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Article

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Michael Frenkel and Benedikt Walter

The EU-Japan Economic Partnership Agreement: Relevance, Content and Policy Implications

On 6 July 2017, after four years of negotiation, the EU reached an agreement with Japan over the main elements of a comprehensive free trade agreement. The breakthrough came at a time when progress on multilateral trade negotiations at the global level seemed out of reach and EU bilateral trade agreements faced strong public opposition. This paper examines the content of the new agreement with a view to global trade dynamics and assesses its main trade policy implications.

Despite the increasing role that emerging markets now play for extra-EU trade, Japan remains an important international trading partner of the EU. Following China, Japan is the EU's second-most important trading partner in Asia. EU exports to Japan amounted to €58.1 billion in 2016, while EU imports from Japan amounted to as much as €66.4 billion.¹ Against this background, the European Commission expects a significant economic impact from a comprehensive free trade agreement with Japan. A study prepared for the European Commission in 2010 estimates that an EU-Japan trade agreement could boost EU GDP by between 0.34% and 1.9% by 2020, depending on the extent to which the agreement envisages the reduction of non-tariff trade barriers.² More recent studies predict somewhat lower but still substantial welfare gains. The most recent one uses the 2011 EU-South Korea trade agreement as a benchmark and estimates GDP gains of 0.2% for the EU from a comparable agreement with Japan. Overall, the authors predict annual income gains for the EU of €11 billion over ten years after the agreement enters into force. In absolute terms, Germany would see the largest annual income gains (€3.4 billion), followed

by the United Kingdom (€1.6 billion)³ and France (€1.2 billion).⁴

In addition to the economic rationale for the trade agreement, political considerations played a major role in the negotiations. Interestingly, the official title of the agreement does not include the word “trade”. The title “Economic Partnership Agreement” rather intends to emphasise that the cooperation goes beyond trade and should be viewed as a strategic partnership including cooperation on many levels. As the EU Trade Commissioner Cecilia Malmström expressed it, the agreement “represents not just a trade deal; but a strategic alliance between the EU and Japan”.⁵ The EU hopes that the conclusion of the agreement will signal to the rest of the world that deeper international economic integration is still possible, even when the fear of new protectionism is on the rise. The agreement might even help the EU to assume leadership in setting global trade rules and standards. Moreover, it could become a vehicle to fill the vacuum created by the withdrawal of the United States from the Trans-Pacific Partnership (TPP). While it is still an open question whether the EU-Japan agreement can eventually meet these expectations, its completion nevertheless already reflects a remarkable achievement given the current dispute about trade agreements, the economic size of the contracting parties and the scope of the agreement. This paper looks at key data on EU-Japan trade, reviews the content of the EU-Japan Economic Partnership Agreement and analyses its implications.

1 European Commission: Trade in goods with Japan, Directorate-General for Trade, 3 May 2017.

2 European Commission: Impact Assessment Report on EU-Japan Trade Relations, Commission Staff Working Document, 28 July 2012, p. 37.

3 The income gains are subject to the rules and conditions that apply to the United Kingdom after Brexit.

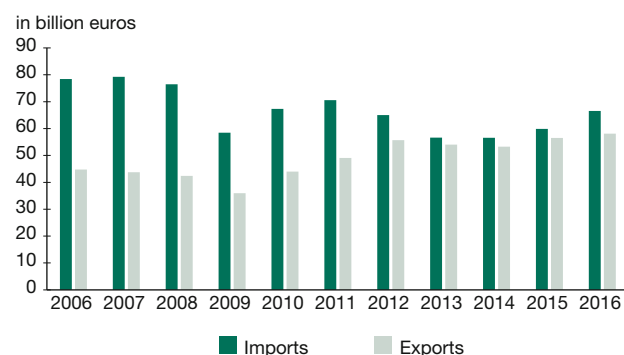
4 G. Felbermayr, F. Kimura, T. Okubo, M. Steininger, E. Yalcin: On the Economics of an EU-Japan Free Trade Agreement, Study of the Ifo Institute on behalf of the Bertelsmann Foundation, Final Report, 3 March 2017, p. 63.

5 C. Malmström: The Benefits of an EU-Japan Free Trade Agreement, Speech at EU-Japan Business Round Table, Brussels, 11 July 2017.

