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Domestic sources of Japanese foreign policy activism: loss avoidance and demand coherence

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Abstract

The conventional view in the field of international political economy – that greater economic interdependence creates an incentive for active foreign policy engagement – is hard to reconcile with Japan's foreign economic policy. To explain this counterintuitive outcome, we develop a new model of domestic demand for policy activism that integrates strands of prospect theory, collective action, and interest aggregation. We argue that both the rationale for mobilization and lobbying capacity are essential elements in understanding the domestic demand for significant foreign policy departures. We apply this conceptual framework to Japanese foreign economic policy in two issue areas: finance (Japan's response to the 1980s Latin American debt crisis and

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the late 1990s Asian Financial Crisis), and trade (Japan's Free Trade Agreement negotiations with Mexico and South Korea).

1 Introduction

Conventional wisdom posits that states should display foreign policy activism (i.e. costly policy departures in the face of significant domestic and/or international opposition) vis-à-vis countries or regions, where significant economic and strategic interests are at stake. The expectation of a carefully calibrated foreign policy based on cost/gain analysis is particularly strong for a country like Japan, whose relatively autonomous government is characterized as the source of its successful economic development (Johnson, 1982) or realist foreign policy (Green, 2001). Nonetheless, Japanese diplomacy is often far more nimble towards far away countries and regions where Japan has limited interests, while it seems to experience paralysis vis-à-vis more important economic or strategic counterparts. To explain these counterintuitive outcomes, we develop a new model of domestic demand for foreign policy activism that integrates strands of prospect theory, collective action, and interest aggregation.[1] We argue that both the rationale for mobilization and lobbying capacity are essential to understand the domestic demand for foreign policy activism. We apply this conceptual framework to Japanese foreign economic policy in two areas: finance (Japan's response to the 1980s Latin American debt crisis and the late 1990s Asian Financial Crisis), and trade (Japan's Free Trade Agreement (FTA) negotiations with Mexico and South Korea). In both issue areas, we observe similar domestic patterns that either inhibit or trigger foreign policy activism.

In this way, we offer a new interpretation of Japan's low key regional policy which has been conventionally attributed to: regional distrust due to the lingering shadow of the failed Greater East Asia Co-prosperity Sphere (Funabashi, 1991), Japan's deference to the United States due to its heavy reliance on American security commitments and markets (Calder, 1988; Deng, 1997), the US preference for bilateral security alliances which prevented Japan from developing closer bonds with countries in the region through collective security mechanisms (Calder

1 Our model therefore corroborates Putnam's (1988) insight on the need to factor in the two levels of policy-making in international economic negotiations.

and Ye, 2004; Katzenstein, 2005), and more recently, a rising China checking Japanese regional leadership (Johnstone, 1999). These are obviously important constraints in Japan's regional foreign policy, but they do not explain why Japan is willing to chart a new course on its regional economic policy in some cases (such as FTA negotiation), and why some of these high-profile initiatives are short lived (Asian Monetary Fund (AMF)). Moreover, there is no systematic explanation yet of what propels a 'reactive state' to be more vocal in issue areas with no significant economic or strategic payoffs. A more nuanced explanation of what influences Japan's foreign policy actions in financial crisis management or preferential trade negotiations, therefore, cannot ignore the domestic politics of private sector mobilization and interest aggregation.[2]

This article is organized as follows. First, we sketch out the empirical puzzle. Second, we develop an analytical framework to argue that cohesive interest groups highly motivated by loss aversion are central in explaining foreign policy activism. Third, we test our hypotheses with a comparison of high-stake/low-stake initiatives in the fields of financial crisis management and bilateral trade negotiations. Fourth, we discuss the implications of our findings.

2 Puzzle

Our research puzzle emerges from a set of structured comparisons in Japan's trade and finance initiatives vis-à-vis East Asia where Japan has high level of economic interdependence and security needs, and vis-à-vis Latin America where it does not. The Japanese government's reaction to these two major financial crises is intriguing since it displayed unprecedented leadership in solving the Latin American debt crisis (1982–89), but was less decisive during the Asian Financial Crisis (AFC, 1997–98). A similar pattern is observed in trade, since Japan successfully concluded an FTA negotiation with Mexico, but so far has been unable to do so

2 This is not to imply that domestic policy supply factors are unimportant. The preferences and tug of war among Japanese economic bureaucracies, and more recently high level intervention by the Prime Minister's office, clearly influence the policy-making process. Instead of conveying the impression that public officials automatically implement the preferences of societal actors, we argue that domestic lobbying patterns impose significant constraints on policymakers, and that absent significant interest group support some policy initiatives may be short-lived (the AFC and Korea FTA cases discussed below attest to this).

with South Korea despite the much higher economic payoffs of the latter negotiation. *Why, then, in these cases has the Japanese government exhibited more decisive leadership in the region/country where smaller stakes are involved?*

2.1 Financial crisis management

Japan's leadership in the area of financial crisis management includes two components: a high level of financial commitment (through rescue package contributions, increased foreign aid, and other public funding such as parallel financing with the IMF); and an original proposal for the long-term solution to the crisis, which is at least somewhat independent of the IMF- or US-led solutions.[3] Although both components are important, it is the second one which distinguishes the Japanese government's policy activism from its usual 'checkbook diplomacy', and indicates the willingness of the Japanese government to abandon its low-risk economic diplomacy.

In both crises Japan disbursed a significant amount of funds. During the debt crisis, the Japanese government committed a $10 billion Capital Recycling Program in 1986, which was expanded to $30 billion by 1987. Parallel to that, and in support of the Miyazawa Plan announced in 1988, Japan pledged $5.5 billion debt relief as a component of the new 5-year ODA package for 1988–92. Similarly, at the time of the AFC, the Japanese government made a large amount of funding available in the form of the 'new' Miyazawa Initiative of October 1998, which altogether provided more than $80 billion in support of six East Asian countries by the end of 1999 (Katada, 2002).

What sets Japan's response to these financial crises apart is that during the debt crisis the Japanese government offered a novel approach to its solution in the form of the first Miyazawa Plan, and *did not back down* despite US displeasure.[4] The US government worried not only

3 The debate over the causes and appropriate solutions at the time of the AFC echoed the debate from the prior decade, where some insisted on the 'liquidity' issue (thus encouraged more funding), while others, concerned about moral hazard problems, insisted on the 'fundamental' problems of these economies (Wade, 1998; Katada, 2001).

