

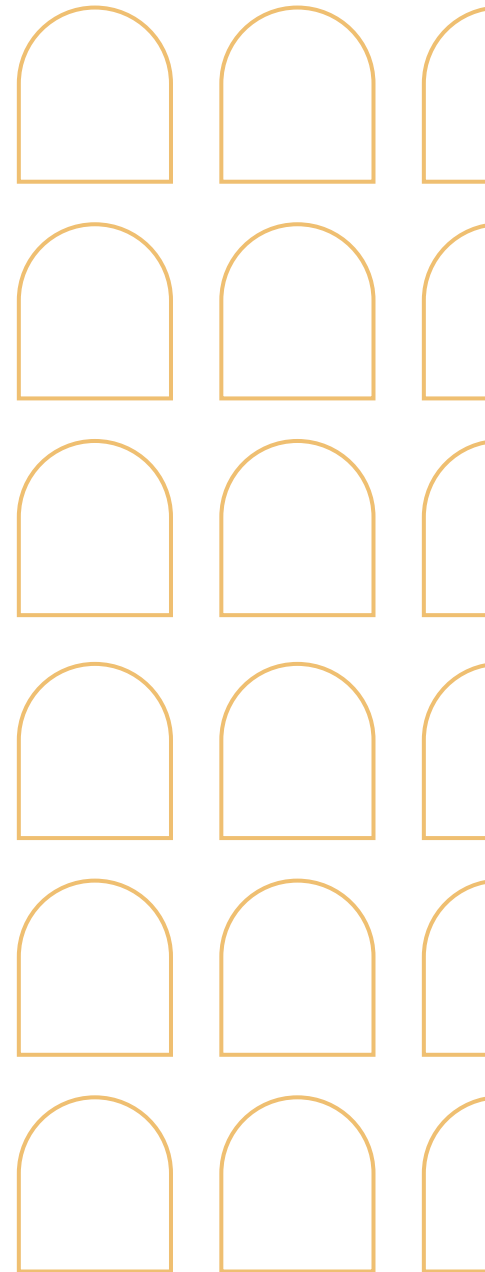
# POLICY BRIEF

## The EU/Japan EPA – taking stock and looking ahead

### Introduction

The world has been through different stages of trade negotiations during the last decade. With the fundamental insight that the world trade order in the wake of the Doha round stalled, countries and established trading areas such as the EU looked for more constructive solutions to bring trade forward. Before the Trump administration took office, the EU and the US were negotiating the Transatlantic Trade and Investment Partnership (TTIP). In the Pacific, the US was engaged in negotiations on the Trans-Pacific Partnership Agreement (TPP) framework, capturing most trade outside China. With the Trump administration, the US view on trade relations and trade negotiations changed drastically. With the US currently withdrawn from both the TTIP and the TPP negotiation frameworks but with the UK applying to join the ‘replacement version’ of the TPP called the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the playing field of international political economy and trade relations is profoundly altered. In the wake of the post-Trump position of the US and continuing tense relations with China, the world has rapidly seen geoeconomics as a new field with strong repercussions on the international political scene.

There has been an intense debate involving both academia and policymakers on the benefits from seeking what is often seen as the second-best alternative to multilateral solutions. Regional/plurilateral trade agreements are examples of such alternatives (e.g. Kawai and Wignaraja, 2008; Wilson, 2015; Solís and Wilson, 2017). A dividing line has been drawn between multilateralism as the only sustainable long-term alternative and the more pragmatic view of regional trade arrangements. These arrangements can be



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seen as incremental approaches towards successful multilateralism. This has resulted in the ‘stumbling block’ vs. the ‘stepping-stone’ metaphor (Alvstam and Nakamura, 2015). In recent years, there has been a process of conversion between the two attitudes, arguing that regionalism and plurilateralism can be multilateralised. This can be understood as regional and plurilateral trade arrangements which obey the general multilateral basic rules and in addition are also able to proceed further than is possible at the WTO level. Eventually, this might increase the possibility of reaching a successful multilateral agreement (Ibid.).

