

## **RULES OF ORIGIN AND AUTOMOTIVE SECTOR IN JAPAN'S ECONOMIC PARTNERSHIP AGREEMENTS**

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### **Abstract**

*This paper examines complicated Rules of Origin (RoO) in Japan's Economic Partnership Agreements (EPA) with East Asian countries. To limit the scope of this research, the paper concentrates on automotive industries in ASEAN4 only. The reason is that, this industry is the world's largest manufacturing activity and had long been protected in Malaysia, liberalized but with limited market access in Thailand, and growing in Indonesia with majority players are the Japanese automakers. The main question that this paper tries to answer is whether these countries should create a different and standardize the existing set of RoO in order to increase the utilization of FTAs with other partner countries. Complex rules in RoO have several implications on Japanese automotive production network when EPAs coming into force. Next, this paper discusses how to understand RoO among automotive related firms and at the same time promote automotive industry in ASEAN to develop to the world class levels.*

**Keywords:** rules of origin, automotive, FTA, Japan, ASEAN

**JEL Classification:** F1, L62

### **1. INTRODUCTION**

Rules of Origin (RoO) are a necessary and important part of preferential trade agreements (PTA). As PTAs are increasing, so are RoO. RoO are a set of discriminative regulations but they must exist in any kind of trade agreements. Governments must categorize the imported products between domestic and foreign origin, and among these foreign products, the origin of the products will determine whether importers can apply for Most Favored Nation (MFN) treatment or preferential tariff treatment (Falvey & Reed, 1998:209). However, with the proliferation of regional trade agreements notified to World Trade Organization (WTO), RoO are designed according to the negotiations between partner countries. The differences in these rules also created possible trade distortions or known as 'Spaghetti Bowl' problems as it have been said by popular economist, Jagdish Bhagwati. Dieter (2004) and Roberts and Wehrheim (2001) explained in their arguments, RoO are considered as one of the hidden protectionist instruments in PTAs.

Japan has been looking into the complex rules and regulations in FTAs and they have come up with "fairer" and wide coverage sectors with a win-win situation both to Japan and its trade partners. Manufacturing industry is expected to become developed with the Japanese advanced automotive technologies. Japanese multinational enterprises' involvement in various economic cooperations within ASEAN has proven that Japan's presence in the automotive regional production networks is important for the future East Asian economic integration. The main question that this paper tries to answer is whether East Asian countries should standardize the

existing set of RoO in order to increase the utilization of preferential trade agreements with other partner countries or not. RoO have great impact on Japanese automotive production network when Economic Partnership Agreement (EPA) coming into force. This paper will analyze RoO in Japan's EPA and in automotive lines too.

## **2. EXISTING LITERATURES**

In order to explain the latest trend of RoO, the paper will look into several literatures on this subject. Without PTAs, stringent RoO cannot attract foreign direct investment enough into their countries although some literatures found that stringent RoO can also boost investment (Estevadeordal et. al., 2006: 5). The quality of a trade agreement can be measured by looking into several factors but the most important factor is the degree of openness in domestic market. RoO are found to reduce utilization rate of preferential trade agreements. This has been proved by Cadot et. al. (2006), where the argument concluded that restrictive RoO caused the utilization rates to be lower as it can be seen in most of EU and US preferential trade agreements.

Krishna (2005) has also interpreted restrictive RoO as result to higher imports although this paper concluded that restrictive RoO can lead to investment in long term. Foreign firms may be motivated to set up a location for their facilities that produce intermediate products within the preferential trade of area. ASEAN market has long been dominated by Japanese auto-manufacturers with their highly efficient and cost competitive among global players. Japanese auto-manufacturers found that it is profitable to expand their business in Southeast Asian countries as the market share will continue to surge along with new model lineups.

Krueger (1993) and Krishna & Krueger (1995) (as cited in Estevadeordal et.al., 2009: 6) stated that RoO are used by FTA members to secure the partners' markets for the exports of its own intermediate products. Moreover, RoO have the potential to increase domestic sourcing and governments can use RoO to encourage investments in certain high value added and high employment sectors as been discussed by Jensen-Moran (1996), Hirsch (2002) (as cited in Estevadeordal et.al., 2009: 7). The voluminous literature on the subject of preferential trade agreements and RoO showed complicated regulations that must be applied to all imported products. Most of the discussions are about North American Free Trade Agreement (NAFTA) and European Union (EU)'s RoO but very few discussed about East Asian trade agreements with RoO in them. The existing literatures about the importance of automotive industries in US and EU market are extensive but few discussions can be found on the significant relationship between RoO and automotive industries in East Asia. In order to have a better understanding on RoO under Japan's model of free trade agreements, the next section will explain Japan's approach to the rules.

