



Policy Brief #2017/01

EU-Japan: Free trade agreement a sign of commitment to economic cooperation

The EU and Japan are important economic partners. They have been negotiating a bilateral free trade agreement since 2013. Both sides could benefit from this. More important than the potential GDP increase, however, would be the strategic value of such an agreement. In this era of Brexit and Trump, it would signal a clear commitment to economic cooperation and free trade.

Electro-mobility, robots, computers – there are many fields in which Japan is regarded as one of the most innovative countries in the world. At the same time, the country's economy is facing significant challenges: an aging society, high government debt and stagnating growth. The Japanese government's reform program (known as "Abenomics") wants to inject new impetus into the economy by negotiating free trade agreements (FTAs), among other things.

The EU and Japan are currently negotiating an FTA and are striving to complete the negotiations quickly, possibly even before the end of 2017. Japan is the EU's sixth-largest trade partner, while the EU is the third most important for Japan. The trade volume between the two countries amounted to around EUR 125 billion in

2016. Yet there is still potential for that to increase, given that trade barriers persist on both sides. An FTA could further reduce duties and non-tariff barriers and have positive economic effects for both sides.

Background and the current state of negotiations

The EU and Japan have long-standing close economic ties, which are supported by a score of formal and informal agreements and opportunities for dialogue. Since 2004, for example, a Cooperation Framework has been in place to promote bilateral investment. Programs such as the Executive Training Programme and the EU Gateway Programme, which are intended

to support European companies entering the Japanese market, have been in place since the 1980s. The EU-Japan Business Round Table, which was set up in 1999, facilitates direct interaction between Japanese and European companies.

At the EU-Japan summit in 2011, these two economic partners agreed to work on a new framework for bilateral relations and analyze the potential for an FTA. In November 2012, following a thorough examination, the EU Council authorized the European Commission to open negotiations for an FTA between the EU and Japan. Negotiations were officially started in March 2013. The first round of talks took place in April 2013 in Brussels. To date, there have been 17 rounds in total, with the most recent round taking place in September 2016, also in Brussels.

From the Europeans' point of view, the greatest challenges lie in the fields of agriculture, food, rail transport equipment, designations of origin and non-tariff trade barriers (NTBs). In these areas, the EU is expecting clear concessions from the Japanese side. Japan, on the other hand, has identified its priorities as being the automobile industry, in which the country still faces tariffs of ten per cent from the EU, along with a whole series of NTBs, such as EU rules on bottling soft drinks, where the quantities permitted per bottle do not always correspond with those in Japan. In public procurement, for example market access to the rail transport sector, there continues to be a wide gap between positions on both sides. E-Commerce, free data flow and the investment court proposed by the EU are other areas of disagreement.

Global political developments, in particular in relation to Donald Trump's election as the 45th US President in November 2016, have recently given the negotiations new momentum. Despite this, they could not be completed by the end of 2016 as was originally intended, since quick agreement on the aforementioned issues did not prove possible. What is more, following the USA's withdrawal from the Trans-Pacific Partnership (TPP), Japan is taking a more hesitant approach to the rest of its trade policy agenda.

In February 2017, the EU Commissioner for Trade, Cecilia Malmström, and the Japanese Foreign Minister, Fumio Kishida, confirmed both sides' intention of bringing negotiations to a conclusion as quickly as possible. However, no firm date has been set for the 18th round of talks, which suggests that both sides still need to clarify how they wish to proceed.

Only an ambitious agreement will lead to significant effects

A glance at the economic impact of a free trade agreement between the EU and Japan shows that it would vary wildly, depending on the scenario. Calculations by the Munich-based ifo Institute for Economic Research on behalf of the Bertelsmann Stiftung concluded that strong impetus for economic growth on both sides could only be expected if an ambitious agreement is concluded that sets about significantly reducing non-tariff barriers. Under a conservative scenario, which is politically more likely, similar in form to the free trade agreement between the EU and South Korea which came into effect in 2011, the economic effect is much more modest and for some EU member states, only marginal. Below we go into more detail on both scenarios and their effects on economic output, foreign trade and at sectoral level. The effects are long term, meaning that they would only be observed after the free trade agreement had been in force for around 10-12 years. The base year for the calculations is 2014.

Conservative scenario similar in form to the EU-South Korea agreement

The conservative scenario could see Japan increase its economic output, as measured by gross domestic product (GDP), by approximately EUR 9 billion a year. That is equivalent to 0.23 per cent of Japanese GDP in 2014, the base year for the model calculations in the corresponding study. For the EU, GDP growth would amount to some EUR 11 billion, around 0.1 per cent of its GDP for 2014. The benefit to individual member states would vary significantly. Germany would see the highest additional growth in absolute terms, at EUR 3.4 billion, or around 0.11 per cent.

