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# Mizuho Economic Outlook & Analysis

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## *Significance of the Japan-EU EPA – The Agreement in Principle Restart of Japan's trade strategy*

### < Summary >

- ◆ The Agreement in Principle of the Japan-EU EPA negotiations was reached at the Japan-EU Summit held on July 6. Going forward, Japan and the EU intend to reach an agreement on the remaining issues by the end of this year and aim to bring the agreement into effect in early 2019.
- ◆ The Agreement in Principle is significant for the three following points: (1) it establishes a huge economic zone by Japan and the EU, (2) it promotes cooperation between Japan and the EU in global rules formation based on the EPA, and (3) it restarts Japan's trade strategy triggered by the agreement.
- ◆ As a result, Japan has gained leverage to guide the negotiations on TPP11, RCEP and the Japan-U.S. Economic Dialogue in a direction favorable to Japan. To begin with, we expect Japan to play a leading role in the early conclusion of the TPP11 and RCEP negotiations.

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## 1. Three significant points of the Japan-EU EPA – The Agreement in Principle

At the Japan-EU Summit held on July 6, the EU (European Union) and Japan reached The Agreement in Principle on the main elements of the EU-Japan EPA (Economic Partnership Agreement).<sup>1</sup> Japan and the EU intend to reach an agreement on the remaining issues by the end of this year and aim to bring the agreement into force in early 2019.<sup>2</sup>

The conclusion of the Agreement in Principle is significant in three main aspects. First, the realization of the Japan-EU EPA will give Japan easy access to the EU market<sup>3</sup> comprised of 500 million people and GDP worth 16.4 trillion USD. This will stimulate reciprocal trade and investment activities between the two regions, forming an enormous economic zone accounting for about one-third of the global economy. In particular, the EU imposes relatively high tariffs on Japan's major export items, such as automobiles, compared with other developed countries, though it has eliminated such tariffs on trade with South Korea based on the EU-South Korea FTA (Free Trade Agreement). Formation of the Japan-EU EPA is expected to enable Japanese carmakers to secure the same competitive conditions as South Korean companies within the EU region.

Second, we expect that cooperation between Japan and the EU in the process of establishing various rules, including regulations and standards, will progress based on the Japan-EU EPA. Japan aims at turning regulations and standards desirable for Japan into global norms by collaborating with the EU, which possesses strong influence on the establishment of international regulations and standards, and the Japan-EU EPA is anticipated to serve as a platform.<sup>4</sup> The EU also considers the Japan-EU EPA to be effective and significant as seen in their close collaborative relations in international regulatory and standardization bodies and in cooperation to tackle global issues such as

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<sup>1</sup> The Japanese government used to aim at reaching an "agreement in principle," but after the autumn of 2016, the expression was changed to an "agreement on fundamental elements." The two terms "agreement in principle" and "agreement on fundamental elements" have no clear definitions, but in recent years the term "agreement in principle" is often used in the case where only technical matters remain until finalizing and signing the agreement. For "agreement on fundamental elements," the Japanese government has provided the following explanation: "The term has no general and established definition, and its meaning may vary depending on the counterparty and the contents of the negotiations; but in the case of the EPA negotiations between Japan and the European Union (EU), we consider the "agreement on fundamental elements" to mean a condition where the two parties agree on the basic elements of the negotiations, and Japan and the EU share a common recognition concerning this matter." (The government's written answer [January 6, 2017, Naikaku San Shitsu 192, no. 113]) on the memorandum on questions by Yasue Funayama, a member of the House of Councillors (Japan) in the Diet [submitted on December 16, 2016, question no. 113]. It should be noted that the EU calls this agreement an "agreement in principle."

<sup>2</sup> With a view to putting the EPA into effect, the EU needs to obtain the approval of each EU member country's government, the European Parliament, the parliaments of all member countries, and a part of the regional parliaments (mixed agreement). Nonetheless, in areas where the EU has exclusive authority, such as customs tariffs, agreements may come into effect with just the approval of the EU member governments and the European Parliament.

<sup>3</sup> Population and GDP include the UK.

