Chapter 1

Major Issues in the Asia-Pacific Region in 2023–2024

Section 1
Transformation of the International Order and the World Economy

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Looking back on the world situation in 2022, although the coronavirus disease (hereafter, COVID-19) is showing signs of being under control, events continued to remind us that we have entered a new phase of global political and economic divide and conflict, as evidenced by the Russian invasion of Ukraine in February. Frequent extreme weather events and natural disasters around the world also indicate that climate change has become an issue of global significance that can no longer be taken lightly.

It is needless to point out once again that China has become a global player in international politics and the world economy since the beginning of this century. Like Japan, however, China's declining and aging population has been a major stumbling block to economic growth. China's total fertility rate (TFR) has dropped below 1.2, lower than that of Japan. Until the Cultural Revolution, China's TFR was around 6.0, and the "One-Child Policy" was introduced in 1979 as a solution to the food shortage problem. However, this radical policy was abandoned due to the labor shortage and wages improved with economic growth, and from 2021, "three children" were allowed, and various pronatalistic measures introduced.

Meanwhile, in Russia, the TFR temporarily dropped to around 1.2 at the end of the 20th century, and the government launched a policy of providing generous benefits to parents with two or more children. Although the birth rate has recovered somewhat since then, the Putin administration's concerns about a declining population appear to be quite strong. The Russian government seems to be facing a significant crisis due to the decline in the number of troops and the tendency of professional personnel to leave the country.

The future appears uncertain for the authoritarian states like China and Russia when considering indicators such as the working-age population and economic vitality. Expansion and growth are typically the results of virtuous cycles, but once the economy moves into a contractionary phase, numerous challenges arise. It is undeniable that the territorial expansionism of the Xi Jinping regime and the imperialism of contemporary Russia are in part uncontrolled actions driven by fears of future governance challenges stemming from a shrinking population and economic stagnation. However, government intervention in childbearing in a liberal democratic state is unlikely to have much effect unless each individual is able to envision a positive outlook towards marriage and family.

The spread of COVID-19 and Russia's invasion of Ukraine had the effect of changing energy prices and the flow of food imports and exports by severing supply chains and blocking trade ports. Furthermore, in response to the pandemic, all countries were forced to launch aggressive fiscal measures as part of their economic policies. Now that the virus is in the process of being contained, it is necessary to take a long-term perspective on fiscal discipline, as the pandemic has temporarily caused a marked increase in public debt worldwide. Although there has been a slight decline in public debt as concerns about the virus have eased in Europe and the United States, it remains considerably high. This high level of public debt and its increase will exert inflationary pressure.

It remains to be seen whether the global inflation, fluctuating with highs and lows, will be transitory or become chronic and persistent. What stance will be taken on the issue of fiscal discipline in the future, when a large amount of funds will be needed for defense spending and economic restructuring? The first step is to determine the nature of inflation, which will be a difficult task. Japan's monetary authorities, under the leadership of new Bank of Japan Governor Ueda, have made it clear that, unlike other major advanced economies, they will continue their large-scale easing measures, but will also begin a review of their monetary policy over the past quarter century and its side effects.

Section 1 provides an overview of the current global economic challenges and identifies major factors that could destabilize the Japanese economy, along with discussing potential future scenarios.

1. Current State of Inflation and Situation in Each Country

The supply- and demand-side factors of inflation are linked by a complex causal relationship that includes the inflation expectations of each economic agent, and are largely determined by domestic monetary and fiscal policies, as well as exchange rates (currency fluctuations). In 2022, the impact of Russia's invasion of Ukraine led to a dramatic increase in energy and food prices, which further intensified inflationary pressure on the global economy, especially in the euro zone. In the case of Japan, which had been in a chronic "deflationary state," inflation has so far remained low by world market standards. Nevertheless, rising food and energy prices has been a contributing factor preventing companies from increasing wages in 2022. The sharp rise in energy and raw material prices is believed to have been a "cost-push" force. Table 1-1-1 shows the movements of the consumer price index (CPI) in major countries.