TABLE 1: Change in real GDP in the EU, Japan and selected third countries (in percent)

	Conservative scenario	Ambitious scenario
EU-28 average	0.06	0.29
Austria	0.05	0.34
Belgium	0.11	0.69
Bulgaria	0.02	0.16
Croatia	0.01	0.01
Cyprus	0.08	0.46
Czech Republic	0.05	0.31
Denmark	0.07	0.53
Estonia	0.09	0.49
Finland	0.06	0.42
France	0.06	0.36
Germany	0.11	0.68
Greece	0.02	0.12
Hungary	0.01	0.57
Ireland	0.19	1.44
Italy	0.04	0.25
Latvia	0.02	0.12
Lithuania	0.01	0.07
Luxemburg	0.13	1.23
Malta	0.11	0.58
Netherlands	0.14	0.98
Poland	0.05	0.32
Portugal	0.02	0.11
Romania	0.02	0.09
Slovakia	0.02	0.12
Slovenia	0.02	0.07
Spain	0.04	0.24
Sweden	0.06	0.38
United Kingdom	0.06	0.45
Japan	0.23	1.63
Australia	0.00	0.03
Brazil	0.00	0.01
Canada	0.00	-0.01
China	0.00	0.01
India	0.00	-0.01
Indonesia	0.00	-0.02
Mexico	0.00	-0.01
Norway	0.00	-0.06
Russia	0.00	0.02
South Korea	-0.02	-0.01
Switzerland	-0.02	-0.11
Taiwan	-0.03	-0.18
Turkey	0.00	-0.04
USA	0.00	0.01

Source: Calculation Ifo Institute

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But for some southern and eastern European countries such as Greece or Romania, the growth effects would amount to a rather negligible 0.02 per cent. That said, no EU member state would be adversely affected overall by a trade agreement between the EU and Japan. Certain third countries such as China (-0.012 per cent), South Korea (-0.018) or Taiwan (-0.025) would experience negative

effects, but these figures are so minor that they are not statistically significant.

Trade between Japan and the EU could be increased via the free trade agreement. Exports between the partners would increase tangibly on both sides. Of the EU member states, the ones that would benefit most would be Spain (+88.2 per cent), Greece (+79.9 per cent) and Belgium

(+75.1 per cent). Germany would be in fifth place, with its exports to Japan increasing by some 72 per cent. The effects on imports would be less pronounced. Japan's imports from the EU would increase by some 61 per cent, and imports to the EU from Japan by around 55 per cent. The highest increases in imports from Japan would occur in Greece (66.1 per cent), Slovakia (64.6 per cent) and Bulgaria (60.9 per cent). Germany would lie in fifth place once more, at 59.7 per cent.

At sectoral level, it is possible to identify winners and losers. In Japan, pharmaceutical products (-5 per cent), wholesale trade (-0.42 per cent) and food (-0.16 per cent) can expect a drop in output. In these sectors, EU companies are formidable competitors. Meanwhile, in the EU, it would be machines and equipment (-0.2 per cent) as well as services in the areas of programming and legal advice (-0.04 per cent each) that would be affected. By contrast, manufacturing sectors would benefit in both Japan and the EU: in Japan's case computer and electronics in particular (+4.4 per cent), mechanical engineering (+1.63 per cent) and automotive (+1.47 per cent). In the EU, the highest growth for output in manufacturing would be apparent in Germany (+2.5 per cent), France (+1.9 per cent) and the United Kingdom (+1.5 per cent). That said, eastern European countries such as Poland would experience slight drops in output for this sector, as it is possible that some EU member states would then source their industrial intermediate goods from Japan. In both Japan and the EU, particularly Germany and the United Kingdom, the service sector would especially benefit from a reduction in non-tariff trade barriers.

Under the conservative scenario, the economic impact for both sides would be relatively minor overall. This shows that the extent to which non-tariff barriers are removed plays a key role in how much potential growth the free trade agreement between the EU and Japan could generate.

Ambitious scenario: Greater reduction in non-tariff trade barriers

An ambitious free trade agreement between the EU and Japan would reduce the non-tariff trade barriers between the participating countries to a level similar to the average of all existing free trade agreements. The reduction would therefore be significantly greater than that resulting from the agreement between the EU and South Korea. If an ambitious agreement were to be achieved, Japan's GDP would be some 1.6 per cent higher year than it would be without the agreement. In the EU, the effects would range from 0.1 per cent (e.g. Greece and Romania) to 1.4 per cent for Ireland. Germany, meanwhile, could still expect an increase in GDP by 0.7 per cent – around EUR 20 billion.

