JEEPA & Its Strategic Potentials in Asia

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The Japan-EU Economic Partnership Agreement (JEEPA) burst into public attention when it was signed just before the G20 summit in Hamburg as a positive symbol for global trade and cooperation in a world that seemed to have become more protectionist and inward looking. It now has the opportunity to move beyond the limited potentials of a "traditional" Free Trade Agreement (FTA) towards a broader platform of "21st century" integration issues in Japan, Europe and Asia.

JEEPA & the TPP — a Short History

The initiative for JEEPA (or JEFTA, as it is known in Europe) started in 2011 when Japanese industry became concerned that a new EU-South Korea FTA could negatively affect business in the increasingly important EU market. The EU Commission seemed initially not too interested in negotiations because heavy criticism of the EU-South Korea FTA from the automobile industry (in Italy and France in particular) was still resonating. A long line of difficult and hard to negotiate non-tariff barriers (NTB) also seemed to hamper further growth in trade with Japan (Hanns Guenther Hilpert, *Japans multiple Handelspolitik*, SWP Studie, Berlin, 2017).

Only when the new, decisively growth and trade-oriented government of Prime Minister Shinzo Abe in Japan promoted the initiative at the highest level did formal negotiations start in 2013. Already from the start, however, negotiations have been overshadowed by the even larger Trans-Pacific Partnership (TPP) with the US and 11 Pacific countries, which Japan joined during the same year. In the EU, at the same time, the Transatlantic Trade and Investment Partnership (TTIP) with the US government became the core of public attention. Unlike JEEPA, both agreements were touted as "21st century" agreements that required significant regulatory integration, from food standards to investor protection, and from e-commerce to environment protection, which resulted in major public concerns and debates on all sides.

For JEEPA, the political swirl around the TPP simultaneously turned into a blessing and a challenge. Negotiations succeeded relatively smoothly without the strong opposition that greeted the TPP and TTIP, although many controversial regulations on food standards and remaining barriers between the world's most competitive automobile markets had to be dealt with. It often suffered, however, from a lack of political attention when milestones had to be secured and a final push for implementation became necessary. Only when the TPP negotiations ultimately collapsed under the current US government could JEEPA be concluded "in principle" in June 2017. During the current final stretch of negotiations, however, particularly important and difficult issues such as investor protection and data security standards still need to be worked out.

Economics vs Politics in Trade

From the start, JEEPA negotiations have been more focused on economic impact and "classic" (non-)tariff barriers, such as food standards, than on "next generation" or "21st century" regulation. The idea of "next generation" agreements was to circumvent the contentious "old" trade issues, which are so very hard to tackle because they require a break with historically grown protection and traditional value chains. By focusing on "new" opportunities in emerging service and digital markets, integration seemed easier to achieve and future-oriented growth opportunities better served. The latter, however, require close integration of regulatory standards for evolving industries, which often overwhelm regulators and frighten the public when key decisions on copyright protection, taxation and digital security might be irrevocably given out of hand. Typical examples, which led to major public disputes, are common regulations on genetically altered food, regulation of (social) media content, and oversight of Internet platform providers.

Since JEEPA has focused on tariffs first, it has often been ridiculed as an FTA to "trade cars for cheese", and not as a true EPA that helps to steer the partnership into the future. So far, however, "next generation" agreements have not become the silver bullet for better regulation and easier economic gains. The current backlash against globalization in many countries, in particular in the US and Europe, will therefore require thorough analysis of voter frustration with changes in sectoral distribution, value chains, and incomes, until a new balance for international integration platforms can be found. For trade agreements, JEEPA's way of a staged progress from basic trade liberalization to efficiency gains and more regulatory integration later, might actually be the best way to go.