In 2021, the U.S. experienced a significant increase in the annual average inflation rate. This was sometimes attributed to "temporary inflation" resulting from the release of "pent-up demand" that had initially been suppressed by the COVID-19 pandemic. However, the average annual inflation rate continued to rise to 8% in the subsequent year of 2022. In response, despite the looming risk of a recession beginning in March 2022, the Federal Reserve Board (FRB) took decisive action, aggressively raising interest rates to curb inflation. This level of inflation, reaching 8% YoY, marked the highest since the second oil crisis.

In the eurozone, inflationary trends have become more pronounced, similar to those in the United States. Consumer prices have surged in major countries such as France, Germany, and the United Kingdom. Fears of inflation due to fiscal expansion triggered by Russia's invasion of Ukraine prompted the European Central Bank (ECB) to sharply raise interest rates by 0.75% in September 2022, followed by another 0.75% increase at the October meeting of its Executive Board. When inflation expectations themselves increase, a mechanism may be set in motion that further exacerbates actual inflation. The policy of raising interest rates is considered to be a precautionary measure against such

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Table 1-1-1 Consumer Price Indexes and Estimates: 2015-25

Country	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
France	0.1	0.3	1.2	2.1	1.3	0.5	2.1	5.9	5.0	2.5	2.1
Germany	0.7	0.4	1.7	1.9	1.4	0.4	3.2	8.7	6.2	3.1	2.3
Japan	0.8	-0.1	0.5	1.0	0.5	0.0	-0.2	2.5	2.7	2.2	1.6
UK	0.0	0.7	2.7	2.5	1.8	0.9	2.6	9.1	6.8	3.0	1.8
USA	0.1	1.3	2.1	2.4	1.8	1.3	4.7	8.0	4.5	2.3	2.1
China	1.5	2.1	1.5	1.9	2.9	2.5	0.9	1.9	2.0	2.2	2.2
Russia	15.5	7.0	3.7	2.9	4.5	3.4	6.7	13.8	7.0	4.6	4.0

Note 1: Annual average inflation rate of consumer prices for the specific year
Note 2: Estimates for France and Russia in 2022 and all countries in 2023, 2024, and 2025
Source: Prepared by the author using data from International Monetary Fund, World Economic Outlook Database, April 2023

"forecast effects."

For Russia and China, both facing economic and political challenges, pinpointing a single reason for the changes in inflation rates is difficult. In Russia, the depreciation of the ruble prompted the Russian central bank to take the emergency step of raising its policy rate to 20% to avoid the risk of inflation caused by the depreciation of its currency. The IMF's Economic Outlook estimates Russia's average annual inflation rate at 14% in 2022.

In China, inflation has remained slightly below 2% for the past year. Even before the outbreak of the pandemic, prices in China had been relatively stable. Consumer demand has been suppressed (pent-up) by the "ZeroCOVID Policy" due to the spread of the coronavirus infection. A heightened sense of caution due to the real estate crisis might also have had a substantial impact.

The impact of the unilateral interest rate hike policy of the U.S. has been significant for the world as a whole. This policy not only led to the dollar's appreciation but also caused currencies of countries with substantial trade volumes with the U.S. to depreciate, leading to a sharp increase in import prices. These soaring import prices essentially exported inflation from the U.S. to the rest of the world, altering global trade flows.

2. Change and Recovery in Trade Volume

In 2021, as the impact of the new coronavirus somewhat weakened, there was a general recovery in global trade. However, the degree of recovery varied across different industry sectors and products. Industries such as telecommunications equipment, precision instruments, and transportation vehicles, which suffered from a shortage of semiconductors due to supply chain disruptions, showed a remarkable recovery, while trade in the energy sector, where price hikes were conspicuous through 2022, showed a high rate of increase in terms of value.

