and investment in January 2007. Vietnam and Chile began free trade negotiations in March 2007. The cross-regional trade arrangements between the Asia-Pacific and Latin America raise the question as to what this could mean for both regions economically.

The Asia-Pacific region offers Latin American exporters a large, continuously growing regional market. Latin America,

on the other hand, presents the Asia-Pacific with the opportunity to access the larger Western Hemisphere market through the various trading blocs and bilateral accords that exist throughout the region as well as the potential for a Free Trade Area of the Americas (FTAA). The FTAA, which was supposed to take effect on January 1, 2005, will form a trading bloc that consists of all of the countries in the Western Hemisphere except for Cuba. Both sides continue to promote economic cooperation across the Pacific. Speaking at the Inter-American Development Bank (IDB) Annual Meeting in Okinawa, Japan in 2005, Asian Development Bank President Haruhiko Kuroda explained:

There is further scope for trade cooperation between Asia and Latin America for the mutual benefit of each other. First, Asia, with some of the most dynamic economies in the world, provides a large and growing market for Latin American products. Although Latin American economy is less than half the size of Asia's, its growth performance has improved recently, and the prospect of a Free Trade Area of the Americas holds out a possibility of an increase in market size there as well.

The ever growing shift towards cross-regionalism between Asia-Pacific countries and Latin America has been overshadowed by discussions and analyses of the growing number of bilateral trade agreements within each of the two regions. In the last decade, various scholarly works on both Latin America and Asia have offered explanations about the growing trend towards the *new regionalism*, which describes renewed efforts by Latin America and relatively new attempts by Asia-Pacific countries to form effective regional trading blocs (Devlin and French-Davis 1998; Pizarro 1999; Devlin and Estevadeordal 2001; Lincoln 2004; Mehta and Kumar 2004; Eden 2006; Scollay 2006). As a result, there are limited studies on the cross-regional trade patterns.

However, the cross-regional trend is slowly making its way to the forefront of debates. The Council of the Americas sponsored a day long conference entitled *Building Global Competitiveness: the Asia-Latin America Connection* in October 2006. The conference addressed the question of whether Asia and Latin America were global partners or global competitors as well as the economic and financial implications of the growth of China and India for Latin America and the Caribbean. The panelists discussed the growing number of FTAs between the two regions. For example, IDB Executive Director of Japan and Korea Tsuyoshi Takahashi described Japan's FTAs with Mexico and Chile and how the country seeks to strengthen and develop new partnerships with other Latin American countries. IDB Principal Advisor of Integration and Regional Programs Antoni Estevadeordal described China as a partner to Latin America through trade and investment linkages such as FTAs as well as the G-20 and the WTO. Additionally, other specific issues pertaining to the growing inter-dependence between Latin America and Asia are also emerging such as SME participation in trade between the two regions (ECLAC 2006).

Although, such accords are receiving more attention, they are not new when we look at those formed between Asia and Latin America. In fact, this trend began during the same time scholars mainly focused on *new regionalism*. The Asia-Pacific Economic Cooperation (APEC) formed in 1989. APEC economically linked developed and developing economies in Australia and New Zealand, the Americas, and Asia. Mexico joined APEC in 1993; Chile, 1994; and Peru later joined in 1998. APEC continues operating in order to meet its goals of free and open trade and investment in the Asia-Pacific by 2010 for developed economies and 2020 for developing economies.

The Mexico-Japan FTA serves as a useful case for a detailed examination of cross-regionalism in terms of trade and FDI flows. Based upon this case, I find that cross-regional FTAs increase trade and FDI; provide market access to larger, developed economies; allow developed economies to export to smaller markets with cheaper labor; and expand regional market access. At the same time, this argument does not claim to draw a direct link between cross-regional FTAs and FDI and trade. Other factors such as the regulatory environment, transparency, tax systems, and physical infrastructure impact both trade and FDI flows. Nevertheless, cross-regional FTAs play an important role in expanding trade and providing additional investment opportunities and sources.

### Perspectives on Regional Trade Agreements

Much of the scholarly work on Latin America and Asia's trading arrangements fall short of in-depth analyses on *cross-regionalism* itself. This remains the case despite the growing existence of cross-regional agreements across the Pacific. A number of regional studies include a description of the cross-regional trend yet within an overall focus on regional bilateral and multilateral free trade agreements. Consequently, regional trade studies fail to strongly emphasize the growing trend towards establishing cross-regional trade areas through formal agreements.

OECD representatives Oliver Solano and Andreas Sennekamp acknowledge the cross-regional trade agreements in a March 2006 paper. However, the brief mention of these types of trade accords fit into a larger working paper on the competition provisions within regional trade agreements. Solano and Sennekamp only discuss cross-regional trade agreements to show that the distinction between two types of competitive provisions that exist in intra-regional trade deals – rules to curb anticompetitive behavior or provisions to encourage coordination and cooperation – becomes blurry with inter-regional trade accords. As a result, very minimal attention is paid to the significance of cross-regional accords and how findings towards RTAs may or may not be applicable to such agreements.

