

Annual Review 2022

Year of the Breakout of the War

6 articles have been selected for the Annual Review 2022 from the six issues of the past year.

- #243 May/June 2022 Issue
- #244 July/August 2022 Issue
- #245 September/October 2022 Issue
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(Listed in alphabetical order by surname as of April 2023)

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Introduction – Year of the Outbreak of War

By Naoyuki Haraoka

The year 2022 will be remembered as the year when the Russia-Ukraine war began with the Russian invasion, even as the Covid pandemic was still raging. This double shock of war and pandemic corresponds to that of World War I and the Spanish Flu early in the 20th century. These unexpected shocks remind us that economic autonomy will be fragile in such circumstances. It seems true now that economics has lost its power over policies; instead, politics has become the driving force to determine even the direction of economic policy and business strategy.

This is symbolized in changing global supply chains. While economic efficiency was a key concept to build up supply chains, now security is the core principle. Friend-shoring (restructuring supply chains to limit production networks to allied nations) or reshoring (transferring production sites overseas to a home country) seem to have become the dominant business strategy today. This is to avoid heavy dependency on nations (typically China) that are provoking geopolitical risks, sacrificing the economic merits of efficiency. The rising risk of China's unification with Taiwan by military force, following the example of the Russian invasion of Ukraine, has intensified this change in global supply chains.

Against this backdrop, we have set the lineup of our Annual Review 2022 as follows.

Starting the review with an article on EBPM (Evidence-Based Policy Making) would suggest the role of economics in policy-making in a period of geopolitics where uncertainty rules the world. Economic theory does not work well when there is growing uncertainty following such shocks as a war. Economists will need to specify the economic consequences of any policy quantitatively, without being preoccupied with theories or ideologies – such as free trade always achieves the best outcome for all players. Security could be damaged by free trade. Or, whether an environmental policy works well or not will depend on energy supply circumstances, which will themselves depend upon geopolitical risks. Promoting only renewable energy sources to meet environmental needs could result in only raising energy prices further, such as through fossil fuel price rises provoked by the Ukraine war. Accordingly, we need to analyze the external conditions around the economy, in most cases quantitatively, in order to ensure the objectivity of the analysis and the legitimacy of any policy. So we will need EBPM to quantify a policy's effectiveness against reality (May/June, 2022, Cover Story 3).

Faced with the risk of global supply chain disruptions at this moment between nations in the West including the United States, Japan and EU member states in which the “rule of law” is observed and nations like Russia and China where “changing the status quo by force” is considered legitimate, Japan must take the initiative in promoting a rules-based international economic system to maintain global

supply chains. Without the necessary efforts, the world cannot continue to enjoy the benefits of stable and transparent trade and investment regimes. This could lower the growth potential of the world economy. Even with the need to address security concerns in trade and investment regimes in addition to economic efficiency, a rules-based approach to integrate these concerns into trade and investment regimes would be effective in mitigating uncertainties in global trade and investment through enhanced transparency. Our JEF Research Study Group 1 examined this issue and made public its “Recommendations for the Development of a Rules-Based International Economic System” in May 2022 (July/August 2022, Cover Story 1).

The METI White Paper on International Economy & Trade 2022, following this issue of growing geopolitical uncertainty and its possible economic consequences, analyzed the economic impacts of Russia’s aggression against Ukraine in detail (September/October 2022, Cover Story 2).

Security concerns need to be addressed not only by national security and trade and investment policies but also by industrial policies. This is because raising national competitiveness through industrial policies in their wider definition will be another important policy pillar in ensuring national security. Our JEF Research Study Group 2 studied this issue and published another policy recommendation on “the need for evolutionary industrial policy to achieve broad economic security” (November/December 2022, Cover Story 1).

As FY2022 progresses, it has become clear that talking about the global economic outlook without a geopolitical and energy development outlook is useless. As the Ukraine war’s main economic consequences are tightened petroleum and natural gas demand and supply and rising energy prices due to the economic sanctions against Russia, without assessing how and when the war will come to an end it will be extremely difficult to predict the future of the global economy. We must discuss the economy, energy and geopolitics simultaneously in the same context (January/February 2023, Cover Story 1).

Finally, our trip into research has exceeded the scope of economic policies, as global economic stability must be brought about jointly through economic policies, national security policies and foreign policies. This is obvious when thinking about a possible Taiwan Crisis in which China could try to achieve unification with Taiwan by force, having drawn some lessons from Russia’s invasion of Ukraine. Our JEF Research Study Group 3 examined the background and scenario of this Taiwan Crisis and provided policy recommendations for three domains: national security, economy, and foreign policy (March/April 2023, Cover Story 1).

Thus, this annual review shows how an interdisciplinary approach would work well in our current times.

Selection of articles in the Review:

- 1 New Direction of Economic & Industrial Policies Supported by EBPM**
By *Japan SPOTLIGHT*
COVER STORY • 3 (May/June 2022, #243)
- 2 Recommendations for the Development of a Rules-Based International Economic System**
By the Research Committee on the Development of a Rules-Based International Economic System
COVER STORY • 1 (July/August 2022, #244)
- 3 Roundtable with Prof. Asei Ito, Prof. Kazuto Suzuki, Prof. Yasuyuki Todo & Yo Okada**
**Roundtable on the White Paper on International Economy & Trade 2022:
Economic Impacts of Russia's Aggression Against Ukraine**
By *Japan SPOTLIGHT*
COVER STORY • 2 (September/October 2022, #245)
- 4 The Need for Evolutionary Industrial Policy to Achieve Broad Economic Security**
By the Research Committee on Evolutionary Industrial Policy
COVER STORY • 1 (November/December 2022, #246)
- 5 Roundtable with Prof. Ken Endo, Dr. Shumpei Takemori, Tatsuya Terazawa &
Masakazu Toyoda**
**How Should We Interpret Geopolitics, Economy & Energy Developments in
Today's World?**
By *Japan SPOTLIGHT*
COVER STORY • 1 (January/February 2023, #247)
- 6 Roundtable with Shingo Ito, Prof. Yasuhiro Matsuda, Satoshi Morimoto &
Masakazu Toyoda**
**Possible Taiwan War – How Should Japan Deal with It Under Intensified US-
China Conflict?**
By *Japan SPOTLIGHT*
COVER STORY • 1 (March/April 2023, #248)

Naoyuki Haraoka is editor-in-chief of *Japan SPOTLIGHT* & executive managing director of the Japan Economic Foundation (JEF).

New Direction of Economic & Industrial Policies Supported by EBPM

By Japan SPOTLIGHT

Evidence-Based Policy Making (EBPM) is defined in Japan as the clarifying of logical links between a policy's purpose and the means to achieve it effectively, the collecting of evidence proving those links. In this clarification, data-endorsed evidence in particular is utilized and thus a basic framework of a policy can be clearly shown to the public. With this definition, the Japanese government officially introduced EBPM in its administrative decision-making process in 2017. An official in charge of promoting EBPM was appointed in each ministry. It also organizes regular inter-ministry meetings to share each ministry's successful cases of EBPM.

METI's Engagement with EBPM

The Ministry of Economy Trade and Industry (METI) has been working on its implementation since 2017 as well. As EBPM is applied to intra-ministerial budget request processes, first it needs to fill in a policy implementation process review sheet and publicize it to show why a national budget is necessary, as well as the policy goals to be quantified, and also set up and publicize a logical model-chart showing how the policy would help change the economy and society. Through this, the relevance of the policy means and objective would be visible.

METI is now attempting to apply a quantitative analysis to examination of a policy's impact in some selected model cases. Within METI, the divisions making a policy and requesting a budget, the policy assessment division and economists from the Research Institute of Economy, Trade and Industry (RIETI) and experts on quantitative analysis are collaborating to examine data to be utilized for the econometric analysis to measure the policy's impact, as well as working on specific quantitative analysis.

METI's New Direction of Economic & Industrial Policies Implemented with EBPM

Industrial policies are now starting to be seen from a new angle. In the 1980s and 1990s, the US and European nations labeled them protectionist and tried to hinder them as unfair practices, though their own national security policies worked as de facto industrial policies to a large extent in enhancing their defense industries with sensitive high technologies. However, today, China is now strengthening its industrial competitiveness significantly at an extremely high speed that has never been seen so far by large-scale

government support for industries. In particular, the expanding high-technology sectors in China are now a threat to all capitalist developed nations. The capitalist nations in the West are now starting to think about application of large-scale industrial policies to counteract this tremendous rise in China's industrial competitiveness.

In addition to this concern about competitiveness, China has presented another challenge. National economic security has emerged as a crucial issue for a nation's survival during geopolitical crises. In sectors with sensitive technologies which could affect security, trade and investment in those technologies may be limited due to concerns about possible leakage of information about them to their trading partners. Excessive dependency on certain vital products by a specific nation would make that nation vulnerable in terms of national security or trade, and investment relations with any country suspected of stealing secrets of vital technology would imperil the country's security through leakage of key information on the technology.

The US-China confrontation, or more generally the confrontation between democracy and authoritarianism, one of the key geopolitical risks to the world today, could exacerbate the situation and the possible disruption of global supply chains between democracies represented by the United States and authoritarian regimes represented by China would make it necessary for each nation to have their own industrial policy to secure vital technology or products in terms of national security. Thus many nations are now pursuing industrial policies based on these assumptions, and Japan should be no exception.

METI is now planning to adopt the following EBPM for promoting its new industrial policies in general with a large-scale budget. A policy's impact, measures to quantify it and how to collect data for those measures need to be clarified before its implementation. Business operators expected to provide such data must agree with the EBPM practitioner on the provision of the necessary data. Explicit involvement by experts on quantitative analysis must be achieved. RIETI, a public policy think tank affiliated with METI, having established an "EBPM Center", is to be officially involved in the EBPM process as an advisor. As a trial, it adopted a subsidization policy to secure production sites for advanced semiconductors in Japan and funding for green innovation (innovation of environmental technology). Thereafter, new policies with large-scale budgets will in principle be subject to EBPM and the effects of the finished large-

scale budget policies will be successively examined.

Ideal Future of EBPM in METI & Issues to Be Tackled for Its Realization

METI eventually aims at becoming a data-driven organization. To analyze policy impacts by data, a wider and horizontal utilization of a variety of data must be accommodated. In particular, in the near future, it would like to get real-time data through a private cloud service on finance, accounting, as well as labor management contracts used by the companies to be covered by the analysis after getting their agreement. With such real-time data, it could have more up-to-date EBPM. But to achieve this there will be challenges to be overcome.

According to METI's Business Process Re-engineering Division in charge of promoting EBPM, there are mainly two issues to be tackled. First, there are not enough data yet necessary for EBPM. Second, government officials' literacy in data utilization and quantitative analysis is not sufficient yet at this moment. There is also frustration with so much paperwork on a wide range of policy assessments that is occasionally duplicated.

On the first issue, the government plans to ask the offices in charge of the relevant policy to obtain the necessary data by using part of its budget at the beginning of the project proposal. These data are, in the case of METI, usually on the business firms intending to apply. Thus, it will also examine the possibility of gathering data sources of business enterprises' activities for horizontal use while promoting accumulation and utilization of digitalized data to be acquired when these business firms apply for any given policy project.

In this regard, it is important first to promote utilization of government statistics, but as government data are not up to date but only available after a time lag, how to promote utilization of real-time data from the private business will be a crucial issue to be solved.

On the second issue, the government plans to organize a training program for those officials to promote utilization of data and expand the data users. It is also going to introduce experts on econometrics in RIETI who could help these officials involved in EBPM. The officials would have a stronger incentive to work on EBPM if it is always a prerequisite for budget allocation.

At this moment, in METI, there are four so-called EBPM concierges providing officials with advice on how to collect data and

how to use them for quantitative analysis to prove a policy's positive impact. It is, however, a bit uncertain whether this is sufficient to allay all the frustrations of the METI officials involved in EBPM.

The United Kingdom and the US are the countries at the forefront of EBPM. In the UK it has been developed since the government of Prime Minister Tony Blair from 1997, and today more than 1,500 government economists are working on pre-policy implementation assessment by social cost-benefit analysis in a policy-making process among different ministries and providing ministers with policy advice. All of them were once employed by the Government Economic Service and have been assigned to each ministry.

In the US, EBPM has been actively developed since the administration of President Barack Obama from 2009. The Office of Management and Budget in the White House has reinforced each government department's involvement in EBPM through its annual guideline for budget requests from each department delivered to them every year. They have \$100 million in budget for promoting EBPM, apart from Tiered Grants, subsidies provided depending upon the robustness of the evidence.

Japan will need to study expanding funding and human resources for EBPM, following these examples. **JS**

Recommendations for the Development of a Rules-Based International Economic System

By the Research Committee on the Development of a Rules-Based International Economic System

The Concerns of These Recommendations: The Rules-Based International Economic System that Japan Should Aim at

As the international trade and investment system weakens, it faces three challenges: 1) the deterioration of the multilateral free trade system, 2) the decoupling between the United States and China and the convergence of security and trade, and 3) the supply-chain crisis.

The Japanese government has worked to maintain a multilateral trading system that is based on the rule of law and includes both the US and China and to develop a multilayered economic order with the aim of constructing a trading system based on our national interests. Since the turn of the century, as the World Trade Organization (WTO), the mainstay of the postwar multilateral trading system, struggled to make progress in the Doha Round, the Japanese government has achieved progress through regional trade agreements (RTAs), including bilateral agreements, with a focus on free trade agreements (FTAs). One feature of an RTA is that it facilitates the development of a framework that provides an upgrade over WTO rules. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), economic partnership agreements (EPAs), the Regional Comprehensive Economic Partnership (RCEP), and other recent arrangements to which Japan is a signatory have contributed to the development of the rules for the 21st century in a wide range of areas including intellectual property, investment, labor, environment, state-owned enterprises, and e-commerce.

However, rules-based multilateralism has been under siege lately from the rising tide of populism that features anti-globalism in the US and elsewhere in the industrialized democracies and the proliferation of unilateralism, in which the US and China as well as others pursue their national interests by unilaterally imposing trade measures. A framework is emerging in the Asia-Pacific without the US as it abandoned the Trans-Pacific Partnership Agreement (TPP) and the RCEP that entered into force in January 2022. Meanwhile, there is an urgent need to deal with states that adopt market-distorting policies and measures. And recent years have seen the emergence of geopolitical and geoeconomic risks in the Asia-Pacific and Indo-Pacific, with the result that economic security is gaining importance in such areas as supply chains, human rights, data governance, and managing high technology.

It was against the background of these changes in the international economic order that the administration of US President Joe Biden in

October 2021 proposed the Indo-Pacific Economic Framework (IPEF) and has been demonstrating a new eagerness to construct an economic order in the Indo-Pacific region. Given its lack of market access commitments, the IPEF is not an ideal approach for promoting the creation of economic rules-of-the-road for the Indo-Pacific region. It remains essential for the US to return to its original TPP initiative, which has now become the CPTPP, and, ultimately for the regional perspective, to explore ways to create the “Free Trade Area of the Asia-Pacific” (FTAAP) which was proposed by the leaders of the Asia-Pacific Economic Cooperation (APEC) forum. On the multilateral front, it is important to look for ways to reawaken the WTO from its stupor and prompt the development of rules on digital trade, labor, human rights, and other concerns. To achieve this, Japan must exercise leadership in building and maintaining economic order as a “global standard-bearer of free trade” with the WTO at its core. However, as part of the international response to the Russian invasion of Ukraine that began on Feb. 24, 2022, 14 countries and regions including Japan, the US, and the EU, who are members of the WTO, decided to revoke Russia’s most favored nation status, and developed countries opposed Russia’s participation in the G20 summit. The enormity of the impact of Russia’s outrageous actions on the international order is obvious. It is necessary to carefully consider how Russia should be treated in international economic forums, taking into consideration the mid- and long-term impact on the international order.

The Japan Economic Foundation (JEF) brought together eminent experts from various fields to set up the Research Committee on the Development of a Rules-Based International Economic System. The Committee reevaluated the rules-based international economic system from the legal, economic, and political perspectives, considered ways to improve it, and makes the following “Recommendations for the Development of a Rules-Based International Economic System.”

Recommendations

① Revitalizing the WTO

A) The Question of the Appellate Body

- (1) To add to the impasse in the rulemaking negotiations, the Appellate Body, the core of the dispute settlement system, which some call the “crown jewels” of the WTO, has been thrown into disarray since December 2019, when it ceased to have enough members

for a quorum to hear appeals. Securing the rule of law by normalizing the Appellate Body is urgently required, but early resolution is difficult. In the meantime, in order to keep harm from coming to the legitimacy of and trust in the WTO from the accumulation of appeals into the void, Japan should give serious consideration to joining the Multiparty Interim Appeal Arbitration Arrangement (MPIA) led by the EU for the provisional revival of the rule of law. Of particular note is the fact that China is a member of the MPIA, giving it a role in trade policy *vis-à-vis* China. The EU has also adopted enforcement regulations to deal with appeals into the void by MPIA non-members and Brazil has followed suit. The time has come for Japan to consider taking this approach.

Note: “Appeal into the void” means to put a case on ice by filing an appeal with the currently memberless Appellate Body while refusing to use the MPIA.

- (2) In joining the MPIA, the Japanese government should make it clear that it is doing so as an emergency measure to maintain temporary order and that it does not support the EU proposal for WTO Appellate Body reform. It should exchange views broadly with all the major WTO parties, not just the members of the MPIA.
- (3) In undertaking WTO Appellate Body reform, Japan should also give heed to US criticism of the Appellate Body and consider specific measures to place institutional constraints on the judicial activism and procedural discretion overreach of the Appellate Body. This does not mean simply following the US lead; instead, Japan should draw a red line in view of its national interests. In particular, it is desirable in principle to maintain the two-tier system and the negative consensus rule, given the benefits that the judicial dispute settlement that the Appellate Body has historically provided Japan.
- (4) The WTO should reconfirm its origins as an international system that is predicated on a system of rules agreed between market economies. When interpreting existing agreements as part of the dispute settlement process, to avoid accusations of overreach from arising, it should not go beyond the elaboration of the agreement of the WTO members according to the standard method for interpreting agreements under international law and should exercise caution in referencing international law other than WTO agreements and make it clear that judicial discretion is not being used aggressively when making interpretations.

B) Reviving the Rulemaking Role of the WTO

- (1) While keeping the WTO from leaning too heavily into its judicial function as explained in A), it is essential to revitalize its rulemaking function in order to restore that balance between the two functions. The Japanese government should accordingly take the lead in revitalizing the negotiations for establishing new rules. Its ongoing efforts in this regard can be seen in such areas as digital trade, fisheries subsidies, and investment facilitation for development. To maintain this momentum, it is important to

produce tangible results and to institutionalize the plurilateral – as opposed to multilateral – format for negotiating rules.

- (2) Regarding (1), it is desirable for the Japanese government to play an active role in the Joint Statement Initiative on Services Domestic Regulation of the WTO, the Ottawa Group, and other plurilateral activities by like-minded countries. It should also work to produce new agreements by incorporating the outcome of the January 2020 Joint Statement of the Trilateral Meeting of the Trade Ministers of Japan, the US and the EU such as the reinforcement of the rules for industrial subsidies, not to mention the negotiations on e-commerce as part of the JSI (see ④A).
- (3) The WTO should reconfirm its original commitment to the system of rules agreed to between market economies and the mutual opening of the domestic market on a most-favored-nation (MFN) basis. Two decades since its WTO accession, China’s influence in the WTO and the international economy more broadly has grown enormously. The time has come to consider whether it has fully implemented the reforms that had been expected in the beginning and has complied with the WTO agreements appropriately. This is essential to the development of WTO rules going forward.

② Utilizing RTAs

A) Utilizing the CPTPP

- (1) For the US administration of President Barack Obama, the TPP was the means to draw China into new trade rules by making it understand that it would be at a disadvantage to stay out of the framework. It is desirable to use China and Taiwan’s bids to join the CPTPP as an opportunity to conduct firm, rules-based accession negotiations. In particular, China’s CPTPP accession should be used as an opportunity to put pressure on China to open its economy, in coordination with efforts by the US from outside the CPTPP framework.
- (2) As an obvious precondition to its accession to the CPTPP, China should be required to keep the promises it made when acceding to the WTO and to immediately eliminate all economic coercion in violation of WTO agreements.
- (3) In the negotiations for China’s accession to the CPTPP, it will be necessary to secure its compliance with the intellectual property, forced technology transfer, state-owned enterprise, labor, environment, e-commerce, and other rules of the CPTPP. Where existing rules are insufficient, the incumbent members of the CPTPP should consider demanding that China make commitments over and beyond the existing agreements. In doing so, adding substantive provisions predicated on China’s singular socio-economic system (or politico-economic system) should be considered, and effective mechanisms to secure compliance with the agreement (e.g. special provisions for the burden of proof in

the dispute settlement system, periodic inspection system) could also be explored.

- (4) China's WTO accession negotiations took 15 years. Similarly, the Japanese government should not compromise in the negotiations on China's accession to the CPTPP and should be comfortable with taking as much time as is required. It should also consider including in the accession protocol provisions to the effect that China could be expelled or that other member countries could withdraw concessions if it is determined that China is not in compliance with the provisions of the CPTTP or its accession protocol.
- (5) To construct the implementation surveillance system of the CPTPP, it is important to strengthen the dispute settlement procedures and implementation surveillance system, establish a secretariat, achieve the early accession of the United Kingdom, and strengthen collaboration with the UK, Canada, Australia, and New Zealand.
- (6) Connection and/or collaboration between the EU and CPTPP should be explored to deal with market-distorting measures by Chinese governments in the future. Adding the US to this should enable the CPTPP to function as a stepping stone for the creation of the WTO or other multilateral rules.
- (7) As the Yokohama Vision and The Pathway to the FTAAP adopted at the 2010 APEC summit in Yokohama make clear, there is an agreement on a long-term vision to create the FTAAP through the expansion of the CPTPP and the RCEP. Efforts towards the achievement of this goal should be continued.

B) Building an Indo-Pacific Order around the US (the US "Return" to the CPTPP and the IPEF)

- (1) Japan should be an active participant in the IPEF, which the US is promoting. However, the IPEF is not the best approach for the promotion of economic rule-making in the Indo-Pacific region, particularly since it does not include commitments on market access, a matter on which bipartisan concern has been expressed in the US Congress. Thus, Japan should be persistent in urging the US to return to what is now the CPTPP.
- (2) A hard line on China policy has bipartisan support in the US Congress. The Japanese government should make a strong appeal on the strategic importance of the CPTPP to the China hardliners in the administration and Congress who are responsible for trade policy including its strategic aspects, as well as the role the CPTPP has as an effective tool for correcting market-distorting policy practices.
- (3) The opposition to free trade in the US comes from certain industries such as steel and automobiles, not the general public. Thus, the Japanese government should strongly appeal to a wide

range of stakeholders including businesses, academia, governors and other local officials, think-tanks, and the mass media for the US to return to the CPTPP. The CPTPP's role in improving environment protection, labor standards, and, more broadly, human rights through the framework of a trade agreement should be used to make a strong appeal to enhance the understating of the CPTPP among the constituencies that have an interest in these issues (such as young people).

- (4) In the US, the Trade Adjustment Assistance (TAA) Program currently does not include compensation for the damage resulting from trade liberalization. It is important for the TAA to be redesigned and implemented to reduce the negative impacts from the CPTPP and other trade liberalization initiatives.

