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WILL JAPAN EXIT THE UK?

Following the UK referendum, in which the country voted to leave the EU, Japan has issued what is regarded as an unprecedented message to both the UK and EU.

Although Japan is keen to state that it respects the will of the British people, the Japanese government have collated the concerns of Japanese businesses operating in the EU to ensure that both the UK and EU remain an attractive destination for doing business.

John Vail, Chief Global Strategist and Simon Down, a Senior Portfolio Manager from our London Office, provide their thoughts on the Japanese statement and the future relationship between Japan, the UK and the EU.

Europe is an important market for Japan with the EU both an important trading partner and destination for outbound FDI. The UK has traditionally attracted a major proportion of these FDI flows, positioning itself as the 'gateway' for Europe. The Japanese ambassador estimates that there are now 10,000 Japanese firms operating in the UK, employing 140,000 people, with 440,000 people employed by Japanese firms in the EU as a whole. In 2014 net FDI from Japan into the UK was £2.2bn, close to 10% of total net FDI.

Key to the future of trade between the EU and Japan is the joint Economic Partnership and Free Trade Agreements. After being launched in March 2013 these agreements are currently scheduled to be concluded by the end of 2016. The main aim of these agreements is to promote future trade and investment between the EU and Japan which combined represent around one third of global GDP. Specifically Japan is seeking to eliminate tariffs on cars and electronic goods whilst the EU is seeking greater access for food and beverages. The UK's referendum vote thus comes at a critical point in the relationship between Japan and EU countries including the UK.

Assessing the Key Japanese Requests

1. **Transparency:** To disclose information on the status and future prospects of the BREXIT negotiations in a regular and timely manner.

2. **Avoiding drastic change:** Providing sufficient time periods for transition and publicising changes

Both the UK and EU are very aware of the need to minimise uncertainty and ensure that firms are able to gradually adapt to changes, so once negotiations on the UK exit begin there is no reason to believe that there will be any sudden drastic changes. Negotiations will take place over a number of years and there could well be a transition period after the agreement is concluded to minimise economic disruptions.

3. **Market Integrity:** To safeguard as much as possible the market integrity encompassing the UK and the EU.

4. **Maintaining the EU-Japan EPA:** To prevent the UK exit from the EU from undermining free trade discussions and delaying the expected agreement by the end of 2016.

EU countries and the UK have a long history of trade which stretches back well before the start of the EU. There is a risk that negotiations could fail and that the UK and EU as a result have some tariffs on each other's goods. Auto's would likely be the most affected as they attract one of the highest EU tariffs at 10%. The negative economic impact on both the EU and UK should put pressure on politicians to avoid this however. Until there is more clarity though this is an area where Japanese firms will continue to have concerns. There is no reason to believe that the UK would want to delay the EU-Japan EPA or FTA as upon exiting the EU the UK is likely to want to have its own agreements with Japan.

5. **Financial Services:** Maintaining the freedom of establishment and the provision of financial services, including the "single passport" system.

6. **EU R&D Budget / European Medical Agency:** Maintaining the UK's access to the EU budget for research and development and participation in the Japan-EU joint research project. To maintain the location of the European Medicines Agency in the UK and to maintain the current certification system for medicines between the UK and EU.

7. **Immigration:** To maintain, at least, the current parameter of the immigration system and with a desire that the rules on skilled labour from outside the EU is liberalised.

These final three points are far more problematic. Immigration was a critical issue during the referendum and controls on EU immigration are a certainty. UK rules for non EU migration are due to be tightened further in 2017 rather than liberalised and there is likely to be a similar system imposed on EU migration in coming years. On Financial Services, there is a clear risk that the UK is excluded from the passport system as a number of EU states have long coveted the UKs position as a global financial services hub. Access to the EU R&D program will be heavily dependent on whether the UK continues to make contributions to the EU budget. If that doesn't happen though, the UK is almost certain to set up its own equivalent to this program. It's difficult to believe that the European Medicines Agency will remain in the UK once the UK leaves the EU and there are already five countries vying to be its new home with Ireland leading the pack.