Direct Market Impact

In pure economic terms, recent studies find only rather limited direct growth prospects for JEEPA. An initial study for the EU Commission (Eva R. Sunesen et al., 2010) found rather strong possible export gains of about 30% in both directions. Agriculture and food industries would gain from a reduction of tariffs, while chemicals, pharmaceuticals, cars and medical devices would mostly gain from a reduction of NTBs. On this basis, a careful modeling of NTBs, including indirect effects on labor markets, by Sebastian Benz and Erdal Yalcin (*Quantifying the Economic Effects of an EU-Japan FTA*, CES-Ifo, Munich, 2013) found overall GDP growth gains of 0.86% for Japan and 0.21% for the EU. This would constitute a significant growth effect for the low-growth environments in both regions. They also pointed out, however, that the additional growth would mostly come from increasing industry efficiency, and not from creating additional employment, which is the main target of governments. By increasing competition, ineffective companies would be pushed out of the market while more productive ones would gain and contribute to higher growth. For Japan, almost two-thirds of gains would come from such (deflationary) productivity effects.

Another EU study, the *EU-Japan Trade Sustainability Impact Assessment* (European Commission, 2016), therefore looked more closely into sectoral effects while coming to basically similar overall growth results. The following *Table 1* shows the sectoral winners of expected gains in percent of the total. Processed foods in the EU and car production in Japan account for about half of all the export gains in both economies! As the European Commission points out, it is also remarkable that the top five winning export sectors account for about 90% of the total gains in both the EU and Japan. On this account, the partnership seems to be rather limited until today. Almost as surprising is that services, which have by far the largest market share domestically and account for the largest export gains in other EU FTAs, are nearly absent in the rankings. Service export gains are estimated at only 5% for the EU and just 1% for Japan. The EPA seems to have significant potential in business relations that have not yet been sufficiently explored by companies on both sides (and therefore do become accounted for in the models). Especially new digital services could provide an important basis for business development.

The potential gains of JEEPA for Japan relative to the EU might be overestimated in traditional trade models, however. The EU-South Korea FTA, for example, has become an unexpected major success for the EU because exports have grown by more than 50% since 2011. South Korean exports to the EU, on the other hand, increased less than 20%. The traditional EU trade deficit with South Korea has been turned into a surplus, while South Korean investment strongly supports emerging regions in Eastern Europe (*Annual Report on the Implementation of the EU-South Korea FTA*, EU Commission, Brussels, 2016). JEEPA, which brings better access to Asia's highest value-added food market and supports regulatory integration with Asia's foremost manufacturing investor, might therefore also become a greater than expected success for the EU's Asia strategies, while gains for Japan's exporters from tariff cuts might be more limited.

To better evaluate such potentials, an Ifo-Institute analysis for the Bertelsmann Foundation (*On the Economics of an EU-Japan Free Trade Agreement*, 2017) adjusted the basic trade model on the basis of a result analysis of the EU-South Korea FTA. They expect an additional GDP gain of 8.6 billion euros (+0.23% GDP) per year for Japan over a period of 10 years, and plus 10.7 billion euros (less than +0.1% GDP) for the EU. Beyond the overall gains, the studies identify most challenges in the most heavily regulated sectors, such as pharmaceuticals in Japan, and head-on competitors in machinery and electronics industries in the EU. The biggest direct price reductions should be expected among Japan's heavily protected food (especially dairy) and wood producers.

As an effective trade agreement, JEEPA will force deregulation and innovation in many markets. Challenges in the pharma industry, for example, do not primarily come from deregulation but from global consolidation trends in the highly competitive industry, which should be addressed as early as possible. Japan's fast greying society will also need the lowest possible healthcare costs to perform sustainably well. Japan's wine production will certainly be challenged by cheaper EU imports, but focusing on local niche markets while developing their products as local brands, as the (meanwhile) globally successful Japanese whiskey distillers have shown, should provide a long-term strategy. The EU's dairy market is still marked by heavy overproduction and Japan's farmers cannot compete with this market. Opening the market over a period of 15 years while

