



**BREXIT, AN EU-JAPAN FREE TRADE AGREEMENT AND BUSINESS
THE NEED TO ENHANCE PREDICTABILITY**

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Brexit, with all its different scenarios, has introduced a major factor of uncertainty for Japanese business. The demand of Shinzō Abe, the Japanese Prime Minister, towards his UK counterpart to “enhance predictability” has yet to be answered.

With the UK Government sending on 29 March its letter under Article 50 of the EU Treaty notifying the European Council of its intention to withdraw from the EU, the initiative within the Brexit negotiations shifts to Brussels and the EU institutions.

At the same time, an emerging EU-Japan Free Trade Agreement (FTA) that the negotiating parties have committed in February 2017 to finalise as soon as possible represents a much needed positive context for the next chapter of relations between Japan and the EU.

The sending of the Article 50 letter means that by 29 March 2019, the UK should no longer be a member of the EU. It is what the Conservative UK government is looking to achieve. Two things are up for discussion:

- **The agreement on withdrawal to deal with past and current assets and liabilities**

*It is **likely** that the exit agreement will be reached, though not without difficulty in view of the UK’s needs to honour its fiscal and budgetary commitments.*

- **The shape of the future trading relationship**

*It is **highly unlikely** that a final comprehensive trading relationship will be negotiated before 29 March 2019, leaving two scenarios of a transitional EU-UK FTA or a cliff edge of immediate application of WTO rules.*

In trade and regulatory terms, where does this leave the UK, the EU-27 and the world?

No one can possibly claim to know for sure but the safest assumption is that the UK will revert to the **WTO and its terms of trade**, which entails full import duties and no harmonised product standards between the EU and the UK.

After all, the UK Government has said it does not wish to have privileged access to the EU’s single market or to be subject to rulings of the EU’s courts – this in spite of the UK Government’s claim that it wants bespoke access for certain sectors to the EU’s single market.

The UK also hints that it will – at most – seek only partial coverage of the EU customs union (i.e. without being bound by EU commercial policy or the common external tariff).

Before we reach 29 March 2019, much more will become clear:

- The Conservatives have the power in the UK; what they say is what will probably happen in terms of the aims of their negotiations. And they are likely to stay in power beyond 2020.
- The EU is a multi-headed machine with the European Commission in pole position to take on the negotiations. But the European Parliament has considerable influence, as does the Council, and its member governments will bring their own priorities to bear in the negotiations: Germany for the inviolability of the four EU freedoms and respect for the rulings of the European Court of Justice; Central and Eastern European countries for free movement of people and budgetary concerns; and France for ensuring that other Member States are dissuaded from talking a similar path.
- The UK consists of four constituent parts with devolved governing powers in certain sectors. While Brexit was supported by a majority in England and Wales, the majority of the population of Northern Ireland and Scotland voted to remain in the EU at the Brexit referendum of June 2016. Scotland looks set to seek independence by April 2019, and the chances of Northern Ireland seeking to do similar have just increased following the recent elections there. Nonetheless, the UK Government is determined to follow through with the Brexit process.
- The UK Government will be passing the “*Great Repeal Bill*” which is intended to cut and paste all EU law into English and Scots law so that on Brexit Day #1, businesses carry on regardless.

But after Brexit Day #1, the trading and regulatory landscape will continue to change depending on the negotiations of the free trade agreement between (a) the UK and the EU, (b) the EU and Japan and (c) a potential future trade agreement between Japan and the UK.

In particular, the EU and the UK will have to discuss whether products compliant with future British product standards and certifications can be granted free access to the EU market and vice-versa. Even if all EU Law will be implemented into Scots/English Law by means of the Great Repeal Bill, this will not necessarily mean that British product standards and certifications are considered equivalent to EU product standards and certifications.

Given the complexity and unprecedented nature of the negotiations, with there being potential for the whole exercise to be blown off course by other geopolitical developments globally and within Europe given upcoming national elections, in particular in France, Germany and possibly in Italy, Brexit represents a moving target.

The process will require close monitoring from business which needs to be prepared for a number of possible scenarios and to be engaged with policy actors: those in Brussels, London and the capitals of the EU-27.

Below we provide an overview of the current political context together with an idea of how the regulatory landscape may look on Brexit Day #1 using the WTO fall back as the most realistic and worst case scenario.

WHERE WE ARE NOW WITH BREXIT

Although the referendum on Brexit took place at the end of June 2016, it is only now (March 2017) that the UK Conservative Government is providing some clarity.

In short, UK Government has signalled that:

- **The UK as a whole will no longer be a member of the EU single market**

What this means is that goods and services that are manufactured in, or provided from, the UK will not automatically be deemed to comply with EU law.

For all intents and purposes, the access to the single market of goods manufactured in the UK will be similar to most other third countries, such as Japan, or even with less access, since Japan and the EU entered a number of sector-specific Mutual Recognition Agreements (and is likely to soon have a full FTA in place).

Access to the UK market of any one of the remaining EU-27 (and the 3 EFTA states party to the European Economic Agreement) will not be automatic.

- **The UK as a whole will not likely be part of the full EU customs union**

Since the UK is likely to lose access to the single market and be outside the EU customs union, Japanese companies should assess the trade-off between continued production in UK and possible tariffs applied to export of those products to the EU.

Japanese companies should also not underestimate cases where the manufacture of products in the UK is also dependent on a EU-based supply chain. As a result, there may be two sets of tariffs applied at the UK/EU border: the first on components/ingredients coming from the EU to the UK; and the second on the finished product going back to the EU.