<sup>4</sup> For example, refer to Keidanren's "Recommendations for Japan-EU Regulatory Cooperation – Looking beyond concluding the EPA/FTA –," March 17, 2015.

global warming.<sup>5</sup> At present, Japan and the EU hold industrial dialogues in such sectors as automobiles, chemicals, information and communication technology (ICT), medical equipment, pharmaceuticals and textiles to further advance regulatory cooperation, and the Japan-EU EPA is expected to “serve as the institutional foundation for regulatory cooperation.”<sup>6</sup>

Thirdly, given the Agreement in Principle, Japan can clarify its position in tackling protectionism in collaboration with the EU, support the free trade system, and restart its trade strategy. With the US withdrawal from the TPP (Trans-Pacific Partnership), Japan has been compelled to reexamine its trade strategy positioning the TPP as a main pillar. However, the Agreement in Principle provides a good opportunity for Japan to advance negotiations on TPP11 (without the US), RCEP (Regional Comprehensive Economic Partnership), and the Japan-U.S. Economic Dialogue simultaneously, and to promote economic integration of the Asia-Pacific region that envisages the US returning to the TPP on a medium term perspective.

Although tariff negotiations were the center of attention in the final phase of the Japan-EU EPA talks, we should also focus on the strategic significance of this agreement, as mentioned above.

## **2. Focal points of The Agreement in Principle**

At the time of this writing, details of The Agreement in Principle had not been disclosed. Therefore, we can only indicate some of the focal points based on the materials made public by the Japanese government<sup>7</sup> and the European Commission.<sup>8</sup>

### **(1) Trade in goods market access**

Concerning tariffs, according to the document from the EU side, Japan will liberalize 91% of its imports from the EU (86% on a tariff line basis) at the agreement’s entry into force, and at the end of the staging period (after 15 years), 99% of its imports from the EU will be liberalized (97% on the same basis as above), while the remaining 1% will be partly liberalized through quotas and tariff reductions.

The EU will liberalize 75% of its imports from Japan (96% on a tariff line basis),

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<sup>5</sup> European Commission, “Trade for All: Towards a more responsible trade and investment policy,” October 2015.

European Commission, “A New EU trade agreement with Japan,” 1 July 2017.

<sup>6</sup> Keidanren and BusinessEurope, “Joint Statement for EU-Japan Regulatory Cooperation,” December 13, 2016.

<sup>7</sup> Ministry of Foreign Affairs Economic Affairs Bureau, “Factsheet on the Japan-EU Economic Partnership Agreement (EPA),” July 6, 2017, and Ministry of Agriculture, Forestry and Fisheries, “Summary of agricultural, forest and fishery products in the Japan-EU EPA Agreement on Fundamental Elements,” July 6, 2017, among others.

<sup>8</sup> European Commission, “EU-Japan EPA – The Agreement in Principle,” July 6, 2017, among others.

rising over 15 years to near 100% (99% on the same basis as above).

It should be noted that the only items fully excluded from tariff liberalization mutually are rice and seaweeds.

With regard to Japan's importation of agricultural goods, while the degree of liberalization was limited for some product lines, such as rice, since they were fully excluded from liberalization, unlike in the TPP where Japan established import quotas with the US and Australia, Japan has promised a higher degree of liberalization compared with the TPP for other lines such as dairy products and processed agricultural products. Notable examples include wines and aromatized wines (current tariff rate: 15% tariff or 125 yen/L, whichever is lower). Although they were to be liberalized within eight years under the TPP, Japan has promised to liberalize tariffs on imports from the EU immediately after the agreement's entry into force. Furthermore, for pasta (spaghetti/macaroni, current tariff rate: 30 yen/kg), while Japan pledged to lower the tariff rate to 12 yen/kg over a 9-year period under the TPP, it has promised under the Japan-EU EPA to fully liberalize tariffs over 11 years after entry into force. For cheese (current tariff rate: 29.8%, etc.), which was said to be the largest point of contention, the agreement provides for full liberalization of tariffs on hard cheeses (such as Cheddar cheese, Gouda cheese etc.) over 16 years after entry into force, just like in the TPP agreement. On the other hand, for soft cheeses (such as Camembert cheese, etc.), meaningful access has been granted through tariff rate quotas (20,000 tons in the first year and 31,000 tons over 16 years) across various items whose tariffs were maintained under the TPP (Camembert cheese, Mozzarella cheese, etc.), in addition to items whose tariffs were reduced (blue-veined cheese) or totally eliminated (powdered cheese, etc.). Tariff rates for the items within these quotas will be reduced gradually over time and fully eliminated over 16 years after entry into force (refer to the **Chart**).