C) Analyzing the Economic Impact of RTAs and Their Expansion

- (1) Ex-ante forecasts and the analysis of ex-post evaluation are both of importance regarding the economic effect of an RTA. Ex-ante simulation using economic models should be utilized in policy planning as if it were a social science laboratory. In developing a rules-based international economic system, the economic effect should be considered and a system that is effective from an economic-benefits perspective should be developed efficiently.
- (2) A preliminary calculation of the economic effects of Asia-Pacific EPAs shows that 1) the CPTPP and the RCEP do not compete against each other but instead are mutually reinforcing, so it is desirable to implement both instead of choosing one over the other; and that 2) including non-tariff measures in addition to tariffs increases economic benefits. However, if the US joins the CPTPP or India joins the RCEP, the economic benefits of lower tariffs is reduced or even turns negative for some incumbent members. In expanding RTAs, the key is not to just add new members but also to deepen measures for liberalizing and facilitating trade and investment.
- (3) Tariff reduction under an RTA is applied on a preferential basis to the RTA signatories, but many non-tariff measures cannot be applied exclusively to the products of the signatories generally speaking, in which case the potential ripple effect of the reduction through their universal application can be expected. It should be noted that even where global rules are not developed under the GATT/WTO system, the global application of an agreement between certain countries has the potential to generate the kind of economic benefits that would be generated by a WTO agreement.

③ Dealing with China's Market-Distorting Government Support and Regulations

- (1) Government procurement is conducted by central and local governments. Foreign companies may be subjected to de facto

discrimination due to political reasons in areas that are nominally opened to the outside world under domestic law. China should be urged to join the WTO Agreement on Government Procurement, which forbids such exclusive procurement practices. The Japanese government should also review its own procurement system with a view to ensuring conditions for fair competition including reciprocity with China and other countries that are not parties to the Agreement on Government Procurement.

- (2) The weaponization of interdependence is emerging as part of the economic security landscape. There has been an increase in recent years of China exercising economic coercion through trade restriction and other means, against Australia and Lithuania among others (② A) (2)). It is necessary to persevere in seeking redress through the dispute settlement procedures of the WTO, multilateral frameworks such as the Council for Trade in Goods, and the negotiation process for CPTPP accession.
- (3) It is possible that market intervention through sovereign funds, given their high tolerance for risk, could fall under the definition of “unlimited guarantees”, one of the items that should be added to the unconditionally prohibited subsidies measures under the WTO Agreement on Subsidies and Countervailing Measures (ASCM) according to the aforementioned 2020 Joint Statement of the Trilateral Meeting of the Trade Ministers of Japan, the US and the EU. It is necessary to conduct a theoretical and empirical investigation of the mechanism by which sovereign funds would be market-distorting.
- (4) As the example of the Chinese steel industry shows, subsidies to cover operating losses, debt forgiveness, or bad debt compensation can lead to excess production capacity. Adding them to the ASCM list of prohibited subsidies should be considered accordingly. As for excess capacity subsidies, it was agreed at the Trilateral Meeting of the Trade Ministers of Japan, the US and the EU to strengthen discipline, so discussions within this framework should go forward as well.
- (5) It is possible to demonstrate through economic analysis that the harm caused by the industrial subsidies that are provided in China constitutes “serious prejudice” under the ASCM. Such economic analysis, particularly methods used in justifying competition policy, should be considered favorably.
- (6) Japan should engage actively in negotiations over AI ethics rules, the concept of data as a human right, government access, and other areas where digital rules are yet to be established, especially where China is participating actively in the rule-making.
- (7) Cases have been emerging where mergers and acquisitions by foreign companies fall through because of delays in the examination by the Chinese authorities (e.g. acquisition of Hitachi Kokusai Electric Inc. by Allied Materials). This has had the effect of

preventing rivals to Chinese businesses from emerging. In the IT industry, where product cycles are short and competition is heavy, it may have had the effect of preventing businesses from establishing themselves in the market. There is a gentlemen’s agreement to conduct examinations expeditiously to prevent these things from happening, but there have been repeated cases where the examination has taken much longer than foreseen in the gentlemen’s agreement. Arbitrary application of the antimonopoly law has also been observed. There is a need for rules that deter the arbitrary application of competition law. International coordination of rules in competition law policy takes the form of creating soft rules such as recommendations and guidelines in the International Competition Network (ICN), the OECD, and elsewhere. Since China is not yet a member of the ICN, consultations between trade authorities and between competition policy authorities should be initiated on this point and China should be urged to participate in the international coordination of rules.

- (8) The Japan-China-Korea Trilateral Investment Agreement and the RCEP are rules for China related to investment that are available to Japan but not to the US or Europe and should be used accordingly. The RCEP recognizes in principle the provision of preexisting national treatment and most favored nation treatment. As for the prohibition of trade-related performance requirements, it covers technology transfer demands and royalty restrictions over and above the WTO’s Agreement on Trade-Related Investment Measures (TRIMS). It is important to secure compliance with the rules through the appropriate use of state-to-state dispute settlement (SSDS) procedures or the investor-to-state dispute settlement (ISDS) in the Japan-China-Korea Trilateral Investment Agreement.

④ Developing New Rules

A) Developing International Economic Rules in the Digital Space

- (1) Japan should work with Australia and Singapore as co-convenors of the negotiations on e-commerce under the WTO to work to achieve substantial progress during 2022 with the objective of reaching agreement at the 13th Ministerial Conference (MC13). The Covid-19 pandemic in particular has given a new urgency to the need for global rules to regulate the surging digital trade. It is desirable to encourage as many countries as possible to join the prospective agreement in addition to developing highly normative rules under the principle of Data Free Flow with Trust (DFFT), which Japan proposed at the World Economic Forum Annual Meeting in January 2019 and the G20 Osaka Summit in June of the same year.
- (2) The multilayered emergence of regional arrangements is occurring for rules on digital trade alongside the multilateral negotiations. There, Japan is securing highly disciplined digital trade rules in the

e-commerce chapters of the CPTPP and the Japan-EU Economic Partnership Agreement (EPA), the US-Japan Digital Trade Agreement, and the like. It should look for ways to broaden the scope of the regional framework by expanding membership in existing agreements while maintaining high discipline and including similar rules in the negotiations on new EPAs and the revision of existing ones. Meanwhile, the Digital Economy Partnership Agreement (DEPA) is now attracting much attention in the Indo-Pacific region. Although it does not match the CPTPP in the quality of its rules – it does not have source code provisions and is non-binding, for example – the Japanese government should consider engaging in this arrangement in coordination with Australia and the like, now that China has applied for membership. It should also engage actively in developing rules for digital trade for the IPEF, which the US proposed in October 2021.

- (3) Government access (GA) is an area where the behavior of governments and businesses as well as the views of civil society have an extraordinary impact on the volume and quality of the cross-border economic space being developed for the digital economy. It is extremely significant that the G7 has produced a roadmap for achieving DFFT and aims to develop guidelines for trustworthy GA and that like-minded states are making progress in the OECD with business support in discussions with input from civil society. As Japan holds the G7 presidency in 2023, it should be expected to use its position between the US and Europe to narrow the difference between the two sides and lead the way to a consensus.

Note: *Government access (GA) means enforceable access by public organizations such as governmental organizations to information in the possession of the private sector.*

- (4) If the increase in cross-border data transfer generates greater concern over the effectiveness of law enforcement or creates concern over unfettered access to domestic data from abroad, it could lead to greater data localization instead. An international arrangement among many countries will be a stable foundation for international cooperation in investigations. In that sense, the Japanese government should aim at the early adoption of the draft additional protocol to the Convention on Cybercrime. At the same time, in the interests of promptness and feasibility, it is appropriate for like-minded states to go ahead and steadily establish a framework in the spirit of DFFT. It is useful from this perspective for the Japanese government to consider the relevant legal issues for concluding bilateral international agreements that fall under the scope of the US CLOUD Act.

B) Theft of Trade Secrets Through Cyber Espionage and What to Do About It

- (1) Existing rules under international law do not provide effective discipline over theft of trade secrets through cyber espionage. Since this is not an easy issue to resolve, the near-term response

by the Japanese government should be to enhance the ability to deal with cyber activities by incorporating and using capacity building and cooperation for the relevant authorities of signatory states and other low-key rules in FTAs and other arrangements as in Article 19 of the Japan-US Digital Trade Agreement, Article 19.15 of the US-Mexico-Canada Agreement (USMCA), and Article 8.83 of the Japan-UK Comprehensive Economic Partnership Agreement. However, it is necessary to remember that there are limits to the extent to which strict rules to regulate cyber espionage can be formed.

- (2) Japan deals with theft of trade secrets through cyber espionage as civil and criminal cases under the Unfair Competition Prevention Act, but this law is weak as a means of deterrence. The Japanese government should look to domestic regulation in the US and Germany, which have provisions for heavy penalties, and revise domestic law, enhance deterrence against cyber espionage, and strengthen measures.
- (3) Directly regulating state behavior is best done through rules as international law. For this perspective, over the mid-to-long term, the Japanese government should spare no efforts in the G7 and other forums where these countries are engaged to develop rules as international law that will enable us to overcome the challenges around theft of trade secrets through cyber espionage.

C) Business and Human Rights

- (1) The Japanese government and Japanese businesses should promote human rights due diligence (DD) to prevent forced labor and other human rights violations in the supply chain. It is necessary to develop guidelines as a first step and then consider legislation as necessary. They should be made easy for businesses to undertake, using the human rights DD systems already in place overseas such as the UK's Modern Slavery Act.
- (2) It is essential for the Japanese government to deal with human rights issues; they should not be left solely to DD by the businesses. The appropriate government response should be targeted sanctions against individuals and institutions engaged in human rights violations. Article 10, paragraph 1 of the Foreign Exchange and Foreign Trade Act stipulates that the Japanese government may restrict foreign currency remittances, capital transactions, overseas direct investment, provision of services, etc., saying "it is particularly necessary in order to maintain peace and security in Japan". One option is to amend this to add that sanctions may also be applied "if it is particularly necessary to improve the human rights situation overseas". Whether or not individuals and institutions are identified and subjected to sanctions, it is important for Japan as a sovereign state to have the means to impose sanctions against human rights violations.
- (3) When considering the introduction of trade restrictions for human

rights purposes, full consideration should be given to the burden on businesses and compatibility with WTO rules.

- (4) Japan must also correct its own behavior as appropriate regarding the human rights issues that have identified by the International Labour Organization (ILO), the UN Human Rights Committee.

Note: For example, Japan decided to ratify ILO C105 (Abolition of Forced Labour Convention) and was in the process of taking the necessary domestic procedures when these recommendations were being finalized. Meanwhile, Japan maintains the death penalty, which has been criticized by the UN Human Rights Committee among others, while virtually all other developed countries have abolished it.

D) Trade and Labor

- (1) The US and the EU have tended to include more extensive labor provisions in their FTAs, a trend that is likely to continue for the foreseeable future. At the same time, regarding labor issues, it should be carefully determined whether it is appropriate to include labor rules in a trade agreement, given the declining significance of the connection between labor and trade. It is desirable to develop rules for substantive discipline regarding labor standards in other forums such as the ILO.

- (2) However, a situation where products become competitive due to poor labor law enforcement and the like in other countries is undesirable from the perspective of protecting the rights of workers as well as in terms of international competition. Moreover, if we are going to seek the return of the US to the CPTPP, Japan should at a minimum take the lead in introducing a mechanism to improve working conditions in sectors closely connected to trade in Asia and related areas. In this respect, given the results that the USMCA's Facility-Specific Rapid Response Labor Mechanism has yielded, it is worth considering whether a similar mechanism can be introduced that goes beyond the bilateral side letters signed between the US and Vietnam, etc. at the time of the negotiations over the original TPP. The discussions here will serve as the basis of the discussions for the labor provisions in the IPEF. In all these cases, the system should be designed as appropriate for the actual circumstances on such matters as the role of sanctions, if any.

- (3) The Labor Value Content (LVC) clause that was introduced in the USMCA for the automobile sector is not sufficiently justifiable as a policy so caution should be exercised as to its adoption. In addition, it is important to keep in mind that the provisions are criticized for being difficult to apply to complex supply chains, which may be the case for the Asian market. However, given the power of domestic forces in the US behind the measure, the possibility cannot be excluded that it will be aggressively promoted in future trade agreements – a reason for now to keep a close eye on developments under the USMCA.

Note: The LVC clause requires the use of automobile parts that are

manufactured under working conditions above a certain level (wage level).

- (4) Given the heavy involvement of labor law and labor policy, the involvement of labor law practitioners is essential when introducing such measures in trade agreements. It will be necessary to expand the collaboration framework for trade experts and labor experts (regardless of whether a trade agreement winds up covering labor issues).

E) Trade and the Environment: Carbon Border Adjustment

- (1) The EU's Carbon Border Adjustment Mechanism (CBAM) is a new trade-related measure without precedent whose WHO compliance is an issue. Although Japan does not export many products covered by CBAM to the EU, it must be actively engaged regardless. The European Commission announced its legislative proposal for the CBAM in July 2021. Beginning in 2026, a business importing merchandise that is covered by CBAM must submit a CBAM certificate. The value of a CBAM certificate is linked to the price of emission allowances in the EU Emissions Trading System (EU ETS). The importer submits the value of the merchandise multiplied by its carbon intensity (emissions per ton). The carbon price in the country of origin will be deducted. The details of the system, which will aim at WTO/GATT compliance, are unclear, but there is potential for GATT violations in most favored nation treatment (GATT Article I), which requires Members to accord to other Members the most favorable treatment given to the product of any one Member, violation of the schedules of concession (GATT Article II), and so on. The EU will impose the obligation on imported products, which would be "internal taxes" imposed at the border" or "other internal charges of any kind", or measures "affecting ... internal sale", which are covered by GATT Article III and could be in violation of the national treatment that the article requires. But even if it is in violation of Article III, there is the possibility that the invocation of the General Exceptions as provided for in the main text and items of GATT Article XX for environmental purposes could be an issue.

- (2) Going forward, surveillance to see if there will be any double protection such as distribution of free credit to domestic businesses or arbitrary discrimination, any misuse of environmental protection as a policy objective, any negligence in international agreement negotiations, and the like is important. These proposals will not escape criticism from developing countries who believe that carbon budgets are not being used much and that they "have low cumulative emissions and the developed countries are to blame for rising temperatures". Provisions for exemptions should be given careful if cautious consideration so that they will not result in the rejection of free trade or new North-South rifts and divisions. Japan should also begin considering a cooperative approach.

(3) Meanwhile, the US and the EU through their October 2021 agreement on steel and aluminum tariffs under Section 232 of the US Trade Expansion Act invited like-minded economies to participate in negotiations for a first-of-its-kind global arrangement to deal with excess production capacity and high carbon-intensity products (products with high emissions per ton). For the next two years, there will be an attempt to seek out cooperation on the method for calculating the amount of emissions, but restricting market access for non-participants that do not meet standards for low-carbon intensity is also on the agenda. This goes further than the Japan-US and Japan-UK joint statements on steel and aluminum. Japan must participate in these discussions.

(4) 71 countries and regions including Japan participate in the Trade and Environmental Sustainability Structured Discussions (TESSD) group, a WTO JSI, and have confirmed that they will cooperate on such matters as trade-related climate measures, environmental regulation and sustainable supply chains (developing countries in particular), assistance for sustainable trade (“AID for Trade”), the environmental impact and related subsidies on trade. The Japanese government should take an active lead in the discussions.

⑤ The Free Trade System and the Importance of Economic Security

(1) The domestic legal system for economic security will be connected to the agreements on strengthening supply chains for semiconductors and other strategic goods and on technology trade that will be formed in the IPEF and security-oriented cooperative arrangements such as the Japan-US-Australia-India “Quad”. Keep in mind that they are likely to move to ring-fence technology and goods among like-minded states, coming into conflict with the non-discriminatory, multilateral, free trade system. It is necessary to keep this from causing a turn to protectionism, undermining the free trade system, keeping in mind the relationship with the Wassenaar Arrangement on Export Controls for Conventional Arms and Dual-Use Goods and Technologies and other security-related trade control regimes.

(2) Japan faces a harsh geopolitical environment, with Russian expansionism evidenced most recently in its invasion of Ukraine coming on top of Chinese expansion in East Asia and the situation on the Korean Peninsula. It is against this background that the economic security legal system is being established. The importance of economic security cannot be denied, but there is a danger of disturbing the balance between the free trade system if there is excess emphasis laid on insourcing and government intervention. Measures taken for economic security purposes must therefore be implemented in compliance with WTO agreements and other international economic treaties. The recommendations issued in February 2022 by the Japanese government’s Panel of Experts on Economic Security makes this point as well.

(3) It is also important, as the Japanese government’s draft Act for the Promotion of Economic Security stipulates, to use anti-dumping tariffs (AD), countervailing duties (CVD), safeguards, and other trade relief measures permitted under the WTO to protect the semiconductor and other strategically important industries from unfair competitive advantages. Japan is extremely parsimonious in imposing anti-dumping and countervailing duties compared to its main trading partners, as WTO data on the cumulative number of cases from its establishment in 1995 to June 2021 in the US (AD 828, CVD 296), the EU (AD 538, CVD 91), and China (AD 292, CVD 17) show. The Japanese government should work more closely with the industries with aim of making better use of these trade relief measures.

(4) As the importance of improving supply chain resilience grows in line with the changing international environment, the Japanese government should consider using trade policy against serious human rights violations abroad on the basis of international coordination, which enhances foreseeability for businesses.

⑥ The Potential for Soft Law

(1) Japan should utilize the G7, G20, APEC, OECD, the Economic Research Institute for ASEAN and East Asia (ERIA), and other international economic forums to develop rules and form public opinion. 2023 in particular, when the US and Japan chair APEC and the G7 respectively, should be an auspicious opportunity for this purpose.

(2) In order to promote a free and fair economic order, remedy market-distorting measures, maintain and strengthen high-level and comprehensive economic partnerships, and other elements of the trade and investment agenda, the role of APEC as an “incubator of ideas” should be emphasized. Energy conservation and renewable energy goals present one example where soft law fully functioned as targets were agreed and implemented. For example, in 2011, APEC set an energy conservation goal to reduce energy intensity by 45% from 2005 levels by 2035. If the current trendline (progress is monitored by the Asia Pacific Energy Research Centre (APEREC)) continues, the target will be reached in 2034. In 2014, it set the target to double the proportion of renewable energy sources in the energy mix and electricity output from 2010 by 2030. If the current trendline (also monitored by APEREC) continues, the target will be met. It is to be also noted as an example of soft law having developed into hard law that the APEC soft-law approach has evolved to become the Institution Technology Agreement (ITA) in the WTO put into effect in 1997. The potential for soft law in a variety of areas as a role for APEC should be explored.

(3) As explained in E)(3), the US and the EU invited like-minded states through their agreement on steel and aluminum to jointly consider the methodology for calculating emissions. Since this could

become the de facto standard for the market in the future, Japan should speak up actively in order to make fair and transparent rules. Meanwhile, German Prime Minister Olaf Scholz, who is chairing the G7 this year, is aiming to include a “climate club” at the June summit. The details are unclear, but his proposal when he was finance minister appears to be aimed at determining a (minimum) carbon price and presenting common rules for carbon border adjustment that can be considered WTO-compliant. In this context, there is the possibility that work may go forward on explicit carbon pricing, measurement methods for implicit carbon pricing under regulation and other non-market measures (and the international comparative analysis of the two), emissions measurement methods for industries, and other matters. This could be the stage for an international cooperative approach in contrast to the CBAM as a measure imposed unilaterally by the EU. It is desirable for Japan to be engaged here.

- (4) The CPTPP has the Labour Council, which is now actively taking up issues. For now, the talks are centered on the construction of the framework for cooperation, but the Council should be developed as a forum for the active discussion of labor laws that affect trade. The CPTPP framework does not exclude activities such as setting guidelines and targets for working conditions according to industrial categories and economic conditions or enhancing the transparency of the labor laws of member states in order to urge their improvement, so there should be no limits to the discussions there.
- (5) It may be difficult to establish strong rules from the onset for the key points of digital rules such as government access. A soft-law approach may be useful here, judging from the experience of the OECD, which has been a pioneer on government access, discussing the principles for government access and their application. The lack of clarity in the national regulation of the digital sphere could reduce predictability and increase costs for businesses due to differences between national regulatory regimes. This makes it important to enhance the transparency of national regulation and reduce differences. The expeditious soft-law approach that the OECD is taking can be useful in this respect.

⑦ Cross-Sectoral Rule-Based Perspective

This Committee looked beyond the international economic system to use Japan’s involvement in disputes regarding its territory and continental shelf to conduct a cross-sectoral inspection to see if Japan has been consistent in its rules-based approach and whether the approach is effective in resolving disputes.

- (1) The Japanese government proposes for the rule of law on the oceans the following: (i) states should make their claims based on law, (ii) states should not use force or threats to enforce their claims, and (iii) disputes must be settled peacefully. International law is the foundation of the international order. This is a principle

that must be maintained at all costs.

- (2) In disputes over territories and the continental shelf, it is not enough for a government to set forth the legal justifications for its claims. It must also appeal to public opinion, both at home and abroad. It is unlikely that Takeshima, the Senkaku Islands, or the continental shelf in the East China Sea will be the subject of an international trial in the foreseeable future, but Japan should urge the relevant states to seek resolution based on international law and to do its best to mobilize public opinion as part of its long-term diplomatic efforts.
- (3) For example, the Japanese government takes the position that there exists no issue of territorial sovereignty to be resolved concerning the Senkaku Islands since the Chinese claims have no legal grounds. However, if the issue is brought to the International Court of Justice (ICJ), it is likely that it will rule that there is a dispute. It is necessary to take this into account and justify its territorial title to the international community. It should also seek a legal resolution of the dispute around Takeshima based on the distinction between territorial and historical issues.
- (4) To be consistent with a position in favor of a rules-based approach to economic issues, it is also desirable to resolve territorial issues based on law while enlisting public opinion at home and abroad. It may be difficult to entrust some territorial issues to international adjudication since they are entwined with the politics, history, and social issues of the contesting states, but as a practical matter many territorial disputes have been resolved through adjudication.
- (5) Japan is unique in having domestic legislation that restricts the application of domestic law on competing continental shelves and exclusive economic zones (EEZs) to within the median line. However, the Japanese position is that it has a 200 nautical-mile title in the Japan Sea and the East China Sea until the boundaries are determined under the United Nations Convention on the Law of the Sea (UNCLOS). It is necessary to raise awareness on this point since the Japanese position does not appear to be well-recognized among experts in other countries.
- (6) How Japan responds to Russia’s invasion of Ukraine could affect the future state of affairs in the East China Sea (Taiwan, Senkaku Islands). Japan must protect the rule of law in the international community. It must be clear in protesting territorial change by force and must not recognize such changes.

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Japan Economic Foundation (JEF) initiated the Research Committee on the Development of a Rules-Based International Economic System with prominent Japanese experts in November 2021, and concluded its role by publishing recommendations in May 2022.

Roundtable with Prof. Asei Ito, Prof. Kazuto Suzuki, Prof. Yasuyuki Todo & Yo Okada

Roundtable on the White Paper on International Economy & Trade 2022: Economic Impacts of Russia's Aggression Against Ukraine

By Japan SPOTLIGHT

In our Roundtable discussion on the White Paper on International Economy and Trade 2022, the main issue was the economic impacts of Russia's aggression against Ukraine. Our participants were Prof. Kazuto Suzuki of the Graduate School of Public Policy at the University of Tokyo, an expert on international politics, Prof. Asei Ito of the Institute of Social Science at the University of Tokyo and Prof. Yasuyuki Todo of Waseda University, both distinguished economists. The Roundtable was moderated by Mr. Yo Okada, former director of the Policy Planning and Research Office at the Trade Policy Bureau of METI, who authored this White Paper, and now counsellor of the Japanese government's Secretariat of New Form of Capitalism Realization Headquarters.

