Asie.Visions 55

A EU-Japan Free Trade Agreement
Toward More Solid Economic Relations

Hiromasa Kubo

November 2012

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ISBN: 978-2-36567-094-4

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Executive Summary

Until the 1990s, economic ties between the European Union and Japan were marked largely by an atmosphere of trade tension. The main reason was the persistent trade surplus that Japan maintained. Over time, however, the improvement of the bilateral trade balance and the massive direct investment of Japan in the EU have alleviated these tensions.

More recently, there are growing signs that their economic ties are actually weakening. But since the EU and Japan share a common set of values (as shown in their commitment to democracy, free-market economic systems, respect for human rights, and the rule of law), it is imperative that they reinforce their ties of cooperation on a range of global issues as well as pursue progress in their own mutual relationship.

In this context, Japan and the EU made efforts to gauge the prospects for a bilateral free trade agreement (FTA).Nevertheless, many challenges remain: For Japan, EU tariff rates are the key matter of concern while the EU deems it problematic that Japan still maintains a number of non-tariff barriers (NTBs) to trade, and has insisted that negotiations on an FTA cannot even begin until Japan dismantles these barriers.

Even if further tariff reductions are not expected to have a major impact on the volume of trade between the two partners, a bilateral FTA could still benefit both Japanese and European economies through positive implications on productivity and innovation.

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Introduction

Years ago, economic ties between the European Union and Japan were marked largely by an atmosphere of trade tensions. The main reason was the persistent trade surplus that Japan maintained as its exports to the EU outweighed imports from the EU. However, the improvement of the bilateral trade balance and the massive direct investment of Japan in the EU have alleviated the trade tensions. Although Japan has continued to run a trade surplus, it is no longer a pressing issue.

As the two regions share common values such as the market economy, democracy, respect for human rights and the rule of law, they have sought to cooperate on a host of global issues, including global warming, stabilization of the international currency system, and the free-trade system. Also increasingly important in exploring the bilateral relationship between these two regions is the fact that they have many things to learn from each other; they confront a set of common problems, including lower birth rates and the ageing of their populations.

Against this backdrop, an effort to gauge the prospects for a free trade agreement (FTA) or economic partnership agreement (EPA) between the EU and Japan has been gaining momentum. This paper aims to present the outlook for an FTA between the EU and Japan by reviewing the history of their economic ties, by discussing how their FTA negotiations have evolved, and finally, by focusing on the impact an FTA would potentially have on both economies.

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Background of Economic Ties between the Two Regions

Trade tensions between the EU and Japan[1]

Concerning Japan's relationship with the EU (the European Community or EC at the time), the period from the 1970s through the first half of the 1990s warrants description as a period of trade disputes. As mentioned earlier, one key background factor was the lopsided balance of trade; that is, the surplus Japan sustained in its trade with the EU. For example, as Table 1 illustrates, in 1980 the value of Japan's exports to the EU was more than double the value of its imports from that region.

In that context, the EU used different kinds of strategies to place import controls on Japanese products and accordingly curb the flow of imports from Japan. For example, some EU member states imposed restrictive quotas on imports of selected Japanese products. In response, the Japanese government demanded that these controls be withdrawn as violations of the General Agreement on Tariffs and Trade (GATT), which had been founded on the principles of freedom and non-discrimination. However, the EU did not readily comply. Japan took steps to cool trade frictions by adopting a set of voluntary restraints on its exports of automobiles and other manufactured goods, such as machine tools, videocassette recorders (VCRs) and semi-conductors. The restrictive EU controls on Japanese imports were not completely withdrawn until March 1994. Additionally, though, the EU imposed anti-dumping duties on imports of Japanese goods and components, but with the real purpose of curbing Japanese imports in general, thus causing distress to many export-dependent Japanese companies. According to Japanese views, the main cause for the trade imbalance was the lack of international competitiveness and also insufficient efforts by European firms to penetrate Japanese markets. The European side, on the other hand, was frustrated by their unsatisfied performances and criticized Japanese non-tariff barriers (NTBs) as being a main cause of the trade imbalance. Examples of these NTBs, it was claimed, were: technical certification

[1] See Kubo *et al* (2011), The EU-Japan Relation, *Modern European Economy* (in Japanese), *Yuhikaku*, pp.407-412.

procedures; vertically and horizontally integrated industrial, commercial and financial groups, and complex distribution systems.[2]

