

Section 4

ECONOMIC STRATEGIES OF JAPAN AND JAPANESE COMPANIES TOWARD EAST ASIA

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1. U.S.-China Conflict and Production Networks

(1) Countermeasure to changing circumstances

The U.S.-China confrontation, which began in 2018 under the Trump administration as a tariff war, has gradually expanded its scope to include competition over technological hegemony among the superpowers and issues of human rights and political regimes, and the degree of confrontation has deepened further under the Biden administration. Japan, an ally of the United States, has been forced to undertake a major review of its security policy. However, there are signs that the tide is turning in the area of economic security, particularly with regard to export controls in the high-tech sector.

Certainly, the deterioration of sentiment toward China in Washington, D.C., is extremely strong, and it is unlikely that the U.S. and China will move toward reconciliation anytime soon, as the US enters presidential election mode over the next year. Meanwhile, a speech given by Jake Sullivan, Assistant to the President for National Security Affairs, at the Brookings Institution on April 27, 2023, suggested that the White House is trying to settle the current issue. He said that export controls over China are “with a small yard and a high fence,” and that the goal is de-risking and diversifying, not decoupling, as European Union President Von der Leyen has suggested. In the context of export control, the US is introducing strict controls to decouple some high-tech sectors, but creating an environment in which other economic activities can develop freely, i.e., decoupling is only partial. This statement is considered to be an indication of the intention to reflect the voices of the economic community that values business with China, which is not readily apparent, although there are probably many competing opinions in Washington, DC.

European countries are visiting China one after another, starting with German Chancellor Scholz in November 2022, accompanied by businessmen, separating politics and economics, in an attempt to expand their business presence in China. In fact, the U.S. also continues its close economic relationship with China, and in 2022, despite the slowdown of the Chinese economy in the second half of the year, both imports and exports reached all-time highs for the entire year. While the impact of export controls in the high-tech sector,

especially as it determines the direction of cutting-edge innovation, cannot be ignored, there is little concern of the world as a whole being split in half. A pragmatic approach is becoming clear: continuing the confrontation with China, but taking immediate economic gains while taking risks into account.

Japan and Japanese companies have seemed to be so caught up in the security debate to prepare for the worst-case scenario that they have stopped thinking. In export control, too much reliance is placed on the anticipation of the other party's moves between the government and the private sector, and excessive careful attention is limiting free economic activities. Certainly, in relations with China, it may be difficult for Japanese companies to start moving aggressively because of the detention of Japanese VIP in March 2023. However, it should be well understood that that is exactly China's strategy to divide the West. And just because the strategy toward China is difficult, can it be said that Japanese companies are embarking on expanding their activities to the Association of Southeast Asian Nations (ASEAN) and other parts of the world? We must not forget the economy. The government needs to create the economic environment and companies need to develop their corporate strategies, while assessing where their competitors are drawing the line and trying to increase their economic activity.

(2) Japan's decoupling policy

The set of policies called economic security-related policies are a mixture of various objectives and measures, but here we will review Japan's decoupling-related policies, especially from the perspective of supply chain decoupling.

First, for a middle power like Japan, which is sandwiched between two superpowers, a distinction should be made between defensive and offensive decoupling policies in light of their immediate objectives. Defensive decoupling policy here refers to the policy of increasing domestic supplies or supplies from a third country in order to reduce dependence on a specific country when there is a risk of sudden supply disruptions of critical commodities in the case of geopolitical tensions. On the other hand, offensive decoupling policy is a policy of restricting the supply of critical commodities to another country with the intention of damaging it.

In the case of Japan, most of the policies adopted so far are defensive decoupling policies. A certain degree of risk management has first been promoted by the private-sector. In particular, the "China+1 strategy" (i.e., separating Chinese operations from the rest of the world) was adopted early toward that country, and was carefully reexamined especially after the Senkaku Islands issue and China's rare earth export restrictions in 2010.