## **3. JAPAN'S ECONOMIC PARTNERSHIP AGREEMENTS AND RULES OF ORIGIN**

Preferential rules of origin can be divided into two categories; wholly obtained or produced (WO) products and non-wholly obtained or produced products. It is easier to obtain the origin country of WO products because they contained no other materials from other countries. For non-wholly obtained or produced goods, the origins are based on any or combination of three methods. These three are Change in Tariff Classification (CTC), Value-Added (VA) and Specific Processing (SP). In June 1989, during Uruguay Round, Japan had proposed to harmonize and standardize preferential and non-preferential regulations in RoO and mechanisms of trade dispute settlements (Wulf and Sokol, 2005: 188). Thus, in order to better support existing multilateral trading system, Japan chooses to follow similar VA rules in ASEAN Free Trade Area (AFTA) when signing EPAs

with ASEAN countries. This way, Japan can proceed with the harmonization of RoO in East Asia. Furthermore, this action will promote for smooth trade facilitation at customs' procedures, particularly in automotive industry where the Japanese related automotive firms implemented Just-In-Time delivery system in their Southeast Asian production facilities.

Japan are constantly concerned over the implementation of Trade Related Investment Measures (TRIMS) Agreement but decided to include utilization of VA rules in RoO chapter in bilateral trade agreements with ASEAN. According to the Joint Study Group Report of Japan-Malaysia Economic Partnership Agreement (JMEPA), Japanese side requested the RoO chapter is based on change in tariff classification (CTC) rules for all industrial products but Malaysian side considered that although they are familiar with value added rules, CTC approach will not be the basic approach to RoO chapter in JMEPA. Japan-Singapore Economic Partnership Agreement (JSEPA) has complex RoO but most of the products are using the simple change in heading in CTC system. However, Japan's agreements with Thailand and Malaysia have the same complex rules as in Japan-Mexico EPA because the involvement of several sensitive products in the agreements.

CTC method only deals with little administrative work and the liberalization level can be altered from change in heading to change in subheading or items. According to Estevadeordal (2000) and Estevadeordal et. al., (2009) studies, which was based on NAFTA's RoO, the change at level of chapter is more restrictive than change at the level of heading and change at the level of heading more restrictive than change at the level of subheading. While for VA method, fluctuation in raw material prices and exchange rates, uncertainty delays and the inspection of part's origin could contribute to the complex RoO. In case of SP method, it must deal with technological innovation and chemical changes, thus can hinder the fully utilization of certain FTAs.

The efforts to harmonize and standardize RoO by Japan can be found in its agreement contents with partner countries with the latest agreement was signed between Japan and Switzerland (2008). Table 1 showed the concluded EPAs and their content of RoO chapters. In order to cover the non-EPA members such as Myanmar, Cambodia and Laos, Japan decided to sign the first multilateral trade agreement with ASEAN (ASEAN-Japan Comprehensive Economic Partnership Agreement; AJCEPA) in 2007. The only significant difference is its RoO chapter; the Cumulation Rule for ASEAN-Japan produced materials. Japan tries to follow similar approach by AFTA with regional value added percentage of no less than 40 percent.

**Table 1: Content of RoO in Japan's Economic Partnership Agreement**

EPA	Rules of Origin
Singapore Malaysia Thailand Indonesia Brunei Philippines Vietnam ASEAN	CTC or VA Rules, ASEAN Cumulation Rule Permits the use of material in non-EPA partners which are ASEAN member countries. Two-Step Rule – under AJCEP Agreement. Issuance of “third-country invoice” is acceptable
Mexico	CTC and VA Rules (Same as NAFTA 50-65% for natural resources, footwear and auto/auto parts)
Switzerland	Self-Certification of CoO

Source: Japan Customs, Ministry of Foreign Affairs (Japan)

The increasing trend of bilateral trade agreements with Southeast Asian countries has made partner countries consider cumulation rules method as an important issue. Cumulation rules are divided into three types; bilateral, diagonal and full. AFTA adopted the full cumulation rules which allows for more economic integration among member countries (Brenton, 2003:5). It is an advantage for developed countries to outsource labor intensive production process to low wages labor countries in developing or less-developed countries. Japanese automakers played a significant role in achieving economies of scale in their automobiles output and cost efficiency. Hence, Japan decided to include ASEAN Cumulation Rule in the AJCEPA under RoO Chapter to further promote intra-firm trade in ASEAN production networks.

