A BETTER FIT

REMODELLING THE EU-JAPAN EPA AFTER BREXIT

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The summary of the policy recommendations set forth in this paper are as follows:

- The UK must prioritise renegotiating the EU-Japan EPA. With nearly 100,000 jobs sustained by Japanese businesses in the UK, and as the world’s second most active (and a growing) actor in global M&A, Japan’s growing importance as a source of investment and jobs is comparable to that of the United States.

- Japan’s preference for a renegotiation of the EU-Japan EPA, rather than a direct transition, is also in the UK’s interest. The EU-Japan EPA is not tailored in favour of UK interests: we estimate that it affords the UK bilateral gains that are only 50-60% of the average gains secured for the other EU27 countries.

- As a result, the quid pro quo achieved under the EPA is poorly suited for the UK. On two key negotiating areas – namely digital trade and investment protection – the UK shares common economic interests and opportunities with Japan:
  - On cross-border data flows, the UK is well placed to agree to Japan’s model FTA texts that are likely to be based on CPTPP, as GDPR cannot be challenged under CPTPP. Neither do such commitments contradict a future adequacy decision with the EU. UK objectives should be to supersede Japan’s level of ambition by removing the sectorial exceptions on financial services.
  - On investments, Japan is keen to include provisions on non-discrimination for its investors, especially in the light of possible rising legal and political risks in the UK. Japan has also a preference for a dispute-settlement mechanism that is more cost-efficient than EU inventions like ICS and MIC, especially as Japanese businesses and wholly-owned subsidiaries have never used the mechanism to challenge a government.

- In addition, the UK must be ready to match the EU concessions on mode 4 supply of services (via movement of natural persons). The concessions include intra-corporate transferees, services providers, short-term visitors, investors – and their spouses and children. If not, neither renegotiation nor transition should be attempted at all with Japan.

- A renegotiation of the EU-Japan EPA between the UK and Japan is most likely a necessary confidence-building exercise to open up regulatory cooperation, including equivalence decisions on financial services that would allow multinationals to operate cross-border with centralised functions or staff. It is also a necessary stepping stone in case the UK attempts to accede to CPTPP, as many of Japan’s model FTA texts are based on it.
INTRODUCTION

As the United Kingdom leaves the European Union, efforts are being made to ensure that UK-based firms continue to have a stable foundation for business operations. Sometimes the best way to meet these challenges may be to replicate existing EU negotiated trade arrangements with key trade partners – but not in the case of Japan.

The UK should not simply attempt to replicate the existing trade deal the EU has recently struck with Japan, as it would not meet the needs or interests of the UK or Japan. The EU-Japan Economic Partnership Agreement (EPA) excludes a number of issues of importance to the UK and Japan. Several important areas of offensive interest to both the UK and Japan had to be carved out of the EPA due to sensitivities in a few EU Member States or the competence issues in the EU.

WHY THE UK MUST PRIORITISE JAPAN

The list of potential trade deals for the UK is long. There are two strategies toward these that may appear tempting, but may also be more problematic. Firstly, simply replicating existing EU trade deals can deliver sub-optimal outcomes for the UK, as the UK does not have the same interests or concerns as the EU as a whole. Secondly, while accession to a larger regional arrangement can look attractive, as it appears to “instantly” give greater access in one shot, it can also be more difficult, as managing expectations with multiple partners can take considerable time, effort and resources. This is not to say that regional trade agreements (RTAs) should not be pursued – but rather that RTAs like CPTPP are constructed as several bilateral agreements on market access that are tied together by a common set of rules. Therefore, a revised Japan-UK agreement is also a keystone for a credible approach to a CPTPP accession.

For these reasons, the UK should adopt a more considered strategy than either automatically "rolling over" (i.e. "transitioning") existing EU FTAs or seeking to instantly sign on to regional agreements. The benefits of engaging with specific partners has to be reflected in the short, medium and long term and gauged against the costs of negotiating in time and effort.

Japan quickly emerges as an essential partner for the UK on nearly all counts. Although frequently flying “under the radar”, Japan remains the world’s third-largest national economy after the United States and China. While Japan’s market is quite open — and very open compared to most of the rest of Asia — there are still gains to be had from smart trade agreements, as Japan continues to keep pockets of overregulation.

The benefits from these can be substantial. Return on investment in Japan delivers twice the growth of investment available to investors into the EU. While tariffs are generally low, Japan has a few, but significant, tariff peaks. Regulatory divergences in the services market (especially on financial services) are problematic, especially for a services exporter like the UK. E-commerce and digital trade rules matter, particularly given the importance of services, high-end retail and the role of IT-systems to manage overseas market presence or investments.