**Chart: Japan's commitment on trade in goods market access (soft cheeses)**

Type of cheese		TPP agreement	Current tariffs	Quota's quantitative threshold and in-quota rate	Out-of-quota rate
Natural cheese	Cream cheese (with over 45% milk fat), Mozzarella cheese, etc.	Tariffs maintained	29.80%	- Quota's quantitative threshold 20,000 tons (first year) →31,000 tons (after 16 years)  The quantitative threshold after 17 years will be determined based on the cheese consumption trend in Japan.	To be maintained at the current level
	Blue-veined cheese	Tariffs reduced	29.80%		
	Soft ripened cheese (Camembert cheese, etc.)	Tariffs maintained	29.80%		
Processed cheese	Shredded cheese	Tariffs eliminated	22.40%	- In-quota rate The rate will be reduced gradually and fully liberalized over 16 years.	
	Grated and powdered cheese (processed cheese)		40.00%		
	Processed cheese	Tariff rate quota	40.00%		

Source: Taken from p.8 of the "Summary of agricultural, forest and fishery products in the EU-Japan EPA The Agreement in Principle (1) (imports from the EU)" (July 2017), Ministry of Agriculture, Forestry and Fisheries (English translation by MHRI).

As for industrial goods, 77.3% of Japan's imports from the EU are currently tariff-free, and this rate will be raised to 96.2% at the time of entry into force of the Japan-EU EPA and rise to 100% in the final phase.

Currently, 38.5% of the EU's industrial goods imported from Japan are tariff-free, but this proportion will be raised to 81.7% at the time of entry into force of the Japan-EU EPA and ultimately rise to 100%. As for passenger cars, which have been the focus of attention (current tariff: 10%), tariffs will be eliminated over 8 years, while the tariff on car parts (current tariff: 2.7% to 4.5%) will be eliminated immediately for 92.1% of the imports from Japan. With regard to agricultural goods and processed food, immediate elimination of tariffs has been promised for such items as seasonings, including soy sauce (current tariff: 7.7%, etc.), green tea (current tariff: 3.2%), beef (current tariff: 12.8% + 141.4 to 304.1 euro/100 kg), and alcoholic beverages (current tariff: tariff-free to 32 euro/100L). Nevertheless, there exist many tariff lines whose imports from Japan are not permitted, such as pork, chicken, chicken eggs and dairy products. To expand Japan's exports to the EU, it is essential to lift the import ban on the EU side as well as to relax or abolish non-tariff barriers.

It should be mentioned that the Japan-EU EPA includes a section on cooperation in areas of agriculture, forestry, fisheries and food. This section stipulates the promotion of agricultural, forestry and fishery products trade between Japan and the EU, cooperation in terms of regulations, and technical cooperation, among others.

## (2) Automobiles

For automobiles and other vehicles, in addition to the EU's elimination of tariffs on passenger cars, as mentioned earlier, the EU presented their document on Non-Tariff

Measures (NTMs) and regulations on Product Specific Rules of Origin (PSR).

For NTMs, an auto annex has been established between Japan and the EU to ensure cooperation and joint work in setting international standards. In addition, it applies UNECE (United Nations Economic Commission for Europe) Regulations as its regulations/standards, with a safeguard clause allowing the EU to snapback tariffs on affected products in case Japan stops applying UNECE Regulations or reinstates the removed NTMs.

The PSR for passenger cars (HS heading 8703) stipulates that the maximum NOM (Non-Originating Material) be 45% (EXW), but there is a staging period of six years during which the threshold is set at 55% maximum NOM for the first three years and at 50% maximum NOM for the following three years after the agreement's entry into force.

### **(3) E-Commerce**

Regarding e-commerce, the “non-imposition of customs duties on electronic transmissions,” etc. has been included, just like in the TPP. However, concerning the “three TPP principles,” which are (1) freedom of cross-border transfer of information by electronic means, (2) prohibition to request installment or utilization of computer-related equipment, and (3) no requirement to transfer or provide access to source codes, only (3) has been provided for. For (1), there is a review clause whereby both sides undertake to revisit the issue three years after the agreement's entry into force.<sup>9</sup>

### **(4) Government procurement**

In the area of government procurement, both Japan and the EU are parties to the WTO Government Procurement Agreement (GPA) and thus have opened mutual procurement regarding certain entities over certain amounts.<sup>10</sup> Japan has also pledged to open its market to the same extent in the TPP as was agreed under the WTO GPA.