(Online Roundtable on July 12, 2022)

Participants



Prof. Asei Ito



Prof. Kazuto Suzuki



Prof. Yasuyuki Todo



Yo Okada

Introduction of White Paper on International Economy & Trade 2022

Okada: The theme of the White Paper 2022 is economic risk caused by geopolitical uncertainty and the challenges and opportunities for international trade in responding to the changes brought about by this risk to economic structure, technology, geopolitics and values. We analyze in particular as a central subject the “economic impacts of Russia's aggression against Ukraine”. On the challenges and opportunities for international trade, we analyze issues relating to the construction of resilient global supply chains reflecting common values as well as economic growth opportunities through innovation, and consider four particular trends that are accelerating globally.

Global economic impacts of Russia's aggression against Ukraine

After Russia's invasion of Ukraine, the G7 and other developed countries promptly enacted unprecedentedly large-scale economic

sanctions and have very quickly promoted reconsideration of their economic and political relations with Russia.

In contrast, most emerging and developing countries refrained from decisive action, including economic sanctions against Russia, and have been neutral in considering their economic and political relations with Moscow. China, presumably believing there would be no area where China-Russia cooperation is prohibited, continues to collaborate with Russia, and among the other G20 members, Indonesia, this year's chair nation of the G20, is opposed to excluding Russia from the gathering in 2022, insisting that all the members are to be invited. Turkey, though condemning Russia's invasion of Ukraine, is not joining EU-led economic sanctions against it. Mexico, though also condemning the invasion, maintains neutrality and is refraining from sanctions. Brazil is also staying neutral and has opposed sanctions, which could possibly have a negative impact on the Brazilian economy, though ready to collaborate with developed countries that have imposed sanctions against Russia. Brazilian Foreign Minister Carlos Alberto Franca

announced a clear objection to excluding Russia from the G20. South Africa has been also supportive of Russia in proposing a “Humanitarian Resolution” in the United Nations without actually referring to Russia.

Among ASEAN countries, Singapore is the only one designated as an unfriendly country by Russia because of its announcement of sanctions against Moscow. Except for Singapore, the countries in cooperation with the G7 in imposing economic sanctions against Russia are Australia and South Korea in the Asia-Pacific area, and a limited number of other countries.

It is also true that Russia’s invasion of Ukraine has unprecedentedly added to mounting concerns about the division of economies in the world since the end of the Cold War era. Polarization has already been occurring and the war has accelerated this trend, and thus the structural changes in the international economy. I think this event could be a historical turning point in the international economic order.

In terms of the ranking of the percentage of a country’s nominal GDP to the global total, Russia is 11th and Ukraine is 54th. Russian nominal GDP accounts for only 1.8% of the global total and is smaller than South Korea’s; however, it is a major supplier of many important staple commodities such as wheat and corn, as well as fertilizers and energy in general. Depending on the degree of a country’s reliance on trade in such products with Russia and Ukraine, the impacts of economic sanctions will differ significantly.

Russia’s exports of wheat rank first in the world, and Ukraine’s exports of wheat and corn rank fifth and fourth respectively. Developing countries in the Middle East and Africa are particularly dependent upon imports of these products from the two countries. In extreme cases, Kazakhstan, Qatar, Armenia, and Lebanon rely nearly 100% on Russia and Ukraine for their consumed wheat imports. In addition, sub-Saharan countries depend on imports for 85% of their wheat, mostly from Russia and Ukraine, and the rise in global food prices is likely to be reflected in domestic price rises of about 30% in those countries, which could also suffer from supply shortages.

Given that the Ukraine crisis is not expected to be resolved soon and we cannot tell how long it may continue, its economic impact will be expanded to the whole world through cost-push inflation due to restricted supplies of commodities and soaring prices, as well as interest rate hikes in developed countries to cope with inflation. Prices of oil and natural gas are rising as well as the forward prices of wheat and corn. Since the Russian invasion, prices of fertilizers such as urea or potassium chloride have also risen and we are now facing a food security threat.

The predicted economic growth of emerging and developing countries and the euro area, which is highly dependent on Russian

energy, will be much lower in 2022, and growth in the countries at war, “both Ukraine and Russia”, is plummeting drastically, needless to say. In particular, with the effect of the sanctions, we have already seen signs of economic stagnancy in the monthly economic data from Russia, which is blaming any negative effects on the wider global economy precisely on these sanctions by the West. This passing of the buck seems to be working to some extent.

Four trends accelerating globally

The geopolitical environment has been deteriorating, supply restrictions and rising prices of commodities and natural resources, accelerated by both the Covid-19 pandemic and the Ukraine crisis, have resulted in global inflation and a worsening economic situation in emerging countries, and the Chinese economy has been slowing down with its zero Covid policy initiatives. All these factors have increased uncertainty in the global economy. Real global economic growth has slowed down drastically compared with 2021, with commodity prices soaring and inflation rates increasing.

The digital transformation, increased geopolitical risks such as the greater need for economic security, enhanced global commitment to common values such as the environment, climate change and human rights, and a shift in public policy to an industrial policy have all been accelerating in response to this heightened uncertainty. I think these four trends will influence the future trajectories of international relations and the global economy, and create further uncertainty in business management while changing the sources of corporate value-added.

In particular, on geopolitical risks and commitment to common values, differences in policy stances have been producing bloc-based rule-making especially on the issues of climate change and human rights. Rule-making has been affecting the structure of costs, capital procurement and conditions of business transactions and competition. With this, the global market has become progressively divided into blocs.

Furthermore, with the trend of strengthened national industrial policies, large-scale markets have been built up in specific sectors such as green-related industries, aviation and aerospace, or semiconductors in the United States and the EU. Thus, there will be various opportunities for businesses trying to gain a market share, depending upon the host country’s policy initiatives.

Under such circumstances, it would be desirable for a company to orient its business towards raising its profits and earning capacity by actively promoting reform of its business model, encouraging product differentiation or enhanced value-added as well as efficient business operations, instead of cost savings or provision of low-priced goods as previously pursued. In addition, I think it will be important to realize a new business model and industrial structure to

create higher value-added by taking advantage of the four trends mentioned: prompting corporate transformation by digitalization, exploiting the opportunities created by the public sector, and turning economic security and the common values into core business value.

As for the Japanese government, it needs to engage in discussions on the international economic order at the G7 and other venues at an early stage to help achieve an environment where Japanese businesses can be engaged in the social implementation of new technologies in the US and European markets. This would be encouraging support for Japanese businesses. It is also important for the Japanese government to play a bridging role between Asian countries and advanced countries for comprehensive rule-making to achieve common values, while considering current conditions of Asian countries. Japan should also promote common values rooted in its own experience, such as with medicare or caregiving in an aging society, for the rest of the world's interest and set up an agenda for a market to be born from these challenges.

Trade policy based on the four trends and challenges and opportunities for Japan

In this White Paper, we made an analysis and policy proposals largely on two issues: construction of resilient global value chains reflecting common values, and Japan's retarded innovation and how it could gain growth opportunities against such a background.

On the first issue, our analysis of the current status of global value chains concludes that Japanese businesses have been working steadily on diversification of production sites and suppliers in Asia as their response to geopolitical risks, the pandemic and natural disasters, and resilient supply chain construction is making good progress.

For example, the share of the Japanese manufacturing industry's foreign direct investment in China to the total in Asia had been kept high, but since 2012 when the Senkaku Islands issue emerged again, it has been declining steadily and its investment in so-called China+1 countries like Thailand, India and Vietnam has increased.

On the second issue, it is becoming important to consider economic security seriously and in this regard a reduction in dependency on specific countries for key strategic items like semiconductors or batteries, appropriate management of sensitive and emerging technologies and prevention of their leakage are vital. Also in terms of stable energy supply, it is becoming more important to develop upstream natural resources, including domestic resources.

On the third issue, supply chain management is now extremely complicated, as businesses are increasingly forced to meet a variety of requirements, such as decarbonization, other environmental issues and human rights, with a firmer interest in common values.

Digitalization of such complicated supply chain management and enhancing its visibility by using data would lead to the build-up of a common database not only in Japan but also in the whole of Asia where Japanese businesses have a network of supply chains. It will be important to lead this to value creation.

On the fourth issue, we made an analysis on start-up companies on the issue of Japan's retarded innovation and their way of gaining economic growth opportunities. While global venture capital investment from 2020 until 2021 almost doubled, Japanese investment, though increasing, was much smaller than other countries, in particular other Asian countries such as China and India. It is also true that facilitation of ecosystems to support start-ups in terms of human resources, capital and place in Japan is far behind the global standard. It is important to promote such ecosystems to achieve mutually beneficial relations among start-ups and their supporters. Japanese businesses should build up active digital transformation (DX) alliances with the Asian countries with high growth potential and invest in Asia and collaborate with them in creating value. This is important for them to get new growth opportunities.

For example, Mitsui & Co. has been investing in IHH Healthcare, a Malaysian large hospitals group, since 2011. Sumitomo Corp. also invested in a large Vietnamese managed care group in 2021. These are both cases of supporting Asian DX in the domains of medicare and caregiving, and I hope support in these areas will expand.

On the fifth issue, although Japan has been investing in R&D substantially, investment in intangible assets, especially in human capital and in organizational reforms, has been low compared with other developed countries. For example, the calculated percentage of intangible assets to the total value of listed companies is 80% in the US and 70% in the EU, but in Japan it is only 30%. Japan must strengthen efforts to raise investment in intangible assets, in particular, in human capital.

Finally, with the accelerated development of new technologies such as AI and robots, we increasingly need to cope with challenges like greater unemployment or expanding income gaps and inequality. It is important for Japan to fully utilize new technologies while responding to these challenges and promote social implementation of these technologies, drawing on the experience of Asian countries undergoing rapid growth.

Increasing the Effectiveness of Economic Sanctions Against Russia

Okada: Prof. Suzuki, what do you think is to be done to increase the effectiveness of economic sanctions against Russia while it is occupying global choke points in energy and food?

Suzuki: Economic sanctions would differ according to their objective, such as a change from the regime of Vladimir Putin leading to the end of the war or creating a situation that makes it difficult for Russia to continue its military actions even without regime change. The current sanctions are aimed at achieving whatever is possible now. If the sanctioning nations try to enhance their effectiveness, they would have to impose sanctions that would be rather painful for themselves as well. In short, there would be rising prices of gas and other fuels and food items that will have a certain negative impact on their economies. So I think it will be difficult for the West to change the Russian regime without stricter sanctions, and worrying about their negative impact on their economies or political objections to them. The current sanctions against Russia are aimed at raising the cost of maintaining the war, but they could result in provoking Russia to target choke points for the West before they can work effectively. It is important for the West to build up economies that could be resilient to shocks as well as domestic political negative reactions.

Okada: Russia has promoted the narrative that economic sanctions by the West are responsible for rapidly rising energy and food prices in emerging and developing countries. I guess those countries facing price increases may understand such a narrative to some extent and ask Russia or China for help. To avoid a divide in the global economy possibly caused by the Russian narrative, what do you think must be done by the West, in particular Japan?

Suzuki: The main factor behind the current rise in energy prices is certainly the import ban on coal and oil from Russia. As for food prices, the main reason for their rise is Russia's blockade of the Black Sea to ban exports from Ukraine. So we cannot simply say the economic sanctions of the West are the reason for rising food prices. There are a large number of emerging and developing nations dependent on food and energy sources from Russia that officially accept this Russian narrative, but with a better understanding of what is happening today I believe this narrative would not lead directly to a division in the global economy.

A total of 141 countries supported the UN General Assembly resolution blaming Russia for the war. There are also many emerging and developing nations depending on imports from the West and those nations will maintain this interdependency hereafter regardless of their relations with Russia. This narrative was created by Russia to identify whether a nation is on its side or not. Russia is certainly intentionally provoking confrontation between the West and the supporters of Russia by making a clear distinction between the two. The West should organize a foreign policy strategy to clarify that rising prices of food items are due to Russia's invasion of Ukraine.

Okada: In the international economy where networks of interdependency among trade, investment and finance are prevalent, some countries occupying nodal points could weaponize this interdependency by using its leverage. At this moment, it seems the West and Russia are trying to weaponize their interdependency on each other. Japan does not occupy any nodal points or have much leverage, so what do you think Japan should do in this situation?

Suzuki: Japan is a net importing country of food and energy resources and it is important for Japan how to overcome such vulnerability. It is rather difficult for Japan to achieve self-sufficiency completely in food and energy. I think the policy to be adopted by Japan should be storage of minimum natural gas supplies and strategic stockpiling of food, and also demand-side control of energy and food distribution, such as saving electricity, rather than rationing. More importantly, as a country with such vulnerability, Japan should do its best to consolidate the free trade system in order to secure stable supplies of energy and food. Diplomacy will also be important in order to prevent a country like Russia from abruptly starting another war.

Okada: Since the invasion of Ukraine, we have seen growing concerns about economic divisions in the world economy. As our White Paper describes, this could accelerate structural changes in the international economy on the back of multipolarization, with rising unilateralism and concerns about economic security. This could eventually lead our international economic order to the historical turning point. How do you think the international economic order will change in the aftermath of the Russian invasion of Ukraine?

Suzuki: I think it will be difficult for us to maintain an international economic order on the basis of optimism about free trade. There would be rising risks of self-centered foreign policies or the weaponization of economic interdependency. To avoid them, it will be important to ensure economic security. If a nation is economically vulnerable, it will need policies to protect its economy that is sensitive in terms of economic security with certain limitations on free trade and carefully manage exports of goods which have their own technological advantages.

But I do not think economic security measures should be adopted in all the aspects of trade. In the future international economic order, I think restoration of a malfunctioning WTO is less likely and regional economic cooperation frameworks such as the CPTPP or RCEP would be more likely at its center. In this way, there is a possibility of a free trade-oriented economic order built up in feasible areas or among economic partners with mutual trust instead of the WTO. Free

trade may be narrowed geographically from a global scope to regional ones.

Another direction would be to focus on distinctions between the items relevant to free trade and those that are not. For example, toys or clothing do not affect a nation's economic security and thus should be traded freely. But specific crucial items in certain limited areas such as rare earths or semiconductors designated by the Economic Security Promotion Law in Japan should be subject to government management. We will have such a two-layered structure of trade – free trade and managed trade – but the managed trade must be minimized as much as possible.

Responses to Digitalization & Global Commitments to Common Values

Okada: Entering the 21st century, especially after the 2010s, the exponential growth and development of digital technology and global data flows under the Fourth Industrial Revolution driven by IoT or AI have been changing economic rules. Innovation is being encouraged with newly emerging technological development and free data flows have become crucial as sources for tech start-ups or value-added. DX is a key for business success in expanding customers, providing them with value, and increasing investment in intangible assets such as human capital, as well as enhancing DX or R&D investment and achieving business reforms and raising productivity. The White Paper mentions that it will be important to create new business models and industrial structures producing more value-added with the utilization of data analytics of cross-border data flows, formation of digital ecosystems, alliances among start-ups and Asia DX.

On commitment to common values, climate change, circular economy, biological diversity, environmental protection, health, human rights and equality are among those that feature significantly in public policy, as well as consumers markets and financial markets. Against this background, businesses are expected to pursue not only added value for shareholders but also for all kinds of stakeholders such as customers, employees, local communities, the public sector and the natural environment in alignment with their purposes. Young consumers today are starting to buy goods and services in accordance with social and environmental concerns. I think it will be increasingly important for a company to create core added value from respect for such common values and build new comparative advantages instead of pursuing only corporate social responsibility activities, incidental ones annexed to the company's main business. For example, Unilever is expanding sales of detergents for dish washing enabling the saving of water as an environmentally friendly product.

It is also important to make rules on common values since they

would affect a company's cost structure, capital procurement and conditions of competition. Prof. Ito, what do you think about these issues, in particular the challenges and opportunities born from them for both the government and business to tackle?

Ito: Digital terminals have become prevalent these past two decades among developing and emerging nations and this completely changes the whole world. According to the International Telecommunication Union (ITU), the number of mobile phone contracts in Japan was 66 million, the third-largest in the world 20 years ago, but it is now eighth in 2020 when in Japan more than 200 million terminals are working, much more than its population. In Nigeria, they already have 200 million digital terminals in use.

In 2005 Thomas Friedman, a well-known columnist, introduced an episode in his book *The World Is Flat* that discussed how American white collar jobs were being outsourced to India. So digitalization from the perspectives of developing and emerging nations at that time was nothing but the informationalization of developing economies to become subcontractors for American white collar labor.

However, the situation has significantly changed in this decade. I call it “digitalization of the South for the interest of the South” where human resources, capital funds, entrepreneurs and challenges are all on the side of the emerging and developing nations. Even without help and support from the North, their own entrepreneurs and technologies are starting to resolve the challenges. In such circumstances, digitalization is commonly set as a goal to be achieved in any country's mid and long-term plan of national economic development. It is a new challenge for Japan to explore what to do in the future under these circumstances. We will need to start thinking about a strategy on the assumption that Japan is “not an advanced nation in terms of digital economy” but is possibly “a partner for collaborative creation”.

In other words, Japanese businesses need to develop their expansion into emerging markets through investment in the host country's business firms or strategic alliances with them, as they cannot achieve it on their own like the giant IT software companies such as Google, Facebook, Apple and Amazon. It should also be noted that Japan itself is behind the global trend in its domestic digitalization. In this light, I think we must think about utilizing digital collaboration with emerging nations. Meanwhile, Japan's presence in ASEAN is extremely limited in terms of investment amounts or M&As. For example, the acquisition of ventures in Southeast Asia by Japanese firms was smaller than that of Thai companies between 2017 and 2021.

On Japanese companies' engagement in promoting common values, I think the issue is whether they can promote what they have

achieved so far to the rest of the world. For example, resource recovery in Japan has been greater than the global average, but it is another question whether Japan can promote this well internationally.

Human rights due diligence is one of these common values. But there is concern that a strategic partnership between China and Russia will be strengthened in the wake of the Russian invasion of Ukraine. Of course, China will have to maintain its close trade and investment relations with the West, but on the other hand it is working on strengthening its partnership with Russia. In a way this is a strategic ambiguity.

At the same time, I think there is a possibility of China's permanent support for Russia financially and materially. I am very concerned about what will happen then. Japanese companies did not necessarily exit from China when the territorial dispute over the Senkaku Islands reignited. Most Japanese companies stayed in China and remained patient. Even with the US-China confrontation worsening, Japanese companies have not largely exited from the Chinese market. The reality is that many companies will wait and see what happens.

Okada: It is certainly true that Japanese companies have not been completely leaving China, though they are trying to diversify their markets and host countries. According to one survey, only a few percent of respondents said they would need to exit China or reduce their business activities there. So the exiting companies remain very few. What do you think is the best way to deal with the gigantic Chinese market and production sites?

Ito: I think there is a misunderstanding of China due to the lack of precise information and policy dialogue. For example, there are extremely simplistic arguments about China's protection of intellectual property rights, such as China's claim that it has a market friendly intellectual property rights system or Western nations' argument that such rights are stolen from confidential business information.

Though it is true that various regulations in China are devised to encourage foreign firms to invest in China or procure local contents or promote R&D in the Chinese market, it is far from the reality that all foreign companies in China have had their business secrets stolen. It is also true that China's intellectual property rights system has recently been developed quite well. I think we need a precise understanding and dialogue to overcome such simple and prejudiced arguments.

On policy dialogue, have there been any venues for exchanges of views over China's application for membership of the CPTPP between the Japanese and Chinese governments since China applied

in September 2021? I have been wondering whether the Japanese government has ever mentioned its specific concerns to the Chinese government about its membership of the CPTPP. Different opinions could always emerge and exchanges of different policy views should be arranged at any time.

Okada: What do you think the government and businesses care about most in promoting the ideas advocated by the White Paper such as the creation of an Asian-wide database, active DX alliances with Asia and joint value creation?

Ito: There is an argument that data sharing in supply chains will be necessary for surveillance of the regulations for the business environment on human rights. If it is necessary to have precise observation of forced labor or child labor in global supply chains, then I think it is desirable to accommodate a low-cost database. On the other hand, for data sharing to create new businesses by using health and medicare data or business transaction data, we will need a completely different database system. So in my view, depending upon the goals for database sharing, there would be divided plural blocs for such an Asian-wide data base construction idea.

On the issue of DX alliances with Asia, we should develop a market for the digital products of Japanese companies mainly in Southeast Asia, especially in medicare, health care and caregiving. These domains are interesting, since Japanese companies already have know-how in the domestic market due to the aging society in Japan. So such know-how could work to some extent in helping Japanese business survive in a time of digitalization. However, judging from the speed of investment or business development by Japanese firms at this moment, there is a risk of Japan failing to be even a "partner for collaborative creation of values for Asia" from the perspective of Southeast Asia. Now is the time to restart efforts for business development in Southeast Asia that were disrupted by the pandemic.

Okada: It is certainly true that the presence of Japanese businesses has been reduced by the disruption of investment and communications during the pandemic, according to Southeast Asian countries. A Japanese Foreign Affairs Ministry survey tells us that more countries in Southeast Asia refer to China as a more important partner than Japan. So I believe we should seriously redouble our efforts to consolidate relations with Southeast Asian countries.

Active Role of Industrial Policy

Okada: Among large countries like the US, China, European countries and Japan, in advanced technology areas such as green technology, the role of active industrial policy is being reconsidered.

This is justified by economics too, given that private sector investment alone based on private returns would be insufficient, while decarbonization is a global public good and the green technology that could contribute to it would produce larger social returns than private returns. Technological progress is path-dependent and thus promotion of industrial policy will be needed to impact the technological revolution in the green industry and make existing technologies causing pollution obsolete. In these respects, industrial policy can be justified.

Prof. Todo, what do we need to keep in mind to achieve the success of active industrial policy? In particular, what do you think about strengthening industrial policy in the semiconductor industry?

Todo: In principle, industrial policy in the narrow sense – promoting specific policies to support limited industrial sectors – seems to have been ineffective so far and this may be true hereafter as well. For example, it is said that China’s industrial policy has achieved success, but data analysis shows us that while an industrial policy assuming value creation by collaboration between the private and public sectors is successful, a protectionist-oriented policy is not necessarily so. China’s industrial policy supporting semiconductors, though implemented on an extremely large scale, cannot be considered very successful as it fails to promote nationalization of production. It should be noted too that industrial policy to encourage competitiveness in limited sectors would also not be so effective.

The second point is that there seems to be a focus on production rather than innovation in the current industrial promotion policy, but this is not so effective in terms of industrial development. I think China should give more thought to innovation, as it is a source of industrial development.

In reality, the so-called policies for strengthening supply chain resiliency of the US or EU contain not only policies to attract production sites but also to strengthen the capacity for innovation. This is not included in Japanese industrial policy.

Concerning R&D in Japanese companies, the level is high but the economy is nevertheless weak. There are issues to be tackled, and I think one of them is alliances with partners overseas. According to my research, international joint research would enhance a country’s innovation capacity. In the area of research on the pandemic, international cooperation has played an extremely important role. According to the OECD, as Japan made little contribution to such cooperation, its achievements have been fairly limited. I think promoting international joint research or strengthening knowledge-based alliances will be increasingly important in the wider sense of industrial policy.

Looking at Japan’s semiconductor sector-related policies today from this perspective, the main recent development has been to

attract a factory of the Taiwan Semiconductor Manufacturing Company (TSMC) to Kumamoto Prefecture, but as it is a production-oriented policy I am afraid that we cannot value it very highly. Japan has developed lots of policies to attract high-technology companies to Japanese regions so far, but they have had little effect.