4 This plan contained three major components: First, debtors would reach an agreement with the IMF on a structural adjustment program promoting economic growth. Second, an increase in the flow of bilateral and multilateral public funds for structural adjustment: Finally, banks and debtors would voluntarily convert a portion of debt to bonds and

about moral hazard from 'publicly bailing out the banks', but also about its own capacity to assume leadership in the debt crisis solution given its large budget deficit and the domestic political difficulties in justifying such policy (Katada, 2001). Nevertheless, one year later, the Treasury Department adopted the same basic scheme in the form of the Brady Plan. According to Japanese government accounts, Japan's views on the solution to the debt crisis finally prevailed, as Japan's Ministry of Finance (MOF) was closely consulted by the Treasury Department prior to the announcement of the Brady Plan in the spring of 1989 (Fujikawa, 1990, p. 16).

The AFC represented a much more serious crisis for the Japanese government because it struck the region where Japan has vital economic and security interests. By the mid-1990s, more than 40% of Japanese trade was with East Asia, and the Japanese banks and companies had high exposure to this region in terms of their outstanding loans and foreign direct investment. However, Japan's policy initiatives during the containment and solution phase of the AFC reached gridlock very quickly. The most well-known initiative taken by the Japanese government was its failed bid to establish the AMF, which would have established a $100 billion fund to provide liquidity to the crisis-ridden economies in Asia, with the Japanese government willing to contribute half of the required funds. Many of the crisis countries in East Asia hoped that a new AMF would enable them to bypass the IMF (with its politically invasive conditionality). Nevertheless, the AMF proposal was put to rest by November of 1997 given the opposition from the United States, Europe, China, and the IMF. In its place, an IMF-based alternative, the Manila Framework, emerged. After the AMF fiasco, the Japanese government became inactive and basically followed the IMF-led financial crisis management, taking up its usual role as financier.[5] It took a few years before the Japanese government gradually started to revisit the regional financial cooperation agenda, for instance through the Chiang Mai Initiative or the Asian Bond Market Initiative.

reschedule the remaining debt under suitable conditions once the structural adjustment program had been carried out.

5 The Japanese government was ambivalent about excluding the IMF from the AFC management from the onset. While the Thai and Korean governments approached Japan for a bilateral rescue package to avoid IMF involvement, the Japanese government encouraged them to go to the IMF first. See Katada, 2001.

In both cases, the Japanese government provided significant funding to contain the financial crises and it proposed long-term solutions independent of the United States. However, considering the much higher stakes involved in the AMF initiative compared with the first Miyazawa plan for Latin America, it is puzzling how quickly the Japanese government gave up in the former case and persevered in the latter. We contend that domestic interest politics played a very important role in these outcomes.

2.2 Japan's FTA negotiations with Mexico and with South Korea

In the fall of 1998, the Japanese government decided for the first time in the postwar period to negotiate preferential trade agreements (better known as FTAs). The new trade policy emerged as a response to a number of perceived threats: stagnation in the WTO negotiation process; proliferation of regional blocs, and the AFC (Katada and Solís, 2008). By the summer of 1998, when Mexico approached Japan about an FTA negotiation, Japanese bureaucrats were already worried that Japan was one of the very few countries that had not yet developed a preferential trading network (Hatakeyama, 2002, pp. 24–25). But when the Korean President Kim Dae Jung proposed an FTA with Japan a few months later, the Ministry of International Trade and Industry (MITI) assigned Korea utmost priority in its FTA strategy because of Korea's geographical proximity, status as a middle power, and eagerness to improve relations with Japan (Table 1).[6]

Despite the high priority MITI attached to Korea, negotiations with Mexico moved faster and an agreement was signed in March 2004, whereas negotiations with Korea floundered with no real progress since late 2004.[7] This is indeed a puzzling outcome given that negotiations

6 Noted in MITI's 1998 memo 'Promotion of Strategic Trade Policy: Orientation of Regional Economic Agreements', reported in Ogita (2003, p. 241).

7 Japan's first bilateral FTA was signed with an Asian nation: Singapore. But negotiations with Singapore were launched only after talks with Mexico and Korea were delayed due to concerns over agricultural liberalization and/or a ballooning Korean deficit, respectively. Negotiations with Singapore moved fast because Singapore agreed to put aside agricultural liberalization (Terada, 2006). This FTA, however, yielded modest benefits to Japanese industry because Singapore already is duty free on most imports. The Japanese government valued the trade agreement with Singapore as a visible measure of progress in FTA

Table 1 Chronology of Japan's FTA negotiations with Mexico and Korea

	Fast lane talks with Mexico	Slow lane talks with Korea
Pre-negotiation FTA initiatives		
First contacts	Blanco–Hatakeyama meetings (June and August 1998)	Han Duck–Soo–Yosano meeting (November 1998)
Individual study	Mexico: positive (spring 1999)	Korea: ambivalent (May 2000)
Reports	Japan: positive (spring 1999)	Japan: positive (May 2000)
Negotiation hiatus	Japanese request for agricultural exemption	Korean concern over bilateral trade deficit
Joint study groups	Positive. Released on July 2002	Positive. Released on October 2003
FTA negotiation developments		
Launch	November 2002	December 2003
Crisis	No compromise on five agricultural commodities	Deadlock after sixth round of negotiation over agricultural liberalization.
	Failed summit meeting in October 2003.	November 2004
		Seaweed quota dispute in WTO proceeding (December 2004)
Agreement	Yes, in March 2004	No, no more FTA meetings since November 2004
Outcome	In force since April 2005	Stagnation in FTA negotiations, but compromise to increase five times Korea's seaweed quota on January 2006

with Korea promised a higher economic and political payoff and were believed to generate fewer adjustment costs than free trade talks with Mexico. The aggregate volume of Japanese trade and investment as well as econometric estimates of gains from FTA-induced liberalization all indicated that a trade agreement with Korea would be more beneficial to Japan (Table 2). Moreover, Korea, in principle, would have posed an easier challenge on the thorny question of agricultural liberalization. Given the much higher share of agricultural commodities in bilateral

diplomacy, but given the unique characteristics of this partner, it could not be expected to lay the basis for a string of FTAs with countries where none of these conditions applied.