Table 1: EU-Japan bilateral trade, 1980 to 2011

Unit: billion yen			
	Japan's exports to EU	**Japan's imports from EU**	**Trade balance EU-Japan**
1980	4,923.3	2,379.6	-2,543.7
1985	4,768.0	2,126.9	-2,641.1
1990	7,733.9	5,070.7	-2,663.2
1995	6,600.1	4,579.7	-2,020.4
2000	8,431.9	5,042.9	-3,389.0
2005	9,651.8	6,470.1	-3,181.7
2007	12,307.9	7,662.7	-4,735.2
2008	11,429.8	7,291.7	-4,138.1
2009	6,749.7	5,512.7	-1,236.9
2010	7,615.8	5,821.0	-1,794.8
2011	7,619.3	6,411.0	-1,208.3

Source: *Trade Statistics of Japan,* Ministry of Finance, Japan (2012)

Against this historical development, in the mid-1980s the EU announced a market unification plan aimed at reinforcing the competitiveness of European industries, and adopted the Single European Act (SEA) as a step toward putting that plan into effect.

However, both the US and Japan condemned this market unification plan as a measure that stressed liberalization only within the EU, while adopting a "protectionist" stance toward countries outside that region. To counter a feared European move toward "protectionist" measures, many Japanese firms sought to expand

[2] See Gilson (2000), *Japan and the European Union*, Macmillan Press, p.29.

their levels of foreign direct investment (FDI) in the EU. This was driven by the aim of securing a share of the EU market by shifting manufacturing bases to the EU and expanding the local production of goods as an alternative to imports from Japan. Their assumption was that, if they procured more parts within the EU and harnessed the EU's own labor pool, they would not be shut out of the EU marketplace even if the EU did impose curbs on products imported from Japan. Another factor behind the expansion of Japanese FDI was the attractiveness of the EU, with their huge mature consumers market.[3] As will be further elaborated below, in monetary terms the volume of Japanese direct investment in the EU began expanding sharply around 1990, but concerns over a European shift to "protectionist" policies can be cited as a key factor behind that trend.

From trade tensions to an era of EU-Japan coordination

Post-World War II global political and economic trends underwent a major transition from the late 1980s through the first half of the 1990s. In particular, the Berlin Wall came crumbling down in November 1989 and Germany achieved reunification in October 1990, while the Soviet Union collapsed in December 1991, bringing the Cold War to an end.

It was against this backdrop in July 1991 that Japanese and EU (then EC) leaders announced the Hague Joint Declaration – an agreement to hold leaders' summits as well as ministerial and cabinet-level meetings between the EU and Japan on a regular basis. Several factors may be cited for this development. First, stable global economic advancement in the post-Cold War period would demand closer trilateral cooperation between the US, the EU and Japan. Second, stronger cooperation between the EU and Japan was important given that relationships between the EU and Japan had been relatively tenuous compared to those established by Japan with the US and by the US with the EU.

In December 2001 – approximately 10 years following the Hague Joint Declaration – at an EU-Japan summit, leaders adopted the Action Plan for EU-Japan Cooperation, which set targets for the year 2010 and designated 2005 the EU-Japan Year of People-to-People Exchanges. As a result, that year witnessed a total of around 1,900 events of various kinds in Japan and throughout the EU that were devoted to the goal of increased exchange and interaction.

[3] There are a number of theories to explain FDI. An important one is the OLI-Model, proposed by Prof. Dunning, who emphasized the importance of location advantage or location attractiveness. See Dunning, J.H., The Eclectic (OLI) Paradigm of International Production: Past, Present and Future, *International Journal of the Economics of Business*, 8(2), 2001, pp. 173-190.

Even at times when trade tensions between the two regions seemed to be intense, the EU and EU member states made efforts to actively penetrate the Japanese marketplace. For example, since 1979 the EU has run an Executive Training Programme (ETP), a human resources development programme that provides young businesspeople from EU-based companies with the training they need to conduct business in Japan. Cumulatively, over 1,000 trainees have participated in the ETP to date, including many people who now have active leadership roles in EU-based corporate units operating in Japan.

As of 2010, the EU and Japan together accounted for only 9.2% of world population (Japan 1.9%, EU 7.3%). However, they accounted for 34.5% of global GDP (Japan 8.7%, EU 25.8%). Clearly, it's important for global development that these two powers develop closer ties and cooperate on global issues.

Features of EU-Japan trade and investment

This section provides an overview of the types of trade and investment activity under way between the EU and Japan, focusing on the trade dimension first. As illustrated above in Table 1, Japanese exports to and imports from the EU has continued to expand at a generally steady pace up to 2008. Since September 2008, however, the value of exports as well as imports has fallen sharply, reflecting the global financial and economic crisis triggered by the Lehman Shock, although Japan's trade surplus has continued.

