

Summary

The Political Economy of Japan and the EU: Challenges and Strategies

Introduction

This document summarizes the symposium ‘The Political Economy of Japan and the EU: Challenges and Strategies’, which took place at Chatham House on Friday 13 November 2015. The symposium was generously supported by the Japan Economic Foundation (JEF).

All discussions were held under the Chatham House Rule. The views expressed are those of the participants and do not represent the views of Chatham House.

Opening remarks

The symposium began with opening remarks by John Nilsson-Wright and Kazumasa Kusaka.

It was emphasized that the symposium was an opportunity to shift the focus away from the more intractable issues of history and national security, and towards opportunities for cooperation. The symposium was designed to bring to light political, economic and social factors constraining sustainable development in Japan and Europe. With global demand slowing, it is imperative that Europe and Japan learn from each other in order to devise new strategies for generating economic growth. Japan is facing substantial demographic challenges. China will face a similar challenge before its social safety nets become functional. Europe has moved forward on these issues through immigration and the transfer of labour within the European Union. Simultaneously, as political and security risks become more salient, the communication between political scientists and economists will need to improve. This event is an effort to that end. Japan has made a concerted effort to revive its economy, participating in the Trans-Pacific Partnership (TPP), through the policies of ‘Abenomics’ and by entering negotiations for a free-trade agreement (FTA) with the EU. However, the most important task will be to reform mindsets – i.e. to reduce resistance to abolishing tariffs, and to provide an investment-friendly climate.

SESSION 1 EU-Japan Trade and Economic Relationships

During the first session, it was argued that the EU has substantial political and economic interests in East Asia. The Asia-Pacific region is host to the world's fastest-growing export markets and economies, and already accounts for nearly 25 per cent of EU exports. Almost 50 per cent of global shipping by tonnage transits via the South China Sea, rendering East Asia's maritime disputes of vital importance to the EU and others. Reflecting this importance, the EU recently concluded FTAs with South Korea and Singapore, and is negotiating FTAs with a number of other countries, including Japan.

The EU and Japan are already cooperating on a range of issues: Japan is an important economic partner for the EU in terms of trade and investment, and is engaged in developmental and peace-building activities in the same regional theatres as the EU. More importantly, both sides share common security interests, such as an interest in human security, inter-regionalism and soft power as a means of foreign policy. Finally, both the EU and Japan are closely linked, making trilateral cooperation a realistic option. For the above reasons, Japan is a natural political partner to the EU, which called for more coherent foreign policy cooperation with Tokyo in its 2012 East Asia Policy Guidelines. At the 2015 EU–Japan Summit, both sides agreed to increase political and economic cooperation, as well as to hold regular ministerial meetings on Europe's Common Security and Defence Policy (CSDP).

Japan and the EU are important partners not only in terms of foreign policy, but also in respect of their trade and economic relations. The automobile industry is an example in point. Over the past few years, Japanese automakers have consistently increased their production in the EU, and today two-thirds of all Japanese-brand vehicles sold in the EU are produced there. At the same time, the share of European vehicles in the Japanese market has steadily increased over the past 15 years, and currently stands at 4.9 per cent.

Should the two sides conclude an economic partnership agreement (EPA) or FTA as planned, this may signify the beginning of a new era. Not only would an EPA/FTA create an enormous economic zone, it would also create employment opportunities and enhance innovation, productivity and competitiveness. Furthermore, such an agreement would be likely to contribute to the establishment of global rules on trade and investment.

In the context of the EPA/FTA negotiations, it appears that Japan's main interests will be to eliminate the EU's current tariffs on industrial products, as well as to remove the regulatory challenges facing Japanese companies in Europe. The EU, on the other hand, is likely to ask Japan to remove non-tariff measures (NTMs), eliminate the relatively high

tariffs on the EU's main exports to Japan (agricultural products in particular), facilitate access to public procurement and protect geographical indications.

For Japan, the potential EPA/FTA with the EU forms part of a number of key trade negotiations, including the TPP, the Regional Comprehensive Economic Partnership (RCEP), and the Japan–China–Korea FTA. It was argued that the TPP in particular would help all countries involved to liberalize by providing a common set of rules – facilitating investment, competition and general business. One speaker expressed his agreement with the EU trade commissioner that the recent agreement on the TPP could inject new dynamism into the EPA/FTA negotiations between Japan and the EU, but cited Dutch Prime Minister Mark Rutte's statement that 'the terms of the TPP deal can't simply be copied and pasted into the EU–Japan agreement'.

To the extent that trade will serve to stimulate economic growth in Japan, these negotiations form part of the policy of 'Abenomics', which was launched in 2013 following the election of Prime Minister Shinzo Abe. It was suggested that Abenomics had helped to pull Japan out of two decades of deflation and to kick-start its hitherto stagnant economy. Based on the results so far, one speaker felt confident that the government would remain committed to Abenomics in order to lead Japan to sustained economic growth.