All countries and regions observed a noticeable decrease in trade. It's worth noting that the "trade in services" sector was hit harder by the coronavirus spread than the trade in goods, with severe restrictions on people's movements, especially across borders, severely impacting the travel and transportation industry. According to United Nations Conference on Trade and Development (UNCTAD) Trade Statistics, YoY, the value of exports of travel services fell by 81.8% in the second quarter of 2020. However, in the first quarter of 2022, the value of exports of travel services showed a sharp and rapid recovery, with an increase of 88.5%, demonstrating a quick rebound from the sudden downturn.

Since global trade was in a recovery phase, increases in both imports and exports were observed in almost all countries, including China, the United

States, Germany, Japan, and the Netherlands. However, it should be noted that changes in the value of trade varied by country, with some countries recording a widening trade deficit and others posting large surpluses. The largest trade deficits are observed in the U.S., Germany, Japan, and the Netherlands.

The main causes of the growing deficits appear to differ from country to country. In the Eurozone, energy prices have been rising since the beginning of the war of aggression against Ukraine in 2022, which has had a major impact on the area. In Japan, not only energy prices but also the rapid depreciation of the JPY contributed to the increase in imports. In the U.S., the trade deficit with China (China accounts for one-third of the total U.S. trade deficit) had been shrinking due to “Additional Tariff Measures” implemented during the tariff war against China under the previous Trump administration. However, over the past year, imports from China have begun to expand, resulting in a goods trade deficit in excess of $1 trillion.

It is undeniable that the “tariff surcharge” has increased inflationary pressure on U.S. retailers and consumers by adding tariffs on many daily necessities, including clothing made in China. There are reports of considerations to review this measure under the Biden administration, but there are also opposition opinions within the Democratic Party. However, some predict that eliminating tariffs on China, the U.S.’s largest trading partner, could suppress the domestic consumer price index by 1% or more. Under these circumstances, the Biden administration is faced with a difficult choice: protect manufacturing workers or contain inflation. Figure 1-1-1 illustrates the changes in China’s imports and exports from January 2020 to April 2023.

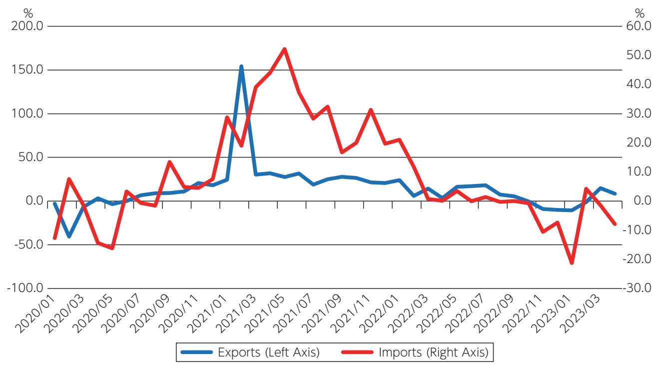

Figure 1-1-1 China’s Imports and Exports YoY : January 2020 - April 2023

Source: Compiled by the author using data from the General Administration of Customs of the People’s Republic of China

China is the world's largest exporter and second-largest importer, while the United States occupies the contrasting positions of being the world's largest importer and second-largest exporter. The United States lags far behind China in exports, and its second place and huge trade deficit clearly show the problems of U.S. trade with China.

3. Current Public Debt Outstandings

How did the ratio of national debt (total general government debt including national, regional, and social security funds) to GDP change as a result of Russia's invasion of Ukraine during the COVID-19 pandemic? As mentioned earlier, the U.S. Fed has been raising interest rates since March 2022, and it is necessary to consider the risk factors implied by these rate hikes. It is crucial to contemplate the implicit risk factors due to these hikes, such as the potential expansion of domestic private-sector debt, leading to financial crises in countries aligning with U.S. policies. The U.S. Fed's "inflation control" measures are not unrelated to its policy of raising interest rates, as bank failures that have been occurring in the U.S. since the spring of 2023 demonstrate.