Regarding sub-central government entities, Japan was committed to open covered procurements in 47 prefectures and 20 government-ordinance-designated cities in the WTO GPA and TPP. However, in the Japan-EU EPA, Japan has accepted procurement in 48 “core cities”<sup>11</sup> covered under the Agreement for the first time. Nonetheless, for these core cities, Japan has excluded construction services, stating that “while construction company location continues to be a selection criterion for participating in the bidding process, it has allowed EU suppliers to be included.” Although the amount

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<sup>9</sup> On this point, during this Japan-EU summit the “joint declaration on the cross-border transfer of personal data” was released. Also, according to the document compiled by the Ministry of Economy, Trade and Industry, (2) was also included as a subject of review.

<sup>10</sup> The revised WTO GPA took effect on April 6, 2014 after the adoption of the “protocol amendment” on March 30, 2012. In Japan, the agreement entered into force on April 16, 2014.

<sup>11</sup> “Core cities” refer to 48 cities of at least 200,000 inhabitants.

subject to this new rule has not been revealed, then-Minister for Internal Affairs and Communications Sanae Takaichi explained that the Japan-EU EPA regulations do not provide for the “expansion of WTO rules to core cities,” but for the “application of special rules to a certain level of bidding in core cities, and therefore the impact on the regional economy is expected to be quite limited.”<sup>12</sup>

Furthermore, Japan has newly included local incorporated administrative agencies established by prefectures or government-ordinance-designated cities as subject to the new rule. In terms of procurement targeting railways facilities, on which the EU has placed emphasis, Japan included “procurement related to operational safety,” which was excluded in the WTO GPA and TPP. The EU in turn has opened procurement for an amount corresponding to the estimated value of Japanese contracts “freed” by the removal of the operational safety clause.

### **(5) Remaining issues**

Although it is not clear what remaining issues exist, the “Investor-State Dispute Settlement” (ISDS) is notable as one still under negotiation. Since Japan had always adopted the conventional ISDS in the TPP and EPA/investment agreements thus far, Japan insists on continuing to use the conventional ISDS in the Japan-EU EPA. But the EU rejects the conventional ISDS as old-style and instead has proposed adopting the Investment Court System (ICS).<sup>13</sup> The EU has already implemented ICS in its FTAs with Vietnam and Canada, and is strongly requesting that Japan adopt this system.

### **3. Restart of Japan’s trade strategy**

Prior to the inauguration of the Trump administration, Japan engaged in simultaneous negotiations of the TPP, RCEP and the Japan-EU EPA, which are interconnected mega free trade agreements. However, while the US withdrawal from the TPP has darkened prospects for TPP to take effect, the US has already begun the Japan-U.S. Economic Dialogue as it favors bilateral negotiations over multilateral treaties. This has prompted Japan to reconsider its trade strategy. We can probably say that the Agreement in Principle of the Japan-EU EPA has prompted a restart of Japan’s trade strategy. Given this agreement, Japan has gained leverage to direct the TPP11, RCEP and Japan-U.S. Economic Dialogue talks in a direction favorable to Japan.

Immediately after the agreement was reached, the National Pork Producers Council

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<sup>12</sup> Ministry of Internal Affairs and Communications, “Summary of the press conference by then-Minister for Internal Affairs and Communications Sanae Takaichi held after the Cabinet meeting,” July 7, 2017.

<sup>13</sup> The ICS is a two-tier permanent court system. The EU also plans to establish a common multilateral investment court in future with countries that have adopted ICS.

(NPPC) in the US expressed concern over losing share in the Japanese market after the Japan-EU EPA takes effect and asked that the Japan-US trade agreement be concluded as early as possible.<sup>14</sup> Canada, which has adopted a prudent approach to the development of TPP11, competes with the EU in terms of pork exports, etc. to Japan, and we anticipate more people in the country requesting the conclusion of an FTA with Japan. By taking advantage of rising domestic pressure in the US and Canada to improve access to Japanese markets, Japan should aim at early conclusion of TPP11 and work to invite the US back into the TPP agreement through the Japan-U.S. Economic Dialogue. Once TPP11 begins to move forward, it may also stimulate early conclusion of the RCEP negotiations. By using the Agreement in Principle of the Japan-EU EPA as leverage, Japan can press ahead with a trade strategy that focuses on propelling mega FTA negotiations, and bring the US back into the TPP.

The realization of this scenario will be difficult. But if we compare the current situation with that before concluding the Agreement in Principle of the Japan-EU EPA negotiations, we can say that its possibility has improved. To begin with, Japan is expected to play a leading role in the early conclusion of the TPP11 and RCEP negotiations.

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<sup>14</sup> National Pork Producers Council, "EU Strikes a Trade Deal with Japan: U.S. Must Do Likewise, Says NPPC," July 6, 2017.