8. **Tariffs:** To maintain duty free trade and customs clearance between EU and UK. This includes maintaining the harmonisation of regulations and standards and unified production of intellectual property rights and information protection.

9. **Investment:** To maintain freedom of cross border investment and free movement of capital.

At this stage there is still a high degree of uncertainty surrounding these two issues which will depend on trade talks between the UK and EU. The UK government have stated that they would like to remain within the single market but with the need to restrict free movement of labour and pressure to reduce, if not stop entirely, contributions to the EU budget, negotiations will be difficult. If the UK leaves the single market then the harmonisation of regulations and standards would be likely to come to an end given complaints from small firms about the unnecessary costs involved for non-exporting companies.

The Investment Dilemma

With a number of Japan's requests unlikely to be fulfilled, Japanese companies in the UK will face a dilemma regarding their future position. A major consideration though is that there are many reasons why the UK attracts Japanese investment other than membership of the EU. This makes any decision more complex.

Benefits of UK for Investment

- Most competitive tax system in the G20 and commitment to reduce business taxes further
- English law is regarded as one of the strongest in the world for the protection of property and business interests as it is based on legal precedent rather than the civil law that is used in the rest of Europe. This means that the majority of international financial contracts are written in English law and disputes settled in UK courts
- Comprehensive regime to support the development and exploitation of intellectual property with preferential regime for profits arising from patents
- One of the world's largest and fastest growing digital economies at £180bn, second only to the US in numbers of secure servers globally
- High quality infrastructure with efficient transport and communication networks, the UK has the largest air transport and sea traffic of any country in Europe
- Ranked 6th globally in World Bank ease of doing business survey, by far the highest amongst major European economies
- Large domestic economy which provides a market in its own right
- One of Europe's largest workforces with high participation and flexible labour regulations. Close to 800,000 students graduate annually from 164 universities and higher education institutes. UK has 7 of the top 10 universities in Europe and 4 of the top 10 globally. Reduced immigration in coming years may make this factor less attractive though
- UK has the second lowest per hour labour costs amongst major European economies (only Spain is lower) according to Eurostat
- English is the global language of business

Over time, as there is greater clarity on how negotiations are proceeding and the future relationship between the UK and EU takes shape, then it will become clearer for Japanese firms on whether they should continue to invest in the UK or perhaps shift investment towards the EU. If there are tariffs imposed by both sides then future strategy will need to incorporate this. Just as there are advantages for investment in the UK there are also significant advantages for investment in the EU.

Benefits of EU for Investment

- The EU is the largest economy in the world with GDP of over $16 trillion. Even after the UK exits the EU it will remain one of the most important global economies with 440m people. EU citizens have full consumer rights when shopping outside of their country within the EU and can travel across the EU without being stopped at borders
- Within the EU there are no tariffs on goods and services between countries, no custom procedures and a common currency, the Euro is used in the majority of EU states all of which reduce frictional costs
- Common product standards and the replacement of complex and different national laws with a single framework make it easier to conduct business across international borders within the EU and thus generate economies of scale
- Within the EU there is free movement of both labour and capital; this allows firms to more easily recruit and transfer staff around the EU
- Access to EU export markets via already negotiated free trade agreements for production within the EU under the EU Origins label
- Tax and investment incentives for foreign firms looking to invest in the EU
- Highly competitive labour costs in some EU states, especially within Eastern Europe

UK corporate taxes are low and will continue to fall in coming years, whilst at the same time the EU are taking a harder line on 'sweetheart deals' on corporate taxes which have benefited smaller EU countries such as Ireland. Even once outside of the EU, the UK will thus likely continue to be a top location for both international investment and multinational headquarters. But the EU will also continue to draw large amounts of foreign investment and corporations will need to judge the advantages and disadvantages carefully for both the UK and EU before making future investments.

The Larger Players

Japanese companies employ around 140,000 people in the UK. The UK auto sector is a key source of Japanese investment in the UK and 2015 saw a 10 year high for total UK auto production, 1.58m vehicles with 1.2m of those exported and over 800,000 of these vehicles made by Japanese firms. Of these exported vehicles 57.5% were to the EU.

