

**CIGS Dr. Hanns Günther Hilpert
Seminar**

**The EU-Japan Free Trade Agreement,
Economic and Political Aspects**

(Summary)

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[Mr. Jun Kurihara, Research Director, CIGS]

The EU already has free trade agreements with several countries and is now busy in negotiating with its American counterpart. Although there are currently few people who pay attention to the progress of EU-Japan trade negotiation, Japan will turn its eye towards negotiations with the EU after finishing the TPP negotiations. Because of the importance of the EU economy, Japan should pay more attention to what is going on in EU. Japan's trade share in EU's total trade accounts for only 3.3%, while the United States accounts for 17.5%, and China around 15%. For this reason, from the viewpoint of the EU, there is actually scarcity of intellectual or the economic necessity to enhance or accelerate trade negotiations.

From a Chinese point of view, the EU's trade accounts for 18%, while the United States accounts for 13%. Therefore, China has great interest in accelerating the progress of negotiations although it has not yet started, and as a result, there may be competition in the negotiation process from the viewpoint of the EU. EU is busy in finalizing the trade negotiation with the United States. The likely next step of EU would be to shift attention to China. On the other hand, China probably has some incentives in negotiation with EU in order to counterbalance against the United States.

Japanese industry has no strong incentive to proceed along with negotiations with EU. However, as the world economy continues to go through a process of globalization, Japanese firms must think seriously about the expansion of the bilateral relationship between Japan and Europe.

[Dr. Hanns Günther Hilpert, SWP Stiftung Wissenschaft und Politik]

My presentation has five parts and the first part is about the relevance of the Japan-EU trade agreement. By size of trade, the EU and Japan are the No.1 and No.4 trading powers of the world. For Japan, EU is the third largest market and the second largest supplier. For the EU, Japan is the third largest out-of-Europe market. From the supplier side, Japan is also the fifth largest supplier and the third largest from out-of-Europe partners. However, from the perspective of outside investments from Europe, there are not many European investments in Japan. This may change with the implementation of a future agreement. If you compare other major agreements and frameworks, the Japan-EU Free Trade Agreement could potentially be the No.2 FTA zone worldwide, even ahead of TPP.

Why is the Japan-EU Free Trade Agreement garnering so little media attention and why are Europe's and Japan's public not more interested? There are many potential reasons, but one is that the negotiations started earlier than TTP and TTIP, but have remained on the sidelines. Furthermore, there is a foreign policy nexus for both TPIP and TPP. TPP is a commitment of the US for Asia and a trade agreement which for now has excluded China. Therefore, the importance of foreign policy and Asia Pacific security issues may explain why there is more media attention on TPP. We have seen high politicization for both TTIP and for TPP, and actual negotiations of Japan with the EU did not remain in focus.

Over the last decade, we have seen a declining trade share between Japan and the EU. In particular, the share of Japan in Europe's trade has declined significantly from 1990 to the present, especially in terms of imports. In 1990, Europe's imports from Japan amounted to a share of 12% of Europe's total imports, now the share stands at 4%. Similar development has taken place in the share of Japan in Germany's trade. Japan's import share have come down from 6% to about 2%. There is a sharp decline in trade when you look at the shares of Japan's trade with the EU and Germany from 1990 to 2015.

Bilateral European-Japanese trade not only declined because China and other emerging markets raised their shares. What is more, both EU and Japan have concluded many bilateral FTAs with other countries, which resulted in economic discrimination from the perspective of both countries towards one another. Therefore, if a bilateral free trade agreement could be concluded, these discriminations can be reversed. There is huge potential of trade expansion between these two mature and developed economic entities.

This potential will be realized once the trade barriers are abolished. Japan is a very attractive market for Europe because it is a high-price market with strong potential. Once, established, companies can gain long-term high profits as the quality standards and customer requirements in Japan are particularly high, and Japan is a reference market for Asia. Therefore, there is a strong incentive for German and European companies to have a presence in Japan and conclude the Japan-EU Free Trade Agreement.

There are also political reasons. Generally, political relations between Europe and Japan are very good. However, Japan-European political cooperation lacks strategic focus and substance. If Japan or the EU are cooperating with an out-of-area partner, it is usually

the US. Beyond diplomatic summits, cooperation is needed in areas such as trade and economy. Parallel to the Japan-EU free trade agreement negotiations, there are also negotiations about a strategic framework agreement which would cover foreign policy, security, and many global issues.