Another illustrative example of the minimal focus on cross-regional trade agreements can be found in an Asian Development Bank report entitled, *Asian Development Outlook 2006*. The report mentions the number of cross-regional agreements that Asian countries are pursuing. The brief discussion takes place within the overall context of the rise in bilateral

agreements. The reader learns that cross-regional trade arrangements are important for exporting final products to other significant markets outside of the region, are driven by the need for energy security via access to mineral and natural resources, and occur purely out of political motivation. On the other hand, the brief description does not include empirical evidence that underscores the unique impact that these types of agreements may have on member countries.

More recent debates continue to focus mainly on the benefits and drawbacks of regionalism<sup>2</sup> whereas earlier pieces focused on explaining regionalism in Latin America and Asia. One side maintains that regionalism is insufficient for addressing the challenges of liberal trading regimes. Instead, a multilateral framework appears more useful. For example, at an Inter-American Development Bank conference,<sup>3</sup> Director of Brazil's Institute for International Trade Negotiation (ICONE) Marcos Jank contended that multilateralism remains better equipped than RTAs to solve the number of systemic challenges that arise such as agricultural subsidies and government procurement. The other side of the debate critiques the multilateral system as a flawed institution while pointing to the successes of regionalism. For instance, the former Deputy Director-General of the WTO Miguel Rodríguez Mendoza maintained that the multilateral system remains "inadequate" and fails to reflect the complexities of both multilateral arrangements and regional agreements.<sup>4</sup> Mendoza suggested the use of a single framework that combines those mechanisms within both the multilateral and regional systems that are actually working.

### History of Latin America and Asia Trade Relations

What is now labeled old regionalism refers mainly to market access programs, in which a fixed preferential tariff applied to specific products or industries during the 1960s and 1970s.<sup>4</sup> Old regionalism trade regimes were limited and restrictive. For instance, the 1965 Auto Pact between the United States and Canada removed barriers to trade only in auto and autoparts (Eden 2006, 2). Throughout Latin America, the old regionalism served as a regional form of import substitution industrialization (ISI) strategy, in which regional economic arrangements between certain countries in Latin America reduced trade and investment barriers amongst themselves while maintaining high barriers to trade and investment to outsiders, including other non-member Latin American countries (Eden 2006, 2). These efforts to promote regional trade cooperation functioned in a tepid manner such as lowering tariffs in weak or nonexistent domestic industries and intensifying the use of quotas and import licenses (Eden 2006, 3-4). Illustrative examples of partial trade liberalization include the Central American Common Market (CACM), the Latin American Free Trade Area (LAFTA),<sup>5</sup> the Andean Group, and the Caribbean Community (CARICOM). The highly protectionist motives behind these arrangements resulted in limited gains for the region as a whole (Blomström and Kokko 1997; Devlin 2000; Eden 2006).

The 1990s, after a decade-long lapse in the move towards regionalism, altered our understanding of regionalism because of the distinctive characteristics of the newly formed trade liberalization accords. *New regionalism* supported a market-oriented trade policy over the protectionist policies of earlier regional integration efforts. Beginning with Mercosur in 1991 and followed by NAFTA in 1994, Latin America began the process of the *new regionalism*. MERCOSUR and Mexico adopted measures favoring market liberalization through lower or common external tariffs, the removal of quotas, and the elimination of import licenses. Additionally, many Latin American countries embraced the NAFTA model, which advanced towards the quick, automatic, and nearly universal elimination of tariffs (Estevadeordal 2003).

On the other side of the Pacific, Asian countries ostensibly partook of the new regionalism ideology. Observers of economic integration in East Asia have been perplexed by the region's shift from no regionalism towards the new regionalism. Despite the geographical proximity of East Asian countries,<sup>6</sup> the regional countries failed to integrate. Economist Edward J. Lincoln attributes the disappointing integration results to the diversity that exists throughout the region (2004, 15-16). That changed in 1989 with the formation of APEC. "Something was stirring across East Asia in the opening years of the 21st century. A region that had been notable for its lack of internal economic links over the previous 50 years was talking actively about regional cooperation," writes Lincoln (2004, 1). By 1991, APEC committed to a long-term goal of free trade and investment through lower trade barriers, reduced costs of conducting business in the region, and trade facilitation (i.e. human resource development, promoting a stable business environment, strengthening small and medium-sized enterprises, and utilizing modern technology) (Lincoln 2004; Scollay 2006). As a matter of fact, APEC went beyond the preferential liberalization that was characteristic of new regionalism by adopting the non-discriminatory trade practices that are encouraged under the multilateral regime.

