

A background image of a cityscape, likely Tokyo, with various skyscrapers and buildings, overlaid with a semi-transparent red filter. The top of the page has a teal-to-red gradient.

JAPAN-UK RELATIONS AFTER BREXIT: LOOKING TOWARDS A CLOSER ECONOMIC PARTNERSHIP

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JAPAN-UK RELATIONS

AFTER BREXIT:

LOOKING TOWARDS A CLOSER ECONOMIC PARTNERSHIP

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EXECUTIVE SUMMARY

INTRODUCTION

The UK and Japan signed a free trade agreement in October 2020, marking the beginning of a new phase in a dynamic – if understated – economic partnership. The last five years have seen global upheaval, with a volatile geopolitical environment, challenges to the liberal trading system, and the COVID-19 pandemic. Domestically, the UK's departure from the European Union on 31 December 2020, and a significant leadership transition in Japan in September 2020, have also been a source of disruption.

Against this backdrop, this report explores the future of the economic partnership between Japan and the UK. The report looks at opportunities to grow bilateral trade within the framework of the new trade agreement and areas of collaboration to develop the global trade environment in ways that will benefit both economies. The report concludes with a set of recommendations for the UK and Japanese governments, as well as other stakeholders involved in international trade.

This report was researched and produced by Asia House. The views and recommendations within the report are a synthesis of the views of business leaders and trade policy experts in Europe and Asia, who took part in focus groups and individual interviews during February and March 2021.

CONTEXT

Economic and trade ties between Japan and the UK have grown significantly since the 1980s, with trade reaching £31.6 billion in 2019, underpinned by a strong but 'quiet' economic and political relationship and a shared commitment to a rules-based international trade system.

The UK-Japan relationship faces three broad challenges: uncertainty over both countries' future strategy and strategic aims; the pursuit of growth as advanced economies; and an increasingly volatile geopolitical situation, marked by the rise of protectionism.

OPPORTUNITIES TO GROW THE ECONOMIC PARTNERSHIP

Building bilateral trade

The new free trade agreement (FTA) between the two countries – critical for continuity post-Brexit – has the potential to drive trade by more than £15 billion, with growth in areas such as digital trade and financial services. While the agreement provides an important framework for bilateral trade growth, more can be done to ensure that businesses utilise the agreement to its full potential. There are also areas where the agreement could be expanded.

We have identified two recommendations for improving UK-Japan bilateral trade:

1. Build out support for businesses to utilise the agreement

Additional government support – and an evolution from the historic UK and Japanese laissez-faire stances – will help ensure more effective utilisation of the FTA. Though the UK and Japan have historically maintained a 'quiet' relationship, the next phase of bilateral relations will require a more concerted effort, particularly in the case of SMEs.

2. Explore expanding the investment chapter

While the UK-Japan agreement expanded on the EU-Japan agreement in several areas, the investment chapter could have gone further. There is huge potential to boost investment between the two countries, given that both have liberal investment policy environments and a need for economic recovery post-pandemic, as well as the changing geopolitical environment. Greater commitments and provisions on investment protections and dispute settlement would enable higher levels of investment. Additionally, while the digital policy provisions in the UK-Japan FTA are progressive, there is still more to be done to boost digital trade and position both countries as global leaders on digital policy.

DEVELOPING INTERNATIONAL OPPORTUNITIES

In the long term, the scope for bilateral trade growth is limited in comparison to possibilities in higher growth markets for both economies. As two of the world's leading advocates for free trade, the UK and Japan can play major roles in the revival of a liberal, rules-based international environment, and drive discussions on key areas of trade policy reform at the global level. Both economies, alongside their many trading partners, stand to gain from this.

There are a number of actions that can be taken to encourage an open and free operating environment:

1. Redefining and re-establishing regional and global engagement strategies

Both countries must clearly redefine their global and regional economic strategies, particularly in the current volatile geopolitical environment. For example, stakeholders in Japan are still unclear what 'Global Britain' means for Asia, and how a more active UK should be engaged.

2. Cooperating to support and uphold a rules-based international liberal order

In the face of increasing protectionism, economic powers with a vested and heavy reliance on an open international system - like the UK and Japan - must continue to uphold and promote an open global environment. Both countries enjoy influential positions in international organisations, and these forums will be critical in developing the rules for trade.

3. Cementing both countries as leaders in digital trade policy

The UK-Japan trade agreement acknowledged the opportunities for growth in digital for both countries, and both have prioritised the digital economy and digitalisation as key policy areas. As leaders in technology innovation, the UK and Japan should collaborate to develop the framework for global digital trade.

4. Cooperating on global infrastructure growth

Both countries are well plugged-in to policy banks active in the region and have unique expertise in infrastructure financing and development. In addition to the opportunities for UK and Japanese businesses in infrastructure development in third countries, both Japan and the UK will benefit indirectly from the economic growth that better infrastructure brings in developing markets.

5. Collaborating on climate change and other global issues

The UK and Japan are well placed to be leaders in sustainable financing and the development of green finance hubs. Green finance activities in both countries have developed rapidly in the last 10 years. As mature and well-established financial centres, public and private finance institutions in both countries have a role to play in addressing climate change as a global challenge. Collaboration on issues such as the development of consistent regulatory reporting requirements, cooperation between green finance hubs, and cross-border initiatives, could support both countries as leaders in this space, as well as supporting climate risk mitigation globally.