In this trade context, it is notable that the relative importance of the EU and Japan to each other has been declining. In 2000, for example, exports to the EU accounted for a 16.3% share of all exports from Japan. This share gradually contracted and by 2010 measured 11.3%. The same pattern is evident with imports. In 2000, imports from the EU accounted for 12.3% of all Japanese imports, but by 2008 dwindled to 9.2%; although 2010 marked a slight increase, this share remained relatively depressed, at 9.6%.

The same trends appear evident in the data for the EU. In 2000, exports to Japan accounted for a 5.4% share of the EU's total external exports, but in 2010 fell to 3.2%. Conversely, as a share of the EU's total external imports, imports from Japan decreased over the same period: from 9.3% to 4.3%. Hence, in terms of trade, the EU and Japan have grown less dependent on each other. One reason for this is China's growing importance as a trade partner for both the EU and Japan.

Table 2 classifies the principal categories of merchandise in Japanese exports to and imports from the EU, along with their respective shares of the export and import total. One of the most conspicuous facts is that automobiles have accounted for the largest share, representing more than 12% of Japanese exports to the EU

during the past decade. This is particularly significant for EU-Japan trade negotiations.

Table 2 (A): Top 5 exports to EU from Japan in 2000 and 2010 (%)

Japanese exports to EU in 2010		**Japanese exports to EU in 2010**	
Automobiles	12.3	Automobiles	12.9
Optical apparatus	6.6	Automobile components	5.2
Semi-conductors	6.2	Engine	4.6
Computer	6.2	Optical apparatus	4.2
Video-equipment	5.1	Semi-conductors	4.2

Table 2 (B): Top 5 imports from EU to Japan in 2000 and 2010 (%)

Japanese imports from EU in 2000		**Japanese imports from EU in 2010**	
Automobiles	11.6	Pharmaceuticals	14.0
Organic chemicals and other chemicals	7.3	Organic chemicals and other chemicals	9.1
Pharmaceuticals	6.4	Automobiles	7.9
Computers	3.8	Steel	7.6
Optical apparatus	3.5	Fish & fish products	5.7

Source: *Trade Statistics of Japan,* Ministry of Finance, Japan (2011)

Automotive components and engines together account for 9.8% of total exports from Japan in 2010. As will be further elaborated below, this mirrors an expansion trend in Japanese exports of automotive components to the EU, one outcome of the large-scale direct investments that Japan's car industry has made in the EU.[4]

[4] According to a Japan External Trade Organization (JETRO) survey, Japanese industries had 1,091 operation sites in Europe at the end of 2010, which include 218 sites owned by Japanese car companies, 152 sites owned by the general machine industry and 100 sites for the chemical industry. See JETRO website: http://www.jetro.go.jp/jfile/report/07000807/eu_tr_manage1.pdf

Therefore, one of the key features of recent Japanese exports to the EU is the growing share of the total consisting of finished automobiles and automotive components, while finished car exports still have the largest share.

Currently, on the import front, pharmaceuticals, organic chemicals and other chemical products account for a conspicuously large share of EU merchandise imports by Japan. This may be one of the benefits of the Mutual Recognition Agreement (MRA) that the EU and Japan signed in April 2001. This agreement defines a framework that allows procedural paperwork mandated by the destination country to be performed in the exporting country for products in four categories: information and communications equipment, electrical goods, chemicals, and pharmaceuticals. The objective is to encourage more EU-Japan trade by simplifying administrative procedures and thus easing the burden on companies that engage in international trade in these products.

Table 2 shows the high share of imports of automobiles, such as high value-added German ones. European brands in sophisticated categories, ranging from automobiles to handbags, have a solid base of popularity in Japan; such brands are likely to enjoy strong and sustained sales even if the current economic slowdown persists for some time to come.

To date, levels of Japanese direct investments in the EU have undergone two distinct booms. The first boom phase occurred around 1990. As discussed earlier, concerns about an EU shift toward "Fortress Europe"[5] mounted at around the same time as expectations that the EU would implement a market unification plan. The second boom came in the first half of the 2000s with the expansion of direct investments, mainly in central and east European countries that were part of the fifth EU enlargement (2004 and 2007). For instance, the establishment of a Toyota manufacturing plant in the Czech Republic, jointly with PSA Peugeot Citroën, prompted many Japanese makers of automotive components to set up manufacturing bases of their own in the Czech Republic and neighboring countries, including Poland and Hungary.