RTAs lead to increased FDI inflows into countries, according to empirical studies. The case of Mexico supports these findings. The Latin American country experienced much higher levels of FDI inflows after signing NAFTA compared to FDI inflows throughout the rest of Latin America (Globerman 2002; Monge-Naranjo 2002). Countries within ASEAN +3 and the EU also result in similar findings. ASEAN +3 and EU member countries experienced increased FDI inflows after joining these regional trading blocs (Tayyebi and Hortamani). This basic argument has led observers to conclude that if countries join RTAs, they would benefit from increased FDI inflows. For example, Yeyati, Stein, and Daude (2002) predicted that if the other Latin American countries joined the Free Trade Area of the Americas, they would experience greater inflows of FDI.<sup>7</sup>

Contrary to earlier evidence, FDI may not necessarily be driven by membership in an RTA alone. Some countries received increasing FDI prior to joining an RTA, as in the case of Mexico. FDI inflows into Mexico from the United States

were on the rise during the 1980s. During this period, Mexico opened its market, enacted trade policy reforms, and joined the General Agreement on Tariffs and Trade (GATT). The flow of FDI from the United States continued during and after the NAFTA negotiations. Economists Magnus Blomström and Ari Kokko contradict the basic idea that RTAs automatically lead to higher levels of FDI inflows for a country. Instead, they turn to economic and regulatory policy reforms as possible explanations for a country's ability to attract more FDI from within.

The timing and character of the changes in the U.S. investment position suggest that NAFTA has perhaps not been the main determinant of the upswing in U.S. investments in Mexico. An equally important stimulus must have been the comprehensive reforms of the country's FDI regulation that commenced already in the mid-1980s and eventually culminated with the NAFTA (Blomström and Kokko 1997, 30).

Asian case studies further advance the argument that FDI may be driven by economic and regulatory policy reforms. China's shift from being a country completely closed to FDI post-WWII throughout the 1970s towards an economic environment more open to FDI by the early 1990s resulted in an influx of FDI into the country. "Even if investors are becoming discouraged by the policy environment currently prevailing in China, the emergence of China as a major host nation to FDI has nonetheless been driven by positive changes in Chinese policy over the last quarter century or so" (Graham and Wada, 6). These inflows came about before China joined an RTA.<sup>8</sup>

While valuable, these earlier premises fall short of taking into account the role of physical infrastructure. Physical infrastructure refers broadly to a country's transportation and communications systems. Weak customs facilities, poor transport and telecommunications mechanism, inadequate services for importers and exporters, and opaque information systems act as bottlenecks to conducting business efficiently. As a result, investors may be deterred from investing in a particular country, thus limiting that country's FDI inflows (Thomas, Nash, et. al. 1991; *World Bank* 2006).

The efforts of developing countries to modernize their physical infrastructure produce a business environment that requires less time to operate and reduces transaction costs. Therefore, the improved business environment makes the country more attractive to foreign investors. In the case of China, the development of its physical infrastructure elicited an efficient business environment that reduced the trepidations of foreign investors. Therefore, China began to lure immense amounts of FDI (Davies 2003; OECD 2006).

On the other hand, critics have charged RTAs with FDI diversion. RTAs can also have the reverse effect on attracting FDI. They can remove investment away from a country that has the most comparative advantage, other regions within the global community, and away from those countries with smaller market sizes. Blomström and Kokko warn that:

Although the underlying assumption is that increased FDI inflows are beneficial to growth and development

in the integrating region, it should be recognized that the welfare effects on the region may in fact be negative if the RIA [Regional Integration Agreements] worsens the allocation of resources or adds new distortions, e.g. in the form of higher average protection of the regional market. In addition, the welfare effects on the rest of the world may be negative if the RIA diverts investment from other countries to the region in question (1997, 4).

Furthermore, RTAs cause the unequal distribution of FDI to countries within the region because of different location advantages (Blomström and Kokko 1997), financially stable economies, larger population size, and a more educated labor force (Jaumotte 2004). These distortions reduce the full potential benefits of the RTAs for all member countries.

RTAs have also been known to increase reciprocal trade flows within a region and globally. In many cases, countries joined RTAs and experienced augmented market access. The increase in total exports has also been notable in the CARICOM Single Market Economy (CSME), which stood at 13 percent during the early 1990s and jumped to 20 percent towards the end of the same decade (World Bank 2005, 66). Between 1990 and 2002, intra-regional export shares for the Andean Group improved greatly from 4.2 to 11.2%; Mercosur, 8.9 to 20.8%; and ASEAN, 19 to 22.4% (Mehta and Kumar 2004, 11). Finally, Mexican exports, especially to the United States, multiplied tremendously after signing NAFTA in 1994 (Blomström and Kokko 1997, 27-8; Monge-Naranjo 2002, 8, 38-40).