Nevertheless, various preferential agreements have become parts of a larger geopolitical, economic and security policy context, where trade has become a token of a lack of political intentions and political will. Therefore, with this backdrop there is an increasing need to view trade negotiations in a multidisciplinary synthesis of economics and politics, where influential stakeholders, such as governments and transnational corporations (TNCs), can utilise the playing field to sustain a rules-based framework towards a multilateral trade order.

## The foundation of the EPA in the world order

Despite a pessimistic outlook for multilateral, and even large FTA agreements, countries pushed on without the US in the Asia-Pacific region, where the CPTPP and the EU-Japan Economic Partnership Agreement (EPA) are the prime stable and concrete examples. First, with the former US administration moving into a more isolationistic position, the need became apparent for the EU and Japan to honour the rules-based international order. With more focus on the EU, Japan can now also commit more resources and political emphasis to the economic partnership as it contains the most clearly spelt-out and concrete aims and statutes of any FTA/EPA deal Japan has closed with a major global economic power so far. Second, the EPA could also offer a rules-based framework for positioning the EU-Japan partnership in relation to the increasing geo-economic weight of China. Third, the fact that relations between the US and China are deteriorating into escalating trade conflicts and security issues, including both threats of trade barriers and military muscle-flexing, is giving the EU and Japan new delicate diplomatic considerations but also new opportunities in the global arena. With this political and geo-economic backdrop, and with the time and effort invested in the negotiations, it was

a great success when the EPA was finally ratified in December 2018 and came into effect in February 2019. This concluded a timeframe dating back to 2013 when negotiations were initiated, which in turn was preceded by six years of preparatory talks.

An important background to the negotiations is that growth in direct bilateral trade between the EU and Japan had stagnated during the previous decades. Adding to this relative decline, both the EU's and Japan's shares of world trade had substantially decreased during the same period. Researchers and policymakers who were assessing the progress of the negotiations saw the launch of a bilateral FTA/EPA between the EU and Japan as a “defensive” measure with the aim of increasing and reaching prior trade levels among the trading partners (Alvstam and Nakamura, 2015). The idea of an EPA as a defensive measure could in today's changing global political and economic arena be transformed into an adaptive economic relationship, with which the EPA partners could put their weight behind the rules-based world order where trade negotiations are the natural starting point.

## The EPA and the complex trade setting

Today, almost 50 per cent of global trade can be defined as in intermediate goods (UNCTAD, 2021). If the capital goods sector is included, the share of world trade in intermediate goods<sup>1</sup>

is likely to be even higher. Therefore, international cross-border transactions have to be understood in the context of increasingly complex global production networks (GPNs). The design and governance of such networks are in this respect a clue to a new understanding of the geography of external trade in goods and services (e.g. Yeung, 2014; Yeung and Coe, 2014; Yildirim, 2015). The focus should therefore be moved from physical products to *tasks*, i.e. the production locations of physical goods and associated services that constitute the nodes between links in a global value chain.

The emergence of global production networks in complex global value chains is a reality that will continue to thrive and develop in an interconnected world, where data and intermediate goods constitute the building blocks of the economy. Facing this world order of global business, the EPA creates a vital framework for including production *and* investment planning by international business rather than merely taking trade research estimations into consideration when assessing the effects of an EPA.

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<sup>1</sup> Products that have not yet reached their final shape or consist of machinery and equipment aimed at generating added value in the production of final consumer products.

Due to the mobile nature of global value chains (GVCs) and GPNs, decisions among TNCs regarding production locations and the choice of suppliers and first-tier customers in value chains are also important to include in such an assessment. Besides the shifting gravity in international trade, with China having strengthened its position in relation to the traditional trading superpowers, both the EU and Japan suffer from relatively slow economic growth due to structural impediments in their economies. By including the effects of GVCs and GPNs on trade patterns between the EU and Japan, the EPA can create an important mutual contribution towards better utilisation of comparative advantages and revitalisation of key domestic industries. The relevance of such considerations is obvious given the asymmetries that exist in the EU-Japan trade relationship in terms of more exports from Japan to the EU taking place through intermediate partners in global production networks than there are in the reverse direction. Indirect trade relations between the EU and Japan within the context of a GVC should therefore be incorporated in an explicit and transparent manner. The stagnating or declining direct trade flow can therefore be partly explained by the fact that trade takes place through intermediate locations along a value chain (Alvstam and Nakamura, 2015).