Again, according to the survey by JETRO, as of 2010, Japanese-affiliated manufacturing operations had set up 80 manufacturing facilities in Poland, 94 in the Czech Republic, and 39 in Hungary. Therefore, 213 Japanese manufacturing facilities were operating in these three countries alone. The intensity of this direct investment drive into these new EU member states by Japanese-affiliated firms seems all the more apparent when compared to the 146 Japanese-affiliated manufacturing facilities that were operating at that time in Germany – a country with which corporate Japan is familiar and in which it has a long track record of direct investment.

[5] See Gilson *op.cit*., p.61.

Another point worth noting is that the EU has become an important partner for Japan in the investment arena. For example, according to the Balance of Payment Statistics of the Bank of Japan, as of 2011, investments into the EU accounted for a 21.9% share of the total stock of all FDI by Japan. This ranks second only to the 30.3% share of FDI made in the US. For comparison, the corresponding share of direct investments made in China accounted for just 8% of the total. One problem, though, is the gradual decline in the Japanese share of direct investments in the EU. That share was 22.8% in 2001, reached a peak of 27.3% in 2004, and declined thereafter. Similarly, the EU accounted for 38.3% of the total balance of FDI in Japan in 2010, topping the corresponding US share of 33.7%. However, in 2001 this EU share was much higher, at 45%.

Another problem is the investment imbalance. The outstanding balance of EU-sourced direct investment in Japan totaled 6.7 trillion yen in 2010, while that of Japanese direct investment in the EU reached 14.9 trillion yen in the same year. This disparity has become one basis for the view that “Japan has a closed market”.

What does this investment relationship with Japan mean for the EU? First of all, as of 2010, according to the Eurostat database, investment stocks in Japan accounted for no more than 2.3% of the total balance of EU investments outside the EU region. Given that the corresponding share was only 1.8% in 2001, this represents a slight improvement but is still at an extremely low level. In 2010 Japan accounted for a 4.3% share of direct investment stocks in the EU, but this represented a decline from the 4.6% level registered in 2001. Hence, in terms of the EU-Japan investment relationship to date, the EU still ranks as an extremely important investment partner for Japan, although there are signs that its level of importance is gradually waning. Conversely, for the EU, it is clear that Japan does not warrant description as a vital investment partner.

Now let us examine the EU-Japan relationship in terms of the structure of their balance of payments. In 2010, Japan had a current account surplus of 17.17 trillion yen. Of that total, 4.42 trillion yen was from the surplus in its current account with the EU, but only 1.657 trillion yen of that surplus was in turn attributable to Japan’s trade surplus with the region. To put this in perspective, this amounts to just a 0.34% share of the 481.8 trillion yen in nominal GDP that Japan recorded that year. Additionally, the main component of the current account surplus with the EU was an income surplus of 2.69 trillion yen, almost all of which derived from securities investment income. In 2011, Japan’s current account surplus with the EU declined to 3.76 trillion yen, due partly to a trade surplus decrease to 9.6 trillion yen. However, Japan’s income surplus increased to 2.81 trillion yen. In other words, while the balance of payments between the EU and Japan is marked by a current account imbalance, securities investment income accounts for most of that gap, and not Japan’s trade surplus with the EU. Both the EU and Japan have already

liberalized their capital markets, so there is virtually no margin for government policy intervention in this area.

Challenges and Benefits of EU-Japan FTA

Briefly summarizing the points made in the previous section, one may conclude that bilateral trade and investment ties are at risk of weakening. However, it is imperative that Japan and the EU cooperate more closely on issues they face in common, as well as on global issues. Here we will cite several of the more important challenges and discuss some current problems.

FTA negotiations between the EU and Japan

The EU and Japan have held repeated negotiations on a variety of issues in order to improve their respective business environments, and encourage the two-way flows of trade and investment as well reforms in those sectors that they still regulate.[6] Japanese negotiators have called for several measures, including:

- Lower tariff rates on information and telecommunications equipment, electrical appliances, and automotive products
- EU environmental regulations that do not place an inordinately heavy burden on corporations
- Recognition of the equivalence between international and Japanese accounting standards

In turn, EU negotiators have called on Japan to:

- Improve its climate for investment (including revisions to its Airport Development Act
- Ensure that EU firms and other private-sector interests are not put at a competitive disadvantage as a result of changes to government plans to privatize Japan's postal service
- Streamline and improve the new drug approval process

[6] See the website of Ministry of Foreign Affairs, Japan (in Japanese): http://www.mofa.go.jp/mofaj/area/eu/pdfs/index-kankei.pdf

- Streamline procedures for the assurance of food safety and the approval of food additives in farm produce

A more far-reaching challenge is that of forming an EU-Japan FTA. To date, Japan has established FTAs with several of its important trading partners, including Singapore and Mexico, thus bringing about vast increases in the volume of trade.[7] However, it does not yet have a comparable pact in place with the EU.