Japan and the UK have maintained strong economic and political ties since 1980, with similarly advanced economies, and similar roles to play in a liberal international order. At a time of changing geopolitics, the COVID-19 pandemic, the rise of regionalism, and changing domestic environments, both countries must look at ways to strengthen the economic partnership – both bilaterally, and by supporting an open and encouraging global environment.



INTRODUCTION: SETTING THE CONTEXT FOR JAPAN-UK RELATIONS

THE CONTEXT

In 2020 the COVID-19 pandemic threw global trade into a state of disarray, resulting in a contraction of international trade of around eight per cent¹ and fuelling existing geopolitical tensions. For the United Kingdom (UK), the departure from the European Union (EU) on 31 December loomed large as the world's sixth largest economy prepared to remove itself from the world's largest trading bloc and the cover of a wide-ranging network of free trade agreements.

On the other side of the world, Japan was undergoing a leadership transition as Shinzo Abe stood down from an eight-year stint as Prime Minister and was succeeded by Yoshihide Suga in September 2020. Under Abe, Japan had significantly expanded its trade arrangements, including joining two major regional trading blocs – the Comprehensive and

Progressive Trans-Pacific Partnership (CPTPP) in 2018, and the Regional Comprehensive Economic Partnership (RCEP) in November 2020, as well as finalising trade agreements with the EU in 2019 and the US - an agreement which entered into force on 1 January 2020.

The UK and Japan concluded negotiations on a Comprehensive Economic Partnership Agreement (CEPA) in October 2020, the most economically significant of the 64 trade agreements concluded by the UK to-date.² The agreement provides a crucial post-Brexit framework for trade and economic relations between the UK and Japan, and is a symbol of a broader commitment to the bilateral relationship and the rules based international order.

FROM BOOM TO BREXIT

The UK and Japan's economic relationship began to resemble its current form in the 1980s under the premierships of Margaret Thatcher and Yasuhiro Nakasone, when Japanese companies started investing heavily in the UK following a transformative economic boom in Japan. These investments, driven by the UK's favourable regulatory environment, talent pool, and access to the European Common Market, helped position the UK as a vital gateway to Europe for Japanese firms.

The 1980s boom in Japan was created by transformations in design, engineering, production, and management techniques, and the advent of the Eurodollar markets and new forms of investment banking. This environment meant that Japanese corporates had an abundance of growth-seeking capital to export and the mechanisms to deploy it, and so beat a path to becoming major international players. While Japan's domestic economy stagnated in the late 1990s, regulatory reforms under former Prime Minister Shinzo Abe – known as 'Abenomics' and marked by expansionist monetary policy – helped maintain Japan's position at the top table for global business.

Trade and investment between the UK and Japan reached £31.6 billion in 2019³, underpinned by a strong, albeit understated, economic and political relationship. Japan and the UK are major investors in each other's economies, ranking sixth and fifth respectively for inward direct investment in 2018.⁴ A raft of commonalities further bolster the relationship, including a background in maritime trade, close economic and security ties with the United States, a commitment to rules-based multilateralism, and a complex relationship with their continental neighbours - which has perhaps encouraged both economies to look beyond their immediate neighbourhoods for trade relationships.

Japanese companies contribute £15 billion to UK GDP annually and play a very significant role in the UK's industrial sector. Nearly 1,000 Japanese companies are currently based in the UK, providing more than 180,000 jobs.⁵ Japan's significant contribution to the UK economy is seen across a number of sectors. The automotive sector plays a major role in the trade relationship; largely through the import of

machinery and parts for vehicle manufacture for the UK and European markets, led by brands including Nissan and Honda. In 2020, Japan was the UK's largest non-EU import partner for road vehicles in the first half of the year. Further, the UK was the only non-EU country from which the total value of road vehicle imports increased from the first half of 2019 to the first half of 2020.

Manufacturing companies represent more than half of the top 30 Japanese companies in the UK, who collectively employ nearly 100,000 people.⁶ The financial services sector also plays a major role; 11.5 per cent of the total number of Japanese companies operating in the UK are in financial services.⁷

The UK is also strategically significant for many Japanese firms, with London providing a valuable corporate hub not only for access to Continental Europe, but also to the Middle East and Africa. Financial services companies and automotive firms in particular have set up strong operations in the UK as a pathway into the EU.

As well as being a significant investment destination, the UK continues to be a major market for Japanese exports. Japanese firms in the UK reported sales of almost £50 billion in 2018.⁸ A large part of this is goods trade, though services trade is a growth area – Japanese services firms account for more than 60 per cent of Japanese investment in the UK.

While somewhat lower, in 2018, the UK exported £1.5 billion in business services to Japan; £4.1 billion in financial services; and £1.2 billion in automotive car exports.⁹ The UK was the fourth largest investor in Japan in 2018, with £17.5 billion invested in the country.¹⁰

Trade between the UK and Japan has not weakened since the referendum to leave the EU in 2016, despite concerns about the impact of Brexit on the position of the UK as a gateway to the European market. However, it has cast a cloud over the relationship, as, like many other trade partners, Japanese observers remain respectfully confused by the decision by the UK to leave the large trading bloc on its doorstep.