Table 2 Economic stakes in Japan's FTA negotiations with Mexico and Korea

	Mexico (%)	Korea (%)
Share of Japanese exports[a]	1.00	6.70
Share of Japanese FDI flows[a]	0.70	1.60
Share of agriculture and fisheries in bilateral trade[a]	21.80	8.50
Estimated gains from trade in FTA negotiation	0.06	0.10

Sources: JETRO, Japanese Trade in 2004; Kawasaki, 2004.
[a]Average percent for 1999–2004.

flows with Mexico (21.8%) than with Korea (8.5%), it would seem much harder for Japan to make substantial agricultural exemptions with Mexico and still meet the WTO's article 24th requirement to liberalize 'substantially' all trade (usually understood as 90% of trade volume).

Negotiations with Korea were also widely perceived to yield significant political and regional leadership benefits to Japan. An FTA with Korea was conceived as part of a much broader package to reshape Japanese–Korean relations for a fresh start in the twenty-first century. By the time of the Obuchi-Kim summit meeting of October 1998, both countries sought to improve overall bilateral relations through financial ties, an FTA, the promotion of historical and cultural understanding, and the tightening of security bonds (Rozman, 2006, p. 6).

The Japan–Korea FTA was also considered crucial to consolidate Japan's regional policy and pave the way to economic integration in East Asia. According to Ito and Fukagawa (2005, pp. 60–61, 72), this bilateral FTA would tilt the direction of economic integration in East Asia toward high-standard agreements with multiple WTO plus commitments (in contrast to the China–ASEAN FTA's low level of institutional sophistication). Moreover, successful negotiations with Korea would set the stage for a future trilateral trade agreement with China. For all these reasons, many believed that the stakes of this FTA negotiation could not be higher 'if Japan and Korea cannot overcome these impediments and agree on an FTA between the two, neither country will survive the challenge of globalization in the twenty-first century' (Yamazawa, 2001, p. 47).

And yet, the promised benefits of a Japan–Korea FTA remain unfulfilled, whereas Japan and Mexico did manage to ink an agreement. In order to explain this contrasting outcome we turn to a domestic politics explanation that identifies the motivations and coherence of the domestic interest groups involved in these two FTA negotiations.

3 Framework

3.1 The domestic roots of active foreign policy: loss avoidance and demand coherence

Domestic politics, we argue, is the key to address the puzzling foreign policy choices of the Japanese government. Taking the pluralist and liberal view of policymaking under democracy (Moravcsik, 1997), and following the insight of two-level games (Putnam, 1988), we argue that the strong push toward foreign policy activism has its roots in patterns of interest group mobilization and organization. In this study, we adopt many of the assumptions of endogenous public policy: self-interested private actors mobilize to demand the public policies most favorable to their narrow interests, and they use the resources at their command, contributions and votes, to ensure the responsiveness of public officials concerned with electoral success (Magee *et al.*, 1989; Grossman and Helpman, 2002). The novelty of our framework is that we focus on the interaction of two variables – mobilization triggers and interest group cohesion – to explain the lobbying behavior of private interests in favor of activist economic diplomacy. Moreover, despite the well-known contrast in domestic politics of trade and finance where trade politics involves significant domestic cleavage of winner and losers, while that of finance does not (Frieden, 1991), we posit a common framework that captures the domestic political dynamics for both issue areas, increasing the potential for broader generalizations.

The first dimension focuses on the underlying motivation for private sector mobilization (mobilization trigger). There are two diametrically opposed views on the basic objectives behind a vigorous lobbying campaign depending on one's position on the rationality assumption. On the one hand, from a conventional utility maximization standpoint, *economic exposure and gains* should be the prime consideration behind the private sector's demand for policy activism (Milner, 1988; Gilligan, 1997). On the other hand, prospect theory argues that loss aversion is a more powerful factor than the pursuit of gains, since psychological experiments on decision-making have shown that people are more prudent and risk averse when they face gains or advances, and are willing to take more risks or support bolder decisions in order to avoid damages.[8] These psychological insights have been applied to analyses of foreign policy decision making from war-making (Taliaferro, 2004) to trade negotiation (Odell, 2006), and international economic cooperation (Stein, 1993). The basic consensus from these studies is that when the issue is framed in terms of avoiding losses, the actors are willing to take more risks. Transposing the findings of prospect theory to interest group lobbying, one would expect that *losses* or *avoidance of losses* creates the most intense motivation for a vigorous lobbying campaign demanding government action in high risk endeavors. For our purposes, we operationalize losses as both realized and expected profit shortfall which can accrue from a variety of sources such as reduced returns on investment, non-performing loans, reduction in market share, increased sourcing costs due to the elimination of tariff preferences, etc.

The second dimension focuses on interest group effectiveness, i.e. the extent to which lobby groups are able to cohesively demand foreign policy activism from the government. The degree of interest group cohesion is a function of two interrelated factors: numbers and consistency. The number of actors in a policy debate is important because, as Olson (1965) reminds us, smaller groups are better able to overcome the challenges of collective action by offering excludable benefits and monitoring against potential free-riding. The number of participating players matters as well because it affects the chances of presenting a set of coherent demands to public officials. Quite simply, the larger the number of actors involved, the more likely it is that they will have clashing preferences regarding government policy. Transnational networks can also complicate patterns of coherent interest aggregation since external actors can use domestic groups to represent their positions in the internal debate. In some cases, such transnational influence increases demand coherence as the private sectors on both countries share common interests; but in others it can accentuate the cleavage among competing domestic groups.[9] Overall, the expectation is that the higher the interest coherence

8 For a thorough explanation of the theory and its application, see Levy (1997) and Weyland (1996).

9 See Risse-Kappen (ed.) (1995), especially Katzenstein and Tsujinaka (1995) for an illustration of how Japanese industrial lobbies penetrated the US political process by using

within and among interest groups, the easier it is to propose a clear-cut policy direction, and the more likely it is for the government to supply the requested policy.