The links between RTAs and trade would lead one to predict that signing RTAs will produce expanded reciprocal trade relationships. During the 1990s, Chile began integrating into the international economy via negotiating bilateral agreements. Chilean President Patricio Aylwin anticipated a boost in trade both regionally and internationally through such agreements. According to ECLAC Economic Affairs Officer Verónica Silva, "The adoption of FTAs, as an effective instrument for market access and for diversifying Chilean exports, could also sustain the liberalization process. In particular, FTAs with other Latin American countries of similar development would facilitate the export of Chile's goods and services..." (Silva 2004, 31-2).

Other cases of regional RTAs prove an anomaly to the link between RTAs and increased trade. Some regions have completed RTAs yet continue to demonstrate low intra-regional and international trade levels. For example, intra-regional trade among members of the South Asian Association for Regional Cooperation (SAARC), which plans to establish the South Asian Preferential Trade Area (SAPTA), remains low at only 4.9 percent of total trade (Mehta and Kumar 2004, 9). Additionally, Caribbean products have lost a significant amount of market share outside of the region, even though intra-Caribbean trade showed significant improvement in the 1990s (World Bank 2005, 64). Similar cases have led observers to identify other mechanisms for increased trade.

Economic and political reforms of RTA countries reduce barriers to trade. Economic reform involves the removal of

tariff and non-tariff barriers. Such economic reform remains crucial to enhancing regional trade (Thomas, Nash, et. al. 1991). Political reform is necessary to reduce those protectionist pressures that frustrate the liberalization process (Naim 1993 as cited in Echavarría and Gamboa 2004; Winters 1996, 57; Heydon and Lee 2006, 3-4). Quelling protectionist influence allows for liberal forces to encourage the transition towards open market economies and participate in regional and global trade.

Additionally, RTAs have been criticized, first of all, for distorting trade benefits within the region. Regional protectionist blocs function as the hub and spoke of a wheel. The hub country has a separate bilateral agreement with two other countries, or the spokes. Whereas the hub has preferential access to two markets, the spokes only have preferential access to one market, which is that of the hub country. At the same time, the spokes are denied preferential access to each other's markets, because they do not have an agreement between themselves (Eden 2006, 3). Accordingly, the hub country receives more of the benefits of the RTAs (i.e. trade expansion) than the two spoke countries (Eden 2006, 3).

Secondly, RTAs receive criticism for its ability to divert trade. RTAs can divert trade globally. These regional arrangements can cause member countries to mainly trade within a specific regional bloc because of the guarantee of preferential access. In effect, these same countries ignore other countries that may be able to provide goods a lot cheaper and more efficiently.<sup>9</sup> Furthermore, RTAs divert trade within a region. High cost, inefficient producers attract the most trade because of their ability to import a lot of cheap goods from within the regional market. Simultaneously, low-cost/more efficient producers lose out when exports are geared towards higher-cost/less efficient producers (Fisher 2006, 3-4; Griswold 2003; Winters 1996, 57).

Multilateralism may alleviate many of the challenges associated with RTAs. The multilateral system provides an overarching framework that reduces the domestic pressures within member countries (Mattoo 2002, 285) and promotes non-discriminatory tariff preferences (Michalopoulos 2002, 62). In other words, all countries can truly benefit from the multilateral system, because it lays out a standards set of rules applicable to all members.

With the shift towards an outer regional focus, the question arises as to whether or not the results are the same when applied to the economic cooperative framework and deeper linkages between Asia and Latin America.

### **A Cross-Regional Free Trade Agreement - Mexico-Japan FTA**

Mexico and Japan illustrate the cooperative commercial relationship that has emerged between Latin America and Asia-Pacific countries. The two countries have gone beyond regional boundaries to form a cross-regional free trade area. Japan joined the General Agreement on Tariffs and Trade in 1955, and Mexico became a part of GATT in 1986. Since becoming a GATT member, Mexico signed 11 free trade agreements with 42 countries, eight of which were RTAs.

Japan, on the other hand, had signed a free trade pact with only one other country – Singapore – in 2002. By 2003, both countries realized the benefits of a bilateral trade accord that extended across the Pacific. As a result, Japan and Mexico negotiated a free trade deal that would allow each country access to different regional markets.

The Mexico-Japan Free Trade Agreement was signed on September 17, 2004 at the National Palace in Mexico City. The FTA's objectives are to promote a free trans-border flow of goods, person, services, and capital between the two countries and improve the business environment and bilateral cooperation in areas such as education, training, and support for small and medium enterprises. The agreement took effect on April 1, 2005.

With the FTA, Japan currently has preferential access to the Mexican market in a number of areas. Mexico agreed to immediately eliminate tariffs, which ranged from 18-30 percent, on imported Japanese games, motorcycles, and musical equipment. Furthermore, tariffs on car imports from Japan will be reduced to zero by 2012, and quota restrictions will be looser on these same imports. In addition, Mexico committed to abolishing duties on Japanese steel products by 2015 (*Mexico Reports Agreement on Substance of Japan Trade Deal 2004*; Japan, Mexico Reach FTA 2004).