Perhaps more importantly, Japan is also a key contributor to the UK’s domestic economy. Over 1,000 Japanese companies are operating in the UK, expanding into advanced manufacturing, infrastructure, financial services and R&D. According to the most recent report from the Ministry of Economy, Trade and Industry (METI), Japanese companies sustained 96,600 jobs in the UK by the second quarter of 2019. Japanese multinationals still employ more workers in the UK than in any other European country, and the number of employees in the UK has also increased since June 2016. According to UK statistics on inward FDI, the amount of investment brought in is close to £60 billion as of 2016, second to the US among non-European countries.

In addition to direct (greenfield) investments, Japanese businesses have acquired numerous UK companies. In 2017, the number of merger and acquisition (M&A) transactions in which Japanese companies were involved was the highest number ever recorded – valued at £6.5 trillion (£47 billion). Since 2018, Japan has overtaken China in outbound M&A volumes with 649 acquisitions, ranking second following the United States.

Labour force, infrastructure, financial services and R&D will also be important factors to consider in any future agreement. Over 1,000 Japanese companies are operating in the UK, delivering twice the growth of investment available to investors into the EU. The benefits from these can be substantial. Return on investment in Japan delivers twice the growth of investment available to investors into the EU. While tariffs are generally low, Japan has a few, but significant, tariff peaks. Regulatory divergences in the services market (especially on financial services) are problematic, especially for a services exporter like the UK. E-commerce and digital trade rules matter, particularly given the importance of services, high-end retail and the role of IT-systems to manage overseas market presence or investments.

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This is a trend which continues to be ongoing as the domestic pressure for higher shareholder value continues to intensify in Japan, which incentivise investments overseas. The Japanese Corporate Governance Code was also amended in 2017 for greater transparency on the cost of capital in business portfolios, which led to more M&A activities overseas. In the meantime, the UK remains the second largest target nation for cross-border activity, despite the remarkable decline of 51% year-on-year.

Recent and notable examples of Japan-UK M&As include SoftBank’s acquisition of ARM Holdings for approximately £24bn, which marks the largest acquisition of European business by a Japanese company. In January 2019, Takeda completed the acquisition of Shire for $US 65 billion which made Takeda a global bio-pharmaceutical leader headquartered in Japan.

Japan also plays an outsized role in setting the rules for trade in Asia and globally. In addition to its leadership role in the CPTPP, Japan has also been an important player in the Regional Comprehensive Economic Partnership (RCEP) trade negotiations which will kick together 16 countries in Asia. Japan is currently the second-largest investor (behind Singapore) across the ten member states of Southeast Asia, with critically important supply chains that have to kick together the region.

Finally, the EU-Japan EPA will create competitive pressure on UK firms on some limited products.


Still, the short-run effects will be largely manageable as EU preferences are often in sectors where the UK economy is less affected, like a variety of agricultural goods market access. Also, some of Japan’s commitments are not implemented on a preferential basis for the EU only: for example, the revisions to pharmaceutical laws, customs clearance and motor vehicle standards automatically benefit any firm entering the market that are compliant with the same standards.

### UK NEGOTIATING INTERESTS WITH JAPAN

Japan is, therefore, a highly desirable target market for the UK: a critical source of capital; and an indispensable partner for industrial cooperation and R&D. Like any entity that negotiates a trade agreement with a major economy like Japan, the UK must carefully assess its priorities to ensure that the final deal best matches its national interests. However, the UK sectoral interests do not necessarily overlap with those of the EU Member States. Although the UK is presently relatively short on negotiation resources and political capital, it should not simply assume that the default option of transitioning the existing EPA is an “easier” policy. Nearly half of the export gains generated by the EU-Japan EPA come from agricultural tariff cuts and TRQs.