These two dimensions of domestic interest group politics, one focusing on motivation and the other on effectiveness, lead us to propose the following hypotheses on foreign economic policy activism.

> *H1*: Interest group mobilization among private actors is much more likely to occur when the objective is to avoid losses rather than to reap gains.
>
> *H2*: Interest groups in small numbers and with coherent demands are more likely to create effective pressure on the government.

Our dependent variable – foreign policy activism – is conceptualized as a continuous variable which at one extreme would represent swift and costly policy departures (activism) and at the other would represent no policy response (inmobilism). Intermediate values of the variable can be characterized as gradualism (incremental policy change) and gridlock (polarized policy debate that impedes policy implementation). In Chart 1, we illustrate how different combinations of the independent variables are expected to affect the degree of policy activism. Box 1 in Chart 1 presents the ideal conditions for bold foreign policy initiatives: a small number of powerful interest groups with a coherent position and highly motivated since they face the prospects of hefty losses. Box 2 shows that policy gridlock is likely to ensue when several domestic actors are keenly interested in avoiding losses, but clash in their respective demands for government policy. Boxes 3 and 4 represent cases where the private sector will not demand bold and risky economic diplomacy initiatives since the underlying goal is gain maximization. When the private sector presents coherent demands we should expect policy gradualism (Box 3), and when there is internal division among interest groups we anticipate immobilism (Box 4). We examine these hypotheses in the cases below.

their business counterparts and by hiring their own lobby firms in the United States to counter protectionist interests.

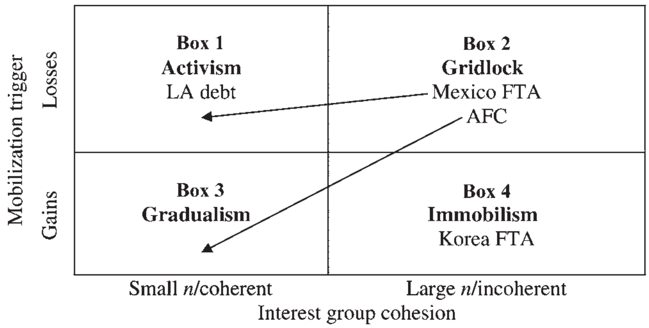

Chart 1 Domestic interests and foreign policy patterns

4 Case I: financial crises management

4.1 The Latin American debt crisis and the (first) Miyazawa initiative

Japanese banks were heavily exposed to Latin American debt since they had been encouraged by their American counterparts to participate in syndicated loans in the region.[10] As a result, by the time the debt crisis hit in 1982, Japanese banks were already lead managers of 15% of Euroloans extended to Latin America, and carried $18 billion in medium and long-term loans outstanding to Latin America, which constituted about 70% of their bank lending to developing countries.[11]

Despite the large sum of loans, the number of banks involved in international lending was limited to only 28 major banks, and a dozen or so minor regional banks. The Bank of Tokyo (BOT), as the lead manager, was the most exposed to Latin American debt, alone carrying $1.9 billion in loans, whereas the other major banks (the Industrial Bank of Japan, Dai-Ichi Kangyo, Fuji, Sumitomo, Mitsubishi and Sanwa Banks) managed 83% of the Latin American loans held by Japan (Stallings, 1991, pp. 15–16). As the traditional foreign exchange bank, the BOT played a crucial role as coordinator relying not only on its expertise, but also on its close connections with foreign banks. The Bank often represented Japan in the Bank Advisory Committees that were established to

10 The linkages among banks through syndicated loans were reinforced by the very structure of these loans which included cross-default clauses, which would not allow a debtor to default a part of its debt with certain creditors.

11 Data from Stallings (1991, pp. 5–7).

coordinate debt rescheduling among the creditors.[12] In the domestic front, the BOT facilitated collaboration among major banks, and increased their political leverage vis-à-vis the government (Spindler, 1984).

Despite their desire to exit from Latin American debt, Japanese banks were quite patient between 1982 and 1987 and followed the no-exit and 'new money' solutions agreed multilaterally. However, the urgency of exit arose as the debt problems of Mexico and Brazil reemerged between 1986 and 1987, and this time the major American banks, such as CitiCorp and Morgan Guarantee, 'exited' the Brazilian and Mexican debt. The situation was more difficult after the decision by the Bank for International Settlements (BIS) to require a capital–asset ratio of 8% by 1992 for banks with international operations. Japanese banks demanded from their government a proactive approach to the debt crisis that enabled them to exit Latin America. The Japanese government complied through the Miyazawa Plan in 1988 along with a series of capital recycling plans to provide public money to major debtors. In this way, 'the Japanese government had purchased for Japanese banks a clear path for retreat' (Rosenbluth, 1991, p. 684). Indeed, Japanese banks demonstrated their desire to 'exit' by refusing to put 'new money' into Mexico under the Brady Plan (JCIF, 1990, p. 18). There was no domestic opposition to this 'retreat' strategy from Latin American debt. The Miyazawa Plan, later adopted as the Brady Plan, was considered (quietly) as Japan's unique activism in the area of international finance (Fujikawa, 1990).

4.2 The Asian financial crisis and the failure of the AMF scheme

The AFC affected many sectors of the Japanese economy and not just the banking industry. Since 1985, Japanese manufacturing firms had established regional production networks in Southeast Asia (Hatch and Yamamura, 1996). Japanese foreign direct investment in the region increased dramatically from the mid-1980s through the mid-1990s as did trade flows. Japanese banks expanded their operations in East Asia during the 1990s to support Japanese multinationals and to maintain their competitive business share in a growing region. Right before the AFC more than 65% of the Japanese Bank claims were placed in Asia, and more than 30% of claims in Asia were owed to Japanese banks.