After 2020, against the backdrop of geopolitical tensions that rose with the new Corona pandemic, two types of METI subsidies were established for Japanese companies: the “Subsidy for Domestic Investment Promotion Projects for Supply Chain Measures” and the “Support Program to Strengthen Overseas Supply Chains for Demonstration Projects and Project Feasibility Studies”. Although not officially specified, the former was intended to encourage production bases located in China to return to Japan, while the latter was intended to diversify production bases from China to ASEAN and other regions. While these policies have produced some results, they have not caused a major leave of Japanese companies located in China.

Furthermore, the Law for the Promotion of Economic Security, enacted and promulgated in May 2022, states that the first of its four pillars is to ensure a stable supply of critical commodities. In December of the same year, the law designated 11 critical commodities (antimicrobial agents, fertilizers, permanent magnets, machine tools and industrial robots, aircraft parts, semiconductors, storage batteries, cloud computing programs, natural gas, critical minerals, and ship parts) and announced a policy of providing financial assistance. Some of the critical commodities are intended as a kind of industrial policy, but most of them are defensive decoupling policies.

Most of the offensive decoupling policies related to Japan have taken as countermeasures to the extraterritorial application of U.S. export controls. Japan itself expanded export control items in 2018 and 2021, but this has not had a significant impact.¹⁾ The introduction of export controls on 23 items of semiconductor manufacturing equipment (scheduled to take effect in July) announced at the end of March 2023, in line with the US, is a new step forward.

A defensive decoupling policy considers how much risk to take in relation to costs, and therefore is considered to be a restraint that limits the scope of decoupling rather than an orientation of total decoupling. On the other hand, an offensive decoupling policy is one in which a middle power such as Japan is likely to keep pace with its ally, the U.S., rather than deciding how far to go based on its own strategy. As long as any decoupling policy is implemented against the market mechanism, it will incur certain costs and leads to the problem of who will bear those costs. In the case of offensive decoupling policies, in particular, it is highly likely that the costs will be borne by industries and companies in which Japan is internationally competitive.

1) Hayakawa, Ito, Fukao, and Deseatinicov (2023) used econometrics to analyze whether exports declined for items that Japan placed under new export controls in 2018 and 2021, but found no statistically significant decline.

(3) Impact of U.S. Export Controls on Japan

The U.S. export control policy in the high-tech sector, which is an offensive decoupling policy for the U.S., could affect not only China, but also Japan and other countries that cooperate with the U.S. How large are the effects?

First, at the industry and sector level (general machinery, electrical machinery, transportation equipment, and precision machinery), no clear offensive decoupling effects are detected based on international trade data, at least until the end of 2022 (Ando, Hayakawa, and Kimura 2023, forthcoming). East Asian machinery exports recovered quickly from COVID-19 and are back on a growth path. This differs significantly from North America and Europe. There was a slight slowdown from the second half of 2022. The reasons for this include the lull in special demand due to the nest egg demand associated with the new corona, the slowdown in the smartphone market, the end of the semiconductor boom, China's zero corona policy, and rising transportation costs due to the war between Russia and Ukraine. In addition to these factors, geopolitical tensions may also be a factor, but it is not clear at the industry or sector level. In particular, China remains an important trading partner for Japan. There are signs of a certain degree of reorganization of production networks to deal with the tariff war between the U.S. and China. For example, in Vietnam and Mexico, which are used as detour points, we observe an increase in exports to the U.S. and foreign direct investment, including Chinese firms. However, the impact of export controls is not clearly seen.