## Connecting the EPA and the SPA

In parallel with the mutual work on the EPA, Japan and the EU are also engaged in negotiations on a new form of international agreement. The framework of the Strategic Partnership Agreement (SPA) was set to expand the collaboration interfaces between the two parties. The fact that it is a platform *complementing* the EPA also pushed the envelope for strengthening relations between the EU and Japan. The format of a legally binding agreement made the SPA stand out from other more ‘communiqué’-style agreements in areas other than trade and investment. After relatively slow progress, the areas of connectivity, digitalisation, climate change and security have become areas of special concern. The issue of infrastructure investment has become a vital area. With the Covid-19 pandemic, the SPA turned into an important future tool for trade and business connectivity. The pandemic has also shown the increasing importance of digital connectivity and data transfers, and in particular the kinds of data transfers including personal information regulated by the European GDPR. These are areas within the EPA that will probably also affect the future development of trade in services and related foreign direct investment. With an increasing possi-

bility of data transfer and value being generated at the interface between service content and goods, the economic interconnection between the agreements will be vital for the future development of political economy and business model connectivity.

## Taking stock of the EPA outcome

With the EPA, both parties foresaw strengthening relations and economic gains in general and for certain sectors (EU, 2018a) in particular. In theory, the overall tariff reduction should generate additional trade, but in the long run the elimination of non-tariff barriers, standardisation, regulatory harmonisation and trade facilitation will probably have a more profound effect on trade. Estimates show the potential gains for the agri-food, textile and leather industries are positive in the long run by involving countries in the rest of Asia, which is something that has also been stressed as a positive *indirect* effect of the EPA (Ibid.). This assessment builds on the understanding of the complexity of regional and global production networks and value chains (Coe et al., 2008). Hence, the EPA will potentially create a more transparent institutional setting for firms in both the EU and Japan to operate in. With a lack of a successful multilateral trading system, this is an essential component of the bilateral economic relationship.

When assessing the implementation of the EPA, it is important to consider the relatively short time period that has elapsed since the agreement came into effect on 1 February 2019. Furthermore, the world has for the last 18 months experienced the severe effects of the Covid-19 pandemic and its repercussions on trade and investment. Originally fearing a deep negative impact on world trade, it seems that these fears have not materialised. However, there are examples of trade restrictions on specific intermediate goods in the healthcare and pharmaceutical sectors, but in general world trade has been surprisingly resilient (UNCTAD, 2021).

From the European perspective, the EPA negotiations also coincided with the complexity of the Brexit vote in the UK. Over recent decades, the UK had attracted a substantial share of the total investments in the European single market in both manufacturing and service industries. The long-term implications of Brexit and the subsequent less comprehensive free trade deal between the UK and Japan will be of significant importance in the economic relation to the European single market and the trade flows between Japan and the EU. Specifically, possible consequences might be changing industrial footprints in both the UK and the EU that

could affect trade flows. Several knowledge-intensive professional service firms, banks and financial service providers have already changed domiciles from the UK to other parts of the European single market (FT, 2018; Reuters, 2021; FT, 2021). Manufacturing firms in the automotive industry have chosen to serve Europe from Japan or relocate manufacturing units to the continental EU rather than expanding UK production facilities (Nikkei, 2018; 2019). The EPA has facilitated this development by making such industrial reconfiguration economically viable. In relation to the overall outcome, merchandise trade has increased by around 6 per cent whereas the sectors of anticipated strong growth such as agri-food, industrial textile and leather have seen increases of about 10 per cent (EU COM, 2020). This seems to be along the lines of the estimates made prior to the implementation of the EPA (EU, 2018a).

## Important future areas of the EPA

In general, the EPA has had a viable start with the intention of creating a broad trading framework that aims to expand the boundaries of traditional trading agreements. In addition to tariff reduction and trade facilitation, with specialised working groups and committees in several areas, the Covid-19 pandemic has also generated an understanding and need to deepen efforts in several areas to strengthen the economic standing of both parties in the world market (e.g. Ström et al., 2021). There are a number of pressing issues that will be of utmost importance in the relationship between the EU and Japan through the EPA (e.g. EU, 2018b):

- Services, servitisation and product service systems
- Digital services
- Sustainability and a green economy
- Localisation of value generation – GPN/ GVC
- Implications of the Regional Comprehensive Economic Partnership (RCEP)
- Trade measurement and business level
- FDI – a need for an investment arbitration agreement?