12 Interview with a Bank of Tokyo official (Tokyo, Japan, June 1997).

Japanese banks' exposure was particularly high in Thailand where the share of their claims was more than 55% of Thai bank loans. Japanese bank claims were also high (between 30 and 40%) in Hong Kong, Indonesia, and Malaysia.[13]

As the crisis hit Thailand in July 1997, the pressure was on both the Japanese government and the IMF to step into action. A $17.2 billion rescue package for Thailand was assembled in August that included no financial contributions from the United States. Aiming to provide a regional solution to the crisis, Japan's MOF proposed the AMF idea at the World Bank/IMF annual meeting in Hong Kong on September 21, 1997. The AMF, if it had materialized, would have been a strikingly proactive initiative, not only because of the large proposed financial commitments but also because it emerged independently of the United States and excluded it from the original scheme (Lee, 2006). The life of this Japanese proposal was, however, quite short: oft-cited reasons behind the downfall of the AMF proposal include (i) the international opposition from the IMF, the United States and European governments, and China, (ii) some inherent problems in the AMF idea including accentuation of moral hazard, (iii) weakness in Japanese fiscal and financial health, and (iv) the split within the MOF over the shape of the AMF (especially its relationship with the IMF). Not well known to external observers, however, are the interest group politics behind the demise of the AMF idea.

Both AMF supporters and detractors within Japan played crucial roles in sealing the ill fate of this extraordinary initiative. Being highly exposed to the outstanding debt in Asia, financially weak Japanese banks going through dramatic institutional changes during this period, quietly welcomed the idea, hoping that the Japanese government would use its public funds to help them withdraw from Thailand (and possibly elsewhere) without themselves accruing significant loan losses.[14] With their weak financial health and under stringent conditions imposed by the BIS standard, non-performing loans would become a grave problem for these banks.

13 Source: Bank for International Settlements, *The Maturity, Sectoral and Nationality Distribution of International Bank Lending*. The publication title changed from its November 1998 issue to *the BIS Consolidated International Banking Statistics.*

14 Interview with several Japanese bankers (Tokyo, Japan, June 1998).

Despite the high stakes, Japanese banks in the late 1990s were in no shape to exert coordinated pressure on the government. It is true that the sheer number of Japanese banks decreased over the 1990s due to mergers and acquisitions (and bank closures as well), and many decided against international operations in order to comply with the BIS standard. But precisely because of the mega-mergers, the Japanese banking community lost its most important coordinator in the area of foreign bank operations: the BOT merged with the more dominant and 'domestic' Mitsubishi Bank in April 1996. This deal removed one of the established communication channels among Japanese banks. The confusion during this transition and the power dynamics within the new BOT-Mitsubishi deprived the banking community of valuable expertise, and thus the coherence of positions that it once had. Furthermore, the MOF scandals and its restructuring in the late 1990s also put distance in bank–government relations (Amyx, 2004).

On the other hand, Japan's large export and multinational sectors opposed the AMF idea, because they feared that injections of 'easy money' would undermine the reforms demanded by the IMF. Japanese businesses with high stakes in the future structure of Asian economies were not interested in 'bailing out' the crisis-ridden governments or debt-ridden banks without imposing stringent conditions for reform (Katada, 2001).

Faced with international and domestic opposition, the Japanese government was forced to withdraw the AMF proposal, and later in October 1998, the $30 billion dollar 'New' Miyazawa Initiative became the focal point of its involvement in the solution to the AFC.[15] By then, Japan's momentum in displaying an independent leadership role in the region had weakened, and it took several years before the Japanese government became involved in other regional financial initiatives such as the 2000 Chiang Mai scheme or on-going discussions on regional currency and bond arrangements (Grimes, 2009).

4.3 Sources of foreign policy contrast

The above analysis illustrated how crises that threatened substantial losses mobilized affected Japanese actors, but also that demand

15 The New Miyazawa Plan consisted of $15 billion in medium- and long-term financial support, and another $15 billion for short-term trade finance and currency swap arrangements in six crisis hit East Asian countries.

coherence (or lack thereof) was crucial in shaping a determined (the debt crisis) or vacillating (AFC) response from the Japanese government. In the case of the debt crisis, Japanese banks strongly advocated an 'exit' strategy from the government in order to avoid significant losses. Demand coherence was also high due to the small number of actors with similar positions. Only a dozen or so Japanese major banks were involved in this crisis, and their actions were well coordinated by the BOT. All the banks were in the same predicament, and thus shared a common goal.

In the case of the AFC, Japanese banks were confronted with the prospect of major losses and were thus eager to see their government play a leading role in crisis management. The financial crisis engulfing neighboring countries in Asia, however, affected many more Japanese economic actors than the crisis involving Latin America, and there were deep disagreements on the best solution among those actors. Banks, which were in favor of Japan's active foreign policy through the AMF proposal, were politically weak at the time and they could not establish a solid political channel to convey their demands, since they had lost their internal coordination mechanism. Furthermore, a large number of non-financial business actors were rather supportive of IMF involvement with its goals to reform and liberalize these Asian economies, and they opposed the government's AMF initiative. In the end, with a high level of inconsistency in domestic demands, gridlock ensued and the momentum for foreign policy activism was lost.

The United States interests also influenced Japanese domestic interest coherence. In the case of the debt crisis, the close coordination between Japanese and American banks through syndicated loans and the Bank Advisory Committees permitted US interests to be incorporated into the demands of the Japanese banks vis-à-vis their government. Thus, the process increased the demand coherence for Japanese government's foreign policy activism. On the other hand in the case of the AFC, not only was there more disagreement between Japan and the United States on the origins and solution to the crisis, but also there were no established private channels to transmit American financial interests into the views of Japanese banks. Ironically, this time United States interests were more in agreement with Japan's real sectors operating in Asia, and this division created a more fractioned decision-making process in Japan.

5 Case II: FTA negotiations with Mexico and Korea

5.1 Successful conclusion of FTA negotiations with Mexico

Japanese interest in signing an FTA with Mexico is a straightforward story of countering trade diversion. Japanese business circles and METI bureaucrats saw the negotiation of the North American Free Trade Agreement (NAFTA) with great concern. NAFTA altered the rules of the game for many Japanese enterprises with operations in Mexico since they did not enjoy the same preferences as their American counterparts (and later than their European rivals as Mexico continued to expand its FTA network). These disadvantages were the result of higher MFN tariffs, more restrictions on foreign ownership, lack of a dispute settlement mechanism available to foreign investors, and unilateral changes in Mexican government policies (Solís and Katada, 2007).