The effects of export control are detected in more detailed product level or for specific companies. Ando, Hayakawa, and Kimura (2023) focus in particular on the tightening of U.S. export controls on Huawei in August 2020 and attempt to quantify the effects using detailed product data on Japanese exports to China. They found that the reduction in Huawei's production of telecommunications equipment reduced Japan's exports by reducing demand for various components used in telecommunications equipment, rather than by the extraterritorial application of U.S. technology exports. The magnitude of the reduction in Japan's exports was about 3% of Japan's annual exports to China. Ando, Hayakawa, and Kimura (forthcoming) analyzed the effect of export controls on U.S. semiconductor manufacturing equipment from November 2022 using data on U.S. exports to China and found that U.S. exports of it to China decreased by about 16-36%. If the export controls on Japanese semiconductor manufacturing equipment scheduled to be introduced in July 2023 were to result in a similar reduction in Japanese exports to China, it would result in a 5-11% reduction in exports of it.

Thus, statistically significant effects were observed at detailed product level

and for companies. However, the magnitude is not so large at the macro level. Offensive decoupling and other restrictions on economic activities in the name of security may increase in the future. However, it is highly likely that complete decoupling of supply chains will not be achieved. If we believe that the final result will be only partial decoupling, governments and companies will have to take appropriate measures to deal with the situation.

2. Asian Economies Remain Vibrant

(1) Growing Southeast and South Asia

In 2023, developed countries are experiencing a marked economic slowdown, if not a recession, and according to the IMF (2023), economic growth in developed countries is projected to slow down from 2.7% in 2022 to 1.3% in 2023 and 1.4% in 2024. Japan's growth rate remains as low as ever, and many media reports take the tone that the entire world is in a recession. However, Asian economies continue to grow robustly.

China has been in a slump since the second half of 2022 and is having a difficult time recovering from the new corona pandemic while also dealing with its own structural economic problems. Although many believe that China will not be able to return to its previous growth trajectory, the ADB (2023) still forecasts economic growth of 5.0% in 2023 and 4.5% in 2024 (Table 1-4-1). Since a large economy can grow at such a high rate, it still has the potential to create many business opportunities.

Southeast and South Asia have already returned to their previous growth trajectory and are growing further. In 2022, Southeast Asia as a whole recorded growth of 5.6%, with Malaysia, Vietnam, and the Philippines performing particularly well at 8.7%, 8.0%, and 7.6%, respectively, and Indonesia and Cambodia at 5.3% and 5.2%. In 2023, it is expected to see a slight slowdown due to the economic downturn in developed countries, but the region is becoming increasingly attractive as a production base and a market. South Asia as a whole is growing at 6.4% in 2022, enjoying a large potential for growth, and is expected to continue to grow after 2023.

It is inevitable that Japan and Japanese companies will seek a deeper relationship with the Asian economy.

Table 1-4-1 Economic growth rates of Asian developing economies (fact and forecast) (%)

	2021	2022	2023(f)	2024(f)
East Asia total	7.9	2.8	4.6	4.2
China	8.4	3.0	5.0	4.5
South Korea	4.1	2.6	1.5	2.2
Taiwan	6.5	2.5	2.0	2.6
Southeast Asia total	3.5	5.6	4.7	5.0
Brunei	-1.6	-0.5	2.5	2.8
Cambodia	3.0	5.2	5.5	6.0
Indonesia	3.7	5.3	4.8	5.0
Laos	2.3	2.5	4.0	4.0
Malaysia	3.1	8.7	4.7	4.9
Myanmar	-5.9	2.0	2.8	3.2
Philippines	5.7	7.6	6.0	6.2
Singapore	8.9	3.6	2.0	3.0
Thailand	1.5	2.6	3.3	3.7
Vietnam	2.6	8.0	6.5	6.8
South Asia total	8.4	6.4	5.5	6.1
Bangladesh	6.9	7.1	5.3	6.5
India	9.1	6.8	6.4	6.7

Note: This table includes data of countries other than those listed ones.
Source: ADB (2023)

(2) Japan's relative position

At the same time, it is necessary to be well aware of the position of Japan and Japanese companies in the eyes of Asian countries.

