

# De-risking and diversification in tough geopolitical times: How can Japan and Europe cooperate more effectively?

This closed roundtable, held in late-November 2023, brought together a select group of experts to discuss European and Japanese approaches towards de-risking, diversification, and economic security more broadly. The half-day discussion was held in hybrid format (at Chatham House in London and online) with the entirety of the discussion taking place under that Chatham House Rule. Participants were drawn from the business, academic, government and think tank communities.

## **Session One** | What does de-risking look like in practice?

The first speaker highlighted de-risking as one of the most pressing issues of the time, commenting that it is far more nuanced than just seeking to decouple. It reflects the needs of countries to find a balance between maintaining trade openness while also safeguarding domestic security and resilience. De-risking has become increasingly important in the UK for three reasons: 1. unpredictable external disruptions, such as Covid-19, and the impact this can have on supply chains; 2. Russia's invasion of Ukraine and the weaponisation of energy supply – while decoupling was the right option in this circumstance, the UK has since had to rethink what its future energy security will look like; 3. trade restrictions which have been applied for a variety of reasons – some valid and others less so. While the G7 nations have made great progress on de-risking, and economic security more broadly, an effective response will require a multi-year effort with continued international collaboration. While the UK has been thinking about de-risking from a sectoral strategy perspective it also remains very focused on maintaining free trade and competition.

The second speaker commented that there is no common definition of de-risking. The US under President Biden has shifted from 'decoupling' to a 'small yard, high fence' strategy, while in Japan, de-risking has often been used as an approach to help it decouple from China. Others, such as German Chancellor Olaf Scholz have suggested that de-risking is the responsibility of companies, rather than government. While China has frequently acted outside of World Trade Organization (WTO) rules – for example, banning the import of Japanese marine products for Fukushima-related reasons – they have justified their coercive economic actions with reasons of national security. While the WTO rules do allow free trade exemptions for countries for security-related reasons, these have not been well utilised over the last 30 years, so it is not necessarily clear when those exemptions would apply. However, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which the UK has recently joined, has very strong provisions regarding security exemptions to its trade rules: if a country requires an exemption, it will need to convince the other member countries for permission. As China has also applied to join the CPTPP, this may offer a forum for the UK and other members to talk with China about raising its standards.

The third speaker commented that while much of the de-risking debate is centred on semiconductors, 95 per cent of the world's medical production and 99 per cent of all penicillin is produced in China. Using this kind of example (that relates directly to the ordinary population) can help to demonstrate how difficult it is to de-risk and reduce dependence on China. China has had its own de-risking strategy for several years. Nearly one decade ago, its 'Made in China 2025' strategy set out the ten most important sectors for keeping supply chains internal to China; in 2018, Beijing introduced the concept of national security for critical

materials, including food and medicines. The G7's current focus on de-risking therefore appears to have emerged quite late in comparison. The strategies of policymakers in Europe and Japan have tended to focus on defensive measures for economic security but should look at more proactive ways to increase resilience too. This includes how to generate and retain the manpower that is needed for countries to produce the things they need and keep supply chains at home. Market inducement measures are also necessary to incentivise companies to reduce their dependence on China. Questions also need to be asked about whether European and Japanese customers will be willing to pay double the price for goods, in the name of de-risking, and how publicly listed companies can justify these increased costs on their balance sheets.

The fourth speaker focused on corporate responses to de-risking. While multinationals do see risk in their China business, they also see risk in working with the US and in international relations more broadly. Companies are naturally always seeking to de-risk, but they approach these issues in different ways to governments – they respond to the needs and incentives of their customers, rather than managing risk for citizens. Given the costs and economic impact associated with de-risking, governments have no choice but to involve the corporate sector, so they should use the natural behaviours of business to their advantage. They should look at where companies are choosing to diversify of their own accord and explore how they can accelerate that diversification; for example, by creating more favourable economic conditions in those countries by working on trade negotiations. They must also recognise that companies will only work within a 'normal' range of risk management and are never going to plan for the next pandemic. At the level of extreme risk, there is always an assumption that government will have to get involved.

In the discussion, participants highlighted the importance of distinguishing between different types of commodity when considering their respective de-risking trade-offs. There is less risk associated with classic technologies, such as penicillin, if a government is willing to bear the financial cost of building new factories, for example. Frontier technologies – such as AI and computing – and natural resources, will, however, require a different approach. Participants also discussed the complexities of de-risking away from China. Moving business to alternative production centres may still result in dealings with Chinese-owned companies or suppliers further down the supply chain. European and Japanese partner countries in Asia can also have different views on economic security, seeing engagement with China as an opportunity, rather than a risk.