Japan, in return, allows preferential access for Mexican goods. Japan agreed to the immediate removal of tariffs on 91 percent of Mexican goods (Landauro 2004). Moreover, Japan committed to lowering import tariffs on the majority of Mexican produce over a three to seven year period. Import tariffs on bananas will be lowered by 2015.

In addition to preferential access, the trade pact guarantees non-discriminatory practices. Mexico and Japan agreed to ensure fair trade practices under the cross-regional agreement. Both sides would apply the same tariffs rates on imported goods as those offered to each other's most favorite trading partner. These are the same principles offered under the WTO Most Favoured Nation provision.

Foreign direct investment between the two countries remained low prior to the signing of the Mexico-Japan trade accord. In 2003, less than one percent of Japan's total FDI outflows went to Mexico, whereas Mexican investment in Japan remained at zero (JETRO) (Table 1).

Mexico anticipates that the trade deal will boost Japanese investment in Mexico. Mexico expects to attract US\$1.2 bil-

Table 1: Japan FDI outflows 1999-2004 (US\$million)

Japan FDI outflow	1999	2000	2001	2002	2003	2004
Mexico	\$1,483	\$208	\$46	\$84	\$140	\$337
Total FDI	\$67,502	\$49,034	\$32,297	\$36,858	\$36,092	\$35,548

Source: Economic Commission for Latin America and the Caribbean 2005

lion annually in Japanese investments (Mexican Embassy 2004). This expectation does not appear unrealistic given that Japan has invested a lot more money in Mexico recently. Mexico's chief trade negotiator, Angel Villalobos, stated that

Japan's direct investment into Mexico jumped up to US\$1.1 billion in 2005 and has reached more than US\$900 million between January and April of 2006 alone (Japan Investment in Mexico to Top \$1.2B 2006).

Over the last decade, Mexico has mainly utilized FDI in its manufacturing sector. However, between 2001 and 2003, the majority of Mexico's distribution of FDI shifted away from the manufacturing towards the services sector. ECLAC attributes the shift in FDI to major changes in the ownership of Mexico's largest local banks (ECLAC 2005, 23).<sup>10</sup> By 2004, the manufacturing sector received the majority of FDI inflows once again. This time the distribution of FDI for the manufacturing and services sectors was almost equal (Table 2).

Table 2: Mexico Distribution of FDI by Sector 1996-2005 (percentage)

Mexico FDI	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
	100	100	100	100	100	100	100	100	100	100
Manufactures	61.4	60.3	61.5	67.2	56	22.3	39.8	43.1	49.9	58
Natural resources	1.5	1.2	0.9	1.6	1.6	0.3	1.9	0.8	0.8	0.7
Services	37.1	38.5	37.6	31.3	42.4	77.4	58.3	56.1	49.3	41.3

Source: Japan External Trade Organization

The trade deal exhibits a great opportunity for Mexico to receive extra foreign investment into its manufacturing sector from Japan. Japan seeks to augment its exports of autos, steels, and electronics to the Mexican market. Japanese investment in Mexico's manufacturing sector has already risen quickly since the trade accord went into effect. For example, the Japanese car companies of Nissan invested US\$1.3 billion to create a new compact model; Toyota, US\$160 million to expand its first Mexican assembly plant that makes the Tacoma pick-up model in Tijuana; and Bridgestone tire company, US\$220 million towards setting up a plant in Nuevo León (ECLAC 2005, 24). These investments help Mexico reduce its reliance upon the U.S. FDI, which accounted for 66 percent of Mexico's total FDI inflows in 2005 (ECLAC 2005, 24, 39).

Concurrently, the agreement presents an opportunity for Japanese products to reach the larger North American market. In 2000, the Japan External Trade Organization (JETRO) described the Mexican market as important for allowing Japanese industries to "secure a foothold in the North American market" (JETRO 2000, 3). Five years later, Japan gained preferential access to 24% of the North American market's population, which includes 427.7 million people; and 5% of the North American economy, which has a total GDP of US\$13 trillion.<sup>11</sup>

Japan is already taking advantage of the agreement to access the rest of the North American market. Japanese car companies are manufacturing contemporary models in Mexico. These cars are later marketed in the other North American countries. For instance, the money that Nissan invested into Mexico for the manufacture of its new compact model was for the purpose of selling it in the United States (ECLAC 2005, 24).

Despite earlier acknowledgements of investment opportunities in Mexico, Japanese investors expressed concerns

about investing in Mexico. The Mexican regulatory environment obstructed capital inflows from foreign investors in certain sectors, maintained state control over particular industries, and its physical infrastructure remained weak and inefficient. For example, JETRO listed Mexico's restriction on foreign investment in the financial, oil, and petrochemicals sectors; problems with the tax and accounting systems; the lack of support for local autoparts and electronic and electric parts; and underdeveloped transport-related infrastructure as significant investment barriers (JETRO 2000, 6). These challenges created an extra burden and augmented the costs of doing business in Mexico. Consequently, Mexico received less FDI from Japan.