There are also sizable trade and income effects to be expected. A study commissioned by the EU Trade Commissioner has shown that if you assume that the tariffs go down to zero, there will be €14.1 billion more exports from the EU to Japan, and €25.2 billion more exports from Japan to the EU. If you assume that there will eventually be a large reduction of non-tariff barriers, it could be even higher, and there will also be some income effects which will size up to 0.14% of GDP in the case of EU, and 0.31% of GDP in the case of Japan. The Prognos Institute in Basel has also made some estimations on the sectoral effects of a potential agreement between Japan and Europe, with the big winners for Japan being in the automotive, electronics, and machinery industries, and the winners for Europe being in the food processing, chemicals, and pharmaceuticals industries.

However, there are obstacles to reaching an agreement, such as the skepticism among European businesses concerning the Japanese market. The Japanese market is very difficult to penetrate. There is a very high agricultural tariff in Japan, as well as some industrial tariffs. There are also non-tariff barriers which effectively protect the Japanese market from foreign competition, such as strict standards for extensive development of foreign products to be sold in Japan. Then, there are restrictions on some business activities in Japan for foreigners, for example, in the field of energy, telecom, and shipping amongst others. There are high fees and charges at ports and airports and a lack of storage capacities, which induce high transport costs for foreign suppliers. The penetration ratio in foreign procurement is also especially low in Japan.

However, the informal barriers are much more important. For example, the legal system, which makes it very difficult to bring civil cases to court; Japanese business culture; weak competition law; and high expectations of "high quality" products held among Japanese consumers. In Japan, considerable time and financial investment is required to break into long-term well-established business relations. It is very difficult for newcomers in general, and it is even more difficult for foreign newcomers. These issues are not addressed by the current free trade agreement, and may explain why there are few foreign companies competing successfully in the Japanese market. If industrial goods could penetrate into the Japanese market in a similar way as into other OECD markets, Japan could profit from higher economic growth and higher exports as well.

Japanese industry would concentrate more on their competitive strengths and would export higher volumes, thus leading to a higher economic growth rate.

Macroeconomic measures show that the Japanese import market is particularly difficult when compared to other developed countries. For example, the share of imports in GDP is very low in Japan, but is rising in recent years, and is now even higher than in the US. If you look at the share of FDI in GDP, Japanese shares are also very low. It is very difficult to establish a company in Japan and acquire Japanese companies. Next, looking at the share of industrial goods imports in GDP, which are total imports minus energy, commodities, food, and beverages. This share of industrial goods imports in GDP is a perfect measure of market penetration in the manufacturing sector. If you compare this with other countries, you see that industrial goods imports into Japan have steadily increased over the last three decades, that there are more and more foreign-made goods purchased by Japanese consumers and Japanese companies, and there are more foreign enterprises actively doing business in Japan.

However, compared to major industrialized economies, access to the Japanese import market is relatively limited. In no other industrialized country do foreign industrialized goods have such a low market share. Japan's industrial goods export share in GDP is also lower than in other countries. In spite of the high volume of high-class and high-quality Japanese goods, Japan is not really an export-oriented economy.

Regarding negotiation issues, what does Japan want from the Japan-EU free trade negotiation? First of all, Japan wants a reduction of tariffs. There are still 10% tariffs in the automotive sector, and in some electronic component products, there is a 14% tariff in Europe. Second, there are some regulatory issues; automotive, chemicals, but also food processing. What does the EU want? The EU has demands concerning the agricultural tariffs, but mostly there are concerns over non-tariff barriers in the automotive industry or in food safety, medical devices, pharmaceuticals, and other areas. The EU also wants to promote European food items by utilizing geographical indicators, which offer higher intellectual protection than trademarks. There is also the Investor State Dispute Settlement topic, which is a very sensitive politicized issue in Europe. The European Parliament has demanded from the European Commission, that all of Europe's trade negotiation partners participate at the future (still to be established) International Investor State Dispute Settlement Court.

What are the remaining obstacles? First of all, there is skepticism on both sides. There is a fear that the Japan-EU trade agreement could be taken hostage by the TTIP

negotiation. Currently, Europe's priority is concluding TTIP first, as the Obama administration is finishing its term this year, and there are uncertainties over whether the next president will be eager to conclude a TTIP with Europe.