In the light of further increases in merchandise trade due to limited tariffs, services have been acknowledged as a highly important area in the future development of the EPA. With the EU and Japan being strong in services and integrating services with manufacturing (i.e. servitisation), digitalisation and data transfer will be the key to deeper trade integration. Digital services are growing both in Europe and Japan, and this development is facilitated by

regulatory harmonisation and market entry processes having been smoothed. With the increased use of the internet-of-things, business-to-business data transfers will also become an important issue in post-pandemic international trade.

Another central area of the EPA that has traditionally been neglected in trade talks is environmental and social sustainability. The EU and Japan share a great interest in pushing green growth forward, and the latest large-scale economic stimulus programmes in the EU and Japan clearly have profiles of green growth and social inclusion (EU, 2018c). The EPA will therefore be an important tool to promote and facilitate increased trade in areas of sustainability.

Acknowledging the complexity of value chains and regional and global production networks could have implications for the development of the EPA (e.g. Alvstam and Nakamura, 2015). Trade will reflect the industrial configuration of GVCs and GPNs. This aspect of the EPA has received relatively limited attention. Localised value in the geographical areas of Japan and the European single market could act as a catalyst for designing effective production structures including hardware, software and service production by lessening the need for complex production network configurations involving third-country locations far outside the EU and Japan. More indirectly, this configuration in the post-Covid-19 pandemic economy will be connected to the recently agreed Regional Comprehensive Economic Partnership (RCEP) comprising ASEAN, China, Korea and Japan. In order to achieve the objective of the EU to play a larger role in wider Asia, the configuration of company locations and hence trade will be of key interest for the competitiveness of both the EU and Japan.

All in all, the combination of the rising importance of services, digitalisation, localised value creation and firm location configuration leads to a need for statistics that can capture this development. This calls for a combination of more traditional macro-economic measures in combination with company-level (micro) data generation. With a steady increase in digitalisation in industries, this will be paramount for developing relevant and effective policy and enhancing trade facilitation measures built into the EPA.

Finally, with regard to the slow progress of the investment agreement, some might question the necessity to conclude such an agreement between the EU and Japan if there is only a limited interest in creating a standing set-up for FDI dispute settlement. On the other hand, the lack of a FDI dispute



settlement mechanism might be the reason for the slow progress of the investment agreement. As the causality between these important items in the EPA talks is still to be established, the question is whether such a mechanism meets any real demand from private sector businesses. From statistics, we can observe that mutual Euro-Japanese investments are occurring anyway. Does this mean that the EPA can develop regardless of whether there is an FDI dispute settlement mechanism in place?

## Conclusions and policy recommendations

The global geopolitical and geoeconomic situation will bring the EU and Japan to the forefront in global relations. If it is possible to showcase the EPA as a platform for deepening economic integration between two of the world's most important trading blocs, this will most certainly have an impact on others. With the new US administration in place, it is also a good opportunity to move onwards by developing the provisions and functioning of the EPA with the mandate and acceptance of the World Trade Organisation. The EPA can act as an example and facilitator for finding broader acceptance of continued liberalisation of trade. The agreement can be the model that the world trade order needs in order not to see inter-regional trade agreements as stumbling blocks for economic development (Nakamura and Alvstam, 2015). This means that the EU and Japan can jointly form a strong vantage point improving the existing rules-based world order. However, if the potential is not acted upon, it will probably be more difficult to enforce the general approach of rules-based institutional support. A related opportunity to enhance the idea of connecting the EU to wider Asia will be a development of trade and investment relations with all the parties to the RCEP trade agreement. Such an initiative would be another positive contribution to sustaining and developing the rules-based world trade order. In this light, the newly established FTA agreement between Japan and the UK can also be seen as a good example for future international trade negotiations.

