Trade Sustainability Impact Assessment of the Free Trade Agreement between the European Union and Japan—executive summary

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The Trade Sustainability Impact Assessment of the FTA between the EU and Japan
—executive summary

1. Introduction

The EU-Japan Free Trade Agreement (FTA) is designed to strengthen Europe's weakening economic relationship with Japan, the world's third largest national consumer market. Yet Japan is only Europe's seventh largest export market, accounting for just 3% extra-EU exports and trade turnover. In the European Commission's Impact Assessment of this FTA in 2012, the 'relative decline' of the EU-Japan relationship is recognised as a problem that needs to be addressed.

Next to the Trans-Atlantic Trade and Investment Partnership (TTIP), the EU-Japan FTA is the most ambitious bilateral negotiation undertaken by the EU. The economic gains of this agreement are in the same magnitude as TTIP, and could lead to major export increases. There are also considerable industrial and consumer benefits, assuming effective liberalisation of both markets. The importance of Japan and the Far-East is also well-established in EU trade policy, reaffirmed in the 2015 Trade Policy Communication, “Trade for All”.

Since the Trans-Pacific Partnership (TPP) involving Japan and the United States was concluded on October 5th, 2015, the EU-Japan FTA is a necessity to maintain the current levels of exports and European market shares in Japan. The EU-Japan FTA is consequential, if not inevitable, following the conclusion of TPP.

Overview of negotiations

Negotiations are approaching conclusion and at the time of the Final Report of the Trade SIA, thirteen rounds of negotiations have been conducted, with many negotiation objects either addressed or in the process of being so – e.g. market access for goods, services, investment, public procurement, NTMs and geographical indications. The negotiations for a FTA between the EU and Japan have been ongoing since late March 2013. At the time of this final report for the Trade SIA, thirteen rounds of negotiations have been successfully concluded, and the latest EU-Japan Summit in May 29th 2015 reaffirmed the importance of a highly comprehensive and ambitious agreement to be concluded as soon as possible. Considering that a significant part of the negotiations revolves around regulatory issues or non-trade measures, considerable amount of progress has been achieved in just slightly more than two years. Aside from the scoping work and the one-year review, the negotiations have resulted in several interim outcomes – perhaps most notably on car safety standards and the joint agreement on railway equipment.

Stakeholder consultations

The report draws on extensive and comprehensive stakeholder consultation on multiple levels with approximately a hundred conversations and interviews, stakeholder roundtables for each of the reports' chapters conducted partly in cooperation with the European Economic and Social Committee, direct conversations and surveys with those unable to attend, including European and Japanese SMEs. Four surveys have been conducted on the social/human rights and environment impact as well as a specific survey aimed at small and medium sized enterprises (SMEs) to test the impact on this group. Two
stakeholders have also presented alternative quantitative impact assessments, which were analysed in parallel to the official impact assessment. For the first time, stakeholders were also allowed to participate in the selection of sectors to be analysed.³

In addition, stakeholder outreach was conducted via regular newsletters, a dedicated website, physical and email information points and social media. The objective of the consultation process is not only to ensure greater understanding and awareness among stakeholders of the Trade SIA, but also to increase transparency and accountability.

2. The economic impact of the EU-Japan FTA

Substantial market potential, US exporters outperforming the EU

Japan is the world's third largest national economy, only recently (in 2010) surpassed by China for the number two position. However, the actual market potential for European trade with the trading partners is different than just the size of nominal aggregate GDP.

Firstly, the theoretical market potential of Japan is high due to high rate of private spending, which is almost twice as high compared to China. Per capital growth is three times higher than the Eurozone in 2015 in absolute terms, most of which is spent on consumption.

Secondly, the rate of imports in the Japanese society is seen as consistently low, but, in reality, it is on comparable (or higher) rates than other major developed economies. Foreign imports (relative to the total consumption) are higher in Japan than in the US (23% versus 19%). Instead, it is EU export of goods and services that is underperforming in Japan, especially in comparison to US exporters.

The economic impact

The economic analysis confirmed the rationale of the EU-Japan FTA given its sizeable market for exports and a source of investments and R&D.