However, taking advantage of the TSMC factory’s introduction to Kumamoto, Japan could enhance its innovation capacity by adopting the following two policy measures. The first one is to strengthen the link between the TSMC factory and Japanese suppliers and enhance its innovation capacity. There are many research outcomes telling us technology prevails through supply chains, and with this policy the TSMC’s impact would be much larger.

However, in order to achieve a smooth alliance, we would need policy intervention such as information provision for finding relevant partners or preventing leakage of confidential information from them.

Okada: In the US and EU, there are some government-led initiatives to enhance the resilience of supply chains by reshoring or friendshoring (alliances with friendly countries) in the light of recent geopolitical risks, such as the US-China conflict, the pandemic and Russia’s invasion of Ukraine, though the build-up of business-led global supply chains has been progressing so far along with free trade principles. Japan will have to join such renewed global supply chains. What do you think about this development? Such government initiatives could distort business decisions and harm efficient management. Could you tell us what the government and businesses need to consider in order to promote the resilience of supply chains while maintaining their efficiency?

Todo: It is certainly true that the risk of supply chain disruption is increasing. But I do not think it is relevant to promote reshoring (bringing back overseas production sites to Japan) to cope with it. Reshoring is not an efficient business decision and would be contrary to globalization, which Japanese businesses have been taking advantage of in pursuing the most efficient means of production. In addition, there are so many risks in Japan as well, such as natural disasters like big earthquakes. They may have to do it to some extent, but reshoring alone would not fix the issue. Friendshoring would be much better and I believe that encouraging diversification of business directions would be most effective in fixing this issue.

It is crucial to lower the dependency of Japanese businesses on China by this diversification of business partners and enable them to replace a partnering country with another country in cases of emergency. This diversification would have costs for a Japanese company as it would need information about replacement countries. To reduce these costs, JETRO or Japanese local governments would

need to provide them with the necessary information for such diversification as well as support them by business matching.

In addition, assuming that friend-shoring will be important in the future, Japanese businesses would have to seek partnerships with nations that Japan has few concerns about, as a strategy for diversification. Therefore, Japanese businesses will now have to take full advantage of international cooperation frameworks such as the Free and Open Indo-Pacific (FOIP), the Indo-Pacific Economic Framework for Prosperity (IPEF) and the Quadrilateral Security Dialogue (QUAD) in order to achieve business matching.

Opacity and unpredictability would be extremely harmful in doing business. As Prof. Suzuki mentioned, there will be two types of goods in the coming days: goods for free trade and goods for managed trade. If the distinction between the two is not transparent, it will be harmful for business. So we need clear rules on this distinction. For example, the Economic Security Promotion Law adopted in Japan needs to designate specific crucial products in terms of economic security on the basis of rules and dialogue between the government and private business.

Furthermore, it will be necessary to apply international rules as widely as possible. The WTO would be the best venue for such rule-making, but it would be difficult. Rule-making could be achieved by utilizing a regional cooperation framework such as the IPEF, and I would like the Japanese government to take a leading role in this rule-making.

Okada: With many countries strengthening industrial policies, there will be large markets created in specific sectors in the US or European countries in particular, such as semiconductors, green-related areas and defense and space-related sectors. Though Japan is also working on creation of such markets by joint funding by the government and private business to develop new technologies, the US or European markets in these sectors are so huge that Japanese companies would also have to get a share of them. How do you think the Japanese government and businesses can work to resolve these issues?

Todo: Private companies must have an incentive to enter such huge markets in the US and Europe even without government help. There should not be any role played by the government in helping these companies. The only exception could be information provision by the government regarding the ambiguity of rules for those markets, if any. Subsidizing businesses designated by the government would not be a good solution. But the government could set up a dialogue with the private sector and get a good understanding of what private businesses would need and then release their message to the rest of the world.

Responding to Rising Geopolitical Risks in the Long Term

Okada: Geopolitical risks are rising, as shown in the pandemic, the Ukraine crisis and the US-China confrontation. This increases uncertainty worldwide. It is therefore very important to learn about the future prospects of geopolitical risks and the government's economic security strategy. Japanese businesses will need to develop supply chain strategies to enhance the resilience of their supply chains to be prepared for unexpected changes in the business environment or rules, for example by diversifying production sites or material procurements or increasing stockpiles in a flexible manner, while the government will need to work on international rule-making appropriately to reduce these risks. Prof. Suzuki, what do you think about these challenges that the government and businesses must work on?

Suzuki: It is true that we cannot expect the continuation of the stable trading environment that we have benefitted from so far, given the continuing rise in geopolitical risks. In this situation, I think the Japanese government and businesses would be expected to promote structural reform continuously and gradually change our country's economy.

Even with the US-China conflict intensifying, sometimes ideologically and sometimes militarily, both nations' economic interdependency will not disappear and probably the economic interdependency between Japan and China would not disappear either. Even though China is considered hostile to the US and Japan, they cannot separate their economies from the Chinese economy. Under such circumstances, it is difficult to reduce risks to zero. Therefore, I think we should aim at surviving with these risks to a certain extent. It will be important to think about what is necessary for survival and prioritize what needs to be protected in the case of emergencies. For example, we should have a risk scenario taking the worst case into consideration to clarify what should be given up and what should be kept for survival in the case of an unexpected decline in sales or suspension of imports due to intensified confrontation between the US and China.

Without such a risk scenario and business continuity plan, it will be difficult to respond to an emergency quickly. We need to think about what to protect in our list of priorities among business operations and how much we would spend to protect them, in considering how to balance the size of the risk and the cost of raising resilience to reduce the risk. JS

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The Need for Evolutionary Industrial Policy to Achieve Broad Economic Security

By the Research Committee on Evolutionary Industrial Policy

1. Recognition of the Current Situation

1.1. Heightening geopolitical risks and decline in the Japanese economy and competitiveness

While geopolitical risks, such as the US-China conflict and Russia-Ukraine war, are fast expanding, the competitiveness of the Japanese economy is declining sharply. Under such circumstance, what needs to be done to realize economic security in a broad sense?

Broad economic security will be defined by the following three points.

- ① (Strengthening competitiveness) Evolution of the Japanese-style industrial policy model
- ② (Expansion of cooperative relationships with neighboring countries) Development of an Asia-wide industrial policy
- ③ (Core of economic security) Strengthening and expanding Japan-US cooperation.

In realizing broad economic security, the concern is the weakening national power of Japan, and this is signified by the stagnant wages of the past 30 years. One of the large factors behind this is productivity being sluggish compared to other advanced nations.

Aggressive fiscal and monetary policies under “Abenomics” brought positive effects to the economy, and corporate earnings improved. However, they did not turn to capital investment or rises in wages and this is thought to be a factor behind the economic slump. In addition, we cannot forget that improvement in corporate earnings under Abenomics was brought on by the good fortune of cheap crude oil and natural gas prices. The rise in crude oil and natural gas prices under the current Ukraine crisis has negated such good fortune.

Stagnant investment is behind the decline in competitiveness of Japanese businesses, and the issue is domestic investment not increasing whilst the corporate sector owns capital. The reason for this is the relative downsizing of the Japanese economy and the slow transformation of its industrial structure. The ageing of society is also having a negative impact on the economic growth of Japan. The fiscal deficit and the decline in the effectiveness of fiscal and monetary policies that come with an ageing society have become a particular issue.

Since GDP is not growing, foreign aid such as ODA is not increasing, and the amount of ODA has been surpassed by China,

leading to a decline in Japan’s influence in developing countries in Asia and other areas.

The promotion of digital transformation (DX), to which Japanese organizations have been slow to respond, and the utilization of diverse human resources will be particularly crucial for Japanese-style management to evolve institutionally.

Unless these things occur, the competitiveness of Japanese businesses will continue to decline further, wages will stagnate, tax revenues will struggle to grow and thus social security which is essential to an ageing society will not develop, leading to a negative spiral of increased income disparities, lack of will to work further, and stagnant productivity.

There is no all-round cure to resolve this negative spiral. As verified below, in order to resolve the structural stagnation due to the current decline in competitiveness even if little, industry (large enterprises and small and medium-sized enterprises (SMEs)), the finance sector, government (central government and local government), universities (universities in metropolitan areas), and each individual citizen all have to reflect on their past and aim for a fundamental reform of their customs and actions that are thought to have invited this stagnation.

1.2. Review of industrial policies and trends in other countries

China’s presence is expanding in Asia both in the quantity and quality of its infrastructure development. Exchange rates of Asian nations are starting to be linked to the Chinese yuan, and China is becoming an advantageous environment for conducting international transactions. Based on the expanding influence of China, there is a need to discuss how to utilize Japan’s quality infrastructure, which is an advantage for Japan, and SMEs which are supporting industries, while also discussing how to nurture SMEs and industries as cooperation with Asian countries is strengthened. Such an Asia-wide industrial policy perspective is also extremely important to heighten the resilience of supply chains.

There is also a movement among Western nations, not only in China, in which industrial policies, once perceived negatively as protectionist, are being actively utilized for economic security.

As was typically seen with solar panels, there is a situation where despite leading in technological development, Japan loses out at the actual business implementation level. In addition to technology development, there is a need to consider policies that will create value-added and incentives to allow scaling of businesses.

Traditional Japanese industrial policies include those that worked negatively for competitiveness by slowing the metabolism, such as regional finance and SME policies.

As industrial policies increasingly require qualitative evolution and a global perspective, there is a need to improve the quality of civil servants in Japan. In Singapore, young and talented civil servants receive high benefits and have been successful amongst the finest. The bureaucratic system of Japan with lifetime employment and a vertical structure at its core is thought to require a drastic makeover.

Evolutionary industrial policies do not directly intervene in the market, but as represented by Asia-wide industrial policies they fulfill the role of “effective coordinator” with a broad ranging perspective to bring out incentives for various market players, such as domestic and international industries, private businesses and foreign governments.

2. Policy Recommendations

2.1. Productivity improvement and economic growth

2.1.1. DX and regulatory reform

What should be aimed for as an evolutionary industrial policy is not direct intervention, but indirect intervention which centers on designing and developing an incentive system that respects the autonomy of private businesses.

The reasons for DX not progressing in Japan are the ignorance of management (asymmetry of information), the prejudice of supervisors without trying (status quo bias), and the lack of chance (failure to coordinate and path dependence). Measures to address this include introducing a competitive market environment (cannot survive without DX), provide re-learning opportunities for middle management and organizational reform, digitalization of the public sector, and diversification and globalization of personnel recruitment.

Through an evolutionary industrial policy, the transition from an industrial society to a knowledge society should be promoted. In order to introduce a competitive market environment, a smooth metabolism of industry is important. Promoting new entries, reforming regulations that protect vested interests, and renewing the political system are all necessary.

Japan's civil law legal system, which does not accept new laws unless there are legislative facts, is a hindrance to regulatory reform. There is a need to release regulatory reform from such civil law limitations. This is because such regulatory reform is critical to creating new industries and businesses.

Specific policies include the introduction of the “spectrum auction” (a bidding system for sales of frequency band licenses) which almost all OECD nations have adopted. (Japan still employs the “comparative screening method” where the Ministry of Internal Affairs and Communications allocates licenses to business entities upon conducting screening.)

Promoting market entry to Japan for ride-share services such as

Uber and Lyft which are widely used around the world can also be considered. As the coronavirus crisis revealed, deregulation in the medical and pharmaceutical area is also required.

2.1.2. Mobilization of the labor market in Japan

Employment is a derived demand of production, and as the environment surrounding the labor market changes dramatically, Japan's employment and working styles inevitably have to change. A flexible labor market is required for people to work in a flexible manner in line with the change in the megatrend. A highly flexible labor market is expected to increase productivity by achieving smooth labor redistribution and allocation of the right person to the right job.

Wage systems need to shift from seniority based to productivity based. If wages and productivity become a match, it will enable providing employment opportunities to all people regardless of their generation, gender or nationality.

Japanese businesses have relied too much on cheap dispatch workers, contract labor and cheap foreign workers as represented by technical trainees, and have failed to make necessary investments such as digitalization. In pursuing reforms such as digitalization, it will be critical to strictly follow equal pay for equal work. Strictly following equal pay for equal work is also important in promoting so-called job-type employment which sets out the details of the job description in the employment contract.

Employment redundancy is not simple in Japan, and as a result businesses are in a situation where they hesitate to proceed with new hirings. Clear rules should be set on dismissals so that labor costs can be saved.

It is also important to work on technological innovation such as AI and robots to support employment of the elderly. This has the potential to become one big industry in the future. It is also important to create a labor market which retirees can enter at any time so that talented elderly workers can fully exercise their abilities through reemployment even after they have retired.

Human resource development has thus far centered on businesses, but it should shift to center on individuals in the future. Online education is a method that allows the acquiring of various skills at any free time and encourages self-enlightenment. The government should consider introducing a preferential tax system for self-enlightenment. Enterprise-specific human investments have been a hindrance to mobilization.

For overseas personnel, while unskilled labor has been actively accepted, Japan has been unable to offer an attractive labor and social environment to highly skilled personnel. As the decline in population progresses, Japan cannot survive without utilizing immigrants. There is a need to squarely discuss immigration policy. Japan has benefitted from having cheap foreign unskilled workers, but it should acknowledge that what is important is whether highly skilled overseas personnel will come to Japan in shaping a future

intellectual society.

2.1.3. Improvement in education environment

It is important to globalize higher education (=universities) in Japan and acquire international competitiveness. In order to elevate the quality of research at Japanese universities, there is a need to increase the percentage of foreign professors and researchers. There are issues such as not being able to bring home talented Japanese researchers, or invite Asians to Japan who have studied in Japan and then gained a Ph.D. from the United States and continued to work there.

In order to resolve this issue, there is a need to increase their salaries or improve their working conditions, but the real impediment is not the level of salary, but more the rigid wage structure where salaries are determined almost solely on seniority with complete disregard for achievements or research areas.

For significant improvement in such working conditions for professors and researchers, an enhanced tax system for donations to universities is crucial, especially tax deductions. There is a need to enable fundraising activities that universities in Western countries are conducting. There is also a need to train experts on fundraising.

For talented foreign nationals to work in Japan, what may be more important than the wage system, in a sense, is the environment for that person and for his or her family to live in, and the education environment for the children is especially important. Not only for those from the West, but for the elites of East Asia and India, whether their children can get into top European or US universities is a highly important issue, and in order to achieve this goal, whether an opportunity to access middle school and high school education in a good-quality English (+French) environment is available or not becomes the key. An enhanced education environment, not just an enhanced English education, that requires the use of English in all of its curriculum and occasions will be important for the Japanese, and it is also equally important in recruiting not just university faculty but also for businesses to hire talented foreign nationals with high academic achievements and high skill-sets.

2.1.4. Industry-government-academia collaboration

In order to strengthen Japan's competitiveness and promote innovation, there is a need to fundamentally revise the role of industry-government-academia collaboration such as by further promoting cooperation between the social sciences and businesses. For universities and businesses to cooperate, coordination on both sides will be required, but from the perspective of SMEs, there is a high threshold in reaching out to universities to trigger that process. It is important to lower the threshold by offering success cases of industry-government-academia collaboration.

University researchers depend too much on government funding, and it is important to lower this and collect private funding. A review of the donation tax system and the introduction of tax deductions are

therefore imperative. Regional universities should enhance funding in this manner and be the center of regional revitalization.

There is also the idea that businesses should retain expert personnel on finance within the company in order to utilize the retained earnings of businesses. To achieve this goal, policy guidance should also be considered.

2.1.5. Activation of regional revitalization

In order to create ideas and projects that will serve as breakthroughs for declining regional economies, human resource development and methods of fundraising such as crowdfunding are necessary. There is a need to create a new system for revitalization of regional economies that does not rely on the central government.

As the regional population declines and downsizing of the market continues, how to urge withdrawal, mergers and succession of businesses, and to what extent mergers and concentration will be tolerated without damaging the region's traditions, culture and vitality will also become big issues.

As services become more important in industrial agglomeration policies and downsizing of industrial agglomeration policies proceed, initiatives by the local intermediary platforms (municipalities, regional finance, chambers of commerce and industry, etc.), local municipalities and citizens are becoming more important compared to the simple government-led subsidy policies.

The idea of industrial policy should be transformed, and the target should change from "hard to soft" and its purpose from "industrial development to nurturing intellectual society". Japan's regional revitalization policy should change from a centralized structure to a diversified and bottom-up structure.

Regional universities need to be more open in order to become the center of regional revitalization. Many undergraduate and graduate students of regional universities become good entrepreneurs, and they are the hidden forces. In this regard, matching regional universities with SMEs is important.

A Japanese local government tends to implement the same policies as other ones do as it is afraid of being criticized for taking a unique approach. Even if it fails by adopting the same policies, it believes it can share responsibility with all the others. However, now, in order to restore the vitality of its local economy, it would need to encourage competition among local government policies, since it is these policies that would attract businesses or universities.

Thus, assessments and rankings of regional governments using various axes is also important.

Consolidation of regional universities should be undertaken rigorously, and strengthening their structure should be planned. Online remote classes, digitalization and a credit transfer system should be utilized effectively.

Policy coordination between regional municipalities and heads of local governments should be strengthened and at the same time researchers in economics should participate in policies, so that

planning of policy ideas, their implementation and assessment should be conducted scientifically.

In addition to traditional loans, policies may be necessary to expand equity financing and crowdfunding, which venture companies in metropolitan areas conduct, to regional economies. Relying on foreign capital and foreign powers is easy but dangerous. Its risks should be fully considered, but on the other hand success cases in certain regions should be researched and analyzed, and it may be worth considering identifying and promoting what industry types and business models are desirable for Japan for investment from foreign-owned companies, including those in China.

In this instance, it is important to put in place a mechanism or system that can clearly protect areas such as infrastructure and sensitive technology where foreign-owned companies or Chinese capital should not enter and also identify actions that are not welcome.

2.1.6. Improving the structure of large enterprises

There is a need for large enterprises in Japan to share the common understanding that a further decline in competitiveness will lead to a national crisis for Japan. In order to find a way out of this difficult situation, drastic reform is necessary. Abolition of the seniority system, building a wage structure utilizing the merit system according to productivity, flexible promotion, and expansion of job-based employment is essential. In addition, Japanese businesses are slow at decision-making and are short of personnel who are competent in the global arena. These points also require fundamental reform.

The current yen depreciation will not contribute to improvement in competitiveness as it once did. This is because Japanese businesses are not profiting from exports but are from entering overseas markets. Rather, the yen's depreciation and the rise in energy prices will further accelerate the vicious cycle of worsening the fiscal deficit through worsening the current balance.

Despite carrying surplus resources, many large Japanese enterprises have been unable to commit management resources to innovative activities with high uncertainties. In order to mitigate this issue, reasoning and story-telling to commit resources to innovative activities such as SDGs becomes important. These do not necessarily have to be economically motivated.

Compared to the Nordic countries or Israel, there is little collaboration between businesses to achieve innovation. Collaboration between large enterprises and venture companies, and creation of an intra-enterprise venture is required.

There is research that found that when personnel who have backgrounds in large enterprises, especially those who have experienced management positions, start a business, it is difficult for them to create innovation. Research and analysis on businesses that have failed in support for start-ups will provide useful information in finding out what is necessary for innovation.

For businesses to grow, there is a stage that creates 1 from 0 and a stage that creates 100 from 1. In order to develop the latter stage where Japan is lagging, promotion of corporate acquisitions should also be considered.

2.1.7. Revitalization of SMEs and support for start-ups

Reform of the credit guarantee system was implemented to support start-ups, but the entry rates of new businesses did not go up that much. There is also research that showed the percentage of women among those that started businesses using credit guarantees being extremely low.

There are issues with the response of financial institutions once credit guarantees are used. Many comments came in from businesses saying "financial institutions actually did nothing". Financial institutions should aim to enhance enterprise value by working alongside the businesses.

The credit guarantee system was originally designed for the government to guarantee start-up capital by bearing the risk, and the role of the financial institutions was expected in working on issues such as employees and business matching. Financial institutions should actively reach out to clients and help clients grow their business. Deposit-taking financial institutions do not necessarily excel at taking risks and play the role of the escort runner to the entrepreneurs. Offering capital through crowdfunding, not loans, is preferable.

Improvement in the financial literacy of management is also required, and the role played by the chamber of commerce and industry and the activities of business associations is significant. There is a need to improve the financial literacy of SMEs on both the fund-raising side and the asset management side. What is most important to improve the productivity of SMEs is human resource development.

Improvement in the status of the Institute for Small Business Management and Technology is anticipated by positioning it as a professional graduate school and conferring degrees on graduates. If students from Asia were to be accepted as well, they can be expected to be active as highly skilled foreign professionals in the future. It is also important to develop professionals who can take on the role of the escort runners of the founders of the start-ups.

Lastly, traditional SMEs, not just the venture companies that are starting up, need to be careful in not becoming a zombie enterprise which has relied too much on interest-free loans from the government.

2.1.8. Need for a national strategy

Finding out the fundamental cause of the continuous decline of Japan's national power for the past 30 years, reversing the tendency of the Japanese economy to decline through a national strategy, and putting Japan on a development path are urgent tasks. One way to put Japan on a development path is raising wages, but this is a

management decision and therefore at the core is expected expansion of demand and improved productivity.

In a nutshell, the root cause of wages being low and stagnant is the deterioration in the competitiveness of the Japanese economy.

Looking back, what led Silicon Valley, China and postwar Japan were national strategies. Going forward, Japan should aim for economic development under a national strategy, and target areas to be considered include information, data, space, medical treatment, health and food. On the other hand, policies that are thought to have delayed the metabolism of industries and lowered competitiveness should be abolished.

2.1.9. Evidence-based policy formulation

In an era where the Information and Communication Technology (ICT) has developed and big data is utilized, there is a need more than ever to implement policies based on evidence (EBPM = Evidence Based Policy Making).

In order for the government to promote empirical studies based on data and quantitative policy evaluation, a budget for data science should be created in economics departments. The time is now for government-academic cooperation to also be brought to departments in the humanities. It is also important to bring in personnel who can conduct quantitative analysis and explain the results to the general public in easy-to-understand language. The utilization of those who have obtained Ph.Ds is expected.

Theoretical research that carries out qualitative analysis and estimations should also be considered as evidence. Economic theory can contribute to EBPM through implicating cause and effect relationships that require attention and analyzing issues where obtaining data and experiments are difficult.

Further, EBPM is also impacting reviews of recent industrial policies. A certain positive impact is now being recognized for industrial policies through a more precise empirical analysis, compared to the past where the market distortion impact of industrial policies was solely emphasized. And those industrial policies were looked upon as typical protectionist policies.

In fact, to this date, research to verify the positive impacts of these policies has been conducted including the economic impacts of JETRO's promotion of export programs and regional trade agreements and the impact of the implementation of technology development.

2.1.10. Sustainability of finance

The fiscal deficit continues in Japan and Japan's debt ratio (to GDP) is exceptionally high by global standards. As calls for fiscal consolidation are expressed around the world, there is a need to discuss the sustainability of public finances. In particular, it should be acknowledged that increases in the issuance of government bonds mean passing the tax burden on to future generations.

Japan's public spending is not necessarily high if social security

expenditure and government bond expenditure are excluded. The key is how to use a limited budget efficiently. Generally, it has been pointed out that the government outlook for its fiscal balance is too optimistic compared to private outlooks. There are substantiated outcomes of analysis that have found that outlooks from the government, which creates the fiscal rules, have smaller gaps than those of private entities.