Figure 1-4-1 shows the value of imports and exports by country and region for the 10 ASEAN countries. Even in 2020, when the impact of the corona pandemic was most severe, the decline in ASEAN's trade, especially exports, was very small. This is largely because ASEAN countries succeeded in mitigating the spread of the virus to a considerable extent, and ASEAN countries were able to enjoy the positive demand shocks created by the work-at-home and stay-at-home effects of the corona pandemic. In 2021, both imports and exports grew strongly.

What is even more remarkable is China's share of imports and exports in this region. While ASEAN countries' internal trade is just over 20%, China accounts for 16% of ASEAN's exports and 24% of its imports (in 2020 and 2021). In particular, imports from China have come to exceed the sum of imports from Japan, the U.S., and Europe. Although the depth of economic engagement cannot be measured by trade volume alone, and direct investment in ASEAN and technology flows must also be taken into account, there is no doubt that

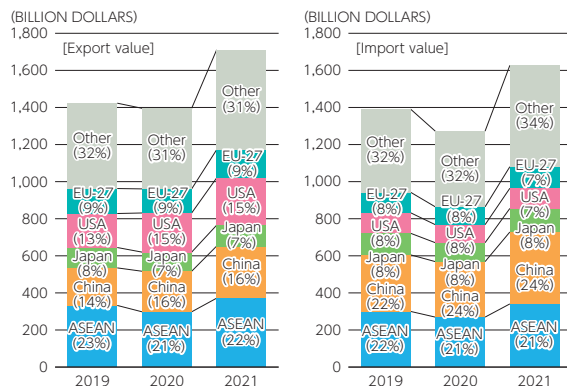


Figure 1-4-1 Exports and Imports of ASEAN Countries by Country or Region

Source: ASEAN Secretariat Website

ASEAN countries are becoming increasingly involved with China. On the other hand, Japan accounts for only about 8% of both imports and exports, while the U.S. accounts for only 15% of exports and 7-8% of imports. It is clear that Japan is not in a situation where it can force ASEAN to select the U.S. or China as a sole partner.

Kumagai et al. (2023) use the IDE-GSM model of the Institute of Developing Economies to simulate the impact on countries around the world if the Western and Eastern camps start decoupling their supply chains by imposing a 25% tariff mutually. The results show that both camps would naturally be negatively affected, but third countries that do not belong to either camp, such as ASEAN countries, would be positively affected because they could continue to trade with both camps. There is certainly an economic incentive for third countries, especially those deeply involved in the East Asian production network, to remain neutral.

(3) Strategies of Japan and Japanese Companies toward ASEAN

If offensive decoupling ultimately remains part of the supply chain, Japan's economic diplomacy with ASEAN will be extremely important. ASEAN, along with China, is the region where the core international production network for the machinery industry in East Asia is deployed, and it has less policy risk in the sense that China bears. Japan is not the only friendly country to ASEAN, but Japanese companies have built up a solid track record, and Japan has earned a great deal of trust. Taking into consideration that geopolitical tensions are difficult to resolve in the short term, ASEAN is a valuable counterpart in maintaining

the economic vitality of “other economies” outside of export controls.

Japan and Japanese companies should adopt the following three strategies to deal with ASEAN. First, it is important to explain well to ASEAN countries the supply chain decoupling policies adopted by developed countries, and to have them understand that there is room for ASEAN to be involved in decentralization of supply sources, especially in industries and products that are subject to defensive decoupling policies. Also, Japan and Japanese companies should firmly explain that there are few cases in which ASEAN needs to immediately deal with the extraterritorial application of U.S. export controls in the high-tech sector, but rather that they open up the possibility for ASEAN to accept high-tech-related investment in the future.

Second, although the era of Japan as a prominent player in ASEAN was over, Japan must continue its efforts to further deepen economic ties with ASEAN countries. Japan has contributed greatly to the development of economic infrastructure and the creation of international production networks, particularly in the manufacturing sector, in ASEAN. While the importance of these contributions will not diminish in the future, the emphasis of ASEAN’s economic development strategy is shifting toward services and urban amenities. The ASEAN is particularly interested in digital and sustainability.