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Figure 1
European Union trade with Japan (merchandise goods)



Source: European Commission: Trade in goods with Japan, Directorate-General for Trade, 2017.

EU-Japan trade relations

The EU-Japan Economic Partnership Agreement is a bilateral trade agreement between the world's second- and fourth-largest economies in terms of GDP in current US dollars.⁶ Combined, the economies account for 28% of global GDP. Japan is the EU's sixth-largest trading partner; in 2016 Japan accounted for 3.9% of total EU imports and 3.3% of total EU exports.⁷ Figure 1 shows the development of EU exports and imports vis-à-vis Japan over the past ten years. The EU has had a negative trade balance with Japan throughout this period, but the EU's bilateral trade deficit has been considerably lower since 2012.

Table 1 shows the top five product groups of the EU's imports from and exports to Japan in 2016.⁸ Machinery and transport equipment, which includes cars, dominated both exports and imports with a total value of more than €65 billion. For EU exports, chemical products were the second-most important product group, with an export value of €14.5 billion, indicating a strong trade relationship in intermediate goods. Despite the dominance of industrial goods, agricultural products (i.e. food and live animals) still had a significant position as the fifth-largest product group of EU exports to Japan.

⁶ World Bank: World Development Indicators, 2017.

⁷ European Commission: Trade in goods with Japan, op. cit.

⁸ Standard International Trade Classification, Rev.3.

Table 1
EU trade with Japan by main product groups, 2016

EU imports	EU exports
1. Machinery and transport equipment (€43.5 billion)	1. Machinery and transport equipment (€21.7 billion)
2. Miscellaneous manufactured articles (€7.6 billion)	2. Chemicals and related products (€14.5 billion)
3. Chemicals and related products (€6.8 billion)	3. Miscellaneous manufactured articles (€9.3 billion)
4. Manufactured goods classified chiefly by material (€ 4.8 billion)	4. Manufactured goods classified chiefly by material (€4.0 billion)
5. Commodities and transactions (€2.7 billion)	5. Food and live animals (€3.8 billion)

Note: Measured at the one-digit Standard International Trade Classification (Rev.3) product classification level.

Source: European Commission: Trade in goods with Japan, Directorate-General for Trade, 3 May 2017.

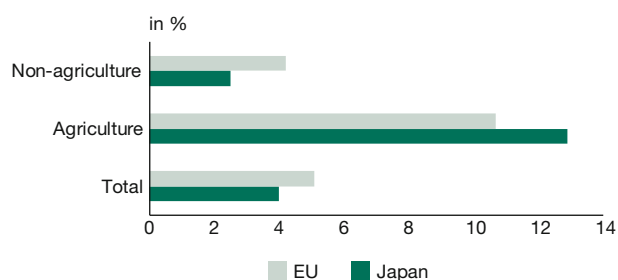
What is the content of the EU-Japan Economic Partnership Agreement?

The EU and Japan call the accord reached in July 2017 an "agreement in principle". Hence, it does not represent a final treaty. Some important chapters are still under negotiation, including the chapter on investment protection and investment dispute settlement. Another topic for which there is still a potential conflict is related to environmental issues, especially whaling. The strict ban on trade in whales in the EU stands in conflict with Japan's active commercial whaling activities. In the EU-Japan agreement, the EU aims to exclude this controversial subject, despite being an active member of the International Whaling Commission, which has repeatedly condemned whaling internationally.

However, while some of the treaty is not yet final, the parts that both parties have already agreed upon indicate a significant liberalisation of EU-Japan trade. The agreement will liberalise 91% of EU exports to Japan on the day of its ratification. After the completion of different staging periods, 99% of EU imports from Japan will be liberalised. Both parties agreed to completely eliminate tariffs for chemical products, plastics, cosmetics, textiles and clothing. Likewise, they will abolish tariffs on automobiles within the next seven years.

