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Japan-Europe, the unnoticed megadeal

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In an environment with growing protectionism and the danger of economic disintegration and shocks for the global trade policy system, a free trade agreement between Japan and Europe could set a positive example. Progress in the negotiations are necessary to foster growth and prosperity and to send a message to other countries, that modern market economies rely on good trade relations.

When they announced an “agreement in principle” in their negotiations for a bilateral trade partnership on July 6, 2017, Japanese and European officials were not short of superlatives. This would be “the world’s largest, free, industrial economic zone”, according to Prime Minister Abe, and the “most important bilateral trade agreement ever concluded by the EU”, according to the European Commission, which recalled that they were jointly accounting for about one third of world GDP. Yet, while the announcement was duly commented, it is fair to say that it received relatively little attention. Nothing comparable, for instance, to the heated public debate surrounding the signature of CETA, the agreement with Canada, despite the far smaller size of this partner –not even talking about the negotiation with the United States, which became a real political issue *per se*. Of course, for most European countries, the bilateral relationship with Japan is less charged politically and emotionally than the one with the US and Canada, and this may partly explain differences in attitudes. Still, this raises the question whether this agreement is really important, and why.

A first approach to address this question is to measure “arithmetically”, so to say, what is at stake commercially, through exchanged concessions of preferential access. The result is far from negligible given the size of both economies, with bilateral goods exports totaling 58 billion euro in 2016 from the EU to Japan and 67 billion euro from Japan to the EU, and services exports representing a large additional amount, worth almost half of goods exports for Europe. In specific sectors where protection remains significant, liberalization could have very significant consequences, as suggested by the nickname “car for cheese” deal sometimes used to refer to this agreement. This is especially true given each partner’s very high competitiveness. Yet, these direct consequences should not be overstated, for two reasons. The first one is that initial protection is already fairly low for most products, with tariffs faced presently in bilateral exports averaging close to 3.5% in both cases, according to CEPII’s calculations. In most sectors, tariff cuts will not be game changers. In addition, both partners already have a number of free trade agreements already in force, so that the preferential

access offered in this agreement would not be unparalleled among competitors. The second reason is that bilateral trade flows, while impressive in absolute, are not that large in relative terms. After all, Japan only ranks 6th among the EU trading partners, and bilateral exports between Japan and the EU only represented 1.1% of world merchandise trade in 2015 (source: Chelem-CEPII database), that is five times less than the UE's bilateral trade with the US, and four times less than with China. This is not surprising given the long distance separating the two partners. But it does not call for superlatives. Taking into account in addition that free trade agreements are not free of shortcomings, such as giving raise to trade diversion and creating additional complexity in trade rules, this context would actually warrant modest expectations about ensuing economic gains.

Does it mean that an EU-Japan Economic Partnership Agreement would be no big deal? Not so fast. A trade agreement is more than an exchange of tariff cuts, most of all in the present context. It is also a political partnership and, increasingly, an economic cooperation commitment. In both cases, the importance is not directly linked to the amount of bilateral trade, but rather to the combined influence of partners –and in the present case, it stands out.

Even from an economic viewpoint, the political partnership takes particular salience in the present context where the United States President has been elected based on a protectionist platform, and has shown repeatedly since taking office his disregard for multilateralism. Meanwhile, China, the first exporter of goods since 2009, still relies upon an economy where state intervention is ubiquitous, with no sign of this situation changing soon. This leaves Japan and the EU as the only defenders, among trade superpowers, of a rules-based trading system between market economies. This is a historical responsibility, against a background where the multilateral trading system is under serious stress.

To gauge the potential importance of economic cooperation commitments, one should keep in mind that non-tariff measures are now a much more significant part of agreements than tariffs themselves. This means *inter alia* improving cooperation in various regulatory areas, so as to avoid unnecessary differences, which impose costs on trade and potentially hurt innovation. This can be a source of concern when it is feared that commercial benefits will lure governments in accepting concessions which will lower regulation standards, and this has been the subject of heated debates in Europe in relation with the transatlantic negotiation. Here lies, probably, one of the reasons why the EU-Japan negotiations received less echo in European medias: the feeling that both partners share in most area similar collective preferences, characterized by very high requirements in terms of health, environment, and food safety, in particular. Put differently, while partners do differ in many respects, there is no serious concern that one of them would enter into a race-to-the-bottom on regulatory issues. This context eases regulatory cooperation, thus making it possible in many cases to avoid wasting resources to comply with regulations similar in their objectives but different in their practicalities. Even though their impact is difficult to assess, more consistent regulations are likely to spur innovation, especially when they are reached across two partners with large markets and cutting-edge producers.

An additional impact might be expected on third countries. Indeed, the standards or rules jointly agreed upon by Japan and the EU might become all the more attractive to third

countries, since adopting them would make access to these large markets easier, and imports of their products cheaper. This standard leader role hinges crucially upon a strong market position, and this calls for a different assessment of the agreement's potential importance: not based upon the importance of bilateral trade relationship, but instead upon the joint importance of both partners on world markets. The picture is very different in this case from the 1.1% figure mentioned before for bilateral trade relationships. Indeed, excluding intra-EU trade, Japan and the EU were jointly originating more than 21% of world exports of merchandises, and receiving more than 20% of imports (source: Chelem-CEPII database, see Table below). More strikingly even, one or the other was involved as either an importer or an exporter in more than 40% of world trade, a share rising above 70% in high-tech sectors like aeronautics and pharmaceuticals, and above 55% in several sectors including machine tools, specialized machines, precision instruments and cars and cycles. In these industries, where regulatory practices are of utmost importance, this means that a joint approach followed by Japan and the EU is bound to be heavily influential on third countries.

Leveraging this strong market position to lead the way in industries which are key to tomorrow world's main challenges is arguably the most important stake of this agreement. In so doing, the aims should go beyond gaining immediate commercial benefits. International trade has now become too important to ignore its interactions with other areas, like social and environmental issues, climate change or fiscal policies. Trade agreements influence the costs and benefits of regulatory policies in these areas, and can be a leverage to spur cooperation in meeting common challenges. This is the reason why non-trade provisions take an increasing importance in the EU's agreements, and why many in Europe are calling for these provisions to be reinforced. In the agreement with Japan, non-trade provisions could be a way to join forces to support common objectives, like reaffirming the Paris Agreement commitments as well as a number of principles and practices pertaining to the social and environmental areas. If this is the case, the Japan-EU agreement might be very influential indeed, well beyond what bilateral exchanges would suggest. That would warrant many superlatives.

Table: Japan and the EU in world trade in 2015 (% , intra-EU trade excluded)

	Bilateral trade in world trade	Joint share in world exports	Joint share in world imports	Joint share in world trade
All products	1.1	21.3	20.0	40.2
Aeronautics	1.7	52.9	21.5	72.7
Pharmaceuticals	3.8	46.7	28.8	71.7
Machine tools	3.0	49.6	15.5	62.1
Beverages	1.9	45.0	15.3	58.4
Specialized machines	2.0	46.8	12.5	57.4
Precision instruments	3.2	37.4	22.3	56.6
Cars and cycles	4.3	48.7	11.9	56.2
Agricultural equipment	1.8	39.1	13.8	51.1

Source: calculations based on Chelem-CEPII database. In addition to "all products", the top product in terms of joint share in world trade are shown. The joint share in world trade refers to the share of world transactions in which at least one of the two parties is Japan or an EU country. EU-Japan trade is accounted only once in such calculation.

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