Table 3: Japan's FTA/EPA* as of August 2012

2002**	Singapore	**2008**	ASEAN
2005	Mexico	**2008**	Philippines
2006	Malaysia	**2009**	Switzerland
2007	Chile	**2009**	Vietnam
2007	Thailand	**2011**	India
2008	Indonesia	**2012**	Peru
2008	Brunei		

Source: Ministry of Foreign Affairs, Japan (2012
* Economic Partnership Agreement
** Concluding year
** For EU FTAs, please see: http://ec.europa.eu/enterprise/policies/international/files/existing-trade-negotiations_en.pdf

For Japan, EU tariff rates are the key matter of concern. Japan does not apply customs duties on most of the industrial goods it imports. Japan's main complaint is that high EU tariffs on imports of cars and electrical equipment constitute a serious barrier to the expansion of trade. For example, the EU applies a tariff of 14% on imports of color televisions, color video monitors, and multifunctional LCD displays, as well as a 10% tariff on automobiles. However, as indicated through its own demands, the EU deems it problematic that Japan still has many non-tariff barriers (NTBs) to trade, and has

[7] Ando (2007) calculated the effect of FTAs on trade volume. Her research indicated that the Japan-Singapore FTA (concluded in 2002) resulted in increases in Japan's exports to Singapore of 6.27% in 2003, 6.79% in 2004 and 6.06% in 2005. Similarly, the estimated rates of increase in Japan's imports from Singapore were 2.51%, 2.56% and 2.34% respectively during the same period.

insisted that negotiations on an FTA cannot even begin until Japan dismantles these barriers.[8]

At the EU-Japan summit in Brussels in May 2011 called the Kizuna [bonds of friendship] Summit, held shortly after the Great East Japan Earthquake, leaders on both sides agreed to initiate a "scoping exercise" as a preliminary step toward starting negotiations on an FTA.[9] Although this scoping exercise was concluded in May 2012, these preliminary negotiations were not taken for granted as a step that would lead to the start of negotiations on the main issue, an FTA. In fact, on June 13, the European Parliament adopted by majority vote a resolution demanding that all member states for the time being reject the start of formal negotiations aimed at establishing an EU-Japan FTA. This resolution in effect called on member states not to approve the start of formal negotiations until the European Parliament had expressed its intentions. The reason for this was that many parliament members doubted whether Japan would show any progress in dismantling NTBs or sectors for government procurements. In these circumstances, the European Commission adopted in July 2012 a draft mandate for opening FTA negotiations with Japan.[10] It is difficult to predict whether FTA negotiations will be launched, or the course they will follow should they actually get under way. At least one thing is certain: the start of FTA negotiations is now on the formal agenda for discussion by these two regions.

The beneficial effects of an EU-Japan FTA

If an EU-Japan FTA were established, what benefits or other effects might it be expected to have? Before dealing with this issue, a preliminary matter needs to be tackled: Does the EU actually have any scope for expanding its exports to Japan, whether an FTA is established or not?

As already observed, pharmaceuticals, chemicals and automobiles are currently among the top five categories of exports from the EU to Japan. With respect to automobiles, it is anticipated that Japan will experience an expansion in domestic sales of imported models from the EU in the years ahead. In fact, according to

[8] Lack of transparency in public procurement, and problems relating to intellectual property rights (IPRs) are examples of non-tariff barriers (NTBs) in Japan, which the European Commission has pointed out. However, the Japanese government has insisted there are NTBs on the EU side, such as differences between the EU and Japanese regulatory systems and technical standards. See European Commission (2012).

[9] 20th EU-Japan Summit, Brussels, 28 May 2011, Joint Press Statement: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/EN/foraff/122303.pdf