In the wake of the Covid-19 pandemic, the potential of combining the EPA and the SPA is obvious. In the post-pandemic world, both the geopolitical and geoeconomic situation calls for cross-functional approaches to create a more resilient structure of both mature and developing economies. Clearly formulated strategic policies in the areas of infrastructure, global health, digitalisation, sustainability, data and connectivity will go hand-in-hand with

economic recovery and fostering trust in the ability of a rules-based world order to deliver continuing relative wealth in different parts of the world. Furthermore, the EU and Japan have the means and ability through their institutions and financial capabilities to back up necessary investments through aid programmes and trade-facilitating measures (Ström et al., 2021).

Finally, for the EPA to capture the full potential of the relationship, a set of areas need special attention in policy recommendations. With the increasing importance of services in GDP growth and employment, and the important role played by knowledge-intensive services as intermediaries for other sectors in relation to innovation and productivity, services will be an important area of the EPA's development. The pandemic has also shown the increasing importance of a digital-ready society both from the private and public perspectives. The need for business-to-business solutions and data transfer will be crucial issues for the future competitiveness of companies based in the EU and Japan. The ongoing business reinvention of corporate Japan (e.g. Schaede, 2020) with a strong focus on digitalisation, also pushes this need further. The digital services and e-commerce markets have rapidly become vital parts of the economy in both the EU and Japan. If these services are to thrive on the basis of the EPA, more is needed in terms of trade facilitation, regulatory transparency and market entry facilitation. The development of categorisations and data capture will be vital to develop viable policies in the EU and Japan and the competitiveness of the companies there. Since services are more affected by non-tariff barriers, this calls for coordinated efforts by both parties to the EPA.

Another area of great importance, challenge and possibility for both the EU and Japan would be to further develop the green economy and trade. Both parties are well established to push this within the rules-based world order. The substantial commitments presented as post-pandemic economic remedies are tightly connected to the delivery of green growth and social cohesion in both Japan and the EU. In addition, the area of green growth is closely related to the enhancement of servitisation of the manufacturing industry and the importance of services in a transition to a green economy (Ström, 2020). Developing this part of the EPA and the related SPA could be a viable way to create resilient societies in the post-pandemic world economic order. Again, strong parties such as the EU and Japan can use the rules-based world order for both geopolitical and geoeconomic purposes.

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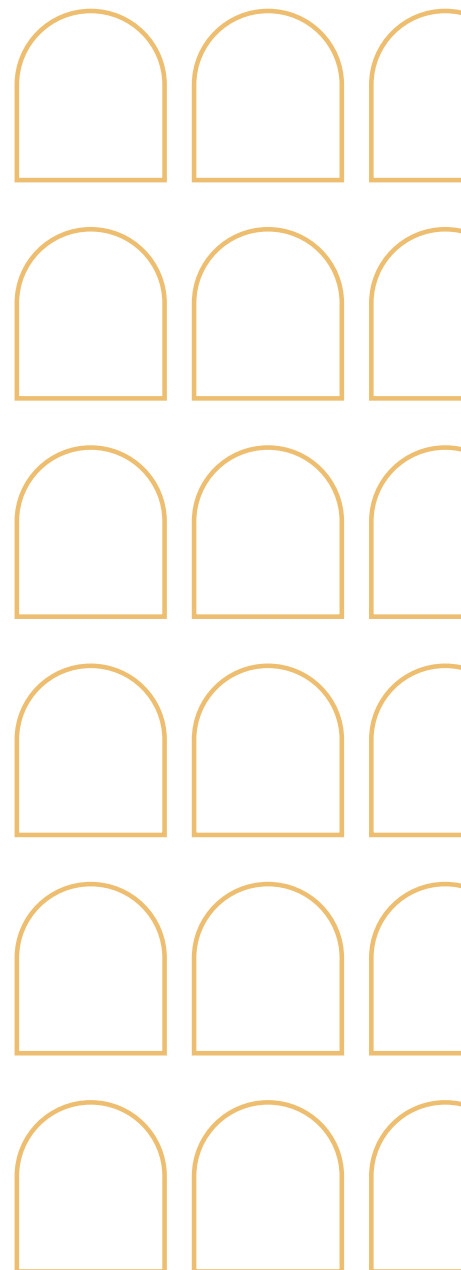
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