Discussions about a carbon tax as a measure against global warming are worth watching. There is a need to consider this within the review of the overall energy tax system. Policies to promote transformation in investment activities from a long-term perspective are necessary to achieve a decarbonized society.

There are also issues with the non-traditional monetary policies that the Bank of Japan is implementing. Up until now the majority of Japanese government bonds with a maturity of less than 10 years have been supported by the monetary policies of the BOJ. But with debt monetization, which covers the fiscal deficit by printing more BOJ notes, consideration should also be given to the possibility of monetary policies not being implemented in a flexible manner when something happens in the future.

In order to unearth bold private investment, pump-priming investment by the government is necessary. While aiming to achieve that through wise spending, it should be noted that under financial restrictions, increases in the consumption tax may also be required.

In considering Japan's financial issues, recovering competitiveness is a top priority. As the ageing society progresses, Japan's domestic savings are declining. The percentage of foreign ownership of Japanese government bonds is also rising. If competitiveness declines and exports do not rise, it will lead to a deficit not only in the trade balance but also in the current account balance. As a result, yen depreciation will continue, leading to inflation through rises in import prices. Financial tightening will be conducted, leading to a fall in government bond prices, and through increases in interest payments public finance will further worsen.

2.1.11. Improving the appeal of the profession of civil servant

In the US, the role of the private sector is more emphasized compared to the bureaucracy. Under the market mechanism, private enterprises are advocated to expand both domestically and overseas using their own power of being a private enterprise. In contrast, the roles of civil servants are emphasized in France and Germany. US private enterprises and private financial institutions do not require much help from the government and rely on their own power using English to expand overseas and raise profits. In contrast, Japan, France, Germany and others do not use English as a mother language and that makes it difficult for them to expand overseas like US businesses have.

Implementing an overseas strategy with the government and the private sector working together is necessary for Japan. In addition,

private enterprises alone cannot collect ample information from overseas, and therefore gathering of information from local Japanese embassies and JETRO will be essential. With talented personnel in the government sector being active on this front, the government and the private sector need to work together on Japan's strategy.

However, the number of those that aspire to be civil servants is currently declining and moreover the turnover of young civil servants is increasing. Enhancement of the quality of civil servants as well as improvements to the working environment are required. In addition, adverse effects of the vertical structure of the government are being highlighted, and improvement in the hiring system of civil servants as well as their promotion system is an urgent issue.

In order for talented personnel to come together in the bureaucratic system, a pay structure based on abilities in addition to seniority should be built, and highly talented civil servants should be paid compensation comparable to the private sector.

Specifically, in order to break down the vertical structure of government, human resources should be unified under the Cabinet bureau of personnel affairs. At the same time, mid-career employment as well as re-employment of those changing jobs should be made possible, and a public recruitment system for positions above certain posts should be considered. In essence, in order to eliminate the involvement of politicians and the Prime Minister's Office in human resources, a third-party personnel evaluation committee should be established. For comprehensive service positions, compensation should be made equivalent to the average of the top 100 corporations listed on the first section of the Tokyo Stock Exchange. Pensions should also be around the same level as in other major countries.

Once personnel enter the bureaucracy, individual skills grow through working in various positions, and at the same time it is necessary to enhance training and study abroad programs as well and establish an online education system. After the expansion of coronavirus infections, the number of remote meetings has gone up, and the education system for civil servants should also include a system where lectures can be attended when there is extra time. Furthermore, human resource development programs such as attending lectures by foreign leaders should be promoted so that a system can be established to provide indirect support to overseas expansion of Japanese businesses.

In order to lighten the logistical office work of the Diet, Diet statements should, in principle, be made by the ministers, and notifications of questions should be made, in principle, one week prior.

2.2. Asia-wide industrial policy and Japan-Asia cooperation

Japan does not possess the power to confront the two great powers, the US and China. In order for Japan to exert its presence in international society, there is a need to collaborate with multiple countries and regions, like the EU does. In order to deepen regional

cooperation with surrounding countries and ASEAN, it is important to dispose of the mindset of being a superpower.

Not only in technology, but cooperation between governments in developing legal systems and setting rules and regulations is necessary, and it is important for Japan here to exert its influence. Japan's rules differ from other global rules. It is thought that if rules and systems were the same for Japan and other countries, it will be easier for businesses to be more active and conduct investment.

If training of civil servants were to be carried out not just for the Japanese, but on an Asia-wide scale, it will be useful in constructing a human network.

2.3. Japan-US cooperation with economic security in mind

2.3.1 Importance of Japan-US cooperation

For economic security, the US is strengthening its industrial competitiveness through active industrial policies, and showing a competitive attitude towards China. External policies under the administration of President Joe Biden focus on a return to international cooperation and coordination of willing nations. While protectionist and US centralistic unilateral measures are still being observed, a framework for Japan-US coordination and cooperation such as the Japan-US Economic Policy Consultative Committee (EPCC) and Quadrilateral Security Dialogue (QUAD) is coming together.

Specific areas of potential cooperation include making supply chains resilient, developing key infrastructure, and developing and supporting advanced critical technologies

2.3.2 Other points to consider

Corporate cooperation between Japan and China can have both positive and negative impacts on the competitiveness of Japanese businesses and economic security of Japan.

On the security side, technology leaks require attention. Developing mechanisms and systems to protect domestic technologies is imperative, such as selection of areas, for example infrastructure and sensitive technology, that require restrictions of foreign capital inflows including from China and clarifying prohibited activities. **JS**

The Japan Economic Foundation (JEF) initiated the Research Committee on Evolutionary Industrial Policy with prominent Japanese experts in November 2021, and concluded its role by publishing recommendations in June 2022.

Roundtable with Prof. Ken Endo, Dr. Shumpei Takemori, Tatsuya Terazawa & Masakazu Toyoda

How Should We Interpret Geopolitics, Economy & Energy Developments in Today's World?

By Japan SPOTLIGHT

Experts: Prof. Ken Endo, Professor of The University of Tokyo, Japan (International Politics)
 Dr. Shumpei Takemori, Former Professor of Keio University, Japan (Economics)
 Tatsuya Terazawa, Chairman of The Institute of Energy Economics, Japan (Energy)
 Moderated by Masakazu Toyoda, Chairman of Japan Economic Foundation (JEF)
 (Online Roundtable on Nov. 28, 2022)

Experts



Prof. Ken Endo



Dr. Shumpei Takemori



Tatsuya Terazawa



Masakazu Toyoda

1 **Toyoda:** The Russian military invaded Ukraine on Feb. 24, 2022
 2 without any warning and many Ukrainians have been killed or have
 3 sought refuge overseas or are remaining in the country under
 4 serious threat of attacks as well as a shortage of electricity and food
 5 supplies.

6 The impact of these shortages is spreading out of Ukraine and
 7 world energy and food prices have been rising, threatening the lives
 8 of people all over the world, including in developing nations. This is
 9 what we call the Ukraine crisis.

10 This Roundtable of experts on international politics, international
 11 economy and energy aims to discuss how to interpret this crisis:
 12 what exactly is happening, why is it happening and how can we cope
 13 with it.

What Is Happening?

17 **Toyoda:** Mr. Terazawa, I would like to ask you how seriously the
 18 global energy situation is now under threat, how much energy prices
 19 are rising and how the situation is different among nations or
 20 regions. To my knowledge, Japan's imported energy prices are
 21 cheaper than many other countries' thanks to the high proportion of

long-term contracts in energy imports, but the situation has been
 recently changing. On the other hand, it seems that some companies
 have ceased to conclude such long-term contracts.

I have also another question. Do you think fossil fuels have truly
 no positive prospects? Or do you think we can continue to use them
 by turning them into hydrogen or ammonia by decarbonization?

Terazawa: Russian oil's share of the global market is 12% and its
 natural gas share is 24%.

Thus, with Russian oil and gas supplies to the West impeded,
 there must be an enormous impact on the global energy market.
 After the invasion, the price of crude oil once rose to US\$130 per
 barrel and the natural gas price in terms of crude oil equivalent rose
 to \$600 in the European market, while LNG in Northeast Asia hit
 \$400. Compared with the crude oil price, the price increase of natural
 gas or LNG was significant. This is because a tanker could transport
 crude oil anywhere in the world, but natural gas can only be
 transported by pipelines and LNG can be transported only by LNG
 tankers after being cooled. Thus, the latter two are short of mobility.
 With a supply shock, prices of the latter two fluctuate more than
 crude oil prices and this results in a more serious economic impact

1 overall.

2 At this moment, since there is concern about a stagnant global
3 economy, energy prices have started to drop; the current crude oil
4 price is around \$80, the European natural gas price in crude oil
5 equivalent is below \$200 and the Northeast Asian LNG price is less
6 than \$150. But we must say those energy prices remain high.

7 How much each nation pays for its energy is another story. While
8 nations in the West, including Japan, stop imports of Russian oil,
9 nations not participating in the economic sanctions against Russia
10 continue to buy Russian crude oil at discounted prices, cheaper than
11 the world oil price by 20-30%. The notable examples are India, China
12 and Turkey. These countries can continue to buy Russian energy at
13 prices close to those before the crisis, meaning that energy prices
14 are relatively moderate for them. On the other hand, the nations
15 suffering most from energy price hikes caused by the Ukraine crisis
16 are European nations. This is because prior to the crisis 40% of
17 Europe's gas consumption was from Russia through pipelines and
18 with the Ukraine crisis greatly limiting these imports, they are now
19 facing a supply shortage of natural gas. In addition, as they
20 compensate for this shortage with LNG imports from the rest of the
21 world at high prices, this will result in a serious impact on energy
22 prices in Europe.

23 As for Japan, we have in general a similar impact from the crude
24 oil price hike to that in the West, as this is the global market price.
25 On the other hand, Japan's LNG imports are significantly based on
26 long-term contracts and the contracted price is mostly connected
27 with crude oil prices. Since the crude oil price hike has been more
28 moderate than the spot market price of natural gas or LNG, Japan's
29 imported LNG price rise in long-term contracts has been restricted to
30 a moderate one. Thanks to these contracts, Japan has not faced yet
31 the supply shortage of LNG as in European nations. So I believe the
32 energy crisis impact overall on Japan has been more moderate than
33 in Europe.

34 However, these long-term contracts were concluded a long time
35 ago, and after 2029 the percentage of the long-term contracts in
36 particular will be declining. Japan had not renewed those contracts
37 before the Ukraine crisis, though there were opportunities for
38 renewal. The background was the growing uncertainty about the
39 future of fossil fuels. LNG users in Japan, electric power companies
40 or gas companies, were hesitating in making long-term
41 commitments. Under such circumstances, the crisis happened.

42 My concern is that Japanese companies are still hesitant about
43 committing to long-term contracts even after the crisis, while

German companies and others are working hard to secure LNG 1
imports and LNG-producing nations are becoming aggressive in 2
refusing to sell LNG to them without their long-term commitments. 3
Chinese national companies are now securing many long-term 4
contracts. So the weight of Japan's long-term contracts in LNG 5
imports will decline in the future and the weight of spot contracts 6
increase. Japan could suffer from a negative impact as in Europe 7
now. I think this would be a challenge for Japan in the future. 8

To overcome this, we would need a roadmap to show how natural 9
gas can be utilized in the long run. Otherwise, Japan's natural gas 10
users cannot step into concluding long-term contracts. 11

Assuming that natural gas would be made into hydrogen or 12
ammonia (realizing what we call blue hydrogen or blue ammonia) in 13
the long run, we should prepare a path for such new use of natural 14
gas to achieve less dependency on Russian energy sources while 15
securing long-term demand for natural gas as blue hydrogen or blue 16
ammonia. In that way we can make long-term commitments for 17
stable procurement of LNG. At the same time, we can contribute to 18
resolving global warming through blue hydrogen or blue ammonia. 19

20
21 **Takemori:** At this moment, gas and oil price rises are coming under
22 control, because global weather in autumn and winter 2022 was
23 historically warm. Without this, European gas storage would be
24 exhausted and planned blackouts or suspension of factory
25 operations would be needed. China's zero Covid-19 policy by
26 continued lockdown of major cities has also been affecting the
27 supply-demand situation of gas and oil, as the Chinese economy is a
28 fossil-fuel consumption-led economy emitting a quarter of the
29 world's carbon emissions and its decline in demand for energy
30 sources would ease the global energy situation enormously.

31 Europe could increase storage of gas in 2022 because it could
32 import Russian gas by pipeline in the first half of the year. However,
33 now that Nord Stream 1 is almost suspended and Nord Stream 2 will
34 not be used hereafter either, it will be difficult for Europe to build up
35 storage in 2023 and thus we presume that the winter in 2023 would
36 be very tough.

37 I think Japan's energy situation will be a tough one as well in the
38 winter of 2023. On the question of Japan's long-term contracts of
39 gas, in December 2021 when the risk of a Russian invasion of
40 Ukraine was globally recognized, the time for renewal of long-term
41 contracts by Japan with Qatar came, but it was not done. I wondered
42 why.

I have a question about the new direction of Russian exports of 43

1 gas. After Europe ceases importing Russian gas, Russia must
2 redirect it to other countries. There is a plan for a pipeline
3 construction, "Power of Siberia 2", from the Yamal Peninsula facing
4 the Arctic Sea through Mongolia to big cities in China. This is
5 planned to be completed around 2030. My question is if China will be
6 truly capable to realize this pipeline construction plan to import
7 Russian gas. I am skeptical about China's capability to achieve this
8 without Western nations' technological support. When the accident
9 in Nord Stream 2 happened in 2022, we clearly learned that Western
10 technology was needed to maintain the pipeline. The pipeline
11 stopped to operate because Canada, a producer of motor propellers
12 for the pipeline, refused to deliver those under repair to Gazprom due
13 to economic sanctions against Russia. With clarification that Russian
14 pipeline operations would need Western technology, I am skeptical
15 about only Chinese and Russian technologies being able to realize a
16 gigantic pipeline construction plan connecting the Arctic Sea with big
17 Chinese cities.

18
19 **Terazawa:** It is true that the energy situation will be more serious in
20 2023. In particular, China's decreased energy demand due to its zero
21 Covid-19 policy has certainly contributed to loosening demand and
22 supply at the end of 2022. If the Chinese economy recovers strongly
23 in 2023, global energy demand will increase strongly as well.

24 In the case of Europe, in the winter of 2022 it could pile up stocks
25 of Russian oil, but in 2023 it cannot do so. It is true that Europe will
26 face a more severe winter in 2023. It would normally take several
27 years to increase LNG supply capacity, so we will see uncertainty
28 and extreme instability in energy supplies including LNG and natural
29 gas until around 2025.

30 Certainly, Russia has a project to construct a pipeline to China and
31 is eager to achieve it. China was the largest LNG importing nation in
32 the world in 2021, having overtaken Japan. To meet its tremendous
33 demand, it has to diversify supply sources, so it would also eagerly
34 pursue construction of a pipeline from Russia as one of its
35 diversified supply sources. However, China would be shrewd to
36 avoid depending solely on one source like Europe and pursue a well-
37 balanced regional allocation of supply sources, considering Russian
38 sources as one of them.

39 How could it achieve this with its heavy dependency upon Western
40 technology? Having perceived a risk of depending on US technology,
41 given the current US-China high-technology conflict, China would try
42 to take maximum advantage of its own technology. It has its own
43 technology that has been used for pipeline construction so far and it

will seek to develop it, apart from whether it is the best or not.
However, as it will take time to accomplish such a pipeline, no
fundamental development will occur in the energy situation soon.
The instability of the LNG market will continue for the time being.

4
5
6 **Takemori:** I have another question for Prof. Endo. Before Russia's
7 invasion, Germany's dependence on Russian gas supply was very
8 high, with 55% of its energy consumption depending on Russia.
9 With the addition of Nord Stream 2, its dependency would further
10 increase. When Russia occupied the Crimea in 2014, German
11 Chancellor Angela Merkel must have actively joined in economic
12 sanctions against Russia, but at the same time Germany has been
13 deepening its dependence on Russia since then. Why do you think it
14 has been doing so?

15
16 **Endo:** Germany's dependence on Russia had been an important part
17 of its economic development model together with a cheap euro and
18 the gigantic Chinese market. With the Ukraine crisis, this model has
19 collapsed. Germany maintained a policy of engagement with Russia,
20 assuming that Moscow would liberalize its economy and eventually
21 politics, too.

22 However, the Ukraine crisis proved otherwise. Current German
23 President Frank-Walter Steinmeier expressed regret about his
24 permissive treatment of Russia when he was foreign affairs minister.

25
26 **Toyoda:** I would like to ask Prof. Takemori about the global
27 economic outlook. Needless to say, the Ukraine crisis has a big
28 impact on the global economy which is still reeling from the lingering
29 impact of the pandemic crisis. In the next few years, what do you
30 think the global economy will look like?

31
32 **Takemori:** In 2023, with the more severe energy outlook,
33 international organizations like the IMF or OECD have presented a
34 pessimistic outlook for the global economy. The short-term
35 challenge is inflation. To cope with it, the United States rapidly raised
36 interest rates and inflation fell to around 7%. Developing countries
37 must be relieved to see it. With high energy prices and food prices,
38 their economies have been slowing down. A continued climb in US
39 interest rates would exacerbate their foreign debt problems as they
40 have a large amount of debt in dollars, and many of them would have
41 to seek help from the IMF.

42 Meanwhile, in Europe, core price indexes except for energy items
43 have not been rising much, unlike in the US. This is why the

1 European Union's interest rate rise is more moderate than the US.
2 Another reason is that in the EU there is one central bank and each
3 member nation has its own public finances, which means a
4 significant rise in interest rates would put the public finances of the
5 weaker economies such as Italy, Spain and Greece into a critical
6 situation. So I think inflation in the EU will continue longer.
7 Whenever high inflation occurs, Germany makes noises to the ECB,
8 but today it is exceptionally quiet. This is probably because it regrets
9 its excessive energy dependency on Russia. With a worsening
10 economic situation hereafter, the EU may decide its own fiscal
11 expenditure again to support the member nations, such as with the
12 "Restoration Fund for Recovery from the Pandemic". But in the long
13 run, its energy policy must pursue blue energy, renewable energy
14 and small nuclear power as its core energy supply by around the
15 2030s. Meanwhile, the global decarbonization drive exerts downward
16 pressure on fossil fuel investments so that we see global fossil fuel
17 supply failing to meet global demand.

18 Until around 2025, the global energy situation will be at a critical
19 stage if all nations try to mitigate their energy dependency on Russia.
20 Even after 2025, I have concerns that the energy crisis may continue
21 until 2030.

22 On developing nations, their food crisis was focused on the
23 discussions at the international meetings in November 2022. At this
24 moment, the issue is not only about the war preventing Ukraine from
25 exporting its food items but also the high rise of prices of chemical
26 fertilizers overshadowing affected economies. There is even a
27 concern about whether it would be feasible to maintain a world
28 population of 8 billion people without chemical fertilizers using
29 ammonia. Anyhow, how we deal with this mid-term energy crisis will
30 be an extremely critical issue.

31
32 **Terazawa:** We argue on the impact of energy prices in dollar terms
33 in the world market, but in Japan the issue is yen-based. In the case
34 of Japan, the impact of energy price hikes is duplicated with the
35 yen's depreciation. I have two questions for Prof. Takemori. My first
36 question is how we should manage monetary policy in Japan,
37 seemingly today inviting yen depreciation. And my second question
38 is about energy subsidies.

39 Daniel Yergin, a distinguished energy policy expert, mentioned
40 that this crisis would be interpreted as the first crisis of an energy
41 transition which started in autumn 2021 even before the Russian
42 invasion.

43 The background of this crisis is underinvestment in fossil fuel

domains and rising prices triggered by it, and Russian President
Vladimir Putin's Ukraine invasion having tried to take advantage of
this situation. These serial events pushed energy prices even higher.

Under such circumstances, Germany has never thought about
changing its energy policy. Its policy is in general to accelerate the
use of renewable energy, though it provisionally prolonged use of
nuclear power but only until spring 2023, and also prolonged use of
coal in the short run.

Investment in fossil fuels has continued to decline reflecting this
policy adopted not only by Germany but also by other European
nations and the US. In this light, if demand for fossil fuels hereafter
remains higher than the level which people promoting policies for
mitigating global warming have ever thought, its supply would not
meet demand. Such underinvestment in fossil fuels in the long run
would result in an energy market structure extremely vulnerable to
external shocks. A big crisis like the current Ukraine crisis would
cause a seriously negative impact upon the world economy and I
have a concern that such a crisis could be repeated in this vulnerable
energy market structure.

I would like all nations including Germany to take note of this and
adopt a well-balanced energy policy to encourage necessary
investment in fossil fuels to meet rather continuous demand in the
long run as well as promoting renewable energy, since renewable
energy cannot meet all the energy demand quickly.

Takemori: Exchange rate fluctuations are generally caused by the
interest rate differential between the US and Japan. And in the US,
the high interest rate now is due to an extremely high inflation rate in
the US. Meanwhile, Japan's inflation rate is not so high. It is now
around 3% and thus Japan does not have an urgent need to raise
interest rates. I think low wage increases must be the reason for the
low inflation rate. To maintain full-life employment in Japan, there
tend to be so many workers in unnecessary sections of unnecessary
industries. To keep such inefficient employment, Japanese business
continues to go through any economic situation without raising
wages. This must be a cause of low productivity as well as low
wages and low prices. To work on reforming this fundamental
weakness of the Japanese economy, we should introduce "layoffs" in
Japan, though it would cause a serious economic challenge in the
short run. With its introduction, labor mobility will be enhanced.
Competition in the job market would be encouraged, and more
competent workers would get jobs with higher salaries. In other
words, employers would need to pay more to get competent

1 employees and thus wages would rise and the inflation rate could
2 also rise. There would be more room for raising interest rates, which
3 is supposed to be normal.

4 Anyway, on the fiscal policy side, we would need to pursue a wise
5 spending policy, namely more budgets for necessary policies such
6 as accommodating electric power systems to introduce solar or wind
7 power while cutting budgets for unnecessary policies. This will be
8 extremely important.

9 Many economists today would say that fiscal policy and monetary
10 policy should work together in the same direction, namely both of
11 them should work expansively on deflation and both should be
12 tightening on inflation. This means there would be fewer boundaries
13 between both. Both of them should work together in collaboration as
14 an integrated policy to control total effective demand. With
15 inflationary concerns modified, fiscal policy as such should focus on
16 what is to be truly needed selectively.

17
18 **Toyoda:** A question for Prof. Endo. In terms of international politics,
19 world nations seem to be divided into three groups: the US, Japan
20 and Europe; Russia and China; and lastly third countries. Meanwhile,
21 the Ukraine crisis was apparently and unanimously considered to be
22 caused by violation of international law. In spite of all this, the UN,
23 G7 or G20 are not working well in dealing with this violation. What
24 do you think is happening exactly?

25
26 **Endo:** I think this war is to be defined as an unlawful invasion
27 reversing a century-long effort by human beings to define wars as
28 unlawful actions and contain war crimes, or more specifically
29 contradicting the Anti-War Pact of Paris in 1928 or the Geneva
30 Protocol in 1924 defining a war of invasion as a crime.

31 However shocking it may look, this is a large-scale limited war,
32 since the combative nations and the means of combat are limited,
33 while in terms of the scale of human casualties and firepower
34 involved it is equivalent to what Russia experienced in the first phase
35 of German-Soviet conflict during World War II.

36 The United Nations Charter provides veto power for the permanent
37 members of the Security Council and therefore as is predicted, the
38 UN does not function if one of those members commits an unlawful
39 action.