More importantly, however, NAFTA created major disadvantages for several Japanese industries with large interests in the Mexican market. Japanese general trading companies, which had been active participants in Mexico's government procurement market, complained of being 'priced-out' due to the higher tariffs applied to their inputs, and because they could not enjoy the 10% discount applied to national bidders or foreign bidders from FTA counterpart nations by the Mexican government (Nakahata, 2005, p. 320).[16] Japanese automobile companies also worried about stringent rules of origin under NAFTA. Riding on the coattails of accusations leveled against Honda in 1991 of inflating its regional content value to meet the requirements of the United States–Canada FTA, the Big Three US automakers successfully pushed for very restrictive rules of origin for NAFTA: mandating a 62.5% regional value added, eliminating roll-up practices, and instituting a tracing system for third country parts throughout the production chain (Solís, 1996, 2003). Whereas foreign car makers in Mexico's FTA network could import finished cars duty-free, Japanese companies operated with a performance requirement, in that they could only import tariff-free an amount equivalent to 10% of their local production – in conformance with Mexico's Auto Decree (Nakahata, 2005). Finally, NAFTA represented a serious challenge for Japanese

16 Japanese companies were in fact entirely marginalized from this market, when the Mexican government announced in the midst of the FTA negotiation (May 2003) that they would only entertain foreign bidders from FTA partners.

electronic companies which had actively invested under Mexico's export promotion program located in the border region with the United States (the so-called maquiladora program). NAFTA mandated the elimination, by 2001, of the duty drawback benefits that had attracted Japanese companies to manufacture in Mexico color TVs and other home appliances for the US market (Solís, 2003).

Not surprisingly, when Japanese industries first mobilized in favor of FTAs, their choice was Mexico. Keidanren (the peak association for Japanese large enterprises) published in 1999 and 2000 two reports that addressed exclusively FTA negotiations with Mexico (Yoshimatsu, 2005, pp. 263, 268). In February 1999, Mexico and Japan agreed to launch individual official studies on the feasibility of a bilateral trade agreement, and both studies concluded positively on the economic benefits of such agreement (see Table 1). However, the prospects of an FTA negotiation between Mexico and Japan soon faded. By June 1999, the Japanese delegation openly acknowledged that there was strong resistance to include agriculture in this FTA; and Mexico deemed unacceptable a blanket exemption of this sector. Facing this stumbling block, both governments turned instead to the negotiation of a more modest bilateral investment treaty (BIT).

Two new developments by early 2001 rekindled the momentum for FTA talks. First, the BIT talks failed as Mexico refused to grant national treatment and MFN status in an investment treaty not linked to a broader FTA. Second, Mexico's FTA with the European Union – which contained multiple agricultural exemptions –sent a powerful signal to Japan that such an accommodation to protect sensitive sectors was possible. The FTA initiative gained new life and official negotiations began in October 2002.

The FTA negotiations, however, proved difficult, and made little progress in the first rounds of negotiations with agriculture as the main bone of contention. On the eve of the visit of the Mexican President Vicente Fox to Tokyo in October 2003, a large gulf still existed on the question of agricultural liberalization. The Fox-Koizumi summit proved to be a disaster as the Mexican delegation resented the limited expansion of the tariff-rate-quota on its main export (pork), whereas Japan was unable to quickly respond to a request for greater market access in orange juice (Solís and Katada, 2007).

With such visible failure, a domestic backlash against the Japanese agricultural lobby ensued. The media blamed the agricultural lobby for its intransigence, and business executives warned that this negotiation failure not only hurt them in the Mexican market, but also curtailed the Japanese credibility in its future FTA talks with ASEAN nations ('Big stakes in trade impasse with Mexico', *Asahi Shimbun* October 19, 2003). In fact, Keidanren was very effective in influencing policy. Its clout had increased as it restarted donations to political parties in 2004 (after a decade-long suspension) and with its chairman Okuda playing a pivotal role in Prime Minister Koizumi's vehicle for the structural reform of the Japanese economy –the Council on Economic and Fiscal Policy. In response to this lobbying campaign, Prime Minister Koizumi decided to intervene directly to rescue the talks. He pushed the agricultural lobby to make more concessions on oranges and other commodities in order to pave the way for an agreement. In March 2004, both sides signed an FTA which entered into force in April 2005.

Although this agreement did not bring a complete opening of Japanese agriculture, it represented the first time ever that Japan has extended WTO-plus market access preferences on multiple agricultural commodities. In this way, Japan and Mexico beat the odds of hammering out an agricultural market opening compromise that would allow Japanese industry to level the playing field in Mexico.

5.2 Impasse in FTA negotiations with Korea

The prospects of FTA negotiations between Japan and Korea looked promising as these two countries commissioned individual studies on the feasibility of a bilateral FTA, and launched the negotiation of a BIT in February of 1999. The Korean government also eliminated restrictions on imports of Japanese products that had been in place through the Import Diversification Program, and the new opening led to a rapid increase in Japanese exports (Yamazawa, 2001, pp. 14, 41). However, the 2000 report of the Korea Institute for International Economic Policy led to an early setback as it predicted an actual short-term *loss* in Korean GDP in the order of 0.07% and a large increase in Korea's trade deficit, due to the greater competitiveness of Japanese industry and the higher average tariffs in Korea.[17] On the other hand, the Japanese report found a small but positive increase in Korea's GDP

17 Adjustment costs were expected to be particularly high for SMEs in general and for firms operating in the transportation, precision machinery, and general machinery sectors (Sohn, 2005, p. 130).

at 0.06% and no significant change in national income for Japan.[18] In this difficult environment, Keidanren played a key role in pushing the negotiations forward (Yoshimatsu, 2005, p. 274). In January 2001, it created the Japan–Korea Industrial Cooperation Committee which issued a report supporting FTA negotiations to address not only tariff elimination, but also mutual product standards, customs procedures, investment rules, labor issues, and technology cooperation (Keidanren, 2001). Perhaps, Keidanren's most important contribution was its search for potential business allies in Korea to keep the FTA proposal alive. First, it enlisted the support of the Federation of Korean Industries (FKI), and later on managed to get on board the Korea International Trade Association (KITA, which represents the interests of Korean small and medium enterprises (SMEs). So much so that during the visit of President Roh to Japan in June 2003, the Japanese and Korean industrial federations jointly made an appeal in favor of FTA negotiations (Yoshimatsu, 2005, p. 275).