[10] Commission proposes to open negotiations for a Free Trade deal with Japan, Brussels, 18 July 2012. http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/810&format=HTML&aged=0&language=EN&guiLanguage=en

the Japan Automobile Manufacturers Association, imported European automobiles have continued to account for a growing share of Japan's domestic automobile market for some years now. This domestic market share reached a record 4.6% in 2011, up from 3.3% in 2009. This was due partly to substitution of Japanese domestic automobiles with foreign-made ones, with the supply chain disruption of the Japanese automobile industry caused by the Great East Japan Earthquake. However, Japan has witnessed uninterrupted expansion in the number of European car dealerships in operation nationwide. These dealerships numbered 755 in 1996, but by 2011 the total had increased to 1,302. In effect, European car sales in Japan have continued to grow despite a general slowdown in sales of domestic models. One background factor of influence is increased awareness among Japanese consumers of the importance of fuel efficiency. Especially noteworthy is the growth in sales of diesel-powered cars. Diesel engines traditionally have been viewed as a source of environmental pollution in Japan. In fact, by units sold, diesel-powered cars accounted for just a 0.3% share of all new-car sales in Japan in 2011. This is one of the reasons why Toyota and other Japanese carmakers have focused on the manufacture and marketing of hybrid models that combine the use of batteries with gasoline engines. In contrast, as one outgrowth of technological innovations, diesel-powered automobiles in the EU are now considered to be symbols of the "fuel-efficient car".

Having fallen behind in the development of diesel engine technology, Japanese carmakers will have no choice but to pursue alliances with their counterparts in the EU. As noted above, however, EU carmakers have been ramping up efforts to sell more of their cars in Japan.

Drugs and chemicals comprise another major category of imports from the EU. In view of the rapid ageing of Japan's population, the growth trend in domestic demand for pharmaceuticals seems certain to continue. Another key point is that most Japanese companies in this sector typically lack competitiveness within the international market setting. According to the European Commission (2009), Japan's pharmaceutical trade deficit has widened from 2,233 million euro in 1995 to 4,259 million euro in 2007. On the other hand, the European trade surplus in this sector widened from 5,621 million euro to 31,976 million euro in 2007. Iwai and Yagi (2011) noted that Japanese industry in the sector does not have enough international competitiveness and pointed out that one reason for this, in spite of R&D activities, is insufficient collaboration with venture capital with high technology in the new bio-pharmaceuticals.

It is also worth noting that imports from the EU can be expected to grow because of the relative strength of the yen against the weakened euro. In mid-2008, the euro traded at 168 yen. At the end of June this year, it had fallen to around 100 yen. On Japan's domestic market for consumer goods, the prices of EU products have not yet fallen at a pace commensurate with trends in the exchange

rate. With time, however, it is anticipated that these prices will increasingly reflect the lower value of the euro and contribute to stronger growth in domestic sales of EU products.

The foregoing observations support projections of conspicuous expansion in imports from the EU in the near future. However, the establishment of an FTA would ensure that EU product imports are duty-free; some import categories are still subject to rather high tariffs – such as agricultural products and processed foods (e.g. butter and cheese). Japan imposes low tariff rates on imports of industrial goods. In fact, as of 2010, only 33% of all goods imported from the EU were subject to import duties.[11] Furthermore, as observed above, import duties have already been eliminated for automobiles, pharmaceuticals and other, selected import categories. Nonetheless, to foster growth in imports from the EU, it will be important to eliminate the duties that still apply to the remaining 33% share of those imports – for example, agricultural products and processed foods.

In this context, what significance would an EU-Japan FTA have for Japanese companies? Being able to export goods duty-free into the EU would certainly be a boon for most Japanese firms. However, as discussed above, most of the important industries to which this might matter have already set up new manufacturing bases in the EU itself. As a consequence, they are unlikely to enjoy any enormous benefit from an FTA given that Japanese exports to the EU are increasingly in the form of semi-finished goods or components rather than finished goods. On the other hand, Japanese consumers would value the wider choice of merchandise that could be expected with access to more EU-manufactured goods. In any event, drawing from the perspectives of globalization, we outline below some of the benefits that Japanese companies could expect from an FTA.

We will divide Japanese companies into three categories: domestic companies, exporting companies, and companies that both export goods and participate in FDI. Comparisons of these categories in terms of productivity reveal that productivity tends to be lowest among domestic firms, followed by export-oriented firms, and highest among firms that engage in exports and FDI (Fig. 1).[12] In other words, a positive correlation is observed between the productivity of a company and its level of internationalization. Many investigators assume this pattern to be the same for Japanese, US and European companies alike.[13]