- **The UK as a whole will no longer be subject to the rulings of the Court of Justice of the European Union (or of other EU judicial bodies) in the sense that these judgments will no longer have a direct effect through English/Scots law.**

What this means is that the UK Government is looking to ensure that any decisions affecting UK businesses and UK individuals are taken in the UK by UK judges. It is of course more than likely that such decisions will not be the same as those taken in the EU Court of Justice.

But it is inconceivable that EU court judgments will not still have an influence on English/Scots law. Judgments of the European Courts will bind the EU Member States and therefore impact on the UK's relationship with the EU through the backdoor. In particular UK based companies will have to comply with the EU Court judgments when marketing products in the EU.

Competence to decide on trade disputes between the UK and the EU will belong to the Dispute Settlement Body of the WTO, as both the UK and EU are members of the WTO.



It may be that an eventual EU/UK free trade agreement will set up its own binding dispute resolution mechanism, but this remains to be negotiated. While there may be some differentiation to the exit agreement to cater for the relationship between Gibraltar and the EU, and between Northern Ireland and the EU, it is anticipated that if there is any deal on preferential access to the market, it will be **sectoral** only.

In its Article 50 letter, the UK Government highlights the case of financial services and network industries as needing to be covered in any EU/UK FTA. Other sectors will be seeking to ensure that their interests (both in the UK and the EU-27) benefit from any trade facilitation deal that is mutually beneficial to both the UK and EU.

Car manufacturers may benefit from preferential tariffs (which otherwise would be 10% under the EU's WTO tariff schedules) such that cars made by Nissan in Sunderland and cars made by BMW in Munich can be sold tariff free across the UK/EU border.

Chemicals companies based in the UK may be allowed to maintain their registrations at the European Chemicals Agency (ECHA) and EU based companies may be allowed to sell products in the UK without having to register a business office therein.

While the EU and UK could bilaterally enter into Mutual Recognition Agreements (e.g. concerning car standards or registration of chemicals), the lowering of tariffs would have to be implemented via a (transitional) FTA to be WTO compliant.

Prime Minister May has often repeated that "Brexit means Brexit". But beyond the summary given above, it remains very unclear just what business can anticipate becoming reality after April 2019.

There is a real risk that to access the EU single market, producers in the UK will have to fall back to the WTO terms of trade and it is indeed something that the UK Government is preparing for.

Business, unfortunately, will have to prepare for precisely that scenario. It remains the case that matters will only become clear once negotiations get under way after April 2017. And the exit agreement, together with what the EU/UK relationship will look like, will only become clear at some point in (late) 2018.

WHERE DOES THIS LEAVE JAPANESE COMPANIES?

The EU and Japan have reached the final stages of the negotiation of a comprehensive FTA. Despite the fact that the UK is a key Member State for Japanese inward investments, the negotiations are now accelerating.

This FTA will clearly have no legal effect in the UK once the country has left the EU, unless the UK and Japan decide to adopt an identical text.

Indeed Liam Fox, the UK Government's International Trade Minister, has expressed the hope that EU free trade agreements can be grandfathered on for the benefit of the UK. It is therefore possible that the UK will want to replicate the agreement. It is however, not possible to predict the willingness of the Japanese Government in this regard, nor any timeline.

In light of the foregoing, Japanese companies may want to assess a number of factors likely to impact their business post-Brexit.

01 UK as administrative centre and EU headquarters

Since UK-based companies will no longer be considered established in the EU, Japanese companies may have to ensure establishing a base within the EU single market when the applicable sector specific EU legislation requires companies to set up a local office or appoint an EU representative to place products on the EU market.

Restriction of labour mobility may also be a problem to consider for Japanese companies, whose staff often need to travel from the UK to the rest of the EU.

02 Manufacturing plants in the UK

Since the UK may very well lose access to the single market and be outside the EU customs union, Japanese companies may wish to assess the trade-off between production in the UK and possible tariffs applied to export those products from the UK to the EU.

Japanese companies should also not underestimate cases where the manufacture of products in the UK is also dependent on an EU-based supply chain, which would imply two sets of tariffs applied at the UK/EU border: the first on components/ingredients coming from the EU to the UK; and the second on the finished product going back to the EU.

03 Market interest in the UK

Due to **(i)** the devaluation of the national currency (pound sterling), **(ii)** the fact that there could be a drive to deregulate and that **(iii)** the UK may enter FTAs with third countries, manufacturing in the UK may provide new opportunities beyond servicing the UK market.

By contrast, any lower product standards (both technical and for safety) established under British legislation would certainly prevent these products from accessing the EU single market.

CONCLUSION

The 29 March Article 50 letter from the UK Government represents the beginning of a process.

There is no certainty in the outcome and Japanese companies will need to prepare for several scenarios tailored to their own specific circumstances (e.g. economic significance of their particular sector, degree of presence in the UK and EU-27).

What is clear is that Japanese business has the opportunity to voice its interests and concerns not only in Brussels and London but also in the capitals of the EU-27 where they have inward investments.

At a time when global and regional trade relations are subject to severe uncertainty and the forces of protectionism are on the rise, the EU-Japan FTA provides a timely and positive context.



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Contact us

Lawrie McLaren
Managing Director

lawrie.mclaren@bm.com
+32 2 743 66 11
www.burson-marsteller.eu

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Contact us

Koen Van Maldegem
Partner

Koen.VanMaldegem@fieldfisher.com
+32 2 742 70 62
www.fieldfisher.com