The existing bilateral trade agreements have showed that different rules will create a stumbling block among member countries. The turning point is when Japan sign the first bilateral trade agreement with Switzerland as one of the European countries. The significance of Japan-Switzerland EPA (JSFTEPA) is that Japan looked at Swiss to be a good model in following its user-friendly and systematic RoO. Switzerland has adopted an improved system of RoO which comprised of self certification of origin by the approved exporters in an invoice for consignments. This will save cost and time for the exporters as the declaration can be issued at the time of export or retrospectively after exportation. Japan will consider RoO system in JSFTEPA for the future bilateral trade agreements with other countries.

#### **4. TRADE FLOWS BETWEEN ASEAN4 AND JAPAN IN AUTOMOTIVE SECTOR**

Japanese automakers have been operating in ASEAN since 1980s after the yen appreciation in Plaza Accord. Japan began to establish regional production bases in Southeast Asian countries. The intra-trade dependence between Japan and ASEAN countries is increasing from year to year. In 2008, the volume of total exports and import in automobiles and automotive parts sector between ASEAN4 and Japan has expanded to surpass the peak point before 1997 Asian Financial Crisis (from 9,285 million USD to 10,036 million USD). Exports of automobiles and automotive parts from Thailand, Malaysia, Indonesia and Philippines to Japan also grew year by year with increasing rate from 7 percent to 40 percent. We can conclude that Japanese automotive related firms that have been established in ASEAN4 fully utilized the lower tariff in AFTA to produce efficient-cost vehicles and exported to Japan particularly after 2006 when JMEPA enters into effective date, Thailand (2007) and Indonesia (2008). The existence of various ASEAN policies such as Brand-to-Brand Complementation (BBC) Scheme, ASEAN Industrial Cooperation (AICO) have motivated Japanese automakers to take significant role in development of automotive industry and these has contributed to the increase of local content in Thailand, Indonesia and Malaysia.

#### **5. COMPARISON OF RULES OF ORIGIN IN AUTOMOTIVE SECTOR**

RoO are negotiated as an independent chapter in the agreement proving that all the goods under several industries are closely monitored to see the liberalization level. In a way, we can know which industry is very much liberalized by the country partner and which industry is being protected with stringent RoO. Trade negotiators took into consideration each of product's specialties from political and economical impact but in turn, it will create incentives for the industry players to push rules of origin to provide greater protection in their favors (Chase K., 2007:2).

Malaysia has been protecting its domestic automotive market due to pressures from this industry lobbyist to develop supporting suppliers under Malaysian national car makers, Proton and Perodua. Thus, we can see that there are non-consistent RoO in automotive lines in JMEPA. Japan-Thailand Economic Partnership Agreement (JTEPA) and Japan-Philippines Economic Partnership Agreement (JPEPA) have the same rules for HS8702 until HS8704, HS8706 respectively because this specification represents pick-up trucks and motor vehicle for transport of goods and they are their largest markets. Higher local content is better to attract investments from foreign firms with package of low labor cost and incentives offered by the host governments. In JMEPA, Malaysia has set higher local content of HS8702, HS8704 to 50% because HS8702 is public transport type passenger motor vehicles and HS8704 is motor vehicles for transport of goods. HS8703 and HS8711 have 60% VC because HS8703 is motor vehicles for transport of persons and HS8711 is motorcycles which both of them present markets of Proton and Perodua and national motorcycle brand, MODENAS. However in JTEPA, Thailand only set 40% VC on both categories. Malaysia eliminated tariff for HS8708 (parts & accessories for vehicles of HS8701 to HS8705) compared to Indonesia, Thailand and Philippines where the rules are CTC and 40%VC. This means that Malaysia liberalizes its auto parts industry to keep trade for automotive parts from Japan smoothly without high transaction cost.

## 6. CONCLUSION

The importance of RoO is not only on economic motive, but also on technological and political reasons. The design on RoO will have effect to the partner's trade and investment flows. Japan's intention to conclude various economic partnership agreements with ASEAN countries are because of their changed policy towards regionalism, maximizing the consistency with AFTA and lowering the transaction cost for Japanese multinational firms. Although RoO are important, the complex and lack of knowledge among Japanese firms have made the EPAs' utilization rate lower than expected. Some RoO in automotive sector can determined the country's way of openness to its domestic market. For example, in JMEPA, Malaysian side has set a higher local content percentage to its automobile and motorcycle categories in order to cushion the impact from FTA and nurture the local automotive supporting industry.

Finally, Japan is looking for the possibilities to simplify RoO in its bilateral trade agreements by concluding a multilateral trade agreement with ASEAN as a region. Japan hopes that ASEAN cumulative rules will further assist their multinational firms to obtain the most efficient economies of scale, particularly in manufacturing industry. In future, the harmonization of RoO will contribute to a better market-driven economic integration in East Asia.

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