Europe is quite skeptical because they think the negotiation process is asymmetrical. The FTA negotiation is mainly about tariffs, and the Japanese demand is to simply abolish industrial tariffs. However, if the EU were to abolish such tariffs, it would only benefit Japanese exporters. On the other hand, NTB abolishment would be profitable not only to Europe but profitable to any importer to Japan. Therefore, it's a difficult situation for both sides.

Second, there are many European companies that see little potential for market access in Japan. There have been many unsuccessful trials to open up the market in Japan from the EU side for more than two decades, and while there has been some achievement, there have also been some failures. There is also a fear that if a FTA were to be signed, under which NTBs were abolished, Japan would still find a way to construct new ones after the conclusions. So there is not only skepticism, but also a lack of trust.

My final point is that in the previous year, European negotiators have perceived they have been taken hostage by the TPP. Japan has prioritized concluding TPP, and we now have to wait for ratification and acceptance by Japanese Parliament as well as US Congress, the latter being quite unpredictable. So there is also a negative perception surrounding this.

While many roadblocks remain, there is a strong need for an agreement to be concluded, which will likely eventually be the end-result of this process. However, it is important to recognize that this is a job which can't be done by negotiators alone. There will be a requirement for political capital to be spent, both by the Europeans and by the Japanese side. Otherwise, there will be an impasse.

Mr. Kurihara: Thank you Dr. Hilpert. Next, I would like to invite Dr. Yamashita to share his views and comments.

[Dr. Kazuhito Yamashita, Research Director, CIGS]

The TPP negotiations improve market access for all participating countries. Tariffs on both agricultural and industrial products will be reduced or eliminated. TPP will result in more liberalized service trade and greater access to government procurement. New

rules and disciplines on trade and investment will be established. TPP will also contribute to leveling the playing field between state-owned enterprises and private companies.

TPP, one of FTAs, could also help expand or accelerate other FTA negotiations. The essence of FTA is discrimination. If you join a free trade agreement, then you can enjoy tariff elimination or protection of investment. Otherwise, you will not have preferential access to such markets. Mega-FTAs such as TPP and TTIP tend to make these effects much worse. Thus Korea, Taiwan, Philippines, Thailand, and Indonesia are currently expressing their willingness to join TPP. They don't want to be excluded from this vast free trade zone. China is also interested in joining TPP. Implementation of RCEP, the mega-FTA which includes ASEAN + 6, has also been accelerated by the TPP negotiations. Several years ago, the EU was not particularly interested in establishing a FTA with Japan, while Japanese industry was, since South Korea had signed an FTA with the EU which might have adverse effects on the Japanese industry.

The EU has become more open to establishing an FTA with Japan, largely because of agriculture. While Japan has achieved some success in maintaining tariffs on some of the sensitive agricultural products in the TPP negotiations, in many products such as wheat, tariffs have been substantially reduced or even eliminated. Japan has reduced the surcharge on wheat within the tariff quota, so that the Japanese market will be more open to exporters of wheat from the United States, Canada, and Australia. On the other hand, Japan has imported products made from wheat from Europe, and Japanese wheat product producers can produce spaghetti and other wheat-related products at a lower price than before because they will pay less for wheat. EU food processing companies may have difficulties exporting their products to the Japanese market, because they will be paying the same kind of tariffs as before.

TPP will also substantially reduce the tariffs on beef and pork, and tariffs on whey and some cheese will be eliminated altogether. Whey is a byproduct of cheese. The European Union is the largest exporter of whey to Japan, and in terms of cheese, the third largest exporter. However, regarding amount of money, the EU may be the largest exporter of cheese to Japan, because it exports more expensive cheese than the other countries. Japan has imported substantial amounts of low-quality cheese from Australia and New Zealand, such as Gouda or Cheddar, for producing processed cheese. The tariffs on those kinds of cheese will be eliminated by TPP. Processed cheese made in Japan will be less expensive compared with cheese imported from the European Union such as Camembert. The export of whey and cheese by the European Union will be

disadvantaged by preferential treatments for TPP participants such as the US, Australia and New Zealand.

Substantial reduction of the Japanese tariff on pork by TPP favors the US and Canada. The US is the largest exporter of pork to Japan, and Canada is the second largest exporter to Japan. Currently, Japanese pork producers are protected by subsidies. Even though there is an increase of imports from the United States and Canada by TPP, Japanese pork producers could be protected from the decrease of pork price by receiving increase amount of subsidies from the Japanese government. However, the third largest exporter of pork to Japan, which are Danish pork producers, may be disadvantaged in such a situation. This is an example of distortion created by the TPP negotiations. As already mentioned, similar effects may take place in cheese, whey, or wheat-related products. So is the case among TPP participants. In terms of the delay of the US ratification of the TPP agreement, US beef producers will suffer greatly from it, because Australia beef producers will be treated favorably by free trade agreement with Japan.