EU EXIT

For Japanese investors, the concerns around Brexit are simple. Many companies had made investments into the UK on the grounds that it was the best base for them to access the entire European market, including the UK. With Britain now leaving the single market, the value and viability of these investments were suddenly at risk. In February 2016 the Keidanren (the Japanese federation of industries) issued a statement indicating its hope that the UK remain within the EU, both for the sake of Japanese investment, but also amid concerns of the destabilising impact of a split in Europe on the global economy. The Japanese Ministry of Foreign Affairs shortly after released a statement addressed to the UK and the EU, calling for the UK to seek to remain in the EU Customs Union as part of the Brexit deal.¹¹

Since 2016, Brexit has remained a key concern for Japanese businesses, and the continuity of the Japan-UK economic relationship has remained high on the priority list through the Brexit process. Warnings that UK-domiciled Japanese firms, and the 140,000 jobs they generate, would re-locate to the continent heaped pressure on the UK to conclude a 'soft' Brexit deal, and placed Japan high up the list of priority countries with which to conclude a trade agreement to provide for continuity of the trading relationship.

At the end of 2020, after protracted negotiations, Britain left the European Union with a Trade and Cooperation Agreement (TCA). Rather than the 'soft' Brexit preferred by the majority of multinationals, the TCA is considered a 'hard' break with the bloc. While questions remain about how to ensure a level playing field in future trade relations, this deal crucially allows for zero tariff and zero quota goods trade with the EU, where goods meet the relevant rules of origin criteria.¹² However, administrative hurdles as a consequence of Brexit have already had a negative economic and political impact since 1 January 2021.

A slow start to the year due to advance stockpiling and the COVID-19 pandemic are giving way to a more complex situation. A survey conducted in January 2021 shows that a third of Japanese companies with bases in the UK say that Brexit will have a negative impact on business, despite the conclusion of the UK-EU agreement. Around one in 10 businesses are looking to reduce their presence in the UK as a result of Brexit.¹³

However, several major Japanese companies in the UK have committed to a continued presence. Japanese carmaker Nissan has said its Sunderland plant, which has 6,000 direct employees and supports nearly 70,000 jobs across the supply chain, is secure

in the long-term thanks to the UK-EU deal.¹⁴ Nissan has further committed to moving production from Japan for its 62kWh battery packs for cars to its Sunderland plant. Given Nissan's significant role in Sunderland's local economy, the Treasury brokered an arrangement for UK support for the firm in 2016, showing the importance of Japanese business to the UK.

Honda however has had a more difficult time with shifting trade relations over the last five years, and announced in 2019 that it would close its UK plant in Swindon permanently, with production moving to Japan, North America, and China. Senior executives from the company have said that the UK-Japan trade deal, which will remove tariffs on Japanese car exports by 2026, has eased concerns about post-Brexit disruption.¹⁵

For now, Japan business has remained relatively stoic, but there are serious uncertainties as to the presence, size and nature of Japanese operations in the UK in the future.

The bilateral relationship

Against the uncertainties of Brexit and its potential implications for the UK as a gateway for Japanese companies, the UK and Japanese administrations have ensured that bilateral trade and investment is maintained. The UK-Japan CEPA provided continuity of bilateral trade as the UK left the EU-Japan trade agreement, and in some places the negotiations have achieved a more modernised approach.

The agreement is the UK's largest bilateral agreement to-date post-Brexit, and was an important early win for the UK's Department for International Trade and the concept of 'Global Britain' in the lead up to the end of the Brexit transition period. Despite receiving a more muted response in Tokyo, this agreement lays the groundwork for deepening this important economic relationship and is a milestone for a new era in Japan-UK relations. It also gives a blueprint for what future comprehensive trade deals with advanced economies could look like and lays some of the groundwork for the UK's accession to the CPTPP.

THE UK-JAPAN FREE TRADE AGREEMENT (CEPA)

The UK and Japan signed the Comprehensive Economic Partnership Agreement (CEPA) on 23 October 2020. UK International Trade Secretary Liz Truss and Japanese Foreign Minister Motegi Toshimitsu signed the agreement in Tokyo, in the first 'new' agreement the UK struck as an independent trading nation. The agreement is estimated to have the potential to boost trade between the two countries by over £15 billion.¹⁶

The UK Department for International Trade estimates that the 2019 EU-Japan trade deal would have added somewhere between £2.1 and £3 billion to the UK's annual GDP after 15 years. The new UK-Japan deal is expected to contribute a more modest £1.5 billion over the same period. The deal strengthens the UK's relationship with Japan, and goes beyond the benefits of the existing Japan-EU trade agreement in some key areas, such as digital, e-commerce, and financial services. The digital chapter for example looks more closely at data localisation, and there are better market access provisions for financial services firms on both sides of the bilateral relationship.

However, despite these advances, the agreement could have gone further in certain areas. Chief among these is investment. Given the UK and Japan's liberal policy environments and commitment to foreign

investment, the investment section of the UK-Japan CEPA remains untouched from the EU-Japan agreement, covering only investment liberalisation. This was allegedly largely down to time constraints in negotiations. A more comprehensive investment chapter could have gone further on issues such as investment protection and dispute settlement.¹⁷

The UK-Japan agreement is not a direct 'roll-over' agreement, but it does mirror many aspects of the EU-Japan agreement. The areas where the agreement does go further are unlikely to counter the disruption and uncertainties of Brexit in the short to medium term and do not change the fundamentals of the UK no longer being in the European single market.