As the EU countries and Japan are members of the World Trade Organization, both economies currently apply the

Figure 2
Average WTO most-favoured-nation tariffs, EU and Japan



Source: WTO Tariff Trade Profiles for the EU and Japan, 2017.

most-favoured-nation (MFN) tariffs in their mutual trade. Figure 2 shows the average MFN tariffs for the EU and Japan. Tariffs are on average relatively low – 5.1% in the EU and 4.0% in Japan. For non-agricultural products, the EU applies on average higher tariffs than Japan (4.2% compared to 2.5%). For agricultural products, tariff rates in both economies are still high, on average above 10%. Japan in particular is protecting its farmers with relatively high tariffs. To some degree, this explains why the EU pushed for agricultural market access in the EU-Japan trade negotiations. In addition, agricultural subsidies (state aid) are substantial in both the EU and Japan. In 2016 the annual producer support estimate in Japan, which measures the annual gross transfers to agricultural producers, was about 48% of the total farm receipt (in total €38 billion), compared to 21% of the total farm receipt in the EU (in total €90 billion).⁹

State aid for agriculture is not part of the EU-Japan trade agreement, but the agreement nevertheless envisages liberalising trade of agricultural products considerably. Table 2 gives an overview of agricultural products with their corresponding Japanese import tariff rates before and after the agreement. For example, tariffs on alcoholic beverages, which are currently set at 15%, will be completely abolished with the entry into force of the treaty. Tariffs on pork will gradually be reduced over the next ten years. Furthermore, the agreement stipulates that, after 15 years, EU exports of cheese and dairy products, currently subject to tariffs of up to 28.9%, can enter Japan without any import restrictions.

The reduction of agricultural tariffs was a main priority of the EU. Japan, on the other hand, was willing to make concessions in this field, mainly in return for the EU's lib-

9 OECD: Producer and Consumer Support Estimates database, 2017.

Table 2
Pre- and post-agreement tariffs on agricultural products

Product	Pre-agreement tariff	Post-agreement tariff
Wine and sparkling wine	15%	Tariff elimination at entry into force
Alcoholic beverages	15%	Tariff elimination at entry into force
Pork	Quota + average tariff of 43%	Tariff elimination over 10 years
Processed pork	8.5%	Tariff elimination at entry into force
Hard cheese	Up to 28.9%	Tariff elimination over 15 years
Soft and fresh cheese	Up to 28.9%	Quota equivalent to current EU exports
Beef	38.5%	Tariff reduction to 9% over 15 years

Source: European Commission: EU-Japan EPA – The Agreement in Principle, Directorate-General for Trade, 2017, available at http://trade.ec.europa.eu/doclib/docs/2017/july/tradoc_155693.doc.pdf.

eralisation commitments in other areas, e.g. on tariffs and non-tariff barriers in the automotive sector. Nevertheless, Japan was able to achieve better market access for its fish exports to the EU, which is of great interest to the Japanese fishing industry. The parties now agree to abolish quotas and tariffs for fish on both sides.¹⁰ The agreement also includes transparency rules for the amount of subsidies given to the fishing industry.¹¹

In the EU as well as in Japan, the service sector plays the most important role in production. In Japan, services accounted for 70% of GDP in 2015. During the same year, this share was 74% in the EU.¹² The trade agreement tries to open this market with a chapter on trade in services, which aims at facilitating cross-border services with provisions on postal, telecommunication and financial services. Concerning postal services, the treaty includes an alignment of universal service obligations (i.e. the obligation to provide a basic level of services for every resident), rules to prevent anti-competitive behaviour, and the obligation to make information on licensing and qualification requirements publicly available. In the field of telecommunication services, the parties agreed to enable service provider access to telecommunication infrastructure in the territory of the other party. The section on financial services contains provisions on cooperation in the field of

10 European Commission: Key elements of the EU-Japan Economic Partnership Agreement, 6 July 2017, p. 2.

11 European Commission: EU-Japan EPA – The Agreement in Principle, Directorate-General for Trade, 6 July 2017, p. 11.

12 World Bank, op. cit.

financial regulation and on common payment and clearing systems. As an exception, the EU negotiated to exclude audio-visual services and air services (i.e. the supply of air terminal, airfield and other airport infrastructure services) from the scope of the agreement. Furthermore, the agreement aims at facilitating trade in services by including provisions on the movement of persons for business purposes. This covers, for example, intra-corporate transferees and business visitors.¹³