SESSION 2 Age, Gender and Migration: The Challenges of Demography

Both Japan and the EU are experiencing an ageing population. This poses a number of challenges to economic growth and the provision of social services, because economic growth models are essentially based on population growth and thus on an expanding base of workers and consumers. An ageing and shrinking population is at odds with this model. Furthermore, an ageing population worsens the dependency ratio, i.e. the ratio of children and pensioners to workers, jeopardizing the affordability of the welfare state. It has been suggested for several years that 'replacement migration' might be an option, i.e. attracting sufficient migrants to maintain the prevailing economic growth model and the welfare state.

However, there are two key reasons why this is no long-term solution to the ageing of the population. First, the number of migrants required for replacement migration could add further pressure to those countries which are already densely populated. Of course, one could manage migration in such a way as to decrease the dependency ratio in the absence of population growth, but this would require migrants to leave before becoming dependents themselves. However, the European experience with guest workers suggests that, even setting aside the ethical dimensions of such a policy, this is a very difficult approach.

Second, a fall in fertility levels is an increasingly widespread phenomenon. Much of the immigration to the United Kingdom comes from the EU's eastern member states, where the current average fertility rate is 1.4, and thus too low to provide sufficient people in the long term.

The same applies to Japan. Japan appears to be suffering from a demographic vicious cycle, in which late marriage, an ageing population and stagnating productivity and demand are leading to low economic growth rates. Given Japan's relatively inflexible labour market, companies are therefore hesitant to hire young full-time workers. Consequently, the proportion of low-wage, part-time workers is increasing, and those who do find full-time employment face tough working hours. This leads the young to postpone marrying and having children.

Since the working-age population is declining and the demand-side stimulation of Abenomics worked for a while, some economists had expected that the labour market would tighten and that this would stop the vicious cycle by raising the percentage of full-time workers and real wage rates. However, with China's economic slowdown weakening growth in Japan, this hopeful expectation is now fading away.

A major source of immigration to Japan is China, where fertility levels are rapidly decreasing. Other source countries include Vietnam, the Philippines and Indonesia, all of which feature declining fertility rates. Fertility rates in these countries may be above replacement level, but possibly not for much longer. Given sustained economic growth and declining fertility rates in many 'source' countries, the pool of potential migrants is likely to decrease significantly.

This suggests that for Japan and the EU replacement migration is not a long-term solution to the problem of an ageing population. That said, migration may very well serve to mitigate the challenges faced. Highly skilled migrants can boost innovation and help countries remain competitive globally. Global recruitment is a way not only to enlist the best people, but also to create a corporate culture sensitive to diversity – thus facilitating international trade and takeovers. Many South Korean companies, for instance, struggle with international takeovers, possibly because the corporate culture is highly homogeneous.

However, too often the debate focuses on highly skilled migrants, despite the fact that migrants are also needed at the other end of the skills spectrum, in particular in the agricultural and care sectors. Despite technological advances – Japan, for instance, is experimenting with care robots – these sectors remain labour-intensive, and efforts to recruit domestic workers have proven rather unsuccessful.

So while migration provides a number of opportunities, it also involves costs. It has been argued that migration may have a negative impact on female labour force participation, as employers may prefer migrant men over women. However, evidence suggests that countries with a high rate of migrant labour participation also have a high rate of female labour participation. Japan, on the other hand, has low rates of both. As has been pointed out before, the reason underlying the low female labour participation rate in Japan may be not so much a lack of jobs, but rather relate to the difficulties of combining work and family life.

Another major concern is that migration will lead to social unrest. To be sure, the process of integrating migrants into the receiving societies in the EU has not been without problems. There are clashes of values, most importantly with regard to gender and religion; and, for some groups, below-average school performance and high unemployment rates. In response to the social problems associated with immigration, many governments have tried to limit all forms of what they consider 'unwanted' immigration. And while countries such as Canada and Australia show that a policy of selective immigration is possible, many countries in the EU and Japan have over-stressed a restrictive attitude, and have done so at a cost. While both the EU and Japan have programmes to attract highly skilled labour, neither market is meeting target quotas, even in times of high migration. One of the reasons may be that the highly skilled operate in a global market and thus have many options, enabling them to choose places that will afford them a good salary while also making them feel welcome. This dynamic seems at odds with the highly negative discourse on immigration, and with the emphasis on assimilation that prevails in both the EU and Japan.