Fujitsu

Fujitsu are the largest employer with 14,000 UK staff, processing 2.8m passports each year as well as 10m driving license renewals and 1m new licenses. The company also has major contracts for IT support for two large rail projects, Crossrail and HS2.

Toyota

Toyota employs 3,800 in two auto manufacturing plants which were established in 1989. After a total of £2.2bn of investment, capacity is around 190,000 vehicles with 100,000 of these sold into the UK.

Nissan

Nissan employs 6,700 people at its Sunderland plant where it builds its Juke, Qashqai and Leaf models. Established in 1985 total capacity is around 500,000 vehicles per year with around 150,000 of these sold into the UK.

Honda

Honda employs 3,400 people at two car manufacturing plants and one engine facility. From 2008 the company have invested a total of £1.5bn and have total capacity of 150,000 vehicles per year. Around 50,000 of these vehicles are sold into the UK.

Suntory

Suntory holdings, the Japanese drinks company, employs close to 5,000 people in the UK where it has its European HQ. Suntory is a private company which acquired US Jim Beam for $16bn in 2014. The company also owns the well known UK brands Ribena and Lucozade.

Hitachi

Hitachi have recently invested £90m in expanding its operations in the North East of the UK, employing 600 people and with another 300 people to join in 2017. This will build trains for sale across Europe and have stated that they have a full order book for the next 3-4yrs.

Conclusion

The statement by the Japanese government on behalf of Japanese firms highlights the concerns at a corporate level regarding the coming negotiations between the UK and EU. They provide clear direction on the priorities of these firms to both UK and EU politicians.

There are a number of areas though where it's extremely likely that changes will occur. It will be impossible for example for the UK to not tighten controls on EU migration and rules for non EU migrants are due to be tightened further rather than liberalised. There are certain roles however, classified as 'shortage occupation', where visa requirements are not so onerous. By raising specific concerns at such an early stage, it may be possible for Japanese firms operating in the UK to have some influence on how UK visa rules evolve as the UK exits the EU. Many firms will then need to carefully weigh up the advantages and disadvantages of further investment in the UK and EU. If the two sides are unable to agree on trade and thus tariffs are imposed then it's likely that UK based Japanese manufacturers will either experience lower margins or face lower sales in the EU unless they relocate from the UK to the EU.

If they maintain production within the UK market, however, they will become more competitive in that market as they will not be subject to tariffs, and are likely to be able to take market share from EU based competitors. For pharmaceutical companies and financial services companies the situation is likely to be complex, with both areas having the potential to see significant changes. Some companies in the infrastructure sector though could end up winners if they stay within the UK. With the largest impact from the referendum vote expected to come via a drop in business investment (The British Chamber of Commerce expect business investment to drop by 2.2% in 2016 and then by 3.4% in 2017), the UK government have indicated that they plan to announce an infrastructure spending plan to counterbalance the expected weakness in business investment. The Chancellor has stated that 'often it is modest, rapidly deliverable investments that can have the most immediate impact, particularly on the road network but also in some places on the rail network'. This has led to speculation of a £20-£50bn infrastructure spending plan, the details of which would be released in the autumn statement and which could lead to opportunities for some firms.

In the medium term, once the UK exits the EU, the UK will move out of the EU-Japan ETA and FTA. Since South Korea agreed its FTA with the EU in 2011, trade with the UK has been the main beneficiary and exports from Korea to the UK have nearly doubled, seemingly at the expensive of Japanese exports. South Korea has been one of the first countries to indicate that they will immediately seek a free trade agreement with the UK once the UK has exited the EU and it will be important for Japan to ensure that it maintains free trade with the UK as well.

Although Japan might not achieve all on its lists of desires, exiting UK investments will be a very uncertain and difficult decision. There will need to be a careful balancing act on whether new investment should be directed at the UK, the EU or even best kept within Japan itself once the free trade agreement between the EU and Japan removes tariffs for goods exported directly from Japan. In sum, there certainly will be individual winners and losers from BREXIT among Japan's corporations rather than an equal benefit or loss for all and each firm will need to adapt to changing circumstances.

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