The Bank for International Settlements (BIS) statistics, Credit to the non-financial sector, allows us to calculate the debt of the non-financial sector as a percentage of GDP in three categories: "general government debt,"

Table 1-1-2 Nonfinancial Sector Sectoral Debt of Major Countries as % of GDP

Country	3rd Quarter of 2022		
	General Government	Non-Financial Corporations	Household Accounting Departments
Canada	90.1	113.8	103.2
France	109.6	164.1	66.5
Germany	64.0	73.4	55.7
Italy	142.2	69.6	42.6
Japan	231.3	116.8	67.9
Korea	44.2	119.2	105.3
UK	94.9	69.5	84.5
USA	103.5	78.8	75.2
China	NA	158.2	61.4
Hong Kong	NA	279.2	94.8
India	NA	52.2	35.5
Russia	NA	72.8	21.0

Note: Data for NA not yet published
Source: Prepared by the author using data from Bank for International Settlements (BIS)

"non-financial corporate debt," and "household debt."

As for the debt-to-GDP ratio of the non-financial sector, except for Hong Kong, where the debt situation of government finances and corporations is in a special position, Japan, as is well known, is the top country in terms of the severity of the debt situation of the non-financial sector (416.0%). Japan's debt situation is characterized by the fact that the debt-to-GDP ratio of the "general government debt sector" is by far the highest by sector. However, the debt-to-GDP ratio of the non-financial corporate debt sector is lower than those of France and Korea, and the debt-to-GDP ratio of the household debt sector is lower than those of Korea, Canada, the United Kingdom, and the United States.

At the end of 2021, the U.S. Congress passed a bill to raise the legal limit on federal government debt to $31.4 trillion to avoid a so-called "Government Shutdown," but by the end of January of the following year, it exceeded $30 trillion for the first time, marking a severe situation. Such government shutdowns are not uncommon in U.S. history, and in May 2023, the U.S. again faced the problem of a government shutdown and default if the debt ceiling was not raised. The crisis was averted in exchange for the Republicans cutting education and social programs in pursuance of a further increase in the debt ceiling from its current level of $31.4 trillion.

In addition to Greece and Italy, Portugal, Ireland, Spain, and other eurozone countries with heavy government debt, as well as China and South Korea, which are facing significant risks due to an overheated real estate market, are confronted with significant challenges in navigating the issue of rising interest rates.

4. Changes in Military Expenditures of Major Countries

The impact of Russia's invasion of Ukraine on world trade has been discussed earlier. The nature of this impact varies depending on the nature of trade with Russia, and the impact of import restrictions from Russia on the economy of the country varies qualitatively. For example, the EU saw a significant change in the value of its imports and exports to Russia in March 2022, the month following the start of the war of aggression against Ukraine. Export restrictions on Russia reduced the supply of high-tech products such as semiconductors, and the value of exports dropped by almost half from 7.37 billion euros in February to 3.84 billion euros in March. On the other hand, primary commodities such as wheat and natural gas were highly dependent on imports from Russia, so imports could not be completely shut down immediately, and the value of imports has increased due to soaring energy prices.

At the same time, we will examine changes in the size and composition of each country's fiscal expenditures, particularly with respect to military spending. Russia's aggression against Ukraine, which has had a major impact on international relations, has also aggravated Russia's own finances through a significant increase in military expenditures. Comparing the "ratio of military expenditures to GDP" of major countries between 2019 and 2022 using data from the Stockholm International Peace Research Institute (SIPRI), no significant changes can be seen.

However, significant increases in absolute military expenditures can be observed in most major countries, including the United States (+9%), the United Kingdom (+20%), Germany (+14%), and France (+13%) among the major NATO countries. It is noteworthy that while the U.S. is the world's largest military spender, China, in second place with the reunification of Taiwan in mind, has recorded a 22% increase. Although Russia's military spending in 2022 increased around the time of the invasion of Ukraine, the total increase in military spending for the entire year of 2022 is negligible, partly due to previous financial strains. For a more accurate assessment, reviewing the 2023 data will be necessary.