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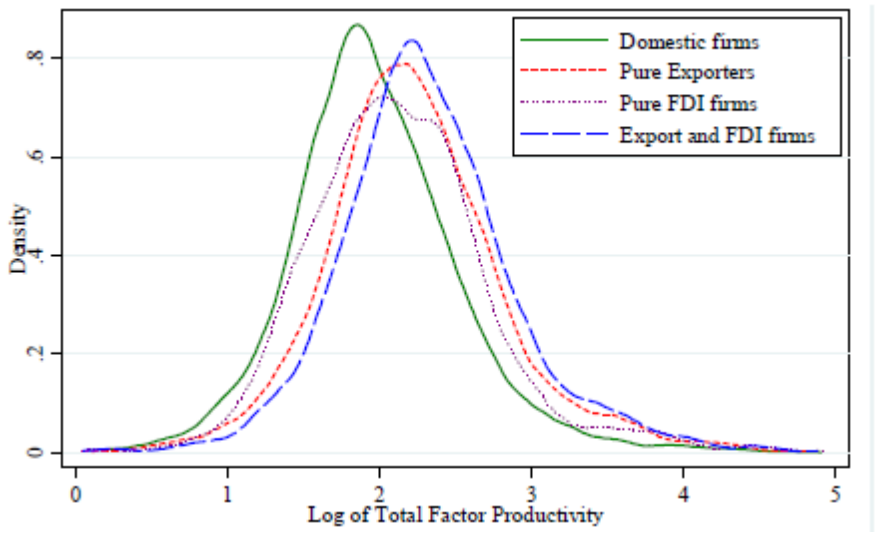
[11] See the website of the Ministry of Foreign Affairs, Japan: http://www.mofa.go.jp/mofaj/area/eu/pdfs/index-tokei.pdf

[12] This analysis is based on Wakasugi, Todo *et al.*(2008).

[13] In any country, domestic industries with low productivity tend to request protective measures and to oppose FTAs. In Japan, the agriculture and construction sectors are examples of such vulnerable domestic industries, while the automobile and

Among the pioneering investigators in this field, Melitz (2003) makes several assertions, as follows. Although correlations of this kind can be observed between levels of productivity and corporate internationalization, the causal relationships appear to have two theoretical sides. First is the thesis that high productivity leads to internationalization; this is termed a hypothesis of "self-selection". In essence, only companies that have achieved high standards of productivity and the ability to absorb the heavy fixed costs associated with the establishment of offshore manufacturing bases can be expected to carry their business to the international level. However, the reverse causal relationship is also plausible. That is, companies that internationalize their operations are better positioned to achieve high levels of productivity. This is known as the "learning by exporting" hypothesis.[14]. For example, a company that competes with or forms tie-ups with its foreign counterparts might be better positioned to benefit through technology transfers or synergistic effects in technology-related areas. Doing business with corporate partners focused in other fields or hiring employees from diverse backgrounds may help a company to better streamline or decentralize its decision-making processes, thus creating a more efficient organization.

Figure 1: Distribution of total factor productivity among Japanese firms



Source: Todo, Yasuyuki (2009), Quantitative Evaluation of Determinants of Export and FDI: Firm-level evidence from Japan, RIETI Discussion Paper Series 09-E-019, p.24

electronic industries are competitive and international-oriented ones, which support FTAs.

[14] Ito, K. (2012).

To date, the findings from most empirical studies appear to lend support to the "self-selection" thesis. However, in some cases, Japanese companies have experienced accelerated gains in productivity once they moved their operations to the international level. This suggests that internationalization creates a favorable momentum or setting, thus supporting the "learning by exporting" thesis.[15] In other words, the reality may lie somewhere between these two explanations and involve causal influences from both directions. Thus, at the investment stage, gaps in productivity may already distinguish an internationally oriented firm from its domestically oriented rivals, but those gaps will widen over time.

It is possible to arrive at the same conclusion from an entirely different angle. One key goal under the Europe 2020 strategy is to boost research and development (R&D) spending in the EU to a level equivalent to 3% of regional GDP – a level commensurate with R&D spending in Japan. However, Japan's economy has experienced a decline in growth potential despite its active investments in R&D. In other words, the benefits of R&D spending in Japan have not been mirrored by gains in latent growth potential. Needless to say, a number of factors affect Japan's economic growth (e.g. demographic trends). However, here we will focus on the relation between Japan's innovation ability and growth potential.

This observation is amenable to a variety of analytical interpretations. As part of one hypothesis, the following points are cited.

Table 4: Percentage of firms with international research consortia (%)

Denmark	**Belgium**	**UK**
14.8	13.3	7.7
Germany	**France**	**Japan**
4.8	6.2	2.8

Source: OECD (2009), *Innovation in Firms: A Microeconomic Perspective* (survey conducted 2002–2004)

Table 4 illustrates OECD findings on the creation of international consortiums within corporate centres for research and development. In Japan, only 2.8% of all private corporate R&D facilities had put together international consortiums. In Denmark and Belgium, the percentage was well over 10%.