It was clear from the discussion that coordination between the private sector and government is key for ensuring economic security, although it remains unclear who will pay the bill. The government can, however, play a positive role by sharing critical information with business, and should also involve the corporate sector in its decision-making and planning processes from the start, to avoid roadblocks further down the line.

## **Session Two | Making sense of the emerging trade architecture in the Indo-Pacific region**

The first speaker began by identifying three key trends in global trade that have emerged in recent years: the replacement of global multilateral initiatives with regional ones; the supplanting of open and inclusive regional trade initiatives with ad hoc trade regimes, such as RCEP and bilateral free trade agreements; and a greater emphasis on trade resilience over trade liberalisation, as seen in the CPTPP and the Indo-Pacific Economic Framework for Prosperity (IPEF). Ultimately, these trends are about reducing dependence on countries of concern, particularly in the field of critical and emerging technologies. The origin of these trends can be traced back to the start of China's weaponisation of trade, in 2010, when it banned rare earths exports to Japan. There has since been a return to a 'noodle bowl' of trade regimes where values-driven initiatives are flourishing; there is a greater focus on the breadth (openness and inclusivity) of initiatives

over depth (technical focus); and security forums and initiatives, such as the Quad and G7, now frequently spillover into the economic domain. There nevertheless remains a gap between the rhetoric and the reality, and the push to 'friendshore' production is not necessarily working to disentangle trade with China.

The second speaker emphasised the importance of having multilayered trade architectures, rather than trying to cover all rules under one framework, such as the WTO. In practice, multiple regional and bilateral frameworks can be combined, and it is possible to build links between comprehensive frameworks and those with a more targeted focus. The issue of how best to build relations with China and position it within the global economy remains a key issue, however, and the development of future trade architectures must give suitable consideration to de-risking.

The third speaker outlined some of the difficulties in assessing the impact of government trade policy on private sector activities, noting that in 2021, the year that the UK-Japan FTA took effect, bilateral trade between the two nations actually decreased, while EU exports to Japan significantly increased. These datasets were impacted by anomalies such as Belgian exports of Moderna vaccines and French exports of Airbus planes to Japan. While it is still early days for measuring the impact of the UK's Indo-Pacific 'tilt' and membership of the CPTPP on its trade and investment activities, 2022 trade data does show a slight increase in the level of the UK's trade to the Indo-Pacific region compared with 2019. It is, however, important to consider the other effects of trade agreements that are not directly measurable; something the speaker termed 'FTA magic'. The signing of any agreement will inevitably send signals to the private sector that will generate new investment and other positive effects that cannot be fully grasped by datasets.

The fourth speaker agreed that the trade liberalisation paradigm is over. Government today tasks trade policy with achieving other substantive policy objectives, such as bolstering labour rights, addressing quality infrastructure, safeguarding national security and mitigating the climate crisis. The IPEF is a good example of a framework that sets out to achieve these goals. It is possible to see both a horizontal and economic fragmentation when discussing economic security issues. Horizontally, countries each work towards different economic security objectives, reflecting their unique market structures and political objectives. Vertically, there is clear fragmentation between the objectives of companies, governments and other key players. The speaker made clear that the WTO was not being used as a forum for economic security-related discussions and questioned whether it could adapt accordingly. One potential role for the WTO could be as a forum for informal discussion and information exchange, between both likeminded and not-so-likeminded countries, outside of their other economic security trade initiatives. The speaker also suggested that now is the right time to have a public policy discussion on the objectives of the WTO's security exemptions: are they sufficient, or do they need to be changed?

During the discussion, the conversation returned to China's membership of the CPTPP. One participant suggested that, while Beijing is aware that China does not meet the high standards required for CPTPP membership, it continues to pursue this as a signal of its willingness to open up to the global economy. It also feeds into Beijing's dual circulation strategy: the second part of which focuses on external circulation as a means to upgrade China's trading system. On Taiwan, while there was a shared desire to see greater Taiwanese participation in Indo-Pacific trade architectures, most participants were in agreement that geopolitical dynamics mean that its participation remains highly unlikely. Participants also discussed the gap between rhetoric and substance regarding India's participation in trade initiatives: while on paper the Indian government does seem committed to trade liberalisation, this is focused on bilateral and minilateral, rather than multilateral, initiatives.