The release later in that fall of the joint study group report on a Japan–Korea FTA gave another boost to the free trade proposal, and negotiations started in December 2003. The joint study put greater emphasis on long-term dynamic gains from increased productivity, technology transfer, and realization of economies of scale, and was more optimistic about mutual benefits to be realized by both countries in the long haul. However, a close reading of the report also underscores two major sources of disagreement, which in fact concentrated the attention of the negotiators early on. First, the Korean side continued to worry about short-term adjustment costs (with an increase in the trade deficit and possibly bankruptcy of many SMEs) and advocated some compensatory measures. Second, non-tariff barriers became a major issue for both Korean and Japanese companies (Japan–Korea Free Trade Agreement, Joint Study Group Report, 2003, pp. 16, 26–28).

The first FTA negotiations (from December 2003 to November 2004) failed to make substantial progress. Sensing wavering support in Korea for the FTA, the Japanese government made a novel move: it proposed that both countries exchange informal liberalization targets prior to the

18 These contrasting results derive from the differences in model structures (for example the Korean study did not include the service sector) or different assumptions regarding capital movements. See Cheong (2005, pp. 147–148).

actual exchange of the offer/request lists which constitute the core of the market access negotiations. However, the resistance from the agricultural lobby allowed the Japanese delegation to disclose only the overall target for industrial goods liberalization, not for primary commodities. The information was leaked, however, that Japan was only prepared to offer 50% liberalization in agriculture. Korea countered that it would not accept anything short of 90%. The FTA talks came to a halt. The rift is so wide that both countries cannot agree as to what is the main source of their disagreement. Korea argues that it is the unwillingness of Japan to open its agricultural (and especially fisheries) sector. Japan counters that Korea in fact has lost interest in the FTA because it fears industrial competition with Japan.[19]

Tension in bilateral trade relations escalated further with the eruption of the seaweed quota dispute in December 2004. Since the normalization of bilateral relations in 1965, Japan had granted an exclusive quota to Korea for imports of seaweed. However, pressed by China, Japan ended the Korean exclusivity in seaweed imports and attempted to ameliorate somewhat the impact in Korea by expanding the overall quota from 240 million sheets to 400 million sheets. Korea protested this move and initiated a WTO proceeding seeking to eliminate the quantitative measure altogether. Fearing broader consequences (as many countries with competitive fishery sectors are considering a WTO challenge to Japan's quotas on 17 marine products), Tokyo reached a deal with Korea in January 2006. The country-specific quota for Korea was to be revived and greatly enlarged: to 1.2 billion sheets by year 2015 ('Nori imports set to roil industry', *The Asahi Shimbun*, February 25, 2006). In return, Korea dropped the WTO proceeding. Although Korea and Japan have reached an understanding on seaweed imports, the FTA disagreement continues. In early 2008, a window of opportunity seemed to open as Japan –concerned by the negotiation of the Korea–United States FTA and seizing the opportunity of the inauguration of Korean President Lee – proposed working-level meetings to revive the FTA talks. And yet, the same concerns with Japanese agricultural opening and Korean SMEs have so far doomed this lukewarm initiative. ('South Korea and Japan to resume free trade talks', *The Hankyorek*, 23 April, 2008.)

19 Interviews with several METI officials (Tokyo, Japan, Summer 2005).

5.3 Sources of foreign policy contrast

In order to explain the contrasting outcomes in Japan's FTA negotiations with Mexico and Korea, we turn to our domestic interest group variables. Demand coherence does not set apart these two FTA initiatives, since in both cases Japanese manufacturing interests were directly at odds with the agricultural lobby. Both industry and agriculture relied on their powerful peak associations (Keidanren and the Central Union of Agricultural Cooperatives –Nôkyô – or its political arm JA Zenchû) to articulate their positions, lobby bureaucrats and politicians, and wage a media campaign.[20]

The key difference between the outcome in Mexico and Korea lies instead in the mobilization triggers affecting the lobbying behavior of the pro-FTA camp in Japan. As prospect theory leads us to expect, Japanese industries suffering significant losses from the trade and investment diversion effects of Mexico's FTA network mobilized actively to restore parity vis-à-vis their American and European rivals.[21] The industrial lobby encountered fierce opposition from agriculture (which resisted WTO plus concessions), and the chances of success for these negotiations seemed to evaporate at times. However, Keidanren never desisted from going forward with the FTA with Mexico and directly lobbied influential agricultural-tribe politicians to bring them on board (Yoshimatsu, 2005, p. 271).

In sharp contrast, Keidanren's lobbying campaign in favor of the FTA with Korea was more muted. For instance, it never formed an FTA committee but only a more modest industrial cooperation forum to oversee FTA talks (Yoshimatsu, 2005, p. 276); nor did it launch a sustained campaign to rescue the FTA talks after their suspension in November 2004, as it did for Mexico. Keidanren's weaker lobbying effort vis-à-vis an FTA with Korea reflected the fact that the most harmful discriminatory measure against Japanese companies (the import diversification program) had been eliminated prior to the initiation of FTA talks. Japanese industry did not lobby so vigorously, nor was it ready to

20 Although Nôkyô has lost its monopolistic powers over the distribution of rice production and fertilizer sales, it remains a key player in the politics of agricultural liberalization capable of mobilizing its members to oppose liberalization and of withholding its endorsement of ruling party politicians (George, 2005).

21 MITI attempted to calculate these losses and placed them in the neighborhood of 395.1 billion yen, and a loss of 31,824 jobs in Japan (Japan–Mexico Joint Study Group, 2002).

directly confront the powerful agricultural lobby, in a situation where gain maximization (not loss avoidance) was the main objective for supporting the FTA. Moreover, Keidanren's interest in a trade agreement with Korea waned as it sensed shrinking support among its Korean industrial counterparts. Although a temporary alliance between Keidanren, FKI, and KITA helped put aside the Korean reservations about the industrial adjustment of opening markets vis-à-vis Japan, support among Korean industrial circles has deteriorated since. The current position of the most important industrial federations in Korea is only of qualified support: agreeing in principle to an agreement, but urging caution regarding the timing of the agreement, the selection of the exemptions, and the duration of those exemptions ('Businesses Lukewarm on Korea-Japan FTA', *Korea Times*, 18 February, 2004). A December 2003, JETRO survey among Japanese companies in fact showed that Japanese companies no longer placed a large premium on an FTA with Korea. Surveyed firms placed China as the most desirable FTA counterpart (43.8% of responses), followed by ASEAN + 3 (13.5%) or Japan–ASEAN (8.9%). Only 3.9% of respondents selected the Korea–Japan FTA (Kajita, 2004, p. 9).