However, TPP has been concluded at a level of ambition that is higher than prior Japanese FTAs. This would have clearly negative effects on the baseline for EU-Japan trade, as trade and investments will be diverted away from Europe. The TPP agreement will be the first serious competing economic integration that could negatively affect Europe, which needs to improve its access to Japan and other major economies within the TPP if it is to retain its current levels of market shares and economic contribution from trade. Given that the existing plurilateral agreements include most of the TPP countries (including the US), they cannot fully address the preference margins that have been created by the TPP agreement. Also, not all EU offensive interests can be accommodated through the plurilaterals or the WTO – especially on tariffs and agriculture.

The long-term GDP increase for the EU is estimated to be +0.76% in the most appropriate scenario.⁴ Bilateral exports increase by +34%, while total global exports increase is +4% for the EU. Export driven growth is particularly important in food and feed, which could be receiving half of the export gains. However, the main growth component is not just exports, but also investments: Japan has abandoned its export-driven trade and transitioned towards investing in production overseas, a strategy that matches Europe’s need for investments and jobs. The main investor concerns are not investor-state disputes however, but the business environment in the EU. The FTA can improve the business environment by tariff elimination on intermediate goods, NTMs and mode 4.

³ Retail, wholesale with particular emphasis on merchandise (leather and footwear; textiles) were chosen based on survey and importance of the sector
⁴ Assuming full tariff liberalisation and symmetrical reduction of NTMs
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The gains and losses from liberalisation are well-diversified geographically, or emphasising the regions that traditionally do not have major offensive interests in trade negotiations. There are no negative impacts on vulnerable groups, fiscal revenues (net results are positive) or the informal economy from the FTA. Cross-effects on the customs union with Turkey are limited to one sector (motor vehicles), which is in Europe’s favour.

3. Sectoral analysis and breakdown of the impacts

The economic analysis highlighted different issues to be examined in different economic sectors: Whether the economic gains can be fulfilled by each sector, or to what extent these gains are outweighed by negative social or environmental impacts.

The indicators examined in the sectoral analysis are exports (food and feed, motor vehicles, medical devices, pharmaceuticals/chemicals) for output; imports or turnover (medical devices, motor vehicles and railway sector) as an indicator for supply-chain integration and consumer benefits; and a qualitative assessment of the changes to the general business climate that encompass jobs, competitiveness and supply-chain benefits and investments.

Also, the environmental assessment is on greenhouse gases, CO₂ and waste while the social assessment is based on employment, wages and possible asymmetric effects on various social groups and SMEs.

Food and feed (processed food) sector

TPP has a considerable impact on this sector. If the scenario there would be no EU-Japan FTA, the EU food sectors covered by this exercise (pork, dairy, cheese, wine, spirits, waters, confectionery/bakery, starch) will lose on average 20-25 percent of their current sales in Japan due to the TPP amongst the items examined, assuming TPP is ratified and no other action is taken in the EU. Considering the negative impact of TPP on EU exports, a partial liberalisation (equivalent to reducing today’s tariffs to half) is inadequate, and cannot bring the levels of EU exports to Japan (e.g. on pork, dairy and cheese) back to today's levels. The greatest negative impact can be observed on pork, followed by dairy and cheese.

The positive net effect on sector employment is confirmed, with no negative spill-overs on employment or environmental impact. Considerable negative impacts are foreseen on SMEs and employment if TPP is concluded and the EU-Japan FTA is not.

Motor vehicle sector

Recent developments show that the foreign imports of passenger cars or commercial vehicles do not threaten the local production inside the EU: The markets are now more stable, Japanese manufacturers produce approximately two-thirds of sales in Europe locally, and use the EU as a base for regional exports. In fact, Europe’s trade surplus on motor vehicles is the world’s largest trade surplus in any category (the car trade with Japan is also in surplus).

Considering several alternative impact assessments on the sector available, the conclusion is that the impact on the passenger car market is exaggerated. Taking into account localised production, the change of EU output is negligible, at 0.1%. The environmental effects are likely to be positive: Production is low energy and emissions intensive, with trade benefitting low emission technologies.

Data shows that producers are not likely to engage in direct price competition as a consequence of trade liberalisation in the EU or Japan, but to improve profits. This applies to all segments, and more so on

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6 Francois, Manchin, Norberg, 2012; Deloitte Belgium, 2011; MRI, 2012; Copenhagen Economics, 2014
commercial vehicles, powered two-wheelers, parts and components. Also, the EU has raised the question about the preferential environmental benefits for kei cars (ultra-light vehicles) in Japan, which is only relevant to a minority of cars exported from the EU, while acquisition tax benefits are already evened out.