The conducted experiments use the commitments under the EU-Japan EPA (tariff and TRQ cuts) applied to the Japan-UK relationship using publicly known simulation parameters (as used in European Commission, 2016; 2018) that were generated for the EU27 depending on the baseline used. These major differences are largely explained by the absence of any increases for the UK in meats, dairy and motor vehicles that account for up to half of EU bilateral export increases. This indicates that Europe’s single-minded priority on agricultural goods and processed agricultural products (PAPs) has resulted in an agreement that does not fully represent the offensive interests of the UK. The market access sought by the EU has resulted in a costly quid pro quo with fewer concessions on other sectors. Practically speaking, the UK could attempt to seek the tariff cuts on PAPs on, e.g., chocolates, candies, biscuits as in the EU-Japan EPA. However, resolving TRQs for products like pork, beef, grains and notable fresh and processed cheese (including blue-veined cheeses like stilton) might be costly: the negotiators from Japan’s Ministry of Agriculture, Forestry and Fisheries (MAFF) are very seasoned and skilled at linking TRQ concessions to the defensive interests of their counterparts (e.g., cars). The negotiations on agricultural tariffs and TRQs also tend to take up the bulk of time and resources.

It is not surprising that the Government of Japan reportedly believes that there is little merit in rolling over the existing EPA with the UK, and a different equilibrium could be reached instead.\[4\] Japan and the UK will be able to focus on adjusting the EPA on primarily digital trade, investment and services where the UK’s position is more aligned with Japan than the EU. These are ultimately more important for the UK in the medium to long term for both domestic gains into Japan and for setting up conditions inside the UK for future trade negotiations with other trading partners. Of course, the overall tariff reductions and improved trade facilitation that were achieved under the EPA are immensely valuable to the UK as well.

### DIGITAL TRADE AND E-COMMERCE

Given the UK’s geographical distance from high-end goods consumer markets, including Japan, putting in place smart, sensible rules on digital trade and e-commerce should be the key priority in every UK trade agreement. The business processes of UK multinationals and SMEs are already highly digitised, especially for those involved in services exports.

An open regime for cross-border data flows is a pre-requisite for e-commerce, services and goods market access due to increasing dependency on software, connectivity and the use of consumer or employee data. While Japan is bilaterally open for data transmissions to the UK, its Asian neighbours are increasingly taking steps to limit cross border data flows by putting in place a range of restrictive policies—particularly for the financial sector. New ideas like customs duties on electronic transmissions are being considered.

Seeing the hazards created by restrictive data policies, Japan has taken global leadership against the proliferation of digital protectionism. The initiatives include the so-called Osaka track for “Data Free Flow with Trust” (DFFT) under its G20 presidency and bilateral accords on digital trade and cybersecurity with the US, Japan and the UK, therefore, have a similar alignment of interests in most of the digital trade space.

However, the EU-Japan EPA excludes provisions on cross border data flows and data localisation. However, Japan’s model FTA text on digital trade build on provisions lifted from the CPTPP chapter on e-commerce for data flows and data localisation measures, according to which the parties shall allow “cross-border transfer of information by electronic means.”\[5\] In addition, CPTPP bans its parties from imposing data localisation requirements that “require a covered person to use or locate computing facilities in that Party’s territory”.\[6\] The lack of understanding of privacy and how it interacts with trade rules left the EU in a cautious rut such that they were not prepared to accept Japan’s model FTA texts. However, the CPTPP language is deemed so strategic to Japan’s interests that its negotiators preferred a rendez-vous clause (where the parties agreed to revisit the provisions within three years) rather than water down the original CPTPP language.\[7\] The EU and Japan also agreed on granting reciprocal adequacy decisions that open the two jurisdictions in a two-way street arrangement for personal information.\[8\] Foremost, this approach does not prevent the flow of non-personal information from being blocked or localised.

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\[13\] Tariff and NTM variables European Commission, 2016 and 2018 have been tested under various conditions and baselines.

\[14\] [https://www.ft.com/content/b6a047c6-dafc-11e9-8f9b-77216ebe1f17](https://www.ft.com/content/b6a047c6-dafc-11e9-8f9b-77216ebe1f17)

\[15\] CPTPP, 14.11

\[16\] CPTPP, 14.13

\[17\] EU-Japan EPA, Trade in Services, Investments and E-Commerce 8.81

\[18\] Amendment to the Cabinet Order to Enforce the Act on the Protection of Personal Information, 2016; also Enforcement Rules for the Act on the Protection of Personal Information, 2016.
In any event, since GDPR provides for multiple means to safely transfer personal information, it is fully compliant with CPTPP rules that exempt any domestic regulation that serves a legitimate public policy objective. The exemption can be invoked provided that UK laws pass the pre-requisites on legitimacy (no “arbitrary or unjustifiable discrimination”, or “disguised restriction”),[20] and proportionality (not “greater than are required to achieve the objective”), respectively.[21]

Also, agreeing to the CPTPP disciplines will not, and cannot, interfere with the standing of the UK as an “adequate” jurisdiction for data transfers with the EU. Multiple jurisdictions (including Japan, New Zealand and Canada’s private sector) have agreed to CPTPP disciplines in FTAs despite having adequacy decisions with the EU. Japan is also a signatory of the APEC framework for Cross-Border Privacy Rules (CBPR), further proving the point that stringent domestic privacy standards do not conflict with certification instruments for international transfers.