Under an ambitious scenario, trade between Japan and the EU would receive a strong boost. On average, EU exports to Japan could see an increase of 146 per cent. The figures would vary greatly for the individual member states. Cyprus (+214 per cent), Luxembourg (+187 per cent) and the United Kingdom (+176 per cent) would benefit most. Germany's exports to Japan would increase by 167 per cent, placing the country in fifth position. Croatia would benefit the least, with an increase of 87 per cent.

Under the ambitious scenario, the impact on imports would be somewhat greater than for exports. The EU average increase for imports from Japan would be 162 per cent. The highest increases would be seen for Luxembourg (191 per cent), Ireland (185 per cent) and the Netherlands (178 per cent). Germany would lie in sixth place, with 169 per cent. Compared to exports, there is much less variation between the EU member states. With 129 per cent, Latvia shows the smallest increase in Japanese imports.

A quick detour: EU, Japan and Brexit

The United Kingdom has decided to leave the EU. If Brexit does become a reality, a free trade agreement between the EU and Japan would not apply to the UK. We have followed up on this line of thought in a separate scenario. This is based on the assumption that there would be a hard Brexit, whereby the EU and the UK would reintroduce tariffs and non-tariff barriers would increase to the level observed between other WTO members. The results show that it makes no difference to the EU whether the UK were to be party to an EU-Japan agreement or not (conservative scenario only): the percentage change in GDP would be zero on average for the EU 27. Brexit would mean a slight reduction in the value of the agreement to Japan. However, with a difference of 0.03 percentage points in the change to GDP, this loss in value is also marginal. This means that Brexit would have a negligible impact on a conservative free trade agreement between the EU and Japan. It would be the UK itself which would suffer the highest losses in comparison to the other EU member states: as a non-member state, its GDP growth generated by the FTA between the EU and Japan would be 0.06 percentage points lower than it would be without Brexit.

TABLE 2: Change in exports and imports between the EU and Japan (in percent)

	Conservative scenario		Ambitious scenario	
	EU-28 exports to Japan	EU-28 imports from Japan	EU-28 exports to Japan	EU-28 imports from Japan
EU-28 average	61.0	55.0	146.0	162.0
Austria	59.1	55.0	139.0	158.0
Belgium	75.1	56.2	152.0	161.0
Bulgaria	73.9	60.9	145.0	174.0
Cyprus	67.3	55.4	214.0	158.0
Czech Republic	62.9	54.6	149.0	160.0
Denmark	42.3	51.2	152.0	168.0
Spain	88.2	54.4	139.0	159.0
Estonia	55.4	47.8	131.0	145.0
Finland	47.9	57.5	140.0	165.0
France	62.5	57.2	156.0	164.0
Germany	72.4	59.7	167.0	169.0
Greece	79.9	66.1	169.0	168.0
Croatia	45.4	59.3	87.0	169.0
Hungary	69.0	52.9	142.0	161.0
Ireland	49.5	55.8	153.0	185.0
Italy	59.6	59.7	154.0	167.0
Lithuania	36.9	50.0	102.0	136.0
Luxembourg	55.9	50.1	187.0	191.0
Latvia	48.5	42.7	116.0	129.0
Malta	52.6	48.2	111.0	141.0
Netherlands	59.4	57.6	141.0	178.0
Poland	56.8	53.3	132.0	159.0
Portugal	54.8	51.9	123.0	150.0
Romania	52.2	58.6	128.0	160.0
Slovakia	76.1	64.6	163.0	172.0
Slovenia	64.7	51.9	167.0	154.0
Sweden	66.7	52.6	164.0	157.0
United Kingdom	64.5	60.4	176.0	166.0

Source: Calculation Ifo Institute

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Under the ambitious scenario, there are clear sectoral winners and losers. The breakdown does not differ significantly from that under the first scenario, but the size of the gains or losses certainly do. In Japan, the highest percentage losses in output would once again arise for pharmaceutical products (–31.7 per cent) and wholesale trade (–5.5 per cent). In the EU machines and equipment (–3.15 per cent) and electronics (–0.75) would be most severely affected. Manufacturing would especially benefit in Japan, in particular mechanical engineering (+28.9 per cent) and computers and electronics (+21.8 per cent). In the EU, the highest growth would be in pharmaceutical products (+10.5 per cent) and wholesale trade (+1.89 per cent), mirroring losses in these sectors in Japan. Under the ambitious scenario, the economic impact is many times greater than it would be under the conservative scenario. Whether such an ambitious free trade agreement between the EU and Japan is even on the table, depends predominantly on whether there is the political will on both sides. Here there would be a need on both sides for significantly greater concessions than the conservative agreement would require. However, the calculations show that such concessions would pay off – in economic terms at least.