So while it is important not to downplay the problems associated with immigration, it seems equally important not to overstate their significance. A key lesson for governments is to face reality. Facing a large influx of refugees, governments should recognize that many of these people will stay. The earlier governments enact policies to facilitate the integration of refugees and migrants into the labour market, the lower the social and monetary costs will be. Neither should the benefits be overstated. Studies suggest that migration may have a positive, but none the less modest, impact on the economy.

SESSION 3 Energy and the Environment: Is a Green Future Possible?

Japan and the EU came to the 2009 Copenhagen climate conference as international leaders on the issue of climate change. Both were early movers on low-carbon innovation, owning the most patents for renewable technologies outside the United States. They came to the summit as polities that were deeply invested in the international climate change regime. At the time that regime was based on the Kyoto Protocol – which had been signed

and agreed in Japan – and arguably no actor had done more than the EU to push for a legally binding agreement. Both Japan and the EU were major providers of international climate finance, and of course both were – and still are – import-dependent entities, and as such vulnerable to the impact of climate change in third countries. This leadership was clearly reflected in the targets that Japan and the EU put forward at the conference.

However, despite this similar starting point in Copenhagen, and similar challenges faced since then, their paths have diverged. Interestingly, one can argue that this bifurcation did not start with the Fukushima nuclear accident in 2011, but actually in 2010, when Japan's emissions increased by 4.2 per cent. At the 2010 UN Framework Convention on Climate Change (UNFCCC) conference in Cancún, when it would have been vital to ensure international cohesion post-Copenhagen, Japan declined to renew its Kyoto Protocol commitment. In 2011, the Fukushima Daiichi disaster happened, with now well-known consequences for Japan's nuclear sector. At the time, Tokyo had planned on nuclear energy constituting 50 per cent of the country's energy mix by 2030, a scenario that had underpinned many of its emissions reduction goals. With the country's nuclear plants temporarily shut down, the resulting hole in Japan's energy mix was filled by increases in fossil-fuel consumption. This resulted in an increase in emissions and carbon intensity. Whether Tokyo's new plan of establishing the nuclear portion of Japan's energy mix at just over 20 per cent is realistic will depend on businesses' willingness to make long-term investments, which is far from certain.

The Fukushima disaster also had implications for Europe. The most striking response came from Germany, which decided to phase out nuclear reactors by 2022. As had been the case in Japan, the short-term hole in its energy mix was filled by fossil fuels, and by coal in particular. However, Germany simultaneously pushed ahead with its emissions reduction targets and commitment to renewable energies. In Japan, on the other hand, targets for renewables capacity were ambitious, but so far have not been met, probably for reasons of political economy. Germany, in contrast, now relies on renewables for approximately 30 per cent of its electricity. Of course, Berlin's 'Energiewende' has had negative impacts in terms of emission reductions, the price of electricity etc., but the key point is that Germany has successfully decoupled emissions from economic growth. Germany's emissions are being reduced while its GDP is increasing, which is quite an achievement.

From 2013 onwards, the shale gas revolution took off in the US. This completely changed the conversation about energy and competitiveness in both Europe and Japan. At the time, natural gas cost \$4–5 per million British thermal units (Btu) in the United States, \$12 in the EU and \$18 in Japan. This had a big impact on the political economy of climate change policy-making and energy security, reflected in the emissions reduction targets proposed in

the 2013 energy and climate change package, which really delivered a business-as-usual decarbonization pathway. In other words, there was little increase in ambition on mitigation. Around the same time we saw Japan abandon its Copenhagen pledge, and put forward a new target for 2020 which included an increase in emissions levels compared with 1990 – quite a reversal in ambition.

Where are we now? Both Japan and the EU have submitted ‘intended nationally determined contributions’ (INDCs). Taking 2013 as the base year, Japan’s emissions reduction targets look more ambitious than those of the US or EU. However, measured against the more common 1990 or 2005 baselines, the targets look less impressive. Also, these INDCs are for the years 2020–30. Looking at the annual rates of decarbonization implied by their respective INDCs, Japan is less ambitious than the EU and the US. On the other hand, the estimated ‘marginal abatement costs’ (the costs for an additional unit of CO₂ being abated) of Japan are higher than those of the EU and the US. Substantial differences between the marginal abatement costs of developed economies (including Japan, the EU and the US) and those of many developing countries could lead to ‘carbon leakages’ – i.e. increases in emissions through carbon-intensive production being transferred to countries with weak regulation. This could undermine efforts to curb emissions. Thus the success of the INDCs of Japan and the EU will depend also on other countries’ efforts and cooperation.