[15] Wakasugi, R., Todo, Y. *et al* (2008) and Ito, K. *op.cit.*

These findings permit the conclusion that a pattern of productivity gains will be evident among companies led by engineers with extensive foreign experience or that have programs of exchange that allow their engineers to collaborate with their counterparts abroad, thus enabling these companies to boost their levels of internationalization. There are a number of other factors behind productivity gains, such as degree of specialization, or technological progress.[16] One issue for this process, however, will be the degree of exchange involving corporate engineers or even executives. If the EU and Japan succeed in signing an FTA, that development will likely foster heightened flows of personnel. Furthermore, if such exchange gains serious momentum, it can be expected to provide benefits not only for Japanese companies but EU companies as well.[17]

The Japanese government should, through its own initiatives, make efforts to reduce all kinds of trade barriers in order to raise Japanese productivity by introducing more competition. It is to be noted that international negotiations sometimes have a positive impact on domestic policy formation.[18]

[16] Otsuka (2011) pointed out that one of the major factors behind the declining Japanese competitiveness is an inefficient R&D system, especially insufficient research cooperation.
Yamaguchi (2007) also insists that, in a period of uncertainties over R&D activities, forming international consortia is important to reduce risks, and that Japanese firms have not yet succeeded in doing this.

[17] One of the most recent examples is the BMW-Toyota strategic partnership. The two companies will jointly develop more sophisticated fuel-cell technology, electric vehicle technologies and an all-new sports car. See the *Nihon Keizai Shimbun* (*Japan Economic Journal*), June 29, 2012.

[18] Putnam (1988) shows that international and domestic negotiations influence each other through his Two-Level Games theory. See his: Diplomacy and Domestic Policy: the Logic of Two-Level Games.

Conclusions

One trilateral view of the world divides it into three major poles or centres – usually in reference to the US, the EU and Japan. These three regions account for 57.6% of world GDP (2010). However, China in recent years has made stunning economic gains and in 2010 surpassed Japan in terms of GDP. By some accounts, this achievement signals that the world has entered the era of the "Group of Two" or "G-2", defined by a special relationship between the US and China.[19] Neither Japan nor the EU has any part in that relationship.

However, in any discussions of foreign relations, it is not enough to rely solely on an analysis of purely economic dimensions. The EU and Japan share a common set of values, as shown in their commitment to democracy, free-market economic systems, respect for human rights, and the rule of law. For that reason, it is imperative that they reinforce their ties of cooperation on a range of global issues, from environmental problems and the stability of international currency markets to the global war on terror. For example, the EU and EU member states are confronted by a serious crisis in the euro. The impact of that crisis is far-reaching and could threaten to spark a broader crisis for the international financial system. Against this backdrop, discussions have begun within the IMF on the issue of additional injections of liquidity as a measure to counter any increase in the severity of the euro crisis. As an outgrowth of this development, on 20 April 2012 the Washington, D.C. conference of G-20 finance ministers and central bankers concluded with a joint declaration pledging an increase of $430 billion in funding for the IMF. At the outset of negotiations over this funding, Japan took the initiative by pledging a $60 billion contribution, the largest amount offered by any single country outside the Eurozone. This is but one example of cooperation between the EU and Japan. Furthermore, the Japanese government has continued to purchase European Financial Stability Facility bonds.

If they are to collaborate more effectively on issues of global scale, it is essential that the EU and Japan pursue progress in their own mutual relationship. However, as stated above, there are signs that their economic ties and specifically their ties in the arenas of trade and investment are actually waning. To revitalize those ties and

[19] Originally proposed by C. Fred Bergsten (2005).

contribute jointly to global advancement, the EU and Japan face the necessity of forging an FTA and thus promoting the heightened exchange of human resources, goods, services and capital. It is clear that an FTA could benefit both economies.[20]

As multilateral trade negotiations at the WTO seem to be in stalemate, regional economic integration should be regarded as an alternative to promote global trade liberalization. In fact, Japan is now under considerations to take part in negotiations about a Trans-Pacific Partnership (TPP) and a tripartite FTA between China, Korea and Japan, besides the proposed EU-Japan FTA. Although there are some differences, these are, by nature, complementary to each other, from the viewpoint of global trade liberalization.[21]

[20] According to the European Commission, the FTA would increase the EU's GDP by 0.34% to 1.88% and Japan's GDP by 0.27% to 0.67% by 2020. European Commission (2012), p.37.

[21] At the negotiations of the TPP and the tripartite FTA, one of the top issues for Japan is to what extent the agricultural sector should be liberalized, while in an EU-Japan FTA, NTBs are, as we have seen, at the top of the agenda.

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