TABLE 1

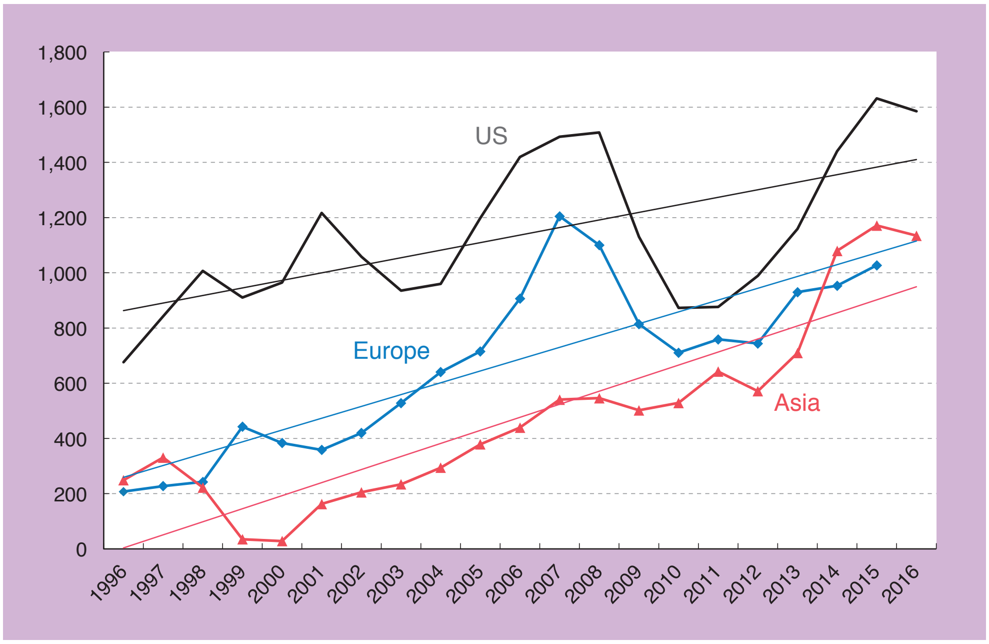
Top 5 bilateral export gains by industry

(% share of total increase)

EU 28 Winning Sectors	Japan Winning Sectors
Food, feed, processed foods (55%)	Motor vehicles (47%)
Other manufacturing (14%)	Other machineries (21%)
Chemicals (incl. pharmaceuticals) (12%)	Electrical machinery (10%)
Business services (4%)	Chemicals (incl. pharmaceuticals) (8%)
Motor vehicles (3%)	Other transport equipment (7%)

Source: Trade Sustainability Impact Assessment of the Free Trade Agreement between the European Union and Japan, Final Report (EU Commission, 2016, p. 57)

CHART
Japan's regional income balance (billion yen)



Note: Current Account, Primary Income, Net Balance.
Source: © FRI 2017. Data from CEIC (2017)

establishing strong brand-awareness along the lines of France's "Camembert" or Japan's "Hokkaido" butter should provide opportunities in the fast growing Asian market, too.

JEEPA's Strategic Potentials

As much as in other "21st century" agreements, the most significant long-term impact of JEEPA would have to be on the implementation of policies that support a broad range of industries beyond trade. Japan's industries have already become major international investors by extending their supply chains into low-cost Asian locations as a reaction to Japan's high-cost structures, and by investing into production directly in their major markets in the US and EU to circumvent (non-)tariff market barriers. Today, about half of Japan's domestic automobile production of about 8 million cars is being exported, and another 18 million cars are produced overseas. With the Japanese automobile market shrinking in absolute numbers and new competition arising from electric vehicles in the US and China, the industry will continuously need as much market access, openness and innovation as possible.

As Japan's foreign income from its major investment regions shows *(Chart)*, the income from the EU has been trending up as fast as in its major growth market in Asia. The difficult financial crisis in the euro area had a strong negative impact, but overseas incomes in the EU are now growing along their trend again. Perhaps as importantly, overseas incomes in Europe and Asia are also catching up with the higher level of incomes in the US, which will further diversify the income sources of investors when taking advantage of profitable foreign investment opportunities.

Such strategic globalization success is now being followed by other industries, in particular the large service sector, on a broad scale (*Recent Trends in Japan's Balance of Payments*, Bank of Japan, 2017). Digital services can now be offered in the Internet of Things (IoT) and managed on global digital platforms in most industries. For the government, too, support for such broad-based digitalization and globalization will be essential for future growth. Supporting productivity and applied technology development is clearly becoming one of the main sources of growth in an aging market. Such potentials, however, cannot be unlocked by simple deregulation, weaker currencies or freer trade anymore. Aging markets need all the help and support they can get. For Japan, JEEPA could play an important role to partner in "smart" regulation of emerging digital markets and industries, as well as promoting applied R&D across the EU and Asia. The trade of "cars for cheese" can easily become a "next generation" transformative regulation framework that way.