Given this limitation, there is limited scope to what the current FTA can do to grow trade between the UK and Japan exponentially. Large companies will continue to take time to analyse the scope and possibilities within the new FTA framework before using it to its full potential, while small and medium sized enterprises (SMEs) may struggle to effectively utilise the FTA without adequate support from both governments and business associations.

IN NUMBERS: THE UK'S TRADE WITH JAPAN¹⁸

UK's **11th** largest trading partner
and **4th** largest non-EU trading partner
Japan accounts for **2.2%** of total UK trade

£31.6 billion

Total trade in goods
and services



CEPA: FIVE KEY WINS¹⁹

A political win for UK

UK's first step in negotiating as an independent trading nation

Business security

Continuity for both sides beyond Brexit

Goods

Tariff reductions in many sectors

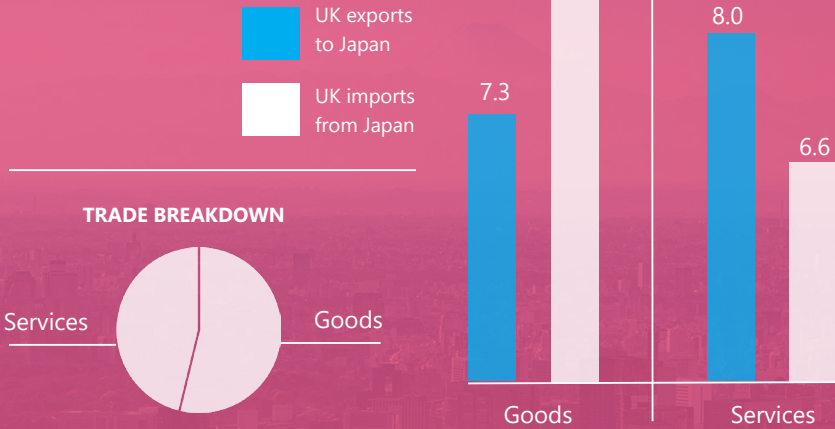
A boost to services

Ban on data localisation and better market access for financial services firms

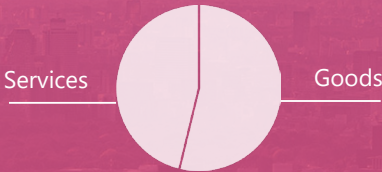
CPTPP

A key step towards the UK's accession to the deal

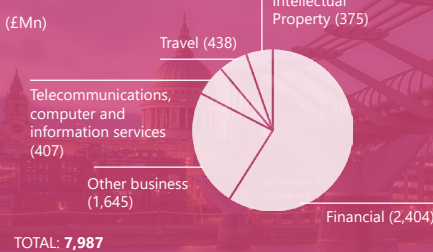
THE UK-JAPAN TRADE BALANCE 2019 (£Bn)



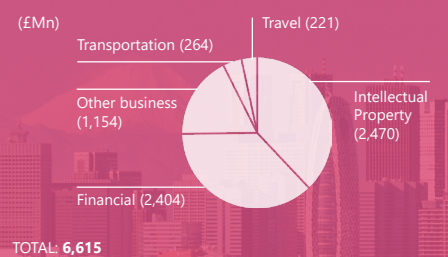
TRADE BREAKDOWN



TOP FIVE SERVICE IMPORTS UK TO JAPAN (£Mn)



TOP FIVE SERVICE IMPORTS FROM JAPAN TO UK (£Mn)



UK TOP THREE IMPORTS AND EXPORTS FROM JAPAN (2019)

(£Bn)

TOP THREE GOODS EXPORTED TO JAPAN FROM UK

Mechanical power generators (1.2)
Cars (1.1)
Medical and pharmaceutical products (0.8)

TOP THREE GOODS IMPORTED FROM JAPAN TO UK

Cars (1.5)
Mechanical power generators (1.1)
Electronic products (0.8)

CEPA: KEY POINTS OF THE DEAL²⁰

Abolishes tariffs on industrial goods imports and exports in terms of quantity and value

Tariffs on Japanese exports of passenger cars to the UK will be cut step-wise until they are eliminated in 2026 (same as with Japan's agreement with the EU)

Tariffs immediately abolished on items like rail cars and components, turbojet engines and control panels for vehicles

Agricultural imports rolled over from the EU

Allows for some exports agricultural products at the same tariff rates as the EU, subject to certain volumes

Forestry and fisheries products

Similar to the agreement in force with the EU

Digital data transfer – more ambitious than the EU trade deal AND the CPTPP

Companies that expand to either market will be protected from having to reveal trade secrets to the government or any businesses in the destination country; and have banned forced disclosure of artificial intelligence algorithms and encryption keys

THE FUTURE OF JAPAN-UK RELATIONS

THE CHALLENGES

The UK and Japan have faced a period of transition over the last five years, both domestically and within a rapidly changing global geopolitical environment, and now find themselves at an inflection point in 2021. In 2020, both countries finished the year looking for opportunities to establish or redefine global strategies, immediately as part of a recovery plan, but also as the beginning of the next long-term phase of their development. In 2021, the UK is keen to prove itself an 'independent trading nation' outside of the EU. Japan finds itself in the position of proving that 'Japanification' is not a terminal condition. Both countries are also urgently trying to drive economic recovery from the COVID-19 pandemic.