40 In a different perspective, the implication of veto power given to
41 permanent members of the Security Council is that they are not to
42 engage in a war against each other. Without this veto system, other
43 members might have had to fight a war with the Russians, under the

mandate of a Security Council resolution. In this regard, the UN
Charter, as devised, could even be seen as preventing them from
starting a war.

It is true that nations are divided into three groups on this Russian
invasion: Russia and China and a few others supporting it, Japan, the
US and Europe opposing it, and developing nations murmuring. I
think there must be strong antipathy among the nations in the third
group, called the Global South, against the Western nations'
monopolizing of political correctness despite historical events such
as colonization, racial discrimination and the Iraq War. Each nation in
this group also has been pursuing its own national interest with
priority placed on a free and independent attitude. For example, India
has been importing cheap oil from Russia, loyal to its long history of
a nonalignment policy.

However, it is also true that there was extensive support for the
UN General Assembly's initial decision that Russia should get out of
Ukraine and stop its invasion: 141 agreed and only five opposed,
with 35 abstentions. This implies that concerns, criticism and
condemnation of Russia's invasion were widespread. Criticism of the
war is shared by many national leaders including Indian Prime
Minister Narendra Modi or Turkish President Recep Erdogan. In
particular, after having had to face the risk of a nuclear attack or
incident, more nations are becoming expressly concerned about the
war. The three group members are thus not necessarily fixed and
with widespread criticism against the war there have been changes
among group members little by little, reflecting it.

Why Has This Happened?

Toyoda: Can we interpret this war as being provoked by Putin's
nostalgia for the Soviet Union and a sense of being under threat of
from a NATO invasion of Russia, as well as the Russian authoritarian
political regime? Some people say that China is also under an
authoritarian regime like in Russia. The latest appointment of the key
officials in the Communist Party and the administration in 2022, to
the majority's view, showed that power is getting concentrated on
President Xi Jinping's aides and people with views different from his
are eliminated.

What do you think will happen to China hereafter, Prof. Endo?
Japan is most concerned about China-Taiwan relations. What do you
think about the possibility of Chinese military action pursuing the
integration of Taiwan into One China?

1 **Endo:** In International Relations studies, we are inclined to think
2 about war from three perspectives: international, national and
3 individual. In international dimensions, it is certainly true that the
4 Russians are concerned about NATO expansion reaching Ukraine
5 and accommodating facilities and equipment to defend missiles in
6 Poland, demonstrating power close to Russia's border. In this light,
7 there is some international criticism that the West has threatened
8 Russia too much with NATO expansion. However, at the same time,
9 there is another view that the West has threatened Russia too little.
10 The administration of President Joe Biden, following the trend of US
11 withdrawal from overseas conflicts, stated that it would not send
12 soldiers to Ukraine. Within this perspective, it could be seen as a
13 failure in deterring Russia, but whether a US threat could make Putin
14 give up his invasion would remain a big question.

15 Lastly on international dimensions, we should not forget about the
16 impact of the collapse of empires that has not been much talked
17 about. A collapse of a big empire could have a durable impact that
18 lasts more than one generation. Empires of the past tell the same
19 story: the Russian Empire, German Empire, Austro-Hungarian
20 Empire and Empire of Japan. Some Russians still have traumatic
21 feelings about the collapse of the Soviet Union in 1991 without a
22 gunshot having been fired.

23 Some groups in Russia have been eager to restore the Soviet
24 Union, but with independent states, new national borders and new
25 ethnic allocations. This war was provoked by such historical
26 developments from the impact of the collapse of the empire. The
27 wars that Russia started after the Cold War took place in "post-
28 Soviet space", i.e. the former Soviet Union's territory. All of them
29 were initiated with little regard to the West's intentions and actions.

30 In the national state dimensions, there have been contradictory
31 political developments: democracy versus authoritarianism or
32 dictatorship in the post-Cold War period. Putin had the impression
33 that waves of democratization were reaching Russia, as even Ukraine
34 was democratized after the waves of democratization in Eastern
35 Europe and Arabic nations. He would most likely consider these
36 waves as US-inspired anti-Russia movements. Some experts on
37 Russia refer to the Rose Revolution in Georgia and the Orange
38 Revolution in Ukraine around from 2003 to 2004 as decisive
39 incidents which made Putin convinced of an American conspiracy
40 behind the events.

41 Meanwhile, Russia itself has been becoming a more dictatorial
42 state and there are fewer obstacles to conducting an invasion within
43 its national politics. This is certainly Putin's war. He always desired

to restore the former Soviet Union's prestige and spheres of interest 1
and has attempted to take advantage of every weakness of the West, 2
such as with the energy dependence. He thought Biden would not be 3
able to produce any counter reaction against Russia since the whole 4
West itself has seemed weaker, exemplified by the withdrawal from 5
Afghanistan, and there is also the business of the US-China 6
confrontation. What is interesting about Putin is that he is not simply 7
trying to restore the former Soviet Union's spheres of interest but 8
also trying to get revenge on the US by imitating the American logic 9
used for justification of its resort to use of forces, which the 10
Bulgarian philosopher Ivan Krastev referred to as "emulation as 11
revenge". 12

To be more specific, Russia invaded Ukraine, saying that it has 13
been developing weapons of mass destruction and had also 14
committed genocide, like the Nazis, and that Russia would have to 15
make a humanistic intervention and change the regime. Showing off 16
the American logic itself used by the US government to start a war 17
against Iraq and others, it revealed the Americans' ruthlessness. This 18
is such a malicious way to start a war. 19

20
21 **Takemori:** I think the long-term energy issue affected Putin's actions
22 as well. He became Russian prime minister in 1999 and president in
23 2000. In the era of Mikhail Gorbachev as president, energy prices
24 had been low, but after 2000, in particular after China's entry into the
25 WTO in 2001, with its economic growth accelerating, energy prices
26 have been rising with China's high growth rate. This was, I believe,
27 the tailwind enabling Putin to win domestic elections continuously.

28 American shale oil production has increased since around 2012.
29 The primary reason was rising oil prices. The background was that
30 China's 4 trillion yuan macropolicy package to stimulate the
31 economy after the Lehman Shock pushed up energy demand. The
32 second reason was the US zero interest rate monetary policy that
33 made high-cost investment in shale oil profitable. Shale oil
34 production was generally unable to meet the cost without low
35 interest rates and high oil prices and those two conditions were met
36 then and encouraged US shale oil production to jump up.

37 However, OPEC tried to inflict damage on the US shale oil industry
38 by its decision to refrain from oil production cuts, and that resulted
39 in lowering crude oil prices to \$30 in 2016. In 2014 when Russia's
40 Crimea invasion took place, crude oil prices had already started to
41 fall. Putin may have thought that unless he took steps to stir up
42 patriotism among the Russians, his popularity would fall with the fall
43 of oil prices.

1 **Takemori:** He must have thought it would be the last chance to
2 consolidate his power, as the global energy shifts toward renewables
3 would one day wipe out demand for fossil fuels.
4

5 **Terazawa:** I think President Putin decided to invade Ukraine at the
6 best opportunity to take advantage of the weakness of the West in
7 the energy domain. It was a moment when the West was faced with
8 the biggest vulnerability in energy supplies with prices rising,
9 underinvestment in fossil fuels and lack of excess supply capacity.
10 Also from a long-term perspective, Russian gas leverage is foreseen
11 to decline under the progress of decarbonization. With this
12 background, he thought it would be a vital moment for him to restore
13 the glory of the Russian empire while he is still alive and mark his
14 name in history.

15 Even with the sanctions of the West, Russia can continue the war
16 because its revenue from energy is unchanged as non-Western
17 nations continue to buy its energy, and even at discounted prices
18 Russian energy revenue has remained unchanged. This is the reason
19 why the West must continue investment to achieve less dependency
20 on Russian energy. However, under pressure from global warming,
21 how much it can do so is uncertain. That is our concern.
22

23 **Endo:** Putin would think so far this war has been to a certain extent
24 successful in destabilizing the energy situation in the West.
25

26 **Terazawa:** It may be successful in the short run, but without the
27 technologies of the West it would be difficult in the long run to
28 develop oil and gas fields. I think this demerit would be bigger than
29 the short-term merits. So this war will never have been a good
30 decision for Russia as a country. It can be rationalized only in terms
31 of what Putin could do to restore national glory in his lifetime.
32

33 **Toyoda:** Prof. Takemori, do you think the economic sanctions on
34 Russia work well or not?
35

36 **Takemori:** Economic sanctions target Russian banks to stop their
37 international settlements, in other words they aim to make it
38 impossible for Russia to buy products made by the West with its
39 dollar income from energy exports. But at the request of European
40 nations heavily dependent on Russian energy sources, energy-
41 related payments were eliminated from the coverage of sanctions on
42 export payments to Russia. This made sanctions as a whole
43 ineffective, as Russia does not export manufacturing products and

its dollar income consists mainly of energy exports. In addition,
Russia can conduct transactions in currencies other than US dollars
with China or India. So the sanctions had little effect on its earning
income in foreign currencies.

On the other hand, it works well on the purchases of goods from
the West. If Russia tries to buy massive amounts of weapons or
machines, once these transactions are revealed they can be stopped.
At this moment, the Russian army's weapons are becoming obsolete
and fewer spares are available. This is certainly the result of
sanctions and the shrinking Russian economy.

The US is applying this lesson in its policy toward China. It has
already promulgated acts to stop providing China with new
technologies in order to make Chinese semiconductor products
obsolete. Russia's current economic power or military power is
gradually deteriorating by failing to receive new products or
technologies from the West. Likewise, the US is promoting a policy
to prevent China from buying advanced technologies and goods from
the West. This will be the core strategy of the West toward China in
the era of the "New Cold War".

Terazawa: In addition to its inability to get new technologies, the
sanctions are working well in creating a tremendous outflow of the
best and brightest in Russia overseas. Investment flows into Russia
could be discouraged as well. These could have a strong negative
effect on the Russian economy in the long run, though sanctions on
the energy industry do not seem to be working well in the short
term.

This could apply to China as well. It is not only about rejecting
technology transfers to China but also whether China's best and
brightest studying abroad will come back to China or stay abroad to
escape its authoritarianism. This will be a key to China's long-term
development. For the US to contain China, it will be important to
attract those best and brightest to the West.

Toyoda: Coming back to the issue of energy, I would like to ask Mr.
Terazawa if we could truly give up upstream investment in fossil
fuels.

Terazawa: I do not think we can stop upstream investment abruptly.
Thinking about newly developing countries and also many "Hard-to-
Abate Sectors" where decarbonization would be difficult to be
achieved, there will still be stable demand for fossil fuels. As we still
have a long way to go before 2050, without investment to sustain

1 robust demand for fossil fuels during this period, our energy market
2 would become very unstable and with some external shocks, energy
3 price hikes would occur easily.

4 In addition, in the light of the global environment, what needs to
5 be mitigated is not fossil fuels but CO₂. Thus, decarbonization of
6 fossil fuels such as by creating blue hydrogen or blue ammonia from
7 fossil fuel gas or elimination of CO₂ emissions from fossil fuels by
8 CCS (Carbon dioxide Capture and Storage) would make it possible
9 for fossil fuels and decarbonization to co-exist consistently.

10 From the perspective of promoting less dependency on Russian
11 energy as well, I think the need for investment will increase, as
12 elimination of energy imports from Russia will need equivalent
13 investment even with the unchanged global energy balance.
14 Underinvestment in fossil fuels has been concentrated on certain
15 regions or energy companies. For example, European and American
16 companies have been particularly underinvesting with pressure from
17 their shareholders. In contrast, Middle East countries or state
18 enterprises have been investing more. Thus, contrary to the common
19 view on the Middle East, its influence has been rising rather than
20 declining.

21 In total, I think we will need to maintain investment in fossil fuels
22 not only from the need for upstream investment in them to achieve a
23 stable energy market but also from the need to achieve less
24 dependency upon Russian energy as well as less dependency upon
25 the Middle East or state enterprises for fossil fuels.

26 **What Is to Be Done Hereafter?**

27
28
29 **Toyoda:** Lastly, shall we discuss about what to do hereafter? On the
30 global economy, the economic outlook for 2023 by the IMF is very
31 pessimistic. National government expenditures have been increasing,
32 as well as fiscal deficits. Prof. Takemori, what do you think is to be
33 done to achieve both goals consistently, getting the economy back
34 on a robust growth track and budget sustainability?
35

36 **Takemori:** I think the main concern in predicting the economy is how
37 this war will come to an end. On April 29, 2022, Jurgen Habermas, a
38 93-year-old German philosopher, wrote an article in the German
39 paper *Süddeutsche Zeitung* in which he said: "It was the lesson our
40 generation learned that no one would be a winner in a nuclear war."
41 This means that we cannot force a country which has nuclear
42 arsenals to surrender; the only possibility is to seek a compromise
43 with the country. Of course, the key issue of the current war is

whether Ukraine can regain its territory deprived by Russia, but at
the same time this war matters in terms of global security. There
needs to be a compromise in this regard. A compromise might
emerge in 2023 when the West may try to mitigate its energy
constraints, though there would be an enormous cost with Putin's
victory in the war of energy. Without an end of the Ukraine war, I
think the global economy will not be stable. After the end of this war,
we will face another challenge provoked by China. China cannot
hereafter update its high-technology goods or enhance the quality of
those goods, as the high-tech industries in the West will stop
providing China with their new semiconductor technologies from
2024. This will push up the price of electronics products in general.
It is true that China has been providing cheap and high-quality goods
so far, but this will not be possible anymore. Production in South
Korea and Taiwan would not make up for China's production decline.
It would have a negative impact on the global economy. With these
two uncertain factors of Russia and China, short-term economic
predictions are extremely difficult.

Endo: How this war ends will be determined by two factors: the
current cost of the war and future risks. Some suggest finishing the
war to minimize the current cost, but others insist on continuing it to
get rid of the seed of a possible war in the future. There is a fight
between the two. Ukraine is now in the second category. I agree with
Prof. Takemori in saying a compromise might be necessary, if
eagerness to continue the war among the West proves limited.

The biggest risk in thinking about how the war may end would be
the US. If former President Donald Trump had won a second term,
as some speculate, the US may have left NATO. If the Russian
invasion had happened after the US left NATO, NATO would have
been powerless and Ukraine could not have continued to resist.
Russia, in reality, has not won many wars by its aggression and it
has succeeded only in pushing out Napoleon and Hitler. It has been
tough in trench warfare to protect its acquired pieces of land. In this
war as well, it will try to protect what it has already taken by trench
warfare. In such circumstances, how long the West can continue to
supply weapons to Ukraine or support it wholly will be a key
question. Though Ukraine is now still in high spirits, if the West's
support declines I guess there could be a moment in the future when
it will have to think about a ceasefire, which might mean stopping
short of regaining its entire territory.

This is an unlawful invasion. There will be an impact on China-
Taiwan relations, though Taiwan is in some ways different from

1 Ukraine, in particular as China considers the issue of Taiwan as a
2 domestic political question. The important lesson of the Ukraine war
3 is first of all that nations with the intention and power to change the
4 status quo and with greater authoritarianism could take extremely
5 risky political actions. In spite of the long history of attempts to make
6 wars of invasion unlawful, we cannot exclude the possibility of wars
7 under such circumstances. This posture could be applied to China
8 under Xi, with its intention to change the status quo, referring to the
9 possibility of resorting to weapons, and with its deepening
10 authoritarianism.

11 However, it seems to be quite a challenge for China to invade
12 Taiwan in terms of its military capacity. The Chinese army cannot
13 easily pass over the 100-kilometer long Taiwan Strait with its strong
14 oceanic current. The Russian army has struggled to pass over only a
15 river. Missile attacks would be possible, but they would result in
16 increasing Taiwanese readiness to resist. The Ukraine crisis must
17 have also given Beijing a simulation opportunity in examining the
18 West's reaction to unlawful war or invasion, namely their restored
19 unity, though in reduced size, economic sanctions against Russia
20 and continuous support for Ukraine. Judging from these
21 observations, I think China's invasion of Taiwan is most unlikely in
22 the near future. We must be well prepared for it, though, since China
23 has never given up its intention to regain Taiwan, and with its greater
24 power and deeper authoritarianism, this risk cannot be excluded.

25
26 **Toyoda:** Assuming that economic sanctions against China are
27 possible in the future, will Japanese companies start thinking about
28 the need for decoupling. Can you comment on this point?
29

30 **Endo:** There have already been developments in businesses invested
31 or settled in China escaping to third nations following the deepened
32 conflict between the US and China. It is understandable to see an
33 increasing number of Japanese companies engaged in such risk
34 assessment with the start of the Ukraine war.

35 For the time being, a Taiwan invasion will not happen, I suppose.
36 But there is a possibility that the US, through thoughtless action,
37 might trigger a crisis. The US has occasionally given wrong signs to
38 its enemies. A long time ago, on the occasion of the Korean War,
39 State Secretary Dean Acheson drew what we call the Acheson line
40 between the Korean Peninsula and the Tsushima Strait, defining the
41 region inside the line as definitely defended by the US army. This
42 sign helped to make Kim Il-sung, then the leader of North Korea,
43 decide to start the war in the Korean Peninsula.

1 On the Gulf War as well, the US ambassador to Kuwait did not say
2 clearly "No" to Iraqi President Saddam Hussain and Saddam thought
3 he could invade Kuwait. With such confusing signs from the US or
4 no clear sign from the US president, China may think this would be
5 an opportunity for invasion. A Taiwan crisis would be dependent
6 upon three factors: Taiwan's willingness to resist, the US willingness
7 and capacity to intervene, and also China's willingness and capacity
8 to change the current situation.
9

10 **Takemori:** Russia has been considering "time as their enemy" over
11 the long term as its economy, depending on only fossil fuels with the
12 progress of decarbonization, is gradually shrinking. In contrast,
13 China has been thinking that "time would support China", since as
14 time goes by the situation becomes more favorable for it as it could
15 keep competitiveness in its manufacturing sectors with its
16 technology catching up with the West as well as maintaining cheap
17 wages.

18 The American strategy to contain China is to stop this catching-up
19 process by ceasing to provide advanced technology and aiming to
20 reduce its military capacity and eliminate the threat of all the high-
21 tech industries in the world being monopolized by China. To achieve
22 this, semiconductors are under export control and chip technology
23 as well as human resources and services related to supercomputers
24 and AI are subject to export bans now. For example, ASML, a Dutch
25 company with lithography technology vital for producing nano-
26 semiconductors, is not going to be involved in business with China.
27 In the domain of supercomputers, China cannot be the recipient of
28 NVIDIA, chips necessary for AI, and thus its technology would stop
29 improving.

30 Japan now considers China as an important part of the global
31 supply chain. But Japan will have to think about withdrawal from
32 business in China or relocation of its supply chains, as
33 semiconductors built in components provided by China would
34 become more expensive and less high-quality. This may not happen
35 immediately but in five years Japanese companies will be faced with
36 a question of whether they can maintain Chinese components as a
37 core part of their supply chain.
38

39 **Toyoda:** To pursue both climate change mitigation and energy
40 security in a balanced way, the global commitment to restrict the
41 global average temperature rise to 1.5 C in comparison to the pre-
42 Industrial Revolution age may be difficult to achieve. Mr. Terazawa,
43 what do you think about this?

1 **Terazawa:** This 1.5 C goal does look difficult to achieve.
2 Furthermore, in responding to the Ukraine crisis, coal-fired power
3 has been increasing, which will make it even more difficult to
4 achieve. Meanwhile, in terms of the energy flow argument, European
5 nations are now ready to promote decarbonization further in dealing
6 with the Ukraine crisis to consolidate energy security. The emerging
7 economies and developing economies are also ready to promote
8 renewable energy. Therefore, though it is extremely difficult to
9 achieve carbon neutrality in 2050, it is also true that expansive use of
10 renewable energy and decarbonization will proceed across the world.

11 Taiwan committed to stop utilizing nuclear power in 2025 and also
12 to reduce coal-fired power. It would increase use of renewable
13 energy. But due to its constraints in using renewable energy, it will
14 have to use more natural gas and increase use of gas-fired power.
15 The Taiwan example shows us that we will need fossil fuels in
16 pursuing the option of no use of nuclear power while pursuing
17 decarbonization. We will need to continue necessary investment in
18 fossil fuels. Without nuclear power, the goal to achieve carbon
19 neutrality in 2050 will be still more difficult to achieve. We need a
20 national debate on nuclear power if Japan truly seeks for carbon
21 neutrality. Carbon neutrality and abandoning nuclear power cannot
22 be consistent for Japan.

23 **Building Japan's Future**

24
25
26 **Toyoda:** Finally, could all of you give your brief recommendations on
27 what Japan should do from now on?
28

29 **Endo:** We are seeing the emerging reality that the UN, the only
30 critical public assistance system, does not work well in the domain
31 of international security. On the possible conflict with China,
32 including territorial issues like the Senkaku Islands, the UN system
33 will not function well either, as it is a permanent member of its
34 Security Council. If it does not work, we should seek mutual
35 assistance. To the extent that the US remains a reliable partner, this
36 mutual assistance system should be strengthened. However, this
37 mutual assistance system may occasionally not work well either
38 depending upon US domestic politics. We will need self-help in this
39 case to some extent including increased defense expenditure.

40 We will need to examine seriously how limited resources, financial
41 or human, are to be wisely allocated, according to well-defined
42 purposes. We should pursue well-focused and functional self-help. I
43 believe we should put greater emphasis on defense capabilities,

1 instead of a deterrence strategy with middle-range missiles equipped
2 with conventional warheads which may not function, and strengthen
3 our defense of the Southwest Islands.
4

5 **Takemori:** Most Favored Nation and National Treatment, two basic
6 concepts of the WTO, are dead. Russia and China are now
7 differentiated. We are seeing friend-shoring, a concept well accepted.
8 Instead of the WTO rules, we see more discussion on geopolitics. I
9 am glad to see in Japan discussion on fiscal sources of increased
10 defense expenditure finally emerging after a long time. I do not think
11 it is a bad idea for Japanese industries to consider corporate taxes as
12 fiscal sources for increased defense expenditure, because we can
13 take advantage of increased defense expenditure for industrial policy
14 to raise the potential of Japanese science technology and military
15 technology.
16

17 Hereafter, the Japanese government must think about what
18 industrial sectors could contribute to enhancing national security and
19 raising international competitiveness. Wasting budgets cannot be
20 allowed. We have to transform our fiscal expenditure to maximize its
21 benefits.
22

23 **Terazawa:** It is extremely difficult to achieve both goals of mitigating
24 global warming and strengthening energy security. It is so in
25 particular for Japan. We Japanese seem to have spent so much time
26 and energy discussing each advocate's preference or dogmatic
27 arguments such as "Which is better, nuclear power or renewable
28 energy?" But we will need to face reality and seek realistic solutions
29 at this stage to engage with these two big issues. There are no
30 exceptions to this among the government, industries and the people.
31 So whether you like it or not, we will need to utilize all energy
32 sources, renewable energy, energy saving, investment in fossil fuels,
33 nuclear power, etc. Otherwise, we cannot achieve both goals.
34

35 Taking advantage of the Ukraine crisis as a wakeup call, the
36 government, industries and people of Japan, under strict economic
37 and natural resources constraints, will need arguments focused on
38 reality to produce solutions rather than dogmas. **JS**
39
40
41

42 Written by Naoyuki Haraoka, editor-in-chief of *Japan SPOTLIGHT*, with the
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Roundtable with Shingo Ito, Prof. Yasuhiro Matsuda, Satoshi Morimoto & Masakazu Toyoda

Possible Taiwan War – How Should Japan Deal with It Under Intensified US-China Conflict?

