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The Japan-EU Economic Partnership Agreement

Economic Potentials and Policy Perspectives

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At their summit on 6 July 2017, Japan and the EU reached an agreement in principle for bilateral free trade. The agreement should be ready for signing by the end of 2018. The intended liberalization of trade in goods, agriculture and services would create the world's largest free trade area – assuming the agreement is successfully concluded and ratified by parliament. Japan and Europe are sending out a strong signal against protectionism and in favour of free trade and modernizing global trade rules. While free trade in the transatlantic and trans-Pacific context may remain an illusion for some time to come, the Japan-EU Economic Partnership Agreement (JEEPA) is a realistic opportunity for trade partners at the western and eastern margins of the Eurasian continent to achieve trade-induced growth and increased prosperity. Given its prominence, JEEPA raises the following questions: What trade liberalization can be expected? Does a free trade agreement between Japan and Europe actually make sense? Who would be the winners and losers? What are the risks and limitations? What are the political implications of the European-Japanese alliance?

JEEPA is an example of a deep trade agreement that goes far beyond mere trade in goods. The provisional agreement of 6 July includes a total of 16 negotiating points. In particular, the two parties agreed on better market access (tariff dismantling, reduction of non-tariff barriers to trade, liberalizing service trade, opening up public procurement markets) and modernizing trade rules (e.g. rules of origin, intellectual property rights, technical barriers to trade, corporate governance, competition, subsidies, state-owned enterprises, sustainability). Negotiations on investment and regulatory cooperation are still ongoing. While the content of investment protection (protection against unlawful expropriation, fair and equitable treatment, national treatment, MFN treatment) has broadly been agreed, the controversial issue of investor-state arbitration has not.

Better Market Access and Modernizing Trade Rules

Tariff dismantling: Despite the EU and Japan already having relatively liberal customs

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regimes, one of the most controversial negotiating areas was dismantling tariffs. Japan's core demands for the duty-free export of motor vehicles, automotive parts and electronics were met by Europe's demand for a liberalization of Japanese agricultural imports. On the European side, exporters of textiles, clothing, cosmetics and chemical products will also benefit. The outcome of the negotiations is that both sides have agreed to almost completely liberalize their bilateral trade, that is to say, between 97 and 99 percent based on tariff lines and import volumes. Only tariffs on rice and seaweed remain in place. However, the transitional periods of up to 15 years extend far into the future. For example, Europe's imports of motor vehicles and motor vehicle parts will only be fully duty-free after a transitional period of seven years. Japanese imports of leather goods and shoes will not be tariff-free for another ten years. However, Japan will be able to import wine duty-free as soon as the agreement enters into force. But Japan envisages longer transitional periods until imports of tuna (five years), wood (seven years), chocolate, confectionery, pasta, pork (ten years) and cheese and beef (15 years) become fully or partially liberalized.

Non-tariff Trade Barriers (NTBs): The elimination or at least reduction of NTBs was a key European objective and was, therefore, negotiated in parallel to dismantling tariffs. In the course of the negotiations, Japan has made "advance payments" already, for example by agreeing to substantially simplify approval procedures and licensing of medical technology and to facilitate the establishment of foreign vehicle workshops. The Commission considers it an outstanding negotiating success that Japan is willing to recognize UNECE international vehicle regulations, to remove all regulatory barriers to market entry in the motor vehicle sector, to recognize European testing procedures and product standards for hydrogen-powered vehicles and to work together with Europe on setting international (automotive) standards. In addition, Japan announced it would approve several food supplements and no longer treat imported beer from Europe as an alcoholic soft drink for tax and regulatory purposes, but to recognize it as beer. Japan also agreed to adopt international standards for textiles labelling and for the notification in the field of pharmaceuticals, medical devices and cosmetics.

Services: On services, Japan and the EU have agreed on rational, transparent, non-discriminatory rules that should improve mutual market access and limit regulatory discrimination without overriding national regulatory sovereignty. Specific agreements were made on telecommunications, financial services, insurance and postal and courier services. Explicit exceptions are basic public services, audiovisual services, maritime cabotage and some air transport. Both sides were largely able to agree on uniform standards in e-commerce. Importantly, the EU accommodated Japan's wishes for visa facilitation for Japanese businessmen and their families.