**Railway equipment**

The analysis in the railway equipment sector balances the gains of this FTA for the equipment firms (the production side) against the gains for the train operators and passengers. The Japanese passenger railway service market is of almost the same size as that of the EU, and the three major players (JR East, Central and West) are entirely privatised, with whom there is now a voluntary agreement to open up their procurement.

In today’s baseline, the bilateral trade is in Japan’s favour given the vast differences in competitiveness and R&D spending. Still, the import penetration on the Japanese railway market is higher than in the EU. The increased competition that the EU-Japan FTA could bring to both equipment production and passenger services provides for the ultimate benefit of the European and Japanese passengers, given that the purchases from the railway supply industry represent a high share of the operators’ investments. Being such a crucial input, the employment amongst operators benefits from increased variety. In other words, a more efficient equipment industry should be seen as a key contributor to operator employment. “Protecting” equipment market employment by closing bilateral trade is unlikely to be successful as the true challenges of the Japanese and EU markets come from third countries. In conclusion, the social and economic benefits in passenger services outweigh trade balances in the equipment sector.

**Life sciences (pharmaceuticals, medical devices)**

In world trade in pharmaceuticals, medical devices and in-vitro diagnostics, both Japan and the EU are major markets, with major potentials and challenges due to the impact of demographics. The increases could affect GDP by 0.5% by 2030. We calculate that 82% of the spending is publicly funded in Japan, making public healthcare expenditure a concern, with plans to expand the use of generics.

The pharmaceutical sector trades duty-free, but faces duplicate testing requirement, reimbursement, adding also specific issues on generics, biosimilars, vaccines and quasi-drugs (cosmetics with medical applications requiring market authorisation). Medical devices are covered by the same law and the analysis concludes that the 2012 Impact Assessment seriously understates the potential in this sector.Tariffs are also still in place on medical devices and reference pricing is applied.

It is concluded that foreign participation, transparency and non-discrimination on reimbursement rules (as in TPP provisions) do not raise healthcare expenditure in itself. Furthermore, it predicts job losses in the pharmaceutical and chemicals sector, presumably from trade liberalisation spilling over to low-cost producers – which is deemed as unlikely as liberalisation takes place bilaterally and developing countries may not fulfil same standards.

Also, there is a considerable SME population in the medical devices sector. There are also supply-chain benefits where European firms use Japanese advanced components, which calls for fast track procedures of self-declaration of conformity (SDoC) in some risk categories.

**Services sectors**

Due to the high growth in the goods sector (especially in processed foods), it is estimated that the FTA generates relatively low gain for services, which otherwise dominate the gains in trade agreements. The entry costs in Japan are high, with an overly regulated business environment. EU participation corresponds to sectors where there is evidence of productivity gains and profits in Japan. Trade dependency of the Japanese services sector is low; so is also the degree of internationalisation outside Asia.

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7 OECD, Public spending on health and long-term care: a new set of projections, June 2013
In general, there are common interests for the services sectors on both sides to negotiate mode 4 related issues and professional qualifications. Other insurances and banking services issues are complex given a major dominant supplier and distributor in Japan Post Inc. (JPI), but the US competitors have successfully negotiated direct agreements with JPI. Aside from the traditional zoning and establishment rules, retail and wholesale trade is affected by TBT and SPS issue on merchandise – in particular on leather, footwear, textiles and foods – that typically make up EU retailer interests in Japan. The FTA should live up to the increases predicted. Moreover, the CGE model results in job losses (in e.g. air travel and professional services) due to the assumption of constant employment, i.e. these sectors would leave their jobs to work in processed foods, which is not a realistic assumption.

4. The social impact of the EU-Japan FTA

The social analysis concludes that economic gains are not crated at the cost of social variables and interests. Rather, the sectoral analysis suggests that income will be distributed geographically to the benefit for those who traditionally do not gain from trade liberalisation, especially in food and feed. There is no negative impact on income inequality (gini coefficient). Real wages are increasing symmetrically, and in all scenarios the income gap between skill groups is never larger than 0.02% in Europe. A case study on gender equality shows that the FTA is beneficial to address the gender gap in the EU.