Table 1-1-3 Military Expenditures of Major Countries as % of GDP (SIPRI)

Country	Percentage of GDP		Percentage of government spending	
	2019	2022	2019	2022
USA	3.43%	3.45%	NA	NA
Australia	1.88%	1.90%	4.82%	5.02%
India	2.55%	2.43%	9.14%	8.26%
China	1.68%	1.60%	4.91%	4.79%
Japan	0.99%	1.08%	2.66%	2.53%
Korea	2.67%	2.72%	11.85%	10.57%
Myanmar	2.19%	3.05%	10.81%	14.24%
USSR	NA	NA	NA	NA
Finland	1.35%	1.72%	2.54%	3.22%
France	1.84%	1.94%	3.32%	3.43%
Germany	1.26%	1.39%	2.81%	2.75%
UK	1.98%	2.23%	5.14%	5.29%
Iran	2.01%	2.59%	13.92%	17.32%
Saudi Arabia	8.13%	7.42%	23.15%	27.79%

Note: Data for NA not yet published
Source: Organized by the author using data form Stockholm International Peace Research Institute (SIPRI)

5. Trade Policy Change and Anti-Globalization

Finally, I would like to add a comment on the outlook for the global economy from the perspective of changes in trade policy and the possibility of bloc formation.

The EU acted swiftly to impose sanctions against Russia, suspending imports of Russian coal in August 2022 and initiating a phased embargo on oil and natural gas. These measures must have been a difficult choice for the EU. In fact, the EU as a whole is not completely aligned. The pro-Russian Orban government in Hungary has allowed some oil imports from Russia, for example.

Another contributing factor to the food crisis was the destabilization of the world grain market due to the massive disruption in the supply of Ukrainian wheat. Despite mediation efforts by Turkey and the UN, resulting in the lifting of the blockade on the port of Odessa, turmoil persists in the grain market. Notable importers such as Indonesia, Turkey, and China continue to face challenges, keeping the market in a state of flux. Additionally, the market has been adversely affected by extreme weather conditions, adding another layer of instability.

This movement toward trade fragmentation and a bloc economy had already occurred with the severing of the supply chain by the coronavirus. The conflict in Ukraine also caused major cracks in the trade structure due to energy and food transportation problems, revealing a serious dilemma of "the separation of politics and economy." A prime example of this is that, from the perspective of national security, the U.S. further strengthened its efforts to hinder China's technological progress by limiting trade with non-friendly countries and restricting exports to China of products whose "technology and equipment are for both civilian and military use" (so-called dual use).

In 2022, the WTO's Dispute Settlement Subcommittee concluded that these U.S. tariff measures "do not constitute a war or a state of emergency in international relations" and that the U.S. "tariff increases" were not allowed. Since then, the U.S. has been steering its policy toward building a strong supply chain and preventing the military diversion of high-tech technology in China, including subsidy measures to attract semiconductor manufacturing companies to the country through the "CHIPS and Science Act" of August 2022 and focusing on concluding a framework trade agreement to exclude China. The global cooperative framework of U.S. politics and trade policy in recent years has been geared toward so-called "friend-sharing," a strategy that emphasizes trade and supply chains with U.S. allies and friends, while keeping China in mind.

Economics can lucidly explain the benefits from free trade and globalization. But how do we deal with situations in which citizens of countries that prosper from free trade face difficulties that offend public sentiment, such as widening income inequality within a country? Unless sufficient consideration is given to this point, the future of free and multilateral trade is not bright. The shift in national security policies by Germany and other EU countries, reducing dependence on the Chinese and Russian economies, is a political maneuver to navigate away from significant economic and political dilemmas. It is not uncommon to find situations where economic interests and the maintenance of peace are incompatible. Striking the right balance is a task left to domestic politics and diplomacy.

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