The UK-Japan economic relationship faces three broad challenges:

1. Uncertainty over the UK's future strategy and strategic aims for its relationship with Japan and Asia more widely

Since at least 2016, one tenet of the UK's 'Global Britain' flagship policy has been an 'All of Asia' approach, aiming to position the UK, independent from the EU, as a major global player in the region. However, based on the research undertaken for this report, the UK's strategy and goals for its engagement with Japan and with Asia needs to be defined more clearly.

The current UK administration has recognised the need for a review of Britain's strategic arrangements. Shortly, the government is expected to publish the outcome of its Integrated Review of Security, Defence, Development and Foreign Policy. This review aims to define the government's vision for the UK's role in the world over the next decade. It should put to rest criticisms over the apparent lack of strategic approach (in foreign policy terms) that has been said to characterise the last few years.

Whilst the review will be naturally wide-ranging, an 'Indo-Pacific tilt' is expected to be a key part of the new strategy, in recognition of the shift of the global centre of economic gravity towards the region, along with its strategically important geographic location and proximity to important British allies.

In contrast, despite Japan's change in leadership in the last year, the government has maintained a relatively consistent role as the West's diplomatic gateway into Asia, and as the only, or key, senior Asian representative at most international forums, most notably the G7. However, given the changing international environment, it will be important for Japan to reassess and recalibrate its global strategy as well.

2. Finding new opportunities to grow trade as advanced economies

The UK-Japan FTA was, given Brexit, an economic necessity for the UK. Historically, government culture in both Japan and the UK tends towards being less interventionist, and the majority of trade between the two countries is through large companies and in goods such as the automotive sector. Further, their mature private sectors and service economies have been capable of working within bilateral and global trading arrangements and the nature of both countries' advanced economies. Given this economic environment and the nature of both economies, finding opportunities to significantly grow bilateral trade may be more limited.

3. An increasingly volatile geopolitical situation

Geopolitical risk has underpinned global uncertainty over the last five years and will continue to do so over the next decade. The international environment is undergoing a fundamental shift – there is a restructuring of the way that global trade and the international order operates. US-China trade tensions, the changing dynamics and role of the World Trade Organization, and the rise of regionalism will all pose challenges to the future of UK-Japan relations and their prospects for economic growth globally.

As middle powers with strong liberal economies, Japan and the UK are among a group of economies that stand to lose the most from disruption of the global trade order. But – at least in rhetoric – the UK's commitment to 'Global Britain' and Japan's 'proactive pursuit of peace' have shown that both countries are willing to remain fully engaged and supportive of an open international environment.



THE OPPORTUNITIES

There are two key areas of opportunity for deepening engagement between the UK and Japan for mutual economic benefit:

1. Improving bilateral trade and investment

While the UK-Japan FTA built on the EU-Japan agreement, there is only so much that a free trade agreement between two advanced economies with established trade links can do to drive more trade. However, the UK-Japan FTA does provide continuity and a solid foundation for modest growth. Growth areas include: financial services, technology, renewable energy, and the digital sector more widely. The COVID-19 pandemic has driven new opportunities for collaboration between the two countries – for example in medical technology, vaccines, and medical devices.

Additional government support – and an evolution from the historic UK and Japanese governments' laissez-faire attitudes – will help ensure more effective utilisation of the FTA. The bilateral relationship has traditionally been a 'quiet relationship', but this will need to change in the next phase of bilateral relations, as businesses require further support to fully utilise the free trade agreement.

2. Improving the international environment for UK plc and Japan plc

The scope for expanding bilateral trade and investment between the two countries is limited. Further, the Japan-UK FTA on its own cannot match the pre-Brexit EU-Japan-UK trilateral relationship, which allowed for seamless trade along global value chains in Europe.²¹

In contrast, there are growth opportunities in supporting and improving the international trade and business environment within which the UK and Japan operate. Our survey of business and trade policy experts emphasised this as the key area of focus, given the opportunity for growth in trade with developing markets.

RECOMMENDATIONS



RECOMMENDATIONS FOR IMPROVING BILATERAL TRADE

Improving bilateral trade and investment between the UK and Japan should be looked at in two ways: first, how to get the most out of the existing trade agreement; and second, areas in which the current agreement can be expanded to benefit both countries.

1 Getting the most out of the existing UK-Japan FTA

The UK-Japan FTA has not fundamentally changed the commercial opportunities for companies operating between the two markets. Typically, FTAs of this nature make iterative improvements to the market structure, thereby increasing profitability and efficiency in certain sectors. Trade agreements have a limited impact on economic demand in comparison to more transformative developments such as technological innovation. In most cases, therefore, they do not result in an immediate expansion of new market entrants, but provide incentives, especially for large multinational companies to expand or refine their operations accordingly. For large businesses, free trade agreements are a 'nice to have' rather than a necessity.

For small and medium enterprises (SMEs), free trade agreements can be difficult to utilise, with anywhere between 50 and 79 per cent of SMEs not fully utilising FTAs.²² Similarly, services trade can be difficult to tie directly to free trade agreements. Services trade between the two countries has already

been increasing over the last years, well before the conclusion of the CEPA.