Developing JEEPA into a blueprint for new international standards in Asia seemed a far-fetched idea before, but now has become one of the most viable options. While Japan is negotiating regulations and options to replace NTBs with the EU, the ASEAN group has already been focusing much of its economic community development on European-style harmonization and integration projects — with only limited success, however. China, at the same time, is boosting its EU investment to get behind tariff barriers and to invest in technology for the Chinese market. It is also tightening the regulatory framework at home, with seemingly little regard for foreign investor interests. For most of these shifts in Asian market frameworks, a well-

TABLE 2

Japanese M&A cases in the UK & Germany

(Top-10 sectors; 2011-1016)

UK	No.	Germany	No.
Commercial Services	13	Chemicals	11
Internet	10	Electronics	11
Food	9	Computers	9
Holding Companies	9	Machinery-Diversified	9
Computers	7	Auto Parts & Equipment	8
Alternative Energy	7	Commercial Services	5
Advertising	6	Misc. Mfg	4
Software	6	Pharmaceuticals	4
Entertainment	4	Biotechnology	3
Misc. Mfg	4	Hand/Machine Tools	3
Total	139	**Total**	109

Source: © FRI 2017. Data from Bloomberg as of May 2016

developing JEEPA with strong support from Japan and the EU could become an important standard setter. The EU, after all, has already become the world's most important source of *de facto* international standards, while Japan has significant clout in Asian investment regulations.

JEEPA as an Investment Framework

Japanese investors are already among the top international investors in the EU, with a particularly strong focus on the United Kingdom. For most companies, London serves as the regional headquarters, service center and gateway to the larger EU market. In contrast, Germany and many other locations on the continent saw most investment go into manufacturing, technology, and distribution services *(Table 2)*.

Japan's investment in the EU clearly show how much companies have already diversified their investment strategies regionally while adding value with sophisticated (digital) services. They have also become important for their host countries in terms of investor involvement in strategic regional development. While the UK's departure from the EU will challenge the organizational structures of Japanese companies in the EU, involvement in the Brexit discussion is also lifting Japan's status as a partner in regional development during difficult times. Certainly not as a framework for Brexit, but as a blueprint for effective investor protection and dispute settlement in Asia, an Investor State Dispute Settlement (ISDS) will become one of the most important issues for JEEPA. Although investor risks and frictions between Japan and the EU are quite low, reaching such an agreement will not be easy. Reservations against a far-reaching ISDS have been growing in the EU and Asia over the last years.

In the EU, regional governments and citizens fear control and "parallel laws" for multinational companies over (local) environmental standards and regulation of large-scale projects. The EU is now trying to address such concerns by proposing a Multilateral Investment Court that would be more transparent, standardized, and more accessible for smaller investors, while focusing on the protection of public (before investors) interests. From an EU perspective, anchoring one of its many supranational regulations in another international court would certainly make sense. If JEFTA could raise the credibility of such a court in Asia, it would be a major legal gain for investor protection. The odds for this happening are not high, however.

In diverse Asia, most initiatives to implement ISDS mechanisms into FTAs have failed on government concerns about challenges to national sovereignty. EU-style institution building would therefore be seen with great skepticism, not only for its high costs but also for its challenges to national sovereignty that might go beyond the risks of single investor demands. Investors, after all, are mostly interested in financial compensation when government regulation breaks their existing contracts and business plans, and not in comprehensive re-regulation. As a result, and not just in Asia, dispute settlement most likely needs a flexible, simple and compensation-oriented approach more than another standing court.

For JEEPA's future success beyond the narrow focus of trade between Japan and the EU, progress on regulatory solutions for better investor-state relations would be a great start, however. Moving on to effective privacy laws as well as to the development of digital security strategies that bridge network and e-commerce integration in Japan, Europe and Asia could further turn it into an important platform for effective integration initiatives in Asia. Connecting it to mutually important "softer" issues, such as sustainable environmental protection and labor market standards, could turn it into a truly future-oriented partnership platform for the Asian market. JS

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