Mexico has made limited progress in correcting for the flaws in its business environment. First of all, Mexico made reforms within its financial services sector, including opening the industry up to outside investors. However, the industry is still plagued by an inefficient banking sector, a high level of non-performing loans, and a complex regulatory framework, which hinders growth (Bonturi 2002; OECD 2005). On the other hand, Mexico has not reformed its policies pertaining to the petroleum sector. The Mexican oil industry remains closed to foreign investment. Secondly, Mexico was encouraged to undertake tax reforms that would ease fiscal constraints and provide revenue to finance the proper level of spending and long-term investment needs (OECD 2005). It has since reduced the corporate income tax from 33 percent in 2004 to 29 percent in 2006 (*World Bank 2006a*). Finally, Mexico sustains a poorly run transportation system that leads to high transportation costs (Peña 2004; Zúñiga 2005). These challenges will have to be addressed so that Japanese investor and Mexican business can fully benefit from the cross-regional bilateral FTA.

Much like FDI, trade between Japan and Mexico reached minimal levels before the trade pact. In 2003, less than one percent of Japan's total trade was with Mexico. Mexico has already experienced growth in the Japanese market. From 2003 to 2005, Japanese imports of Mexican goods increased by 43 percent. From 2004 to 2005 alone, Japan imported 17 percent more of Mexican products (Table 3).

Table 3: Trade between Japan and Mexico 1998-2005 (US\$million)

Japan to Mexico	1998	1999	2000	2001	2002	2003	2004	2005
Exports	\$4,209	\$4,406	\$5,211	\$4,087	\$3,766	\$3,643	\$5,190	\$6,881
Imports	\$1,229	\$1,661	\$2,388	\$2,008	\$1,791	\$1,781	\$2,174	\$2,542
TOTAL	\$5,438	\$6,067	\$7,599	\$6,095	\$5,557	\$5,242	\$7,364	\$9,423

Source: International Monetary Fund, *Direction of Trade Statistics Yearbook 2005/ June 2006*

The trade pact affords both sides the opportunity to diversify their export markets. Mexico was the world's 12th largest global market in 2003 and Latin America's largest market economy with a GDP of US\$684 billion.<sup>12</sup> Now, Japan has preferential market access to the prominent Mexican market. Additionally, Japan will have tariff-free access to Mexico's other free trade partners if it opens up factories in

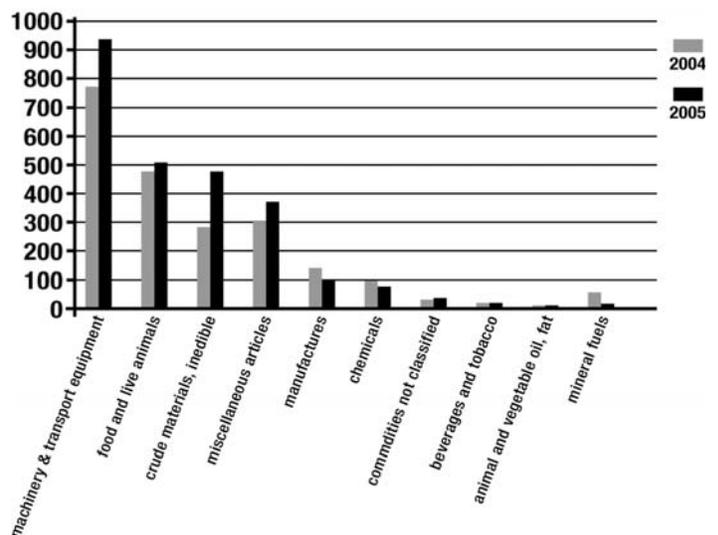
Mexico (*Mexico, Japan sign free trade agreement 2004*). Likewise, Mexico can diversify its export market by gaining access to the world's third largest global market.<sup>13</sup> Mexico will also have entry into the Asia via the region's largest market economy with a GDP of US\$4.6 trillion.

On a cautionary note, the increased trade flows between Mexico and Japan by 2005 cannot be directly attributed to the cross-regional trade agreement itself. Figures before the trade negotiations illustrate expanding trade between the two countries. From 1998 to 1999, Mexico-Japan trade had risen 12%, and from 1999 to 2000, 25%. The growing trade could be ascribed to a number of related factors. Those factors include, *inter alia*, the reduction of tariff barriers to outside exports and the growth of domestic demand for goods from either country. Afterwards, trade decreased annually from 2000 to 2003 (Table 3).