Public procurement: In addition to the WTO Public Procurement Agreement signed by both sides, the EU and Japan have also pledged to transparent, electronically supported tender specifications, mutually recognizing test results and selection criteria and opening up procurement markets further by including hospitals, universities and all municipalities with more than 300,000 residents. In construction, Japan has agreed to fair tendering practices. National rail procurement markets are to be opened up on both sides, a key demand for both Germany and Europe. Explicitly included are Japan's privatized rail operators (JR Central, JR East, JR West). Japan's Operation Safety Clause on the procurement of equipment, whose deliberately broad interpretation regularly led to European offers being disregarded, is to be lifted one year after the agreement comes into force.

Intellectual property rights: Since both Japan and the EU already have advanced intellectual property systems in place, the agreement only concerns improvements to individual areas. For example, they have agreed on the protection of trade secrets and on advanced standards in patent protection for pharmaceutical products and crop protection. However, the EU was unable to secure copyright protection for musical works, in particular for sound recordings. Nevertheless, the Commission considered getting Japan to recognize geographic indications on a total of 205 European agricultural products and food products a considerable success. Once the agreement comes into force, they will be subject to trademark protection in Japan.

Reviving Euro-Japanese trade

Although Japan and Europe are important trading partners for each other, their mutual significance in both countries' total trade has been declining. According to Eurostat, in 2016, Japan was the EU's sixth largest trading partner after the US, China, Switzerland, Russia and Turkey with total exports worth 58.1 billion euros and total imports worth 66.4 billion euros. Germany accounted for around one quarter of all EU-28 trade. Conversely, the EU is proportionately even more important for Japan as its third most prominent export destination (after China and the US) and its second most important source of imports (after China). However, both for Japan and Europe, the relative importance of their bilateral trade has been declining for several years. As a result, the share of EU exports to Japan in total EU exports fell from 6.2 percent (1990) to 3.1 percent (2015), while the share of EU imports from Japan in total EU imports fell from 12.2 percent (1990) to 3.4 percent (2015) (see Figure 1, p. 4). With overall higher initial levels, Europe's share of Japanese exports fell from 20.8 percent (1990) to 10.2 percent (2015), and Europe's share of Japanese imports decreased considerably in the past two decades from 16.3 percent (1990) to 10.4 percent (2015) (see Figure 2, p. 4).

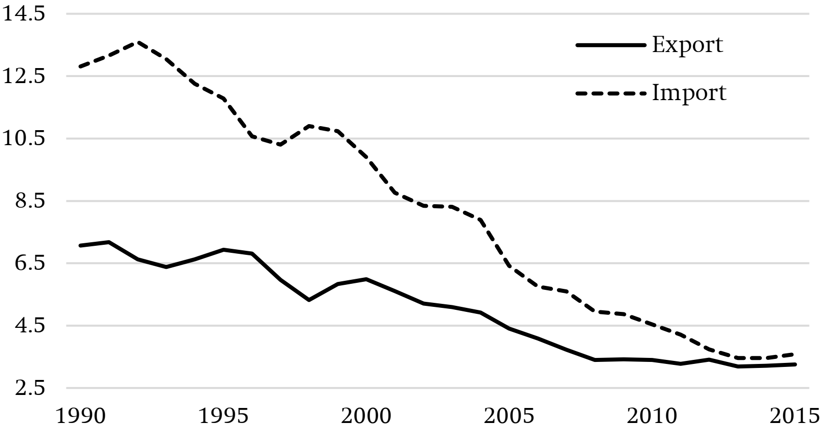
It seems evident, that a bilateral Japan-EU free trade agreement could counteract the trend of bilateral trade integration and, in particular, offset the trade diversion effects of Japan's and Europe's agreements with third countries. In addition, there would be further trade potential in reducing tariffs, NTBs and other market access barriers.