Despite operating under the EU-Japan EPA for almost two years, many companies trading between the UK and Japan struggled to capitalise on its benefits given the focus on Brexit. This was especially the case for SMEs.²³ The opportunity of a new agreement should not be wasted and the UK and Japanese governments should increase the utilisation of the agreement. Actions to support the utilisation of the CEPA could include:

- Creating platforms for networking and business-matching between smaller companies on both sides of the trade relationship, sponsored and supported by both governments.
- Greater government support for SMEs who do not have the inbuilt capacity to determine how they can leverage trade agreements.
- Government support for companies looking to restructure supply chains, such as subsidies for the movement of production facilities to the UK or Japan.

2 Exploring areas for expansion in the existing FTA

There are two key areas in which the UK and Japan can look at expanding the existing FTA: investment, and digital policy.

Investment

The investment chapter in the UK-Japan FTA adds no substantive concessions on investment beyond those included in the EU-Japan EPA, which covers only investment liberalisation. This could be built upon by including a greater commitment to foreign investment, through provisions on investment protections and dispute settlement. This is unlikely to be a particularly contentious issue for either country in the event of further negotiations, given that the investment policy environments in both countries are already fairly liberal.²⁴

An expanded investment chapter, supported by other activities to promote bilateral investment between the UK and Japan, may further support trade relations, given the additional protections and structure it would give to bilateral investment.

Recommendations to support this could include:

- Developing further policy and committing to greater investment between the two countries, by strengthening investment protection and dispute settlement in a revisited FTA
- Looking at the potential of negotiating additional agreements on investment policy specifically, to develop bilateral investment.
- Practical support for investors to seek opportunities in the UK and Japan.

Digital policy

Though there are provisions within the digital policy section of the FTA that go further than the EU-Japan EPA, there is more that could be done in the future on digital trade. The UK-Japan FTA includes provisions for a higher level of regulation on digital data transfer for example, so companies expanding to either market are protected from having to reveal

trade related secrets to the government or any businesses in the destination country, and there is a ban on forced disclosure of artificial intelligence algorithms and encryption keys.²⁵ Rules on issues such as e-commerce and digital policy on financial services are also more ambitious than the EU-Japan agreement.

The provisions in the new agreement show that the UK could be moving away from the EU's digital trade policy approach, which values data privacy and security, towards a more Asia-Pacific and US style approach, that looks at market dynamism and innovation.²⁶

The area of digital trade policy is developing fast, and while there are not a significant number of changes to be integrated into the agreement at this time, the UK and Japanese governments should seek to revisit this chapter in the future as their digital economies develop further.

Recommendations include:

- Follow developments in global technology and data policy in both countries, and actively update digital policy provisions within the agreement to ensure both countries remain leaders in digital trade.
- Continue support for a Digital Trade network between Japan and the UK to exchange best practices on technology development in areas such as medical technology, green technology.
- Create a government to business platform for networking and business matching
- Improve support for SMEs who do not have the capacity to determine how to best leverage the digital policies set out in trade agreements to support growth.

RECOMMENDATIONS

RECOMMENDATIONS FOR IMPROVING THE INTERNATIONAL TRADE ENVIRONMENT

Both Japan and the UK are entering distinct new political eras, with Yoshihide Suga succeeding Shinzo Abe as Japanese Prime Minister in late 2020 and the UK having left the European Union. COVID-19 has further highlighted the need for creative strategies for growth. Suga's focus since taking office has been largely domestic, however he has shown early signs of re-committing to Abe's landmark foreign policy concept of the "free and open Indo-Pacific". This strategy places at its core a network of nations and regional organisations throughout the Indo-Pacific region that value freedom, the rule of law and market economics. Although Suga appears to be favouring a more reactive and less structured approach to foreign policy than his predecessor, the complex regional security environment in Asia implies that Japan is likely to prioritise cooperation with like-minded nations to ensure a desirable regional power balance.

Having left the EU, the UK has an opportunity to better define the meaning of 'Global Britain' and develop its offering to global partners. The UK intends to take a "leading role in responding to global challenges"²⁷ through re-investing in key relationships. The commitment to the Japan-UK bilateral relationship, manifest in the signing of the CEPA, opens the space for the UK and Japan to work together in pursuit of mutual strategic interests such as free trade, multilateralism, and a rules-based international order.

Our research has identified five key recommendations to support an open and free international environment which enables economic and trade growth in both Japan and the UK.

1 Redefining and re-establishing regional and global engagement strategies

National, regional, and geopolitical changes over the last decade mean that both countries will need to comprehensively reassess and redefine their global strategies. There is also an understanding in both governments that there is an ongoing shift in the global economic centre of gravity towards Asia.²⁸ Being clear about interests and strategies will be important for future engagement both globally and in the region.

The UK and Japan have the potential to 'lead' like-minded liberal nations on the international stage, working together to build consensus among smaller and middle-power states. Other like-minded countries include Australia, New Zealand, Canada, and Singapore. This can only be effectively achieved after each country has clearly defined its own foreign policy and international trade strategy.

For the UK, the country's 'Global Britain' and 'All of Asia' strategies need to be further defined. Under its flagship policy, the UK at first glance appears to be more interested in security issues in the Indo-Pacific. The 2008 Global Financial Crisis marked the point at which the value of UK trade to non-EU states exceeded UK exports to the EU – something that has only intensified post-Brexit.²⁹ The UK has recognised the importance of a free and open Indo-Pacific to global stability and prosperity, and that trade and investment is, and must be, a key dimension of the UK's tilt to the region and future engagement strategy. This has been exemplified in the UK's prioritisation and commitment to negotiating free trade agreements with a number of Indo-Pacific nations, and applying to join the CPTPP. However, details of how the UK will position itself and engage with the region moving forward should be better communicated to partners in the region, such as Japan.