Furthermore, Mexican-Japan trade has demonstrated the opportunity to expand specific domestic industries that are competitive in each other's market. Mexican agricultural goods and manufacturing inputs grew within the Japanese market. According to Mexico's Ministry of Foreign Affairs (SRE), close to 80 percent of total Mexican sector exports to Japan consisted of machinery, transport equipment, food and live animals, and inedible crude materials in 2005. The latter export showed the largest annual export growth rate (2004-2005) at about 75 percent (Figure 1).

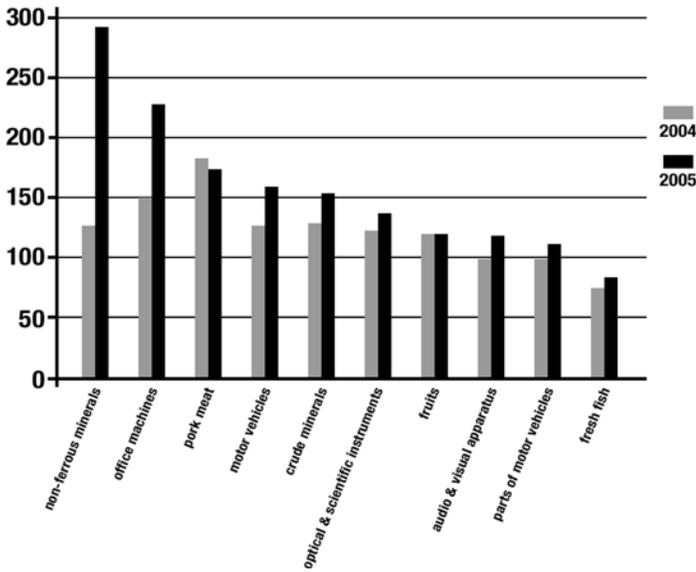
The products that Mexico has exported to Japan in the last couple of years emerge from the main export sectors. Mexico's top exports to Japan in 2005 were of nonferrous minerals, which accounted for 12% of total exports to Japan; office machines, 9%; and meat of pork, 7%. Nonferrous minerals exhibited the largest growth rate between 2004 and 2005 of 137 percent (Figure 2). Mexican farmers have the privilege of exporting 80,00 tons of pork and 6,500 tons of orange juice per annum to Japan under the accord's preferential tariffs (*Japan, Mexico Reach FTA*).

Figure 1: Mexican exports to Japan by economic sector 2004-2005 (US\$millions)



Source: Ministry of Foreign Affairs (Mexico)

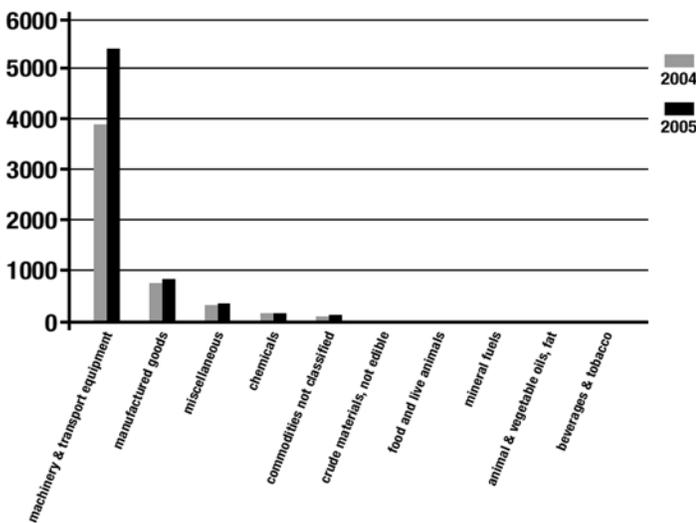
Figure 2: Mexican exports to Japan by main products 2004-2005 (US\$millions)



Source: Ministry of Foreign Affairs (Mexico)

The possibility of identifying various industries that would benefit from the trade pact also rests with Japan. The main Japanese sector that experienced export growth in the Mexican market was the manufacturing sector. Machinery and transport equipment and manufactured goods accounted for a little over 90 percent of Japanese exports to Mexico. Of these exports, 78 percent consisted of machinery and transport equipment (Figure 3).

Figure 3: Japanese exports to Mexico by economic sector 2004-2005 (US\$millions)

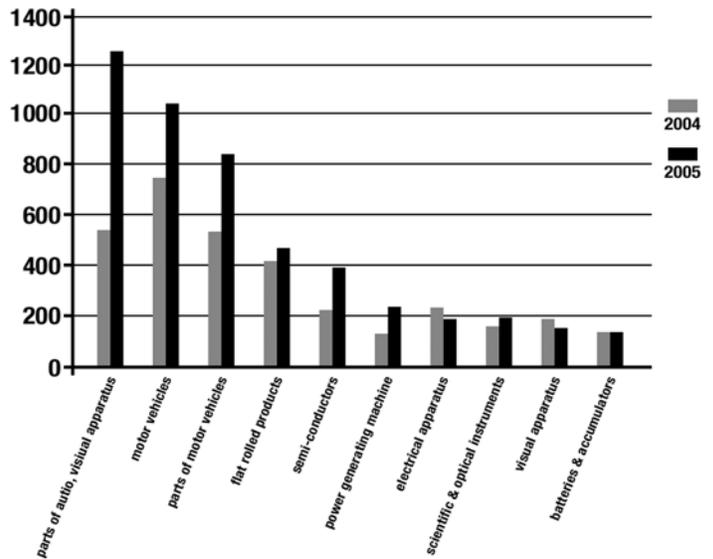


Source: Ministry of Foreign Affairs (Mexico)