By Japan SPOTLIGHT

Participants: Shingo Ito, Senior Researcher of Institute for International Economic Studies, expert on economic relations between Japan and China, as well as Japan and Taiwan; Yasuhiro Matsuda, Professor of the University of Tokyo, expert on Taiwan and China; Satoshi Morimoto, Former Defense Minister, expert on military security; Moderated by Masakazu Toyoda, Chairman of the Japan Economic Foundation (JEF).
(Online Roundtable on Jan. 20, 2023)

Participants



Shingo Ito



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Current Situation of Ukraine War

Toyoda: The Ukraine war has continued for more than one year, following Russia's invasion that violated international law. There have been many victims on both sides. Japan as well as the United States and some European countries have imposed economic sanctions on Russia and taken a wide range of measures to support Ukraine.

Meanwhile, there has been a growing concern about Taiwan for Asia-Pacific nations including Japan, in the sense that this Russian attempt to change the status quo by military forces without consideration for rules could be followed by China. Chinese President Xi Jinping firmly declared in October 2022 at the 20th Chinese Communist Party National Meeting that "China must achieve unification with Taiwan and it is definitely possible."

On the other hand, the US has clarified its policy to support Taiwan even by use of military force.

How should Japan face this situation? Though Japan is a US ally, its economic dependency on China has been significantly growing,

like many other major powers in the world. In this light, if military unification with Taiwan by China happens, Japan will face the need for well-considered plans and preparations for its own survival.

At this critical moment, I would like the experts of this roundtable to discuss the following three issues: How do you assess the current Ukraine war? How could this war affect China's attempt to unite with Taiwan? And how should Japan deal with the confusion that such an attempt would cause?

We have three distinguished experts to discuss these issues: Satoshi Morimoto, a military expert and former Japanese defense minister; Yasuhiro Matsuda, an expert on Taiwan and China issues and professor at the University of Tokyo; and Shingo Ito, an expert on the economic relations between Japan and China as well as Japan and Taiwan, and a senior researcher at the Institute for International Economic Studies.

Let me start the discussion by asking Mr. Morimoto about the first issue. Why do you think Russia violated international law and started a military invasion of Ukraine? What do you think would be the benefit of this for Russia? When do you think this war will most

likely come to an end, and what do the Russian people think about it all?

Morimoto: There is no definitive interpretation of the causes of this Russia-Ukraine war. I just would like to mention that Russia continues to maintain a strong grudge toward the US about being demoted to an ordinary European power by a superpower following the end of the Cold War between the US and the Soviet Union.

In addition, NATO has been expanding its membership to the East since the Cold War ended and the territory of its member nations has come closer to the Russian border. Among Russia's neighbors, there are only three non-NATO members: Belarus, Ukraine and Georgia. If Ukraine joins NATO, Russia will view this as an even greater threat from NATO. So in this regard, Russia's invasion of Ukraine can be seen as a military strategy to bolster its national security by integrating Ukraine into Russia. There is also a false perception in the depths of the Russian mind that Ukraine was historically part of Russian territory.

Anyhow, the views of both sides in the war on the territorial issue differ so much that diplomatic negotiations between them have been stopped since the fifth meeting for peace promotion on March 29 in 2022. Given that in any further talks for peace the nation which has taken a military advantage over the other would be the beneficiary, each of them has been trying to expand its territory by military force and thus battles have been continuing for a year in the East and South of Ukraine, in the Crimean Peninsula and also in Kyiv, the Ukrainian capital.

As most commentators on the war can see, neither of them has ever thought of accepting defeat in diplomatic negotiations. For the time being, from March to April, to achieve a great military success in a spring offensive, Russia appointed Chief of the General Staff Valery Gerasimov as overall commander and shook up its military leadership, having now mobilized many soldiers to win the final battle.

A key to this spring offensive, on the Ukrainian side, is military support from the US and Europe. They want heavy tanks in order to give them an advantage in close combat when tanks can move at ease in the melting snow in the spring. A definitive impact would be provided to them by the German-made super tank Leopard 2.

Another key weapon is anti-aircraft missiles to counter ground attacks by the Russian air force. The center of the current battle is the East of Ukraine, but it will be moved to the South. As the Russian army has retreated from Kherson, it would be a key to the entire war for Ukraine if it could regain Zaporizhzhia and move to the South and the Crimean Peninsula.

It will be difficult to reopen diplomatic negotiations, but the keys to the future of this war will be the Victory Day in Russia in May and the NATO leaders meeting in July.

There will be two big issues at the NATO leaders meeting. The first is the membership of Finland and Sweden. At this moment, Turkey opposes Swedish membership. On this issue, the task will be how to achieve those nations' membership while managing to maintain the unity of NATO. The other issue is whether NATO members could unanimously support Ukraine with military forces.

The US and European nations are now divided into two groups. The first one, including Germany, France and Italy, aims at maintaining long-term European stability with ingenious management of cooperation with Russia as much as possible, while the second, including the US, the United Kingdom and Canada, are thinking about reducing Russia's military capacity as much as possible by exhaustive war and turning it into a state that could not attack a European nation anymore. In this light, Japan, the host country of the G7 meeting, is in a difficult position to achieve a compromise between these two groups.

Furthermore, I think US domestic politics will be another key factor in the direction of the war. As is known, the US Congress, which reopened from Jan. 3, 2023, after the November mid-term elections, now sees the Republicans with a majority of seats in the House of Representatives, at 222, while the Democrats hold 212. In this political situation, right-wing Republicans are now coming back to an "America First" foreign policy by saying they should strengthen national borders instead of sparing military support for Ukraine and financial reconstruction. You cannot expect easily unanimous support from the US for Ukraine.

As for Russian domestic politics, I think 60-70% of the nation still support the war started by President Vladimir Putin. This is because there have been very few ordinary citizens in Russia killed by the war, even though 80,000 to 100,000 have been killed or injured on

both sides. In Russia, it is soldiers that have been killed in the war. When the bodies of these Russian soldiers were returned to their home country, the union of their mothers protested and objected to the war, but that was the main sources of opposition.

It is also true that many citizens were afraid of being called up as soldiers, and last year when the Russian military tried to mobilize another 300,000 soldiers, around 200,000 tried to escape overseas. But in 2023, I believe the announcement of the mobilization of an additional 1.5 million soldiers was made after tightening border security to prevent such escapes. The weakness of Russia is its shortage of soldiers, a weakened industrial base and the possibility of declining logistic support for the war.

On the Ukrainian side, the motivation of the soldiers is not an issue but the damage suffered by the citizens is extremely serious. Many Ukrainian citizens have been sacrificed. In spite of this, there is still strong motivation for fighting among Ukrainians. The issues for them are how to maintain their soldiers' military skills and how much support they can gain from the US and European countries.

As a matter of fact, the US had been hesitating to deliver weapons to Ukraine to enable it to attack Russian territory directly, probably out of concern that Russia might resort to using tactical nuclear weapons. The US is thus trying to manage its military support for Ukraine to avoid such a catastrophe. Ukrainian President Volodymyr Zelenskyy has been extremely unhappy with US military support and at the end of 2022 he visited the US Congress and asked the US to provide more weapons and ammunition to Ukraine as they were shedding blood to protect democracy. I believe this is what the Ukrainians truly believe.

Anyway, I am afraid this war will continue for a long time. Some are saying it could finish by the end of 2023, but I do not think so. The most important thing is for the G7 leaders meeting in May and NATO leaders meeting in July to think about how to achieve a compromise to end this war. How can Japan take a diplomatic initiative in this work? I believe we must think about how a Japanese initiative in these diplomatic efforts could impact relations between China and Taiwan and what implications it could have for stability in the Indo-Pacific area.

Toyoda: I would like to ask Mr. Ito about the economic issues. Could

you tell us how the Ukraine war would affect the rest of the world economy, excluding Ukraine and Russia, and what impacts could be produced in different regions? I would also like to ask for your views on the reasons why countries' responses to economic sanctions differ. Some countries have joined in the sanctions but some have not.

Ito: First, the Ukraine war dampened the global economy which was just starting to recover from the pandemic. Together with developed nations' economic sanctions against Russia, the supply of energy, food and fertilizers has become restricted, which raised the prices of those commodities hugely and led to further price hikes on a wide range of other goods.

Russia is the second-largest producer of natural gas in the world in 2020 and the third-largest petroleum producer, as well as the largest wheat producer in the world and the largest exporter of fertilizers. Ukraine is the largest sunflower oil producer in the world and one of the major exporters of corns and wheat. Since the major developed nations have been engaged in large-scale monetary loosening as well as expanded fiscal expenditures to soften the economic damage caused by the pandemic, such active macro-policy measures further raised commodity prices.

With such a significant rise in energy and food prices, the terms of trade have been greatly worsened, mainly among nations with low self-sufficiency in energy and food, and this provoked a flow of national income in those nations to overseas. Above all, the low-income or middle-income nations with a high Engel coefficient (proportion of food consumption to total consumption) or a high percentage of utility costs to disposable income suffer more from such price hikes. Also, not only the Commonwealth of Independent States (CIS) members but also African nations and Middle East nations are in general highly dependent upon wheat and corn or fertilizers provided by Russia and Ukraine.

It is to be noted that with the normalization of extremely loose monetary policy to modify the damage from the pandemic by curbing inflation and raising interest rates, for the newly emerging economies suffering from tremendous external debts there would be the additional burden of income outflows overseas due to worsening terms of trade. For example, concerns have arisen about the

reimbursement risk of external debts in nations like Turkey, Argentine and South Africa. In nations like Egypt, Lebanon, Sri Lanka and Pakistan, rising inflation caused by high increases in food prices has provoked political unrest.

Among developed nations, European Union countries are suffering most. This is because EU nations' energy dependency on Russia is high and their natural gas supply from Russia became restricted due to economic sanctions and the destroyed pipeline with Russia. In 2020, for example, 55% of German imports of natural gas came from Russia and it is the same situation in Italy. Also in the case of the EU, Russia occupies a certain share of its market, but in the light of national security and maintaining international order, it imposed economic sanctions on Russia and the cost has become enormous.

There has been not a small impact on the Japanese economy. Inflation has been continuing, initiated by price hikes of food and energy. With the yen's depreciation against the US dollar due to differing monetary policy directions, people are starting to sense a decline of real income in their daily lives. The yen rate on a customs declaration basis reached 131 yen to the dollar on average in 2022, the lowest value since 1998, and with the drastic increase in imports due to price hikes of fossil fuels, Japan's trade deficit reached around 20 trillion yen, the largest in its history. Since the Ukraine war, based on these observations, the IMF revised its outlook for real GDP growth drastically downward for low and middle-income nations with a low self-sufficiency rate of energy and food, as well as for the EU and Japan. They lowered their estimated growth of these countries by around 1 percentage point after assessing the Ukraine war impact on their economies.

On the question of different responses to the war, it is developed nations and regions in general that have joined in economic sanctions against Russia. To be more specific, these countries and regions are the US, Japan, the EU, the UK, New Zealand, South Korea, Taiwan, Singapore, Canada, Iceland, Liechtenstein, Norway, and Switzerland. Such nations and regions are considering the prevention of further threats to their national security rather than any damage incurred by economic sanctions. In particular, the EU is afraid of threats to security and the other countries are all ready to accept the economic cost of sanctions, believing it more important to protect international norms as stated in the UN Charter.

However, I need to mention that those countries not joining in economic sanctions against Russia do not necessarily all approve of the Russian invasion. As a matter of fact, on March 2, 2022, in the UN National Assembly, the resolution of condemnation against Russia was approved by 141 nations, while only five countries objected and 35 abstained. So the overwhelming majority supported the resolution. Many of the nations of what we call the Global South condemned the Russian invasion as the "use of arms not consistent with the objectives of the UN Charter" and considered it an infringement of sovereign rights under international law.

Nonetheless, there are many reasons why so many countries have not joined in the economic sanctions, and these seem to differ from country to country. First, there is a group of nations that regard the US and other nations in the West as a threat to their national security and which have close military cooperation with Russia. Typical examples are those that objected to the UN Resolution on March 2, 2022.

Second, there is another group of nations that have purchased Russian weapons, even though they do not consider the nations of the West as a threat to their national security. India is one such nation. It is said that 80% of the nations that objected to or abstained in the vote in the UN National Assembly on the condemnation resolution are those that have purchased Russian weapons.

Third, there are countries finding tensions with their neighbors more imminent and in this regard thinking that decisively worsening relations with Russia would not be to their advantage. Fourth, in the case of newly emerging countries, they would find their economies could be more seriously damaged by retaliation for economic sanctions and thus they try to protect their economy by balancing their relations with the major countries.

And fifth, there are cases of Western nations' former colonies where a lack of confidence in the West is the reason why they did not join economic sanctions against Russia. There are countries in this category where the West supported their authoritarian administrations in the Cold War and they could only manage to be liberated from such governments with the help of the Soviet Union.

Also there are nations who are resisting the dichotomy of authoritarian states versus democratic states. There is such a wide range of historical contexts and views in the background of the many

countries that condemned Russia for invading Ukraine but which have not joined in economic sanctions.

Toyoda: I have a question for Prof. Matsuda on the similarities and differences between the Ukraine war and the Taiwan contingency. Many nations see Ukraine as an independent state, whereas Taiwan is viewed as a part of China. In this sense, could you clarify how the issue of reuniting Taiwan and China is to be interpreted in international law and what would be the legal basis for interpretation of the issue for the US and Japan?

Matsuda: At first glance, Russia's invasion of Ukraine to try to integrate it into Russia and China's possible attempt in the future to unite with Taiwan by use of force resemble each other. These are identical in the sense that dictatorial nations try to use force to restore their "lost territory". Thus, our concern about Taiwan coming under military attack from China has been exacerbated since the outbreak of the Ukraine war. But though they look similar intuitively, there are several differences between the two.

First, geographical difference. As Ukraine and Russia are connected by land, an invasion is easier with a strong army. In the case of Taiwan and mainland China, there is the more than 100-kilometer wide Taiwan Strait. They used to be both part of the Qing Dynasty's territory, but Taiwan was an outlier of Qing and is too large to be regarded merely as a remote island.

In addition, Russia and Ukraine were once part of the same country in the 20th century, namely the Soviet Union, while Taiwan and mainland China were parts of the territory under the same nation's rule only from 1945 until 1949 following the Qing's ceding of Taiwan to Japan in 1895. Thus for more than 120 years, both peoples have been educated differently in a different country and under a different political regime. Even the letters they use for writing are different. Therefore, they have a rather different cultural identity from each other and the logic of both nations belonging to "the same people, the same nation" is increasingly invalid.

China often claims to be "one China" as a principle. This is a three-steps logic, namely, "There is only one China", "Taiwan is an inalienable part of China" and "the Government of the People's Republic of China as the sole legal Government of China". However,

in this logic, "China" and "the People's Republic of China" do not necessarily match. Whenever China concludes diplomatic relations with another country, it refers to Taiwan as "a part of China" or "a part of the People's Republic of China" and with such remarks tries to make the issue ambiguous. But most nations do not approve of Taiwan being a part of the People's Republic of China, except for friendly socialist nations such as North Korea.

In the case of the US, it acknowledges the Chinese position that there is but one China and Taiwan is part of "China". But this does not mean that it recognizes that Taiwan is part of China. The US only "acknowledges" the Chinese position. Other nations such as Canada or the Philippines use the expression "take note" in response to this Chinese claim.

In the case of Japan, responding to this Chinese claim that Taiwan is a part of the People's Republic of China, it officially says that it "fully understands and respects this stand of the Government of the People's Republic of China, and it firmly maintains its stand under Article 8 of the Potsdam Proclamation." This is meant to be "the terms of the Cairo Declaration shall be carried out, Formosa (Taiwan) and the Pescadores (Penghu Islands) shall be restored to the Republic of China."

China made a compromise with Japan by having agreed upon this expression and signed the Joint Communiqué of the Government of Japan and the Government of the People's Republic of China in 1972. However, with this Japan said that it "firmly maintains its stand to restore Taiwan and the Penghu Islands to the Republic of China" and it did not recognize that Taiwan was a part of China. In a Diet session, the Japanese government publicly announced that it did not naturally recognize it.

If Japan approves naturally the Chinese claim that Taiwan is a part of China, it would need to ask China to issue permissions and visas to maintain economic relations and human exchanges with Taiwan. The Chinese side as well understood that this issue was not resolved clearly on the occasion of the normalization of Japan-China diplomatic relations. However, China has been trying to turn the "one China" principle into a *fait accompli* by repeatedly mentioning that Japan has approved "one China" principle since 1972.

Similarly, in the UN as well, the "one China" principle has never been approved. In the UN, the right of representation of China has

been transferred from the government of the Republic of China to the People's Republic of China, but the UN has never decided to approve that Taiwan is a part of China. Keeping this question unresolved but repeating its claim that Taiwan must be a part of China, China has created a situation where other nations would find it difficult to oppose it explicitly.

On the question of “peaceful resolution” of Taiwan issue, in the case of the US, a domestic law, the Taiwan Relations Act, mentions that normalization of US-China diplomatic relations was achieved under the “expectation that the future of Taiwan will be determined by peaceful means”. In other words, it indirectly indicates that use of force for unification would collapse the premises for normalization of US-China diplomatic relations. Meanwhile, in the case of Japan, then Foreign Minister Masayoshi Ohira told the Diet, “I think a rivalry between the People's Republic of China and Taiwan is basically a Chinese domestic issue,” adding “I believe there would be no possibility of this issue ending in a military conflict.”

But according to former Ambassador to the US Takakazu Kuriyama's interpretation, “As long as they talk peacefully about this issue, it is a Chinese domestic issue,” but “if China attempts to achieve unification with Taiwan by use of force, what we call the liberation of Taiwan by use of forces, this will not be considered as a domestic issue anymore. This is what ‘basically’ in the above meant.” (Takakazu Kuriyama, “Normalization of Japan-China Diplomatic Relations”, *Waseda Law Journal*, Vol. 74, 4-1, 1999).

This is how the US and Japan share the basic view that “peaceful unification would not be a problem but unification by force must be another story.”

In the argument on international law, I think this would be probably an issue of international humanitarian law. In this law, even in the case of domestic issues, the slaughter of a nation's own people is not allowed. Use of force could kill people and any attempt to change the status quo by military means is in general not to be allowed by international law.

Another issue is that if a Chinese military attack on Taiwan went beyond the Taiwan Strait, it would not be as a matter of fact considered a domestic issue. The Taiwan Strait, for the most part, is what we call international waters, excluding territorial waters and contiguous zone. International waters mainly consist of Exclusive

Economic Zones (EEZ) and the high seas. In an EEZ, coastal countries' rights are limited to sovereign rights to biological and non-biological resources, and the rights to freedom of navigation or national security are the same as on and under the high seas. In this light, China is not allowed to make the Taiwan Strait a battlefield on its own.

It is physically impossible to achieve unification by force without turning international waters into a battlefield. For example, in the case of a blockade of the Taiwan Strait by setting up floating mines there, some mines could flow into the sea close to Japan. In such a way, China's claim that it is a domestic issue would almost certainly prevent ships from passing in the seas neighboring Japan. It would be then impossible to tell Japan not to intervene in a Chinese domestic issue.

In this regard, the fact that the “importance of peace and stability of the Taiwan Strait” was mentioned in the joint statement of the “US and Japan 2+2 meetings” in 2005 as a common strategic goal and was repeatedly raised in the “US and Japan 2+2” and also in the US-Japan leaders' meeting in 2021 has crucial implications.

Here is to be noted is that Taiwan and the Taiwan Strait are geographically different concepts. The use of the word “Taiwan” in the context of the US-Japan alliance would offend China seriously, but the Taiwan Strait is mostly international waters and Chinese territorial waters and contiguous zone are limited there. Thus, the emergence of threats to its peace and stability would be an extremely big concern. By saying that must not be allowed, it is logical that China should not be allowed to achieve unification with Taiwan by force under international law.

On the other hand, a legal basis would be needed for the US to prevent China from use of force. In the US Taiwan Relations Act, the general gist of it is that the US shall “maintain the capacity of the United States to resist any resort to force or other forms of coercion that would jeopardize the security, or the social or economic system, of the people on Taiwan” and also that the US shall “provide Taiwan with arms of a defensive character”. It further suggests that “the President is directed to inform the Congress promptly of any threat to the security or the social or economic system of the people on Taiwan and any danger to the interests of the United States arising therefrom. The President and the Congress shall determine, in

accordance with constitutional processes, appropriate action by the United States in response to any such danger.”

It is interpreted that “appropriate action” would include anything appropriate, and thus the law permits the use of force to cope with the war, if necessary. In this light, China’s military actions are deterred by the risk of US intervention.

In the US the legal basis for defending Taiwan was changed around the occasion of normalization of US-China diplomatic relations in 1979, but in Japan the legal basis for support for the US military around the time of the establishment of a law of situation in areas surrounding Japan was changed. In the case of a Taiwan contingency, US military activation to deal with it is assumed. Meanwhile, the US-Japan Alliance predetermines the area where the US and Japan could cooperate in military action as the area of “the Far East”. This basically means “in general, the area to the north of the Philippines and also Japan and its surrounding areas including the areas under the rule of the Republic of Korea and the Republic of China.” This definition remains unchanged even now. In other words, Taiwan belongs to the area of “the Far East” where the US-Japan security alliance is supposed to work.

However, it is to be noted that the Japanese interpretation of this security alliance assumes that US military action is to be “always taken only as the execution of the right of individual or collective self-defense allowed by the UN Charter to resist an invasion”.

This means that US military forces were to act for the right of collective self-defense to defend their allies including Taiwan when the US and Taiwan had official diplomatic relations. In this case, it was assumed that Japan would allow the US army to use its military bases in Japan after advance talks with the US. However, since 1979 there have been no official diplomatic relations between the US and Taiwan and Taiwan has not been considered an independent state. The US cannot defend Taiwan legally based on the execution of the right of collective self-defense and its actions must be based on only its domestic Taiwan Relations Act.

On the other hand, China committed to a policy of “peaceful unification” on the occasion of normalization of US-China diplomatic relations and thus such a defect in the defense of Taiwan did not matter for the time being. But the question arose when the Taiwan Strait war occurred in 1995-1996 whether it was necessary to revise

the legal basis for Japanese support for the US military in the defense of Taiwan. In the “Guidelines for Japan-US Defense Cooperation” in 1997 and the law of situation in areas surrounding Japan in 1999, a contingency in areas surrounding Japan is meant to be one that has a grave impact on the peace and security of Japan. In legislation on peace and security in 2015, it is clarified that if Japan perceives a military conflict as a “situation that will have an important influence on Japan’s peace and security”, it can engage in rear area logistical support for US military forces participating in the conflict, while keeping the concept of the area of “the Far East” in the Japan-US Security Treaty as it is. This is because Japan cannot support US military action anymore if it is not based on the execution of the right of collective self-defense but based on the Taiwan Relations Act, a US domestic law, according to the existing interpretation of the law.

In addition, in 2015 another concept – “situations of existential crisis” – was created. This was meant to allow Japan to use limited execution of the right of collective self-defense to protect the US military if it was attacked, and if this attack poses threats to the survival of Japan and the people’s rights to freedom and happiness (situation of existential crisis). Also, if the US military bases in Japan were attacked, this would be literally an armed attack on Japan and Japan could counterattack by executing the right of individual self-defense, interpreting it as “a situation of an armed attack against Japan”. So, this is how Japan can now provide different ways of being prepared for a possible Chinese use of force against Taiwan.

Toyoda: How do the differences in the political systems of China and Taiwan affect this war?