In addition to the liberalisation of trade in goods and services, the objective of the agreement is to reduce non-tariff trade barriers (NTBs). This is likely to create the highest economic gains.¹⁴ Concerning NTBs, Japan maintains high requirements in the area of sanitary and phytosanitary measures, including food safety and health regulation. The United Nations Committee on Trade and Development database on NTBs counts 99 sanitary and phytosanitary measures in Japan that affect trade.¹⁵ For instance, Japan has increased phytosanitary requirements for plants imported from the EU in 2015.¹⁶ With the EU-Japan trade agreement, NTBs in this area would be reduced substantially. For example, the mutual approval of food additives will be facilitated, and regulations on the manufacturing process of pharmaceutical products will be aligned. Progress has also been made in removing NTBs in the automotive sector. Reflecting a list of NTB's identified by industry associations, the treaty harmonises regulations that hamper access to the car market. For example, hydrogen-powered cars type-approved by European authorities will be accepted by Japanese authorities, allowing European carmakers to export such cars without any technical alterations.¹⁷

The agreement also deals with public procurement, a politically sensitive area in many economies. However, it is also an area in which the EU pushed for liberalisation in other negotiations (e.g. in the context of the Transatlantic Trade and Investment Partnership, or TTIP). The EU-Japan agreement envisages facilitating market access by granting the EU access to the procurement of 48 Japanese municipalities (with approximately 15% of Japan's population). This also includes procurement by local hospitals and academic institutions. For railway services, Japan opened up procurement for projects with a value exceeding €400 000. Likewise, the EU agreed to a partial

opening of procurement in the sector of overland and urban railways.¹⁸

What does the agreement mean for EU trade policy?

The EU-Japan trade agreement comes at a difficult time for international trade liberalisation. The withdrawal of the United States from the TPP, the de facto suspension of the negotiations on TTIP, the renegotiation of the North American Free Trade Agreement, and the public resistance to the Comprehensive Economic and Trade Agreement (CETA) between the EU and Canada show how difficult it has become to further advance trade liberalisation. While a few years ago bilateral trade liberalisation was regarded as a second-best solution compared to a multilateral approach, today the discussion has shifted to the question of whether more trade liberalisation is sensible at all. The EU-Japan trade agreement proves to be an exception to the current trend and shows that partners committed to economic integration are still able to reach such an agreement.

Ironically, while the success of the negotiations can be interpreted as a victory for free trade in times of protectionism, it was precisely these adverse circumstances which made the agreement possible. The negotiations on the EU-Japan trade agreement were launched in 2013, at roughly the same time as the negotiations on TTIP, but they only gained momentum when it became clear to the EU that an agreement on TTIP with the United States would be very unlikely in the near term. Also, Japan intensified the negotiations once the new US administration's opposition to free trade became clear. The withdrawal of the United States from the TPP proved these concerns right and led Japan to further reinforce the negotiations with the EU. Both the EU and Japan regarded the agreement as a political tool to signal their commitment to free trade and international cooperation.

The success of the negotiations is also due to modest public opposition to the agreement. Compared to TTIP and CETA, trade unions and anti-globalisation groups were unable to mobilise considerable resistance. Part of the explanation might be that the most controversial issues in TTIP and CETA, i.e. those related to the provisions on investor-state dispute settlement (ISDS), are still under negotiation in the EU-Japan agreement. Given the controversy over investor dispute resolution, it will be interesting to see how the contracting parties will design ISDS in the final EU-Japan agreement.