A positive assessment

Following the agreement in principle from 6 July, there is a good chance that JEEPA will expand and deepen trade and economic relations between the two partners. Japan and Europe are regions with a high per-capita income, highly developed industrial and service industries and discerning consumer markets. Both parties are committed to similar future areas such as digitization, interconnectivity, robotics, mobility, life science and energy efficiency. The potential for positive synergies and network effects is, therefore, significant. Even though JEEPA will only remove some of Japan's market access barriers and will not meet all the liberalization demands of European business, the FTA should increase intra-industrial trade in goods and create new opportunities for cooperation between European and Japanese companies. The exchange of bilateral services and investment is likely to become broader and deeper and the growth climate should improve overall. Europe and Japan – geographically located on opposite margins of the Eurasian landmass – would converge economically, and perhaps socially and politically as well.

Two pieces of empirical evidence support this optimistic assessment. Firstly, the dynamic development of trade between Korea and Europe after the bilateral (Korean-European) Free Trade Agreement came into force, illustrates how lifting trade barriers between two developed industrial regions can stimulate bilateral exchanges far beyond what is expected. Secondly, several

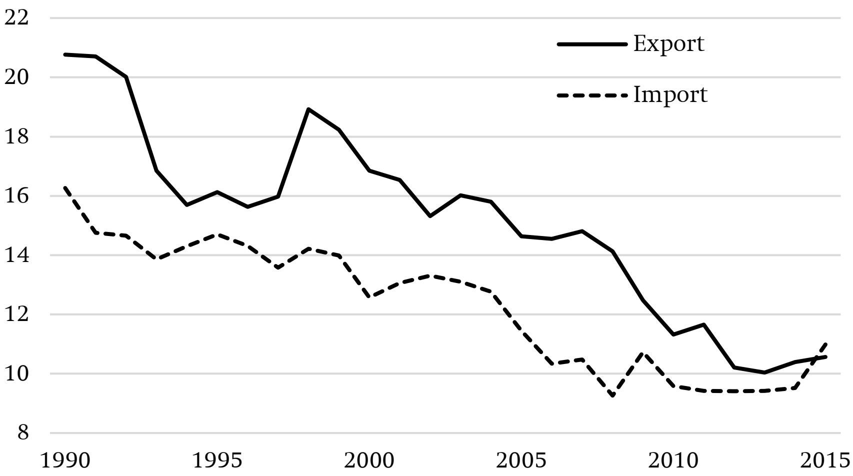
Figure 1
Japanese share of EU-28 trade in goods (in percent)



Non-EU trade.

Source: International Monetary Fund, Direction of Trade statistics, accessed 8 September 2016.

Figure 2
EU-28 share of Japan's trade in goods (in percent)



Source: International Monetary Fund, Direction of Trade statistics, accessed 8 September 2016.

scientific studies and simulations compiled in the course of JEEPA negotiations (Copenhagen Economics, Ifo Institute for Economic Research, European Center for International Political Economy) clearly indicate a positive impact on foreign trade and income, although the orders of magnitude calculated are sometimes rather small.

It is plausible to expect that a free trade agreement will benefit particularly those European countries already closely intertwined with Japan via exports, imports and direct investment. It is equally plausible to assume that a free trade agreement will primarily benefit those branches of industry that are already well represented in the trading partner's market. Consequently, Japan's automotive, electrical engineering, electronics, mechanical engineering and fine chemicals industries can expect greater exports to the EU, while the Europeans can look forward to expanding exports to Japan in the food production, automotive, chemical, pharmaceutical, medical, cosmetics, mechanical engineering and electrical engineering industries. By far the biggest beneficiary of dismantling tariffs and NTBs would be Europe's agriculture and food manufacturing. The export profits resulting from the free trade agreement would, therefore, be relatively widespread throughout Europe, from north to south and east to west.