There is also a new leadership dynamic involving neither Japan nor the EU, both of which have been somewhat marginalized as the US and China have taken on a leading role in the climate change agenda. The G7 countries are now rolling back from developing new coal capacity, with a number having enacted laws that prohibit developing coal without abatement. Other countries are facing substantial stranded assets in the coal industry, and hence have very little appetite for developing additional capacities in this respect. Japan, however, is planning some 40 new coal plants. Also, Japan is among the largest financiers of coal generation overseas, including through financing coal in developing countries and export credit guarantees.

A green future is possible and no doubt under way, but the question remains whether the world will get there fast enough to avoid more than two degrees of global warming. The costs of solar and wind energy have significantly decreased since Copenhagen, and there are significant advances with regards to storage.

Going forward, critical issues for the EU will include energy security; the need to avoid excessive focus on the role of gas in the planned Energy Union; enhancement of grid interconnections; repair of the emissions trading scheme; decarbonization of transport; and

the need to maintain a steady course in climate change policy given a host of crises and policy distractions plaguing Brussels.

Arguably Japan has backtracked recently, despite having the potential to stand as one of the largest winners in low-carbon development. Whatever the next wave of low-carbon technologies will be – storage, smart grids, second-generation solar, autonomous vehicles or hydrogen – Japan should focus on ensuring that it is not left behind. In fact, Prime Minister Abe has expressed his intention of developing an aggressive diplomatic strategy for global warming response measures based on technological contribution'. Such statements suggest that efforts are under way for Japan to contribute to tackling global warming, possibly by developing and making widely available innovative technologies for increasing energy efficiency, e.g. in respect of steel production or coal plants. To this end, in 2014 the Japanese government established the Innovation Cool Earth Forum (ICEF).

SESSION 4 Local Government and New Models of Accountability

This session provided an overview of the significance, structures and objectives of local and regional governments in Japan and the EU.

It was shown that Europe is host to a range of networks of local and regional governments aiming to influence policy-making at the national and international level, in the EU and at the Council of Europe. One speaker argued that for some countries, European affairs had become an extension of domestic affairs, reflected for example in the name of the Austrian 'Federal Ministry for Europe, Integration and International Affairs'.

Local and regional authorities in Europe frequently encounter similar problems, such as:

- Unclear allocation of competences and responsibilities within/among different levels of authority;
- Inadequate financial resources;
- A lack of or inadequate consultation; and
- A lack of or inadequate legal remedies against infringements of local and regional authorities' powers

In contrast to the European experience, Japan is a highly centralized state, with very few arguing for greater local government power. However, current demographic trends – moderate growth in big cities, population decline or stagnation in rural areas – suggest that local governments outside major cities will face major challenges in maintaining public and social services, including medical care to the elderly. The failure of these services, a scenario

that could come true in parts of the country as early as 2030, could seriously undermine local politics in Japan.

Compared to European metropolises, Japan shows an extreme concentration of its population in its capital city. Against the background of Japan's recurring fiscal deficit and continued vulnerability to natural disasters, the challenge for local authorities in Japan will be to maintain the quality of public/private services to citizens living in local areas. There are a number of potential solutions:

- Traditionally, the LDP has tended to subsidize rural authorities with central government funds. After the Fukushima nuclear disaster, there was a sense of local ties and community among local citizens. Many policy planners thought that reconstruction should be combined with decentralization or devolution. At the same time, reconstruction helped to revitalize traditional Liberal Democratic Party (LDP) politics as, before the disaster, public investment in rural areas had been shrinking. Following the tsunami and nuclear disaster of 2011, 77 per cent of GDP was invested in reconstruction, well above the optimal level recommended by economists. However, Japan's mounting public debt, slow growth and ageing society mean that this approach will not be sustainable into the future.
- Alternatively, Japan could opt for a model of slower growth, sometimes named 'Satoyama capitalism', emphasizing quality of life over material wealth. However, the archetypical 'Satoyama capitalism' model envisages a self-sufficient economy in a rural area, where economic growth is no longer necessary. Attaining slow or even zero growth under such circumstances would be highly ambitious. For such a model to be sustainable, Japan's rural areas would need significantly to enhance their productivity, which would inevitably alter the social structure of these areas.
- A third option would be decentralization and devolution, an approach often advocated by social democrats and neoliberal economists. Neoliberalists tend to advocate cuts in financial support from central to local governments, emphasizing the need for self-sufficiency, self-accountability and autonomy for local governments. This approach (the neoliberal LDP way) was supported by the administration of Junichiro Koizumi in 2001-06. Another argument suggests that improvements in bureaucratic efficiency and productivity will require the decentralization of public services. Resources should be reallocated to compact cities in rural areas, and local industries should undergo substantial reforms to enhance their productivity. However, this option will be very difficult to apply in practice. Reallocating funds from the national to the local level is difficult, and

efforts at industrial reform will encounter resistance. Substantial efforts at decentralization will therefore require strong leadership in both central and local governments.