SME tests on social indicators are inconclusive as they depend on the implementation of the agreement. However, there are positive SME effects on at least two sectors (food and feed, medical devices) with no negative SME impact on any of the observed economic or social indicators. However, the no-FTA scenario would disproportionately affect the agricultural sectors and exporting SMEs that are unable to mitigate the negative effects from TPP.

The sectoral analysis and a simplistic macroeconomic examination of output and employment confirms overwhelmingly positive impact on employment in the EU identified in the 2012 Impact Assessment. Japanese firms have 460,000 employees in the EU, a number has increased by 29% in the past five years, regardless of growth in the EU. Additional jobs come also from Japanese invested firms and joint-ventures.

The tariff elimination on motor vehicles is not likely to significantly change the production levels or employment in the EU compared to a non-FTA scenario, with less than 0.1% of output in the passenger car segment being affected. Impact on employment is also within the same negligible range. Other impact assessments leading to negative results have been found to have some methodological omissions that led to their results.

The sectoral analysis showed positive impact on EU consumer’s ability to benefit from the internal market on either consumer prices, safety, quality or choice. No detrimental impact could be identified on consumer protection, safety, sustainability, or vulnerable consumers in the EU. Moreover, no public health (or other regulatory risks) could be identified.

5. The environmental impact of the EU-Japan FTA

With no additional environmental impacts identified in the sectoral analysis, it is possible to conclude that there is no negative impact on greenhouse gases and CO₂ emissions from the FTA. In fact, the FTA favours relatively less energy and emission intensive sectors, leading to a reallocation towards these cleaner sectors instead.

Lower trade barriers to environmental goods and services contribute to increased competition inducing greater innovation. This yields to positive environmental benefits with improved resource-use efficiency and pollution prevention. Nor will the FTA will induce a pressure on energy demand, nor imports of natural resources and waste production. The only area of limited concern regards the pressure on biodiversity and the environment exercised by the increased output in the food and feed sector.
The case study on forestry concludes that sourcing timber within the EU will not lead to negative impacts. The risks are imports from third countries as both the EU and Japan are known to import significant volumes of high-risk timber. In fishery, the FTA will not affect trade given that both economies are highly import dependent with little surpluses to export; as of today, the quantitative import quotas are not exhausted. Similar to timber, the risks are in third country trade, e.g. on eels.

In addition, a variety of environmental organisations representing civil society interests in the EU were consulted for the overall environmental analysis and only very limited feedback was received, indicating that the EU-Japan FTA negotiations are not a major concern for environmental stakeholders.

6. Conclusions, recommendations and flanking measures

Competitive liberalisation from TPP will have a serious effect, further diminishing the declining economic relations with Japan. There will be serious negative effects from trade diversion, which may only be overcome through completion of the EU-Japan FTA. There are several other growth drivers than exports, notably investment.

As the indicators on employment, inequality (skills, gender, geography), SME, consumer impact and other social factors were positive, and the impacts on environmental indicators (GHG emissions and waste) were non-existent, the EU-Japan FTA adheres to the objective to create ‘smart, sustainable and inclusive growth’, jobs and welfare gains. It also supports the EU trade policy strategy as communicated in 2015.

This Trade Sustainability Impact Assessment comes to the conclusion that the potential economic gains, outlined in the overall economic analysis, will not be outweighed by negative social and environmental impacts. The EU-Japan FTA adheres to the objective to create ‘smart, sustainable and inclusive growth’.

Recommendations

Given the concentration of gains to the processed food for Europe, conclusions of the market access negotiations (especially on agriculture) should be given precedence. Although this conclusion acknowledges that such option may not have been available to the EU. This is particularly true for European interests that are not likely to be liberalised under TPP. Overall, emphasis must be given to offensive market interests with intentions to use the liberalisation achieved in the negotiation.

Regulatory non-tariff measures are the main focus. They are numerous, some are complex or politically difficult to address, and the existing bilateral forums of cooperation have not been able to address them adequately. New regulatory divergences may arise in the future – especially in highly regulated and innovative areas like motor vehicles, chemicals, medical devices and services.

Therefore, a more horizontal and permanent instrument of addressing the current and future regulatory divergences between the EU and Japan may have to be developed. Almost all sector analyses pointed to the need to establish a more comprehensive and predictable solution than MRAs – either through equivalence, mutual recognition or self-declaration of conformity.