Beyond the immediately foreseeable trade effects, Europe's export industry would also be well positioned in a free trade agreement to expand sales to Japan over the long term. In particular, this would serve the strategic interests of German industry in being well positioned to sell high-tech products in high-priced industrial markets. A steady increase of exports to Japan can be expected due to a variety of Japan-specific reasons, such as the country's demographic change, dependence on imports, internationalization of its business culture and the stuttering but ongoing process of economic structural reforms. Furthermore, a bilateral agreement would have an indirectly positive impact on sales for Europe's companies in third markets due to Japan's extensive overseas presence and Japan's continued pivotal role in Asia.

In addition to new export opportunities, JEEPA might also benefit Europe's economies through increased imports and direct investment from Japan. Firstly, reducing tariffs provides European consumers with real income gains which, in turn, indirectly create new income through additional expenditure. Secondly, importing high-performance industrial components from Japan strengthens the qualitative competitiveness of European companies. It is not widely known that, beyond large-scale industry, there are a large number of small and medium-sized companies operating in Japan with unique engineering and process expertise in their respective fields. Closer integration of this industrial culture, with its orientation towards technical perfection, into Europe's entrepreneurial networks could increase the efficiency and competitiveness of Europe's business. Thirdly, JEEPA would make Europe more attractive to Japanese investors. To date, Japanese companies have been reluctant to invest in continental Europe compared to competing locations, such as the US, Asia and the UK. Fourthly, European interest in Japan's technology, culture and everyday life has increased in recent years. On the one hand, it is expected that Japanese goods will meet with broad demand and enrich Europe's consumer culture – for example in the fields of food, living, design, accessories, horticulture, sports, comics, media and film. On the other hand, as a reference model, Japan is likely to stimulate European development in digital networking and the robotization of the economy and society.

Pitfalls and limitations

The expected positive effects of JEEPA cannot and should not obscure the limitations and risks of the intended trade integration. It is worth noting four critical points:

Firstly, JEEPA knows not only winners but losers as well. This is because liberalization will lead to displacement effects on both sides. In Europe, the automotive industry will have to deal with tougher import competition from Japan as a result of removing the ten-percent tariff. In Japan, the dismantling of agricultural tariffs will affect agriculture which is not a particularly competitive industry. The dairy industry, in particular, will face difficult structural adjustments.

Secondly, JEEPA contains plenty of fuel for political and societal conflict. The free trade agreement could face opposition from civil society in Europe should investor-state arbitration tribunals be created or a kind of regulatory cooperation be agreed that might jeopardize the precautionary principle. It is feared that multinational corporations will benefit from special rights which would undermine consumer protection and could lead to a loss of national regulatory sovereignty. Another criticism of the agreement is the low level of liability in its sustainability chapter, for example with regards to illegal logging imports from third countries.

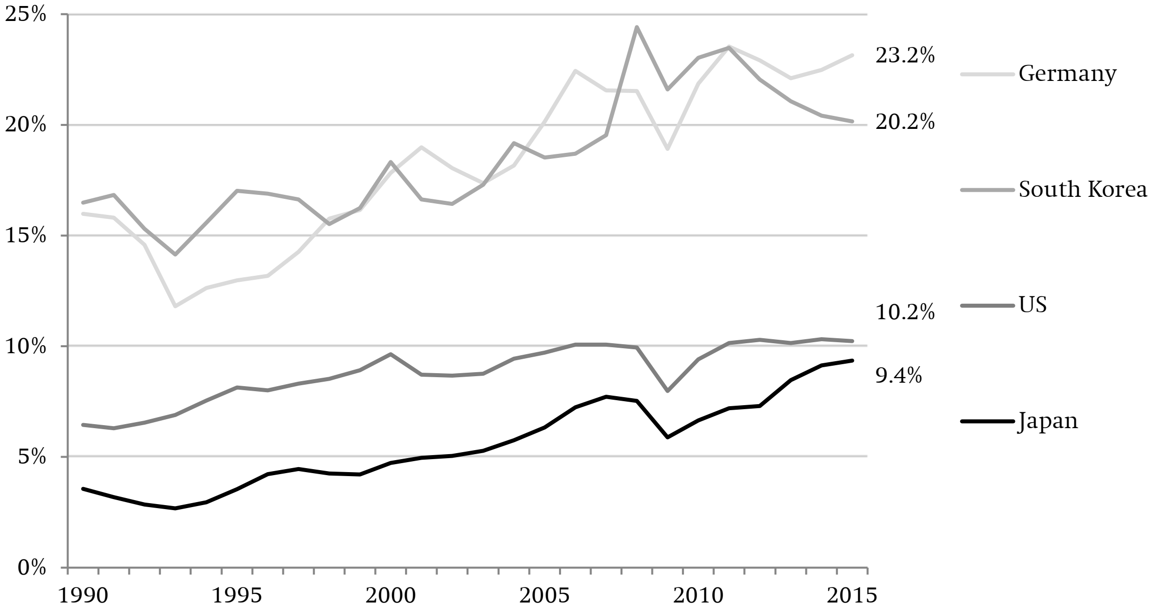
Thirdly, the agreements reached in JEEPA can only be a first step towards achieving better market access in Japan. Politics and industry must also ensure that its implementation is in line with the content and spirit of the agreement and that no new, currently unforeseen barriers to trade are created. A great deal of stamina will be needed to overcome opposition to Japan liberalizing its industry and agriculture since those lobbyists are well-connected in civil society, the governing party LDP and the ministries.