The reason there are such kinds of distortions in the field of agriculture is because tariffs on agriculture products are very high. If there are low tariffs on all products, there will be less distortion created by the free trade agreements. However, in the case of industrial products such as automobiles, there are high tariffs in the European Union. One reason why there has been a decrease in the Japanese export of industrial products to the European Union is that there has been substantial foreign investment by the Japanese automotive and electric industries in Europe so as to circumvent tariffs set by the European Union. There is no guarantee that by concluding the Japan-EU Free Trade Agreement, we could reverse this trend, and could export more industrial goods from Japan to the European Union. This is the difference between the industrial sector and the agriculture sector, because agriculture cannot shift its production site from Japan to Europe. We will wait and see how the TPP negotiations may promote or accelerate the trade negotiation between Japan and the European Union.

[Question & Answer Session]

[Questioner 1]

I have one comment and one question. My comment is that I have exchanged views with many European businessmen and associations that have had little issue regarding market penetration in Japan. My question is: what do you think will happen in terms of trade and business if the Brexit were to happen?

[Answer 1 by Dr. Hilpert]

The European businessmen active in Japan and Tokyo are happy because they became insiders. They have sustained profit from large economic gains, long term, because Japanese customers are very faithful once they have your trust and believe in your product and service. That is why a substantial amount of time, dedication, and investment, is required to be successful. But this is a selected few. There are many companies who could be successful in Japan because they have good products but they can't make it. This is a loss not only for exporters, but also a loss for the Japanese economy, because these products could make a really good impact.

Regarding Brexit, nobody can be sure what will happen. My feeling is that the UK would get a similar deal as Switzerland or Norway or Iceland. Now, the UK has a rebate, contributing less to the EU budget than it should according to its income size. As a consequence of Brexit, the UK would lose her rebate her vote in EU matters, but would still be obliged to follow Europe's single market decisions. But I do not foresee any discrimination of Japanese businesses as a result, with the possible exception in the financial industry sector

[Questioner 2]

There is a shortage of food and energy globally, and world trade may not grow in the future for several decades. Japan is now opening its market for food along with Europe. What kind of challenges will we be addressing, and what is your thinking of this trend?

[Answer 2 by Dr. Hilpert]

World trade has been stagnant over the last two years and we are seeing the side effect of declining commodity prices. For example, energy, iron ore, and other raw materials

prices have declined heavily, which means that the volume and the price of these commodities are lower. Countries like Japan or Germany, which are commodity and energy importers, need to produce and export less industrial goods such as cars to pay for let's say ten barrels of oil and a ton of steel. The declining price trend is not simply limited to oil and energy, but also includes other commodities as well. US companies will continue to be dependent on Asia and Europe terms of high-tech supply networks and also on gaining income from the US subsidiaries.

[Mr. Kurihara]

Dr. Hilpert, do you have any comments on the presentation by Mr. Yamashita?

[Dr. Hilpert]

I enjoyed your comment regarding the automotive industry. Manufacturing investment is required because European consumers' tastes are not the same as Japanese consumers' taste, and also there are some different regulations. Therefore, it makes sense to retain the manufacturing process in Europe. If the British Pound gets expensive after appreciating against the Euro, manufacturing in the UK may not be competitive anymore. Regarding European food exports to Japan, the example of Danish pork producers being at a disadvantage is an interesting one. A potential Japan-EU Trade Agreement would have to be ratified not only by the European Parliament, but also by all European Union member states' parliaments. And if Denmark, in that case, decided to vote no, then there would be no agreement.

In that sense, negotiations with the EU are very complicated. It is not like the US or Australia. Negotiating with the commission is important, however it is also a requirement to keep in mind all member countries. Wheat could be an issue. Beef should not be a major issue, as Europe is not as competitive as the US and Canada. But pork is an issue along with dairy, so those will be areas that will require work to solve.