Third, Japan, together with ASEAN, must preserve the rules-based trading regime as much as possible and emphasize its importance to the world. Since the 1990s, East Asia has led the world in the development of an international division of labor based on tasks, especially in the machinery industry, and the preconditions for this were a rules-based trading regime and a long-lasting peace. In the future, technological progress will make possible a more sophisticated international division of labor, but these two preconditions must continue to be met in order to make effective use of the division of labor.

One of the major problems with the current policy measures to geopolitical tensions is that developed countries are openly violating existing trade rules for reasons of security. A prominent example of this is the domestic priority for subsidies in high-tech sectors such as advanced semiconductors. It may be difficult to push back the logic of security or the structure of confrontation between the superpowers head-on, but this does not mean that the trading regime based on rules should be seriously damaged. It is essential to keep other economic activities under trade rules as broadly as possible, while ensuring the consistency with trade rules of security policies as much as possible. China may not agree with the content of trade rules, but it feels a strong desire to be respected as a

respectable country that abides by the rules in the international arena²⁾. There are still many meanings of international rules.

ASEAN can be a valuable partner in advocating the importance of a rules-based trading regime. ASEAN has utilized globalization in economic development most effectively in the past 40 years under international rules. ASEAN should not free-ride on global policy governance, as it has done in the past, but should take responsibility for its own development.

There are many ways in which Japan and ASEAN can cooperate to preserve the rules-based trading regime. First, in relation to the World Trade Organization (WTO), the second tier of dispute settlement, the Appellate Body, has ceased to function with zero members due to the U.S. blockade. As a result, cases of so-called “appeals into void” have been piled up, in which appeals are filed to the Appellate Body, which does not function after the panel of first instance reached a conclusion.³⁾ In March 2023, Japan announced its participation in the Multi-Party Interim Appeal Arbitration Arrangement (MPIA), which is intended to temporarily replace the functions of the Appellate Body. However, Singapore is the only ASEAN country that has already joined the MPIA, and it is important to encourage other ASEAN countries to do so. In addition, Japan is co-chairing a joint statement initiative for e-commerce, and Japan could cooperate with ASEAN, which is also taking steps to establish its own rules.

We would also like to promote the use of the mega-FTAs (Free Trade Agreements) that Japan has concluded with ASEAN countries. In particular, the Regional Comprehensive Economic Partnership (RCEP) agreement covers the whole East Asia, including China, and is expected to reduce policy risks within the region by actively using such opportunities as regular meetings⁴⁾. In the Indo-Pacific Economic Framework (IPEF) currently under negotiation, a substantial agreement was reached in May 2023 on supply chains, the second of four areas: trade, supply chains, clean economy, and fair economy⁵⁾. The agreement is to cooperate in preparation for sudden supply disruptions of critical commodities such as semiconductors and critical minerals. It is not clear to what extent this will be effective, but it is not a matter of course to force the stakeholders to

2) See Watanabe, Kamo, Kawashima, and Kawase (2021).

3) For example, the EU sued Indonesia for a nickel ore export ban and domestic processing requirements (DS592), and Japan sued India for higher tariffs on ICT products (DS584), both of which have been appealed out of court after the panel decision. See Trade Policy Bureau, Ministry of Economy, Trade and Industry (2023) and WTO website.

4) See Kimura (2022) for a discussion of the role that RCEP could play.

5) Japan External Trade Organization (JETRO), “Business Brief: U.S. Department of Commerce Announces Substantial Conclusion of IPEF Supply Chain Agreement, Offers Measures to Realize Business Benefits,” Accessed on May 29, 2023.

declare which side they will be on.

Geopolitical tensions are a major headwind for free economic activity, but they have not run the entire world. We must pursue a balanced economic diplomacy and corporate strategy to ensure sound rules and vigorous economic activities as broadly as possible.

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