Fourthly, even after JEEPA has come into force and been implemented, market access in Japan will still remain extremely difficult for European companies. Although JEEPA is expected to effectively dismantle import duties and NTBs in Japan, it will not overcome informal market barriers, that is, the specific socio-economic and socio-cultural difficulties facing foreign suppliers in the Japanese market. Four special characteristics of market access conditions are critical in Japan.

Firstly, it is extremely difficult for foreign newcomers to adapt to Japanese business culture. Actors need to be extremely proficient in writing and speaking Japanese and must be prepared to spend a lot of time and money establishing and maintaining business contacts. Products must be tailored to the specific needs of the Japanese market and it is important to meet consumers' demands for extremely high quality and service. The Japanese domestic market is dominated by fierce and intense competition not only on price, but also on quality and service. In general, Japan's economic relations – both inside and outside companies – are more long-term than in other markets. Newcomers must, therefore, invest a considerable amount of time and financial resources if they want to break into existing business relationships. As a rule, foreign newcomers can only succeed if they have a decisive advantage in price-performance ratio or a convincing product innovation. Secondly, there is a distinct insider culture in Japan's economy and society. It is very difficult for foreigners to find acceptance because of the pressure to adapt and conform and the closed nature of Japanese society. They are always treated as outsiders. Thirdly, the Japanese legal system and legal practice tend to discriminate against foreign companies (generally outsiders or the economically weaker party). For example, in Japanese legal practice, companies are often denied legal remedies or are restricted in their ability to respond to contract infringements, infringements on immaterial property rights, unfair competition, bidding cartels or government discrimination. Fourthly, companies must take into account high market-entry and operational costs, not least because of the market access barriers mentioned above. In addition, there are high prices for land and property, considerable sales and distribution costs and top tax rates of more than 50 percent – all in a stagnant domestic market. The result is that investments in Japan promise lower returns and lower growth rates than alternative investments in other markets.

An obvious consequence of informal market barriers is the below-average integration of Japan into the global economic division of labour. In overall economic terms, imports, exports and direct investment are surprisingly low in Japan. Japan is only slowly getting closer to the structures of comparably large economies and trading nations. One striking example is that Japan's imports make up only 15.2 percent of gross domestic product (GDP), compared to Germany (31.4 percent), France (26.9 percent) and South Korea (31.7 percent). In no other industrialized country do industrial imports play such a minor role in domestic market supply as they do in Japan. This is reflected in the unusually low share of imported industrial goods to GDP (which excludes quantitatively significant imports of energy, raw materials and agricultural products) (see Figure 3).

Figure 3
Share of imported industrial goods to GDP, Japan compared to Germany, South Korea and the US*



* SITC 5 to 8 without 667 and 68.