[Dr. Yamashita]

Regarding TPP, the Japanese government is trying to eliminate tariffs on the automotive industry. For example, Toyota is producing Corolla cars and other medium-class cars in the United States, as well as exporting the Lexus to the United States, which is a highly value-added product. A 2.5 ad valorem tariff rate on Lexus amounts to US \$1 billion, which is a huge sum of money. Therefore, a similar pattern may emerge in the Japan-EU trade relationship over automobiles.

Regarding cheese, in the TPP negotiations we will eliminate tariffs on hard natural cheese such as Gouda and Cheddar, which is used for producing processed cheese. Tariffs have been set aside on soft cheese like Camembert and Mozzarella cheese. The Japanese government, especially the Ministry of Agriculture, Forestry and Fisheries, presumably sets aside tariffs on soft cheese for the sake of the Japan-EU trade negotiations. Japan will likely treat the Danish pork industry likewise, so there will be

no unfavorable asymmetric negotiations setting. Therefore, when it comes to tariffs, tariffs on industrial products and agricultural products can be eliminated together. That is a mutually beneficial way to eliminate tariffs on those products.

Having TTIP with the European Union, TPP with the United States, as well as the Japan-EU free trade agreement, will result in great economic ties between Japan, EU and the United States. That means that we are going to have a very huge free trade zone consisting of the three major economies in the world. That may put more pressure on China to accelerate free trade negotiation, RCEP negotiations, or to join TPP themselves. That could in turn improve negotiations in the World Trade Organization, because the Doha round negotiation of the WTO has been stalemated. Forming mega-free trade agreements consisting of these three major economics in the world could help overcome this situation.

[Dr. Hilpert]

There is strong Chinese interest to conclude an FTA with Europe, but there is no major interest from Europe to conclude an FTA with China, because Europe is fearful of Chinese competition, particularly as of the end of 2016, China can be recognized as a market economy. There will be more intensified competition from China, so the commission has not decided yet how to deal with that problem. For example, low-priced steel coming from China would destroy the European steel industry, which is something nobody would allow in Europe. Therefore, for the time being, there will be no FTA negotiations with China. Currently, there are negotiations underway about bilateral investment treaties with China, however this has also stalled because European demands are too high and there is a lack of strong interest. Most European countries have already established bilateral investment treaties with China, so there is not a strong need for a European-regional FTA.

[Question & Answer Session Continued]

[Questioner 3]

I would like to briefly make two comments. Firstly, you and Dr. Yamashita-san suggested that there is some sort of huge distortion because of the asymmetric pace of negotiations among the largest world economies. I am also interested in following the so-called trade agreement because some individuals in Japan are suggesting that in order to outsmart the slow pace of negotiation, major Japanese multinationals could filter into markets by enhancing FDI. The Chinese are taking advantage of this, which can be seen in how the Japanese and American governments are currently concerned about high-tech penetration through Chinese purchases of European affiliates of companies operating in the United States. Therefore, one of my major concerns is how to lessen the threat of the fear of the spread of dual use technology. China's maneuver is highly ambiguous, and contains both economic and security implications. My second comment is an anecdote. I met with several Europeans the other day who are working for Michelin, and they said that the rubber industry is very happy with the Japanese market currently. However, when I visited France and Germany, I met several business people who had difficulty penetrating the Japanese market. Ultimately, we must find ways to help each other reinvigorate our economies, and so I believe we should turn to free-trade agreements.

[Answer 3 by Dr. Hilpert]

There are many German, French, Italian, and other European companies who would like to do business in Japan, but have given up. Specifically regarding Germany, the automotive industry is against a potential Japan-EU free trade agreement. On the other hand, the chemical industry is in favor of it because there are still tariffs in Japan and if tariffs are lifted, then they will obtain market share and increase their sales because chemical commodities are very price sensitive. The apparel, textiles, and food processing industries are very much in favor, too. However, most of the other industries feel neutral about a potential FTA. Their thinking is that, "Japan is an interesting market, but we can't sell our products there anyway, so we're better off going to Brazil, China, or Southeast Asia. We can invest in their markets and see returns. Japan could potentially be a major waste of time and resources." However, with a structural and attitude change on both sides, I believe that these companies could make some positive contribution to Japan, such as through increasing the competitiveness of Japanese companies, increasing consumer welfare. While a potential Japan-EU free trade

agreement may not change business culture in Japan or abolish its structural impediments, it would at the very least raise the profile of Japan, and foreign companies would think again to go to Japan and there will be some positive examples and that will induce more trade and more economic integration.