The top Japanese products that have proven successful in the Mexican market are from within the manufacturing sector. In 2005, Mexican demand for Japanese goods rested with audio and visual products, which demonstrated a 131 percent annual growth rate from a year before. Motor vehicle

exports ranked second in the most shares of the Mexican market during the same year (Figure 4).

Figure 4: Japanese exports to Mexico by product 2004-2005 (US\$millions)



Source: Ministry of Foreign Affairs (Mexico)

In sum, the cross-regional FTA between Mexico and Japan functions in the same manner as both RTAs and the multilateral system. Although the agreement operates outside of a geographically contiguous trading area, the trade pact remains reciprocal. Both sides have agreed to tariff schedules or the complete elimination of duties on those specified goods. Additionally, quantitative restrictions (i.e. quotas) had been eased on specific goods. Furthermore, the agreement adopts the MFN provision, which is upheld by the WTO. The MFN provision guarantees equal treatment in terms of the application of tariffs on imported goods.

The agreement has demonstrated an increase in FDI and trade flows. Japanese investment in the Mexican market has surged since 2004, and trade between the two countries has grown in the double digits. Concomitantly, the higher levels of FDI and trade may not be the direct result of the signing of such an agreement. Instead, other associated factors such as business environment, regulatory reform, and physical infrastructure may play a more significant role in making a country much more attractive to foreign investors.

**CONCLUSION**

Cross-regional trade has been a growing trend between Latin America and Asia for a little over a decade thus illustrating the cooperative relationship between the two regions. The Mexico-Japan FTA has been valuable towards examining the impact of cross-regional FTAs on trade and FDI flows. Cross-regional agreements result in increased trade and FDI. However, the existence of such an agreement itself does not automatically result in trade expansion and increased invest-

ment. Rather, other factors such as improved regulatory systems and physical infrastructure allow countries to expand trade and FDI to the fullest under inter-regional trade agreements, which can also be said of intra-regional FTAs. Unlike intra-regional FTAs, cross-regional FTAs address concerns about FDI and trade diversion away from more efficient producers outside of the region. Inter-regional trade pacts allow member countries to look beyond regional borders and gain access to other regional markets.

## ENDNOTES

1. The FTA between China and Chile is an agreement for trade only in goods.
2. For the purposes of this paper, multilateralism merely refers to the multilateral trading system (i.e. General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO)) while acknowledging that multilateralism can take place within regional trade agreements.
3. Third CEPII Conference: The New Regionalism: Progress, Setbacks, and Challenges, Feb. 9-10, 2006. Inter-American Development Bank, Washington, D.C.
4. Please see Devlin 2000; Devlin and Estevadeordal 2001; Estevadeordal 2003; and Burfisher, Robinson, and Thierfelder 2003 for more on the distinctions between *old regionalism* and *new regionalism*.
5. LAFTA became known as the Latin American Integration Association in 1980.
6. In Lincoln (2004), East Asia refers to East and Southeast Asian nations – Japan, South Korea, China, Taiwan, Hong Kong, Macao, the Philippines, Thailand, Malaysia, Myanmar, Singapore, Vietnam, Laos, Cambodia, Indonesia, Brunei, and Papua New Guinea. The small island nations in the South Pacific are excluded from the study.
7. The FTAA was still under negotiation at the time of Yeyati, et. al's analysis in 2002. The deadline for completion was Dec. 2004, but the FTAA negotiations are still stalled two years later.
8. Please see Gliberman and Shapiro 2002 for more on the impact that governance infrastructure has on attracting U.S. FDI alone.
9. This argument based on studies of recent RTAs was initially highlighted by Jacob Viner in *The Customs Issue* (1950).
10. Under NAFTA, Mexico made a number of reforms within the banking sector. By the mid-1990s, the Mexican legislature passed a new banking law that reduced barriers of entry to U.S. and Canadian financial entities. U.S. and Canadian banks can now wholly acquire Mexican banks with certain restrictions.
11. Calculations based on World Bank figures for 2004.
12. These market size figures are based on 2004 numbers by the World Bank. Mexico has since fallen to the second largest Latin American economy behind Brazil.
13. The United States and the European Union are the first and second largest global markets respectively.

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