For Japan, clearly defining its relationship in the context of US-China relations and the growing presence of ASEAN is critical. Japan is focusing on 'smart' strategic engagement in its key areas of interest, and this has largely included Southeast Asia in the last 10 years. Japan, by looking to set itself up as a 'liberal' alternative partner, has put the defence of liberal norms at the core of its new diplomatic approach to ASEAN and to the rest of the world.

Building and cementing economic and political engagement strategies will be important for both Japan and the UK to maintain stability in a changing global order. Solutions to this could include:

- The UK to very clearly define its global engagement strategy, particularly in the case of Asia-Pacific based on the Integrated Review and global trade priorities.
- Japan will similarly need to clarify its foreign policy strategy, both in Asia Pacific and in Europe.
- Both countries should identify and coordinate on areas of mutual interest.
- Strengthening, supporting, and engaging in multilateral economic and security institutions, despite their limitations.



2 Cooperating to support and uphold a rules-based international order

Both Japan and the UK have played important roles in maintaining the international rules-based order. As open economies, with foreign trade accounting for 36.8 per cent of Japan's GDP³⁰ and 64 per cent of GDP in the UK,³¹ and relatively free open markets, both countries are highly exposed to international trade and changes in the global environment. Previous prime ministers in both countries have shown a particular interest in defending the rules-based order; during a state visit to Japan in August 2017, UK Prime Minister Theresa May and Japanese Prime Minister Shinzo Abe signed the Japan-UK Joint Vision Statement, which begins by declaring that the UK and Japan are: "Global strategic partners, sharing common interests as outward-looking and free-trading island nations with global reach, committed to the rules-based international system."³²

The last five years have seen major challenges to the rules-based order – with a rapidly changing geopolitical situation, and a marked shift away from a commitment to the institutions that uphold the order by key leading nations. Global economic conditions, including the impact of the COVID-19 pandemic, have further encouraged countries in turning inwards towards more protectionism and regionalism.

However, despite a global trend towards protectionism and away from free trade, 'middling' economic powers like Japan and the UK, who have vested interests in an open international system given their dependence on international trade, should prioritise the support and maintenance of a global rules-based order and its key institutions.

Economically speaking, maintaining the stability of global economic markets, institutions, and rules is fundamental to the Japanese and UK economies. If global trading networks were to collapse into further protectionism, or even increasingly exclusive regional trading blocs, the effects on international trade would be devastating.³³

Japan and the UK hold prominent places in international multilateral forums and international organisations and can use these roles to support and maintain their roles as leaders of a global, rules-based international order, with a focus on encouraging open economic relations and international trade.

Recommendations:

- Ensure continued commitment to the G7 and other multilateral forums and summits, in order to provide forums for leaders from liberal democracies to work together to uphold the international order.
- Create room for more unconventional international governance models, and following that, giving them greater institutional strength. Creating space for forums that bring in other countries, and with less rigid arrangements, will be important as the global geopolitical order shifts. Global and regional public-private partnerships will also be important to this.
- Supporting reform of the WTO to maintain its central role in structuring the global trading order.

RECOMMENDATIONS

3 Be at the forefront of digital trade policy

Both the UK and Japan have prioritised the digital economy and digitisation as key areas for economic growth. The UK has committed to a Digital Strategy aimed at making the UK the best place to start and grow a digital business, and its Transformation Strategy highlights the need for digitisation and an efficiency drive across government. It launched its first Digital Trade Network in Asia Pacific, committing £8 million to increase digital trade and investment opportunities, and to forge new digital partnerships in the region.

Japan meanwhile ranks 23rd on digital competitiveness in a recent study. In recognition of this, the government made digital transformation a key policy plank in 2020. However, Japan consistently ranks as one of the most open in terms of technology investments.

Both countries are leaders in technology innovation. The UK has demonstrated its strength in developing successful technology businesses in recent years, with 79 technology unicorns developed in the UK – more than Germany, France, and Israel combined. Japan is an innovation hub for automation, sensory technologies, and artificial intelligence.

Given the importance of the digital economy to growth in the UK and Japan, there is significant mutual interest in being at the forefront of setting the global rules for digital, data and technology. Unless the UK and Japan support the development of a global system for digital trade, there is a significant risk of further splintering of digital trade policy.

Areas for cooperation include:

- Partnering on Joint Statement Initiative (JSI) on the development of digital trade policy at the WTO level, to better encourage multilateral engagement on this issue.
- Furthering work at the G20 on digital policy, including on digital tax. With work already being done to cooperate on reforms to the international tax systems to accommodate the changes posed by increasing digitalisation, this work can be sped up with support from key players like the UK and Japan.

- Working through other international forums such as the OECD to establish consistent rules and global policy on digital issues such as e-commerce.

- Engaging and supporting commitment to work within the G7 to develop regulation on issues such as digital tax, digital currencies, and digital payments more widely.

- Leveraging new agreements such as the CPTPP to provide global blueprints for more advanced digital agreements.