13 European Commission: EU-Japan EPA ..., op. cit., p. 7.

14 European Commission: Impact Assessment ..., op. cit., p. 37.

15 UNCTAD: TRAINS database, Sanitary and Phytosanitary measures, 2017.

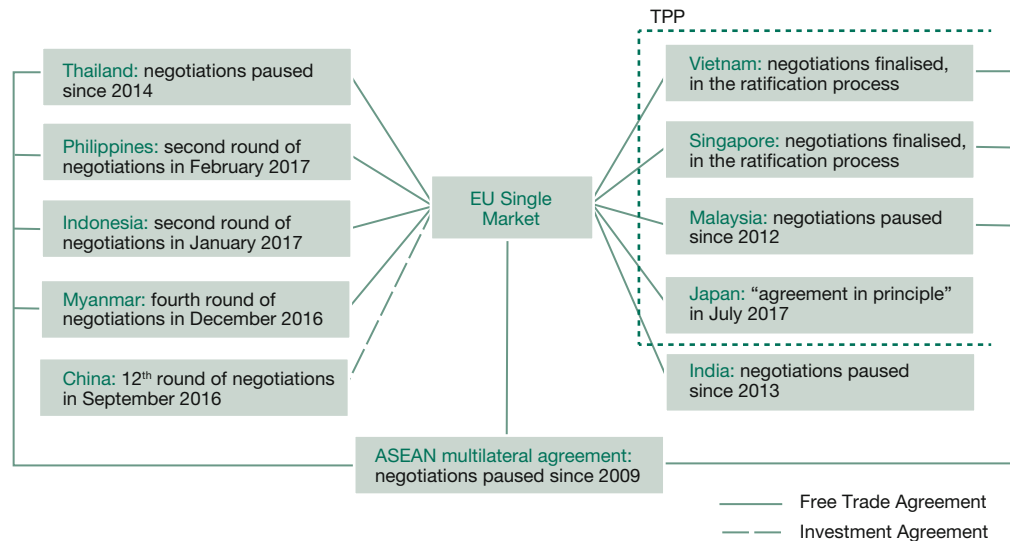
16 G. Felbermayr et al., op. cit., p. 33.

17 European Commission: EU-Japan EPA ..., op. cit., pp. 4-5.

18 Ibid., p. 9.

Figure 3

Overview of the EU's ongoing trade negotiations with Asian countries



Source: European Commission: Overview of FTA and other trade negotiations, Directorate-General for Trade, 2017, available at http://trade.ec.europa.eu/doclib/docs/2006/december/tradoc_118238.pdf.

With CETA, the EU has negotiated an agreement which includes revised provisions on ISDS. The EU aims to use these new provisions in all future agreements, including in the EU-Japan agreement. Japan, however, regards the traditional ISDS rules as sufficient. The revised provisions on investment dispute resolution try to address transparency concerns, reform the process of arbitrator selection, and include so-called *amicus curiae* provisions, which allow third parties (e.g. civil society groups) to participate in the arbitration process. In the same context, a controversial point between the EU and Japan remains the creation of a permanent arbitration court in the new ISDS system. In 2015 the EU initiated its Multilateral Investment Court project, through which it advocated a new permanent arbitration court in a multilateral setting. The new ISDS system proposed by the EU for the EU-Japan agreement is seen as a step towards a multilateral investment court. Such a permanent court would mean a departure from the current ad hoc procedures, in which the parties agree on a case-by-case basis to the exact rules of the arbitration procedure and the arbitrators are appointed individually for every case.

The EU hopes to establish its new ISDS system as a global standard in international dispute settlement, and thus it will be essential for it to eventually convince Japan to accept these new ISDS rules. The success of the EU's initiative to establish a new standard in dispute resolution crucially depends on the number of countries willing to adopt such a framework. If too few states agree to the new ISDS

rules, the EU runs the risk of creating unnecessary complexity for European investors. It will also become harder to convince other countries to join the initiative of creating a multilateral investment court if the EU-Japan agreement does not include the new style of ISDS provisions. If one accepts that the current system of ISDS has largely proven to provide satisfactory results, then one could argue that replacing it with an incomplete system might raise the risk of negatively affecting the international investment protection of firms.

A further disputed issue concerns the appointment of arbitrators in a new dispute settlement system. So far, arbitration courts, in most cases, consist of three arbitrators appointed for every case individually. The investor appoints one arbitrator, the state appoints a second arbitrator and the two disputing parties appoint a third arbitrator (the president) by consent. The new ISDS rules envisage an alternative appointment procedure, in which the contracting states appoint a pool of full-time arbitrators without the influence of the investor.¹⁹ Currently, this is a concession Japan is not willing to make. The dispute over ISDS shows the importance of the issue for the EU, and it is no coincidence that this highly controversial topic has been left aside in the preliminary agreement.

¹⁹ European Commission: Establishment of a Multilateral Investment Court for investment dispute resolution, Inception Impact Assessment, 1 August 2016, pp. 3, 5.