Source: International Monetary Fund, World Economic Outlook Database; UN, UN Comtrade Database; UNCTAD, UNCTADstat Database (accessed 20 October 2016).

The share of foreign direct investment to Japanese GDP is also exceptionally low, at just 3.7 percent in 2015. By contrast, China's corresponding share was 10.8 percent, South Korea 12.9 percent, Germany 19.3 percent, France 25.6 percent, the US 30.9 percent and the UK 56.4 percent. Clearly, investing in the market, for example by constructing a local production site, selling services or acquiring a local business, is much more difficult and unprofitable in Japan than elsewhere.

Informal barriers to trade cannot really be overcome by a free trade agreement. This would require a change in business culture, mentality and consumer behaviour as well as long-term structural reforms. However, such factors are not the subject of free trade agreements. Nevertheless, ongoing efforts in Japan to implement structural reforms and internationalize business culture have led to an improved business environment for foreign companies. However, at best, JEEPA can only support this process.

Foreign policy perspectives

Beyond trade policy, JEEPA also has a political dimension. In addition to the free trade agreement, Japan and Europe are also negotiating a strategic partnership agreement for political, global and sectoral cooperation. The fact that Japan and Europe are conducting negotiations to deepen and intensify relations in the two key areas of external relations – trade and foreign policy – has political significance. It documents that both sides are seeking closer political cooperation extending beyond holding regular summit meetings and cooperating politically on peripheral fields of foreign policy. It shows the political will to counteract economic disintegration and the loss of political substance in the bilateral relationship. The aim is to intensify cooperation which would benefit both sides economically and politically.

In a globally fragile security environment, Japan and the EU are endorsing each other as reliable partners with shared values. Both sides are aware they need to take more responsibility in the world. While uncertainty has increased in the fields of trade and security policy during the Trump administration's first year in office, the chances and potential for closer EU-Japan cooperation are considerable. A joint commitment to preserving the rule-based, liberal world order, supported by ever closer economic integration, would give real substance and focus to the Japanese-European partnership. It seems that Japanese-European relations are entering a strategic dimension in the current era of uncertainty in which authoritarian rule, transactional politics and unilateral action are taking hold.

Outlook and conclusions

Japan is opening up to foreign trade and is slowly adjusting its import structure in line with other OECD countries. This process is mainly due to internal developments in Japan itself, but is effectively supported by liberalizing trade policy. Japan is undergoing an internationalization of its business culture. Structural reforms eliminate market barriers and discrimination and the ageing demographic of its society is resulting in an increased dependency on imports. The intended dismantling of tariffs and NTBs as part of JEEPA will give European companies the opportunity to participate in these processes taking place in Japan, thereby counteracting recent creeping losses in market share. By the same token, Europe can also benefit from cheap, versatile product offers from Japan. In macroeconomic terms, Europe can expect increased trade, investment, production and income, as well as additional stimuli for innovation and competition. It is in both Europe's and Japan's interests to liberalize bilateral trade and investment with a far-reaching free trade agreement with high mandatory standards. And the method of its implementation will be important.

Politically, the proposed Euro-Japanese free trade agreement is a clear sign in favour of a rule-based liberal world order and against trade protectionism. The free trade agreement and the partnership agreement negotiated at the same time could be the starting point for closer cooperation on trade, foreign policy and security between the two sides. European-Japanese relations can achieve greater substance and liability from this alliance. It can strengthen Europe's political profile in Asia, and Japan's in Europe.

On regulatory issues, the EU and Japan are natural partners as they pursue similar philosophies. Cooperation should, therefore, be easier than with the US. The trade rules agreed in the FTA, such as on sustainability, property rights, industrial standard regulation, competition and procurement, should serve as the basis for future trade agreements with third countries and become a joint position that both sides represent in the World Trade Organization (WTO). If the Trump administration attempts to isolate the US import market by means of arbitrary commercial measures or even disregards the authority of the WTO's dispute settlement mechanism, the EU and Japan should act together and oppose such measures jointly instead of acting in isolation.

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