A final issue to consider is whether issue-linkage (to historical and territorial issues) has served as an additional impediment in Japan–Korea trade negotiations. It is true that 2005, a year designated as one of Japan–Korea friendship to commemorate the 40-year anniversary of normalization of relations, was characterized instead by intense frictions over the Dokdo/Takeshima islands (February 2005), compensation for past war deeds (March 2005), and protests over Koizumi's visit to the Yasukuni Shrine (October 2005). However, the flare-up of these long-standing disputes took place after the FTA impasse in November 2004. Disagreements over compensatory measures to cope with short term adjustment issues, non-tariff measures, and agricultural opening are the real reasons for the collapse of the talks. The broader shadow of historical and territorial disputes, nevertheless, impacts the chances of these free trade talks in a fundamental way. Since there are no strong domestic champions of these talks in Japan or Korea, political leadership at the highest level is necessary to break the impasse. It is precisely this kind of political leadership which fails to materialize in a context of renewed bitterness in bilateral relations.

6 Conclusion

The conventional view, in the field of international political economy, that greater economic interdependence creates an incentive for active foreign policy engagement, is hard to reconcile with the cases of Japanese foreign economic policy examined here. Rather, they show that levels of economic exposure or regional security interests are unreliable indicators of patterns of foreign economic diplomacy. In both episodes of financial crises in Latin America and East Asia, Japanese banks were heavily exposed and were concerned with broader issues of systemic instability. The Japanese government, however, was unexpectedly active in the Latin American crisis, but was paralyzed in the case of AFC. In the case of trade, the positive relationship between economic exposure and active policy does not seem to hold, since an agreement was possible with Mexico but not Korea; even though the former country represented a smaller market for Japanese exports, promised fewer gains of trade, and would yield larger adjustment costs in sensitive sectors.

Japan's active foreign policy, or lack thereof, is better explained with a look at the domestic lobbying activities of affected interest groups. We developed an analytical framework with two main variables involving mobilization triggers (gain maximization or loss avoidance) and demand coherence. We posited that the optimal conditions for foreign policy activism involve a small number of powerful and coherent interest groups that are keen supporters of swift government actions to avoid economic losses.

Our test of these variables across issue-areas and geographical regions generated a number of significant findings. First, we found a strong match between the predictions of our model and the outcomes of our four case studies. *Activism* (Box 1 in Chart 1) during the Latin American debt crisis reflected the demands of the Japanese banking community to devise an exit strategy from these markets by endorsing the novel concept of debt reduction. *Immobilism* (Box 4) in FTA negotiations with Korea resulted from the clash of interest groups in Japan and the muted lobbying campaign of industry to reap the economic benefits of such an accord. *Gridlock* (Box 2) in the Japanese early response to the AFC ensued when manufacturing interests opposed the bailout favored by the banks, and sided with the United States' preference for structural reform of affected Asian economies. The Japanese government's policy on regional financial cooperation later moved to *Gradualism* (Box 3 in

Chart 1) as the crisis ended and only few actors remained involved in regional financial cooperation. And FTA negotiations with Mexico moved from *Gridlock* (Box 2 in Chart 1) due to the clash between agriculture and industry, to *Activism* (Box 1 in Chart 1) as Japanese manufacturing companies spurred by trade diversion losses refused to let the talks collapse.

Second, the key analytical variable explaining diverging policy outcomes was different in finance and trade. In the case of financial crisis management, the most influential dimension was interest group demand coherence. Whereas the Japanese banking industry effectively articulated its policy demands for debt crisis management through the leadership of the BOT, the restructuring of the banking industry in the post-bubble period seriously disrupted established channels for corporate coordination. Moreover, in the case of the AFC, the Japanese government had to heed to the demands of industrial interests with a large export and/or multinational presence in East Asia. External interests supported the views of the Japanese manufacturing sector, which strengthened the domestic opposition to Japan's activism favored by of the banks.

In the case of trade, the contrasting degree of foreign policy activism derived instead from variations in mobilization triggers for the pro-FTA camp. In the trade talks with Korea and Mexico, the same private sector actors were involved: (Keidanren for industry, Zenchû for agriculture), and there was no change in their ability to represent their respective interests or in their sharp disagreements on whether to support or not the FTA talks with Mexico and Korea. What distinguishes these two FTA negotiations is the zeal displayed by Keidanren in the case of Mexico in order to counter on-going trade diversion; and the apathy shown towards talks with Korea given that the discriminatory treatment of the import diversification program had already been eliminated and Korean industrial federations were less supportive of the trade talks.

Third, in both finance and trade, private actors mobilized more swiftly to *avoid losses* than to realize potential gains. Japanese banks lobbied to protect themselves from financial losses due to loan exposures in both Latin America and East Asia, uncompetitive Japanese agricultural interests mobilized against free trade talks, and a potent industry lobby came to life when confronted with tangible losses from NAFTA's trade diversion effects. No similar sense of urgency was at work in FTA talks with Korea, even though the gains from the FTA with the country are estimated to be much higher for Japan. Our findings, as applied to the dynamics of domestic lobbying for foreign economic policy, lend strong support to prospect theory's insight that actors spring to action to eliminate tangible losses rather than to materialize potential opportunities.

In this manner, we hope that we have made two contributions to our understanding of foreign economic policy activism. First, we temper the functionalist expectation that high levels of economic interdependence will pave the way for bold regional integration initiatives. Multidimensional economic relations may in fact work against regional leadership if a state finds itself unable to reconcile conflicting demands from competing private interests. Second, we complement the two-level game framework with the insights of prospect theory, as we integrated interest lobbying arguments into foreign policy decision making to show that the range of variation in policy outcomes is best captured through the interplay of domestic interest perception and interest aggregation.

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