These conclusions have a significant bearing on the future Japan-UK negotiations. Since UK privacy rules stand up to CPTPP exceptions and have no bearing on the future relationship with the EU, any “watering down” or exclusion of cross-border data flow and localisation provisions would only be detrimental to the UK’s offensive interests.

### INVESTMENT PROTECTION AND SERVICES

Under the competences within the EU Common Commercial Policy, investment is an increasingly complex issue to negotiate. The Opinion of the European Court of Justice (ECJ) confirmed the EU’s exclusive competence in investment market access, investment protection (as far as it concerns FDI) and state-to-state disputes. However, portfolio investment and investor-state dispute settlement (ISDS) are shared competences where the Council may decide to exercise its competence on a proposal from the European Commission.

Understandably, the existing EPA omits investment protection (on both direct and portfolio investment) and dispute settlement that fall partially or fully under mixed competences. At the time of writing, the negotiation for a separate bilateral investment treaty (BIT) is still ongoing between the EU and Japan that will eventually cover these topics, but since the EU model on dispute settlement is based on creating a multilateral investment court (MIC) or a government-to-government investment court system (ICS), the discussions have been lengthy.

As the world’s second most important source of FDI, Japan is keen to include investment protection in all its trade agreements, not least given the risk of rising legal and macro-political risks in the UK. This interest is also rooted in Japan’s trade strategy, which is based on FDIs (i.e. setting up plants and subsidiaries overseas in the target market) rather than exporting goods and services made in Japan. As the UK economy traditionally depends on FDIs, it has always been in its own economic interest to issue guarantees on rule of law and national treatment to all investors.

Japan has a strong preference for the investor-state dispute settlement (ISDS), even though a Japanese business (or a wholly-owned subsidiary) has never launched a investor dispute against a foreign government. Japan’s rationale for demanding the inclusion of dispute mechanisms nonetheless is largely about making sure that the commitments are credible and enforceable. As their businesses have no intention to seek dispute in practice, Japan’s preference is to avoid costly and less efficient EU inventions like ICS and MIC that require government-appointed judges on call.

If the UK insists on a construct where the investment protection are enforced guaranteed through a government-to-government mechanism (like ICS or MIC), it may downgrade any concessions Japan will offer in return. In a similar fashion, the delinking of trade and investments into two separate agreements effectively postponed the realisation of one of Japan’s key requests against the EU. Given it was uncertain whether the outcome of the later investment negotiations would meet Japan’s expectations, Japan must have also withdrawn some concessions on goods and services in the EPA.

Many UK firms will be directly investing in Japan in the wake of a trade agreement and taking advantage of Japan as a potential base for the wider East Asia region. However, the UK’s interests are primarily as an FDI recipient. Improved investor protection mitigates some of the current macro-political risks for risk-averse investors and helps to protect existing investments and jobs in the UK. From a purely economic perspective[22], therefore, the UK shares the economic interests of Japan for ambitious investment provisions with effective approaches to investor-state dispute settlement.

Furthermore, the UK is a services economy driven by London as the global hub for capital, supported by banking, insurances and professional services. The UK also has highly competitive services in both consumer and business markets, including retail, education, construction and engineering services.

The Japanese market may offer de facto non-discriminatory national treatment across all sectors on licensing, central government procurement and equity limitations. Nonetheless, prominent liberal economists like Paul Krugman have also accused Japan of being over-regulated for domestic and an FDI recipient alike[23] in a situation which the Abenomics policy package has been addressing – with growing corporate profits as a result.

An FTA between the UK and Japan is most likely a necessary “downpayment” to open up regulatory cooperation, including equivalence decisions on financial services that would allow multinationals to operate cross-border with centralised functions or staff.

In that regard, the EU—Japan EPA includes the most advanced provisions on mode 4 supply of services (via movement of natural persons) ever to be negotiated in a bilateral trade agreement, which...