Countering Trumponomics: The strategic value of an FTA between the EU and Japan

Above and beyond the economic impact, which depending on the scenario may turn out to be rather moderate, the strategic component of an agreement between two of the world's largest economic powers should not be underestimated. This applies to an even greater extent in light of recent political developments. With Donald Trump and his “America First” policy, there is a president in the White House who is prepared to turn his back on the global economic order that the USA itself helped to build after the Second World War. This process included promoting world trade by reducing tariffs and non-tariff barriers on the one hand, and avoiding protectionist measures which could lead to the outbreak of a trade war on the other hand. In the 20th century, the negotiation of bilateral FTAs

and finally the establishment of the WTO were important steps in achieving these aims.

In the 21st century, the following scenario would have been conceivable for the future trade order: the USA and EU would set the tone for trade relations between industrialized countries with the Transatlantic Trade and Investment Partnership (TTIP), while the TPP, covering twelve member states including the USA and Japan, but not China, would set new standards for mixed agreements between industrialized countries and developing or emerging economies.

These negotiations would not only be limited to technical standards, but would extend to labor, social and environmental standards, too. The latter in particular play an important role in international trade, in order to avoid a “race to the bottom” – the steady erosion of such standards in favor of economic profits. In addition to this “western” trade agreement, the Regional Comprehensive Economic Partnership (RCEP) would probably be concluded in Asia, which could probably set comparatively lower standards.

RCEP was launched by the Association of Southeast Asian Nations (ASEAN), however as a member, China plays a central role in the negotiations. Of the aforementioned agreements, RCEP has become the only one with a realistic chance of actually becoming a reality in the near future. One of President Trump's first acts upon taking up office was to withdraw the USA from the TPP, which had not yet been ratified. This could also cause the TTIP, the negotiations for which have already been difficult, to grind to a halt. There has never been quite such a question mark hanging over the future of the world trade order as there is right now, especially given that advocates of protectionism have been gaining ground worldwide.

The USA's withdrawal from TPP was a shock for Japan, since the country had invested high hopes in the agreement, seeing it as a counterweight to regional rival China, which is not a member. This means that Japan faces a similar situation as the EU does over TTIP. Traditionally, the USA has been the EU's most important partner in international political and

economic cooperation. TTIP was to be a crowning touch to this relationship, which has grown close over the years. However, under President Trump, the USA appears to no longer be a reliable partner for world trade – neither for the EU nor for Japan. This is not only true for trade issues, but also for many other policy areas. In order to fill this vacuum, both Japan and the EU will need new allies as they move into the Trump era.

It therefore makes sense to strengthen the European-Japanese relationship through this FTA, not least since the EU is already focusing more in the direction of Asia, for example through its agreement with Singapore (not yet ratified) and South Korea (in force). An FTA signed in the near future between the EU and the second biggest Asian economy would therefore send an important political signal to other Asian countries: while the USA is pulling out, the EU is strengthening its commitment and continuing to show its Asian partners that there are still alternatives to China. From a Japanese point of view too, it would therefore be good news if the EU were to strengthen its position as a western economic power in Asia, rather than leaving the field to China.

In the world trade order, the FTA between the EU and Japan would strike a radically different note compared to “Trumponomics”. It would show that two of the largest global economic powers are continuing on a course of economic integration and cooperation, and are working together to reduce protectionist measures.

Outlook

An FTA between the EU and Japan would bring positive economic effects for both sides. More important than the potential GDP increase, however, would be the strategic value of such an agreement. In times of economic disintegration and rising protectionism, this would signal a clear commitment to economic cooperation and free trade. Furthermore, the agreement could serve as a first step towards filling the vacuum in the world trade order created by the USA and its rejection of free trade.

However, both the EU and Japan should act quickly and try to actually complete the negotiations before the year is out. Japan should not allow itself to be thrown off balance by the USA's withdrawal from TPP, and should allow caution to prevail in any potential negotiations for a bilateral agreement with the USA. Japan too can only lose under Trump's “America First” policy.

Furthermore, neither Japan nor the EU should forget that China has already positioned itself – both at the G20 Summit in Hangzhou 2016 and the World Economic Forum in Davos at the beginning of 2017 – to have more say in the international free trade regime in future, and to set its own standards (for example, within the RCEP). This development may not be in either European or Japanese interests.

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