4 Cooperate on infrastructure growth globally

Both Japan and UK will benefit from steps taken globally to boost economic development and thus increasing the global trade pool. One of the most important drivers of economic development is infrastructure development, and this is especially important in regions such as Southeast Asia.

Asia's infrastructure demand was projected at US\$26 trillion over the period 2016 to 2020.³⁴ These investment needs are so vast that no single institutional lender can meet the demand on its own. Though the US and China are active in infrastructure investment in the region, Japan in 2019 was the single biggest investor into investment projects in Southeast Asia, valued at US\$367 billion, in comparison to second largest investor China at US\$255 billion.³⁵ This can be attributed to some big-ticket projects, such as a revived North-South high-speed railway in Vietnam, and its historical presence in the region. The UK also has long-standing historical ties in the region, and such relationships will help both countries continue to contribute to infrastructure projects, with their own particular strengths.

The UK and Japan are also both well plugged-in to policy banks active in the region, including the Asian Development Bank, World Bank, and the Asian Infrastructure Investment Bank.



However, public sector financing cannot fill the infrastructure gap alone; private finance must play a role. Infrastructure financing has traditionally (and globally) been considered a high-risk investment, and capital requirements and existing risk structures for infrastructure financing are not conducive to both smaller investors and to private capital. If these issues can be addressed, including the establishment of strong legal frameworks and investment structures, the infrastructure gap can be closed. Private finance pools in London are particularly deep; as they are in Tokyo, and in coordination with policy banks in the region, this finance could be effectively deployed.

Further, Japan and the UK bring to the table unique expertise with regards to infrastructure financing and development. The UK can offer capital and an investor base; expertise in the world's leading speciality risk insurance market, including in infrastructure; and specialist advisory services to support infrastructure financing. Japan has similar expertise, including on the infrastructure development side, with extensive experience around the Asia region and beyond.

Some ways to develop the frameworks needed to boost infrastructure development in the region and increase infrastructure investment to boost economic growth could include:

- Establishment of an Indo-Pacific investment mechanism to support emerging UK and regional-led economic development assistance initiatives.

- Public-private engagement to support the development of stronger legal and regulatory frameworks to support private capital flows into infrastructure investment in the region.

- Improving coordination with development banks and the private sector, particularly the deep capital pools available in London and Tokyo, to finance further investment in infrastructure.

5 Cooperate on global issues such as climate change

With COP26 fast approaching and an irreversible shift towards sustainability principles and national, regional, and global climate change mitigation targets, Japan and the UK are among the best-placed to be leaders in sustainability financing and emerge as global green finance hubs. Japan's green finance activities have increased exponentially in recent years, with US\$17 billion in cumulative issuances at the end of 2019, and a ranking of 9th in the world and 2nd in the Asia Pacific for green finance.³⁶ The UK is a leading hub for sustainable finance services, with a wealth of experience and networks to draw on. The London Stock Exchange was the world's first exchange to introduce a dedicated green bond segment, which is now home to the first certified green bonds out of China, India, and the Middle East, and the first sovereign green bonds from both Asia Pacific and the Americas.³⁷

RECOMMENDATIONS

Both countries have mature, well-established finance markets that are at the forefront of innovation and growth. Both public and private finance institutions in the UK and Japan are playing important roles in developing green finance capabilities and providing an example to the rest of the world in incorporating sustainability into business and economic growth. By setting an example, both financial centres are well-placed to cement their statuses as global leaders in this space and support the growth of this sector globally.

Japan has committed to carbon neutrality by 2050; its public finance institutions have signalled their intentions to refuse loans for coal power plants; and its three largest megabanks – Mitsubishi UFJ Financial Group, Mizuho Financial Group, and Sumitomo Mitsui Financial Group, have all committed in principle over the last two years to stop lending to coal power projects.³⁸ Such actions have a major knock-on effect on domestic, regional, and global sustainability and energy trends.

With the understanding of the growing importance of environmental, social, and governance factors and criteria in decision making, more rigid reporting requirements and disclosure standards, and the development of a green bond market, the UK and Japan can support the continued growth of this sector and remain global leaders in this space.

Specific actions include:

- Open a UK-Japan dialogue on global sustainable infrastructure development.
- Increase cooperation between green finance hubs and capital markets for infrastructure finance such as London and Tokyo.
- Create fast track export finance clearance procedures for clean technology use across borders.
- Establish cross-border strategic resilience initiatives to reduce supply chain vulnerabilities.



CONCLUSION

The UK and Japan's historic relationship has steadily grown since the 1980s and the free trade agreement signed last year stands to maintain a close economic relationship in this next phase of bilateral relations. This report has explored the future of the economic partnership, looking at opportunities to grow bilateral trade within the current global framework, amid changing geopolitical tensions, the impact of the COVID-19 pandemic, and changing domestic environments both in the UK and in Japan.

There are two key opportunities to grow the economic partnership: within and through the existing free trade agreement, and by improving the international environment for British and Japanese business and government to operate in.

There are some clear areas for expansion and growth in existing free trade relations – namely in investment and in digital policy. But there is huge scope for growth in improving the international environment, given the UK and Japan's shared roles as leaders and staunch supporters of the rules-based liberal international order.

The UK and Japan can cooperate in a number of areas, from infrastructure to digital policy and climate change, to support the continuation and strengthening of global institutions, and in leveraging their privileged positions across a wide range of international forums.

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