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[19] CPTPP, 14.11 para a which paraphrases the WTO two-tier test under GATS article 14 and GATT article 21
[21] Definitions under CPTPP 14.1
sets a very high bar on the Japan-UK negotiations. The EPA covers not just all categories of mode 4 – e.g., intra-corporate transferees (ICTs), contractual service suppliers and independent professionals (CSS/IPs) – but also added new categories for short-term business visitors, investors as well as spouses and children to accompany transferees and services providers.

Also, the EPA sets forth a specific procedure for mutual recognition between competent authorities in the EU and Japan, agreeing to recognise each other’s qualifications as equivalents. The UK and Japan could also directly negotiate the list of mutually recognised qualifications in professional and technical services within the negotiation process rather than delegate the matter to relevant authorities in the future.

In conclusion, both mode 4 and qualifications are significant determinants of investments and placement of regional headquarters, especially in the services industry that drives job creation. In order to promote investments and job creation in the UK and avoid Japanese investments being diverged to the EU, it is essential that the UK can match (or preferably even improve on) these EU concessions to Japan.

CONCLUSIONS

Negotiating a trade agreement with Japan must be a key objective for the UK. It is important to begin talks in the near term, with the recognition that a renegotiation is more relevant to the UK’s interests than a speedy transition of the EU-Japan EPA. It is in the direct interest of the UK to adhere to Japan’s rejection of a “copy-and-paste approach”, and approach the UK-Japan talks as a renegotiation.

In fact, several arguments speak in favour of prioritising optimal outcome before timing. The possible investment diversion to the EU from the UK is far more detrimental than the trade diversion. With one of the world’s lowest MFN rates on non-agricultural goods, Japan is already sufficiently open under MFN for the purposes of UK/Japan industries.

While there may be genuine interests for the UK on exporting agriculture and PAPs to Japan’s consumers, they are likely to be minor relative to the value of bi-directional investments. Specialised and novelty trade is also sufficiently differentiated and not directly replaceable: UK-made textiles, clothing, leather goods or confectionary items are often high-end branded goods that are less price sensitive. This condition is also the case for stilton cheeses and other dairy products, notwithstanding the limited demand for them in Japan. In most of these products, Japanese tariff cuts on EU exports are also subject to long staging periods, which softens the impact of trade diversion on the UK.

Meanwhile, many sectorial commitments on goods and services under the EU-Japan EPA were also undertaken on an erga omnes basis that continues to apply to the UK, including Japan’s commitments on motor vehicle standards. In the pharmaceuticals sector, Japan’s reforms were largely undertaken unilaterally through the revised Pharmaceutical Medical Devices (PMD) Act in 2014, which addressed the need for price premiums and fast-track authorisation.

In other words, the potential investment and job diversion of Japanese multinationals relocating to the EU is far more detrimental than any trade diversion created by the UK not being party to the EU-Japan EPA in the short-term. As discussed, there is ample scope for Japan and the UK to adjust the EU-Japan EPA, including digital trade and investments in a comprehensive package. On these areas, there is ample scope for a “win-win” outcome that better meet the interests of both sides.

In addition, the UK must be ready to match the EU concessions on mode 4 regardless of its political sensitivity for the UK, or even potentially improve upon the EU-Japan agreement. If not, neither renegotiation nor transition should be attempted at all.

There are also minor adjustments that have little meaning for the UK, for example, the seven-year staging of tariffs on passenger cars – which was insisted on by the EU side – where the UK could instead agree on duty-free upon entry. The UK could agree to simpler rules of origin on textiles and clothing which is preferred by Japan given the considerable intra-sectorial trade within the fashion industry.

Finally, as the UK embarks on talks with Japan, it is also worth remembering that the trade deal is not the only goal or objective. Aligning with Japan also becomes the enabler of other important policy objectives, including:

- Regulatory cooperation on financial services between the UK and Japan’s financial authorities to develop more bilateral equivalence that will allow the UK to operate as an offshore location for clearing and other back-office functions;
- Adequacy decisions on personal information in both directions (by the UK to Japan, and Japan to the UK) that mirrors EU/Japan decisions that coincided with the signing of the EPA;
- Supporting and encouraging UK interest in joining the CPTPP.
The Initiative for Free Trade is a private, not-for-profit, non-partisan research organisation making the intellectual and moral case for free trade. Seeing Brexit as an opportunity to liberalise global trade, our research focuses on developing policy proposals that maximise those opportunities.

The IFT was launched at the UK Foreign & Commonwealth Office by the Rt Hon. Boris Johnson MP, the Rt Hon. Dr Liam Fox MP, and IFT President Daniel Hannan MEP, in September 2017.