The new EU-Japan trade agreement also has implications for the world trade order, as it has the potential to strengthen the role of the EU in setting global trade standards, thereby allowing it to assume a leadership role in global trade policies. With the successful negotiations of the EU-Japan trade agreement, the EU is also strengthening its trade ties to the Pacific Rim, the most economically dynamic region worldwide. With the United States leaving the TPP, this trade pact has lost much of its relevance and opened the door for the EU-Japan trade agreement to be finalised relatively fast.²⁰ The agreement allows the EU to implement its own rules and standards with a major Pacific economy. If a strong TPP had been concluded, the EU might have been forced to adopt its rules when negotiating new agreements with Asian-Pacific countries. This would have limited or eliminated the EU's ability to exert significant influence on such rules.

This might become important in the near future, as the EU is currently negotiating bilateral agreements with ten Asian countries (see Figure 3).²¹ Three of those countries, namely Singapore, Malaysia and Vietnam (as well as Japan), are also part of the original TPP initiative. Additionally, a trade agreement is being negotiated with the ASEAN community as a whole in a region-to-region agreement, but those negotiations have been paused.²² If the EU-Japan agreement had been delayed, which would have been very likely if the United States had not withdrawn from the TPP, that trade pact's regulations and standards might have played a much greater role in the negotiation of new treaties. Furthermore, a strong TPP including the United States might have created a trade bloc in the Pacific that would have led to much more trade diversion – to the EU's detriment.

There is also an aspect of the EU-Japan trade agreement that could become important in the context of the UK's decision to leave the EU. Although it is still unclear what form Brexit will eventually take, trade between the UK and the EU will be subject to more barriers than is currently the case. As trade agreements already concluded by the EU with other countries will then no longer apply to the UK, this means that the EU-Japan agreement will not apply to the UK either. For Japan, this makes the agreement less attractive, as the market access to the UK will be closed. The UK leaving the EU is estimated to reduce Japan's real

GDP gains from the EU-Japan free trade agreement by 14%.²³ On the other hand, the EU-Japan trade deal will help secure EU market access for Japanese firms now situated in the UK and using it as an export platform to serve the Single Market. The trade agreement can therefore be a backup for Japanese firms that now operate in the UK but will lose access to the Single Market after the UK leaves the EU.²⁴ If these Japanese firms do not relocate to an EU27 country, they will have better market access to the EU out of Japan.

Concluding remarks

The global situation on international trade policies motivates the EU to seek ever more bilateral agreements with its largest trading partners. The departure from the multilateral approach, which would be preferable from a theoretical and empirical perspective, seems to be irreversible. With NTBs as the primary obstacle to trade, countries need to make much greater concessions in trade agreements now than in the case of trade agreements that focus simply on tariff reductions. The associated complexity of any trade negotiation will make any agreement in a multilateral or more global setting increasingly difficult. Political reality makes it necessary to follow the bilateral approach as a second-best solution and accept the risk of trade diversion associated with this approach. The EU-Japan Economic Partnership Agreement is a step following this logic.

The advantages of the EU-Japan Economic Partnership Agreement are obvious: economically, both the EU and Japan rely too much on their export industries to pass up the opportunity of further removing trade barriers between them. The economic gains that an agreement would be able to reap are considerable. Politically, the agreement is an opportunity for the EU to solidify its position in the Pacific Rim and to increase its presence in the fastest-growing region of the world economy. The US withdrawal from the TPP has created the chance to strengthen the role the EU plays in setting global trading standards. However, it is unclear whether the TPP will further develop without the United States and how Brexit will ultimately be structured. These developments will have a decisive effect on how the EU-Japan Economic Partnership Agreement will be assessed in the future.

20 Despite the US decision to leave the TPP, Japan and New Zealand have already ratified the treaty and are pushing to move forward without the United States.

21 The conclusion of the EU-Vietnam Free Trade Agreement was formally announced in December 2016 and is now in the ratification process.

22 The EU intends to recommence the negotiations and sees the bilateral agreements with the ASEAN countries as a way towards a future multilateral agreement. However, at the moment this remains unlikely.

23 G. Felbermayr et al., op. cit., p. 64.

24 R. Langhammer: Freihandelsabkommen EU/Japan: Trump und Brexit als Helfer, in: Wirtschaftsdienst, Vol. 97, No. 4, 2017, p. 236.