Matsuda: Until the 1980s, the difference in the political systems between the two was simply socialism and capitalism. Taiwan called its political system the “Three Principles of the People”, but the Communist Party of China (CPC) in the People’s Republic of China and the Chinese Nationalist Party (KMT) in the Republic of China (Taiwan) were both building up dictatorial regions. Both parties were contradicting each other and competing continuously, but there were two occasions when they agreed to cooperate before 1945, namely the First United Front and the Second United Front. And in the 1980s,

Chinese supreme leader President Deng Xiaoping proposed a unification formula of “one country, two systems” to integrate the two different political systems, socialism and capitalism, into one single country after achieving a Third United Front through dialogue between the two and peaceful unification. However, with the democratization of Taiwan, the preconditions for this proposal totally collapsed. In democratized Taiwan, the administration is established on the basis of elections: how voters think about a policy is important and dialogue between two dictators cannot decide anything. At this moment, most Taiwanese people would not be interested in unification. Besides, the KMT is not in power now, so based on these facts a Third United Front would be impossible. It is also almost impossible for Taiwan to accept the idea of peaceful unification through dialogue.

It was also Deng’s plan to achieve the success of “one country, two systems” in Hong Kong first to reassure the Taiwanese. But since Hong Kong was returned to China in 1997, Beijing has failed to achieve success to reassure the Taiwanese people. Social and political confusion in Hong Kong in 2019 and the legislation of the Law of the People’s Republic of China on Safeguarding National Security in the Hong Kong Special Administration Region further pushed Taiwanese people to refuse China’s proposal of “one country, two systems”.

“One country, two systems” was a kind of formula of collusion between the dictators in the 1980s. But with the democratization of Taiwan and China’s failure to create a model of “one country, two systems” in Hong Kong, it has become almost impossible to be achieved. In other words, it has been theoretically proved that a peaceful co-existence between dictatorship and democracy, completely different political systems, would be almost impossible.

However, China has not given up the idea of “peaceful unification” despite this. This is because if it gave up, it would be in trouble as it would bring back the Taiwan Strait as a potential battlefield and discourage Taiwanese companies from investing in mainland China. So, China would probably become obsessed with menacing Taiwan with its huge military forces without actual use of force. I think this “coercive peaceful unification” would be its strategy to adopt. With its nuclear arms preventing the US from intervening, as well as military forces enabling it to conquer Taiwan, it could coerce Taiwan

into surrender. It might be possible, without losing a single soldier and without a single gunshot, to force Taiwan to submit and achieve unification. I think this type of “peaceful unification” is what China is aiming at now.

Impact of the Ukraine War on China’s Unification with Taiwan

Toyoda: Prof. Matsuda, I would like to ask you further about the implications of the Ukraine war for China? Do you think its attempted unification with Taiwan could be prompted or delayed by the Ukraine war? What do you think would be the timing of attempted unification?

Matsuda: China is now very carefully observing the Ukraine war and learning many lessons. In February 2022 on the occasion of the Beijing Winter Olympic Games, a China-Russia leaders meeting was organized and both leaders emphasized that there should be no taboos about both nations’ cooperation. It is said that Putin gave notice to Xi of the impending Russian invasions of Ukraine in a private conversation.

Xi did not try to dissuade Putin. Rather, in telephone talks on the day following the commencement of the war, Xi expressed his understanding of the Russian national security environment and confirmed his approval of the invasion. He did it after having recognized that not only the Donbass region but also Ukraine’s capital Kyiv had been attacked by Russia.

In other words, at the beginning of the war, as all in the world thought, Xi believed Russia would win completely and had never thought that Ukraine would demonstrate such strong resistance or that the war would be prolonged for such a long time. Therefore, it is true that China miscalculated the direction of the war, just like Russia did. This is why we guess the lesson that China is learning from the war is a negative one.

China supports Russia, but at the same time does not reveal that it supports Russia, or seems to try to give an impression to the world that it is keeping its distance from Russia. Actually, on the China-Russia meetings, while China used unclear expressions about the meetings in press conferences or avoided reference to the language

used in the meetings in its public announcements, Russia announced a clear statement on the website of the embassy in Beijing that China supported its actions. Having understood that too close relations with Russia could invite secondary sanctions from the US and EU, and possibly worsen relations with them, China has now been trying to keep a measured distance. In the light of such Chinese reactions, it may have drawn negative lessons from the Ukraine war – the most important one being that military power alone cannot determine the direction of a conflict so easily and may not work very well in remedying a situation.

There are many in China today who claim that unification with Taiwan would be easy. There are even people saying that with their military strength unification could be achieved within several days or even several hours. The Ukraine war has reminded such people that arms alone could not decide anything very easily. Besides, Russian weapons in the battlefield in Ukraine are not as effective as the Chinese expected.

A second lesson is that – given that Ukraine is connected to Russia by land – it would be rather easy to send a massive army into an enemy's territory by land. But it would be extremely difficult to send hundreds of thousands of soldiers across the Taiwan Strait to Taiwan, because they would have to practice landing operations in full view of the enemy. Land forces are the most vulnerable when they are using the sea or sky – a direct hit on a ship could cause thousands of soldiers and their equipment to sink. So, this presents a bigger challenge.

A third lesson is that powerful economic sanctions were implemented at the earliest occasion. Both Russia and China must have thought that economic sanctions against Russia could not be implemented, as European nations' dependence on Russian energy sources is high. What Russia can sell to the rest of the world is only energy resources and weapons, but China has much closer ties with the world economy and economic sanctions against China could damage not only China but also the rest of the world. If such a situation continued for a long time, Chinese opportunities for economic development would be finished and other nations, such as those that could not replace Chinese products with other ones, would be in enormous trouble. However, in the case of assembly-oriented simple manufacturing, there are alternatives to Chinese

goods, so with prolonged economic sanctions we could say that China would be at a disadvantage. Beijing must have understood from the Ukraine war that economic sanctions against it should not be underestimated.

Nonetheless, China may also have learned some positive lessons. For example, one crucial lesson is that deterrence by the threat of nuclear weapons can work effectively. Russia's nuclear threat may well have deterred direct US intervention in Ukraine, so China may now believe that there would be a high threshold for the use of military force against a nuclear superpower.

However, from the West's viewpoint, nuclear deterrence also works well for the US, Europe, and Russia in their own interpretations. For example, in the current situation, the West cannot directly attack Russia for fear of Russia's retaliation with nuclear weapons and Russia cannot invade NATO member states, as it thinks that its own possible use of nuclear weapons would provoke the West to respond in the same way, which would be disastrous for Russia.

In this regard, what China is doing is expanding its own nuclear arsenal. It thinks that an overwhelming nuclear arms expansion surpassing US nuclear weapons would prevent US intervention, and seems to have drawn a theoretical endorsement for this strategy from the Ukraine war.

A second positive lesson is that in the case of military action, a quick "blitzkrieg" attack to try to finish the war in a moment with full utilization of all its military powers from the beginning must be recommended. In other words, gradual development of force must be avoided. The Russian military initiative was started in the belief that Ukraine, a big country, could be overwhelmed by use of a small-scale military force in a short period, but because of Ukrainian strong resistance, Russia could not help but send gradual and continuous military forces to the battlefield and this has resulted in the decline of Russian national power. Perhaps a Russian victory in this war is not possible.

A third positive lesson is the importance of creating a *fait accompli* at an early stage. In sum, to control Taiwan at a very early stage it would be important for China to create a situation in which Taiwan has already submitted completely and is under Chinese governance, and in this sense any military support for Taiwan or economic

sanctions against China would be senseless. Russia's merger of the Crimean Peninsula in 2014 would be a case in point. If such a *fait accompli* by China could be made as quickly as possible, it could avoid the economic sanctions that Russia now faces, since its economy is the second largest in the world while Russia's is merely 11th.

China has been observing the impact of economic sanctions on Russia. Moscow has continued to export its energy resources, but imports of various electronic components, machine tools and the introduction of high-technology have all been stopped, and human resource exchange also. Sending students to the US to gather new knowledge or learn about technology and then calling them back to China was a trigger for China's emergence in the world economy, but with the intensified "cold war" between the US and China it has become almost impossible to do this. In Russia, since the war with Ukraine started, several million people have left the country. Most of them were young and bright. In other words, with such effective economic sanctions against Russia, China may be wary of similar outcomes. This is an important goal of the economic sanctions against Russia for the US and Japan.

As a matter of fact, it would be far more difficult to impose economic sanctions against China than Russia. First of all, needless to say, China would veto any resolution of condemnation against it in the UN Security Council, and Russia would at least abstain. So, the UN Security Council could not issue any condemnation resolution against China. In addition, on the question whether an Emergency Special Session of the United Nations General Assembly could issue such a resolution or not, as in the case of Russia, we must take account of the fact that Taiwan is different from the case of Ukraine, an independent state and member of the UN. Not a few countries consider Taiwan as a part of China and China's influence upon the Global South is far greater than Russia's. Based on these facts, it would also be difficult. So, it would be difficult to carry out sanctions against China in a format justified by international law. The current economic sanctions against Russia are led by the G7 and most likely there would be no other way but economic sanctions against China being likewise organized mainly by the G7.

In this light, what is important is for us to lower our dependency on China in some extremely crucial areas at the earliest opportunity,

namely in peaceful times. More importantly, there will be cases where China imposes sanctions against us and to be resilient against such sanctions we need to think about the weaknesses in our economy, including supply chains, from now on. If a Taiwan emergency happens, we cannot expect to control China's actions with economic sanctions in the short term.

As for the timing of China's attempt to unite with Taiwan by military force, it is certain that it cannot achieve it immediately. This is true regardless of the Ukraine war. The reason is, as I mentioned, that the cost of such a war for China would be too great and it cannot ignore the risk of exceeding the Taiwan Strait as well as risk of US military intervention.

On the other hand, in 2023 Xi will turn 70 years old. At the age of 80 or 90, it would be difficult for him to lead a large-scale war due to his physical condition. But while he is still in his early 70's before 2027, he will be physically and mentally tough enough, and at a time when Taiwan, Japan and the US still need to strengthen their defense forces, some may see an early occasion as a window of opportunity to try to unite with Taiwan. According to this view, China's military invasion of Taiwan should be realized sooner rather than later.

In contrast, the view that an invasion would be postponed is based on the time that Xi has left. As seen in the announced personnel assignment of his administration at the 20th National Congress of the CPC in October 2022, Xi will not quit for another five years, but at minimum he has another 10 years until leaving the post of supreme leader of China. Would he risk all his political assets in his first or second year, given that he still has another 10 years ahead? There must be a high possibility that he would wait and see during the next five years.

Another basis for this view is the speed of China's nuclear weapons expansion. According to the US intelligence, China is now aiming to have 1,000 nuclear warheads in 2030 and 1,500 in 2035, meaning it will take more than another 10 years to create a nuclear force for immediate use nearly equal to that of the US. At that point, China could find it possible to deter US intervention by its own nuclear force. Over the next few years, however, there would be still a large gap between the US and Chinese nuclear arsenals.

There is another view that China may try to achieve its aims by taking advantage of a moment when the US has ceased its

commitments to somewhere in the rest of the world. For example, a political movement in favor of isolationism could be born in the US with people wondering why the US should have to send military forces to protect Taiwan when the US is no longer the “world’s policeman”. Or there may come a time when the US would not want to intervene in other nations’ military conflicts anymore because of problems caused by previous such interventions. China may just wait for such an occasion, which could bring it a better outcome.

There are also occasions when military invasions would be difficult to achieve. For example, it would be critical to create a safe and tranquil situation without any challenges such as on the occasion of the Party Congress of the CPC. This is a political season when all party and government officials from the top to the working level would not want to make any small mistakes. Under such politically sensitive occasions, high-risk military actions would be most unlikely. In this sense, in 2027 when the 21st Party Congress is planned, such an action must be unlikely.

In addition, a full invasion of Taiwan by military forces would be limited by the seasons. There are high waves in the Taiwan Strait in winter and it would not be good for conducting a landing by military forces. Besides, it would take a few months or few weeks to occupy a large island in general, according to historical precedent. In this regard, the best time would be the season when there would be no typhoons for several weeks, which means there is no other good occasion but a couple of months between April and October.

If, in such period, the Chinese military carries out a large-scale military exercise, our allies could raise their alert and be well prepared for a possible invasion resulting from that military exercise. As a matter of fact, several months would be needed for a military invasion and it could not be concealed. Therefore, a surprise attack would be extremely difficult. Thus, it is not certain whether China could choose the best time for a full invasion. Therefore, there is no simple answer. The Ukraine war would not necessarily serve as a judgement on whether a Chinese military invasion should be carried out soon or be delayed.

Toyoda: A question for Mr. Ito. The economic interdependency between China and the rest of the world is much greater than that between Russia and the rest of the world. China’s GDP is nearly 10

times as big as Russia’s. With economic sanctions imposed on China, the sanctioning countries would be seriously affected as well. How would those countries deal with it? What impact would Japan have from sanctions against China?

Ito: Economic sanctions on China would have an enormous economic impact on the world, far bigger than the ones on Russia. China is an economic superpower with the second-largest GDP. Though China’s personal consumption is half that of the US, it still accounts for more than 10% of the world’s private consumption. China’s investment has reached a little less than 30% of all global investment. With such a large-scale economy, sanctions against China and its own retaliatory measures would seriously affect the world economy.

Meanwhile, the presence of Chinese tourists in the world tourism market is significant and as their zero Covid-19 policy has ended, in many countries there are high expectations for inbound Chinese tourists. Even before the pandemic, China was already the source of the largest number of tourists in the world. But if economic sanctions against China are imposed, the Chinese government is expected to tighten the flow of tourists to those nations with which it has worsened foreign relations.

China’s presence in global supply chains has also been raised. In terms of the scale of manufacturing GDP, China is the largest and around 30% of manufacturing GDP in the world is now accounted for by China. Though its status seems to have started to decline as a base of assembling and exporting labor-intensive products it still maintains a base of manufacturing we can call the factory of the world.

The Chinese manufacturing industry has seen higher value-added and its role as a supplier of intermediary goods and capital goods has been significantly raised. With the pandemic having stopped the supply of parts and components from China, we really sensed its big impact on production, ranging from home electrical appliances to automobiles. We will see another big impact on production if mutual economic sanctions are imposed. We also saw during the pandemic that there was concern about the shortage of medical products due to limited production of those goods, such as masks and personal protective equipment (PPE).

As is seen in the intensified US-China high-tech war, China has been highly competitive as a supplier of high-tech products. It has the largest share of production in the world in domains like solar panels, wind turbines and storage batteries. China is still the largest supplier of IT products, though the production bases of IT goods are becoming diversified. China also keeps its influence in the supply of rare earths. With restricted supplies, various products would be negatively affected in some strategic goods like permanent magnets.

There are now far more countries with more imports from China than from the US, so we can say that the status of China in global supply chains has been particularly raised. I think disruption of economic relations with China would have an enormous impact on the world economy. In finance as well, the Chinese presence in the world is rising. Above all, newly emerging countries have high expectations of China as a provider of economic aid. Its FDI stock amount has exceeded Japan's.

Politically, China is one of the permanent members of the UN Security Council and it has top officials in a variety of international organizations. These political factors would prevent many countries from imposing economic sanctions on it. Each nation would have to make a more difficult decision on imposing economic sanctions on China than in the case of Russia.

Of course, as China is also engaged in economic activity in the international network of global supply chains, it too will suffer critical damage from economic sanctions. It is to be noted that the proportion of exports of goods and services in China's GDP was about 19% in 2020 and the percentage of the imports in GDP was 16%, still higher than for Japan or the US.

On the destination of Chinese exports, the US, Japan and the EU account for around 40%, and they account for around 25% of total Chinese imports. More specifically, China would be in difficulty with economic sanctions covering semiconductor manufacturing equipment, related chemical goods, and the Electronic Design Automation (EDA) used for circuit design. China also considers high-quality industrial machinery or ultra-precision polishing technology as a choke point. In terms of sources of technology imported to China, relations with developed nations are still crucial for China, and if dollar settlements are stopped it would inevitably have a grave impact on the Chinese economy.

The impact of economic sanctions against China could be significantly changed depending on what kind of sanctions are imposed in response to what situation and what kind of retaliation China would make. Anyway, the impact on Japan would not be small. China is the largest trading partner for Japanese exports and the percentage of the value-added induced by Chinese final domestic demand to Japanese GDP has reached 3.1%. The percentage has been increasing year after year.

Japan's staple export items to China are computer memories, auto parts, automobiles represented by hybrid cars, and semiconductor manufacturing equipment. The percentage of Japan's GDP from imports from China was 3.7% in 2021, the highest so far. The staple import items from China include note PCs and mobile phones, with the share of these imports exceeding 80%. Meanwhile, the share of exports to Japan from China to total Chinese exports of those products is now less than 10%. In the case of Japan, the number of items with the percentage of imports from China to total Japanese imports exceeding 50% is larger than the ones in the case of Europe and the US. And China's export dependency rate on exports to Japan has fallen to around 1%. Under such circumstances, China could take export restriction measures against Japan more easily.

This is how Japan-China mutual dependency in trade is asymmetrical and Japan's vulnerability has been rising. Under such circumstances, with retaliatory measures against sanctions taken into account, there would be a risk of serious stagflation. For example, one calculation shows that production equivalent to around 10% of Japan's GDP would be gone, if 80% of Japan's imports from China are suspended for two months. We cannot exclude the possibility of Japan being significantly affected.

How Should Japan Cope?

Toyoda: Mr. Morimoto, do you think the US would seriously protect Taiwan in the event of China's attempt at military unification? In general, it is said that people in the US are reluctant to send soldiers to Taiwan. What do you think the US can do more specifically?

Morimoto: I believe that Ukraine war will continue longer than we imagine. I do not agree with a few experts saying that around the end

of 2023 the war will be ended. Both nations' claims are so different and they are reluctant to make concessions. Also their support bases are working well, so I guess they will continue to fight until they are truly exhausted. Their supporters would be also exhausted. Within two or three years from now, the US and Europe will be truly exhausted politically, economically and on national security issues. They would still probably support another victim of a new war, like Taiwan, or hope the war will end somehow.

As is known, there will be important elections in 2024, such as a presidential election in Taiwan in January, a Congressional election in India in February, a Russian presidential election in March, a Ukrainian presidential election in May and the US presidential election in November. In those elections, how to deal with the Ukraine war will be an important issue. At this moment it is difficult to foresee the future, but I would like to say a couple of things.

First, it would not be bad for China if the US and Europe become exhausted as the Ukraine war continues. If the war comes to an end quickly, the US and other Western countries could have extra energy to look to China, which would not be good for China.

Second, whatever may happen in the Ukraine war, I think China will choose its own way. It cannot ignore the Ukraine war and will draw some lessons from it, but I believe China will work on unification with Taiwan using its own kind of logic. I do not think it will be relevant to think about the issues of Ukraine and Taiwan as being connected.

Based on these two assumptions, I would like first to talk about how the US would react to a Taiwan war. President Joe Biden has clearly mentioned four times so far in responding to media questions that the US would come to the support of Taiwan in the event of Chinese military action to pursue unification. But you would be wrong if you believe that this policy will remain unchanged in future US administrations. The US overhauls policies by administration every four years and adopts new strategies. Biden would observe what he has said in his presidency to a certain extent at least, but we need to think about the future direction of US policy, bearing in mind whether future administrations would observe it or not.

It has been the principal thought driving US politics so far that it should prioritize US national interests most, while maintaining the role of leadership in the international community without being

closely engaged in other countries' issues. I think this principle will not change hereafter as well. But I also think the US would not intervene in the Taiwan issue if China attempts to unite with Taiwan by means other than military force, such as dialogue, negotiations or persuasion not considered as military intervention under international law.

If political confusion arises in Taiwan as a result of the group of people whom they call the "faction of independence" and China tries to achieve unification by military force by taking advantage of it, it would be difficult politically as well as in the light of international law for the US to stop Chinese military intervention, since unification efforts would be the result of this Taiwanese group's own initiative.

As is known, there is a procedure to be taken defined by the War Powers Act that in the case of the US president's sending the US military overseas, it is to be reported to Congress within 48 hours after the issue of the order and their approval is to be confirmed within 60 days. If it is not approved by Congress, the US president must legally order the military to retreat.

The US, in trying to prevent China's unification with Taiwan by military force, may deploy its air force, Marines, and nuclear submarines in the Taiwan Strait area and restrain the Chinese military forces and stop them landing on Taiwan. But China, expecting this, might pull all its forces together to secure command of the sea and the air in the Taiwan Strait and strong blockage around the whole area surrounding Taiwan and Japan.

It may be possible for the US to restrict partly China's actions but it would be extremely difficult for it to stop a landing campaign by military efforts. What the US can do is to provide Taiwan with weapon systems to prevent Chinese military forces from landing, such as anti-ship missiles or anti-aircraft missiles.

Unlike the case of Ukraine, there are not so many countries supporting Taiwan. In the light of the current North Korea situation, South Korea can move very little. ASEAN countries only have sufficient weaponry for their own defense, and in their thinking about their future relations with China it would be difficult to imagine that they would cooperate with the US to stop a Chinese landing campaign in the Taiwan Strait.

The US and Europe may come to support Taiwan, but they would have to go through the seas and China would almost prevent sea

lanes communication such as in the South China Sea and around the Penghu Islands and make it difficult for them to aid Taiwan. It would be only Japan and Australia that could support Taiwan. Even if Canada or Europe try to intervene, they would not come to Taiwan directly but come via Japan. In this case, Japan would play a role like that of Poland in the Ukraine War.

Taking these things into consideration, my Taiwan scenario is as follows. It is expected that China would try to unite with Taiwan without resorting to weapons, but it is not assured. Taiwanese people firmly believe that Taiwan and China are different nations now and they do not think they are a part of China. In December 2022 on the occasion of Japan-Taiwan policy consultations, the Taiwanese side strongly said that Taiwan is different from China and they have never thought about its being a part of China as was stated by Chinese. I do not think that such convincing Taiwanese would accept a scenario of unification with China even if they were threatened by China.

On the other hand, China, considering unification with Taiwan as the Chinese Communist Party's historical mission, will pursue it without fail. Trying to prevent China's unification with Taiwan is extremely important in terms of foreign policy, military strategy, and economic policy. But there is no guarantee of success. We must think about how to deal with this war assuming that Taiwan would not be a region Japan favors in the future. In this case, the region southwest of Japan would be set as a frontline against China, and a possible military strategy would be for some US military forces to leave there and instead set the US defense line on Hawaii and Guam, maintaining an Indo-Pacific alliance to secure the national interests of all Indo-Pacific nations.

As a matter of fact, the US Air Force let all its F-15 fighters return to the mother country and it keeps F-22s and F-35s on rotation duty in Okinawa, but it does not think about keeping them there permanently. On the other hand, the largest military power threatening China's command of the seas and the air in the Taiwan Strait is the US Air Force in Okinawa, and then it would be likely for China to try to destroy it before a war begins in earnest. I suggest that the Japanese Defense Ministry creates a facility at Kadena Air Base to contain all the fighters in it and at the same time build up alternative facilities and airports to be used by the US Air Force for

their activities on the west side of Japan.

Meanwhile, as the frontline of the US itself is Guam, it will be able to set up an integrated air and missile system to try to protect the mainland of the US from Guam, and Japan will be clearly seen as only an advance deployment base in the Indo-Pacific region for the US. Bearing this in mind, we will have to work on preparations for such a war.

The key points for China in determining the timing of an attempted unification by force are firstly how much the US would be ready to prevent it and how China can assess this readiness. Secondly, what would be the military balance at that time? Thirdly, how much would other nations, in particular those in Europe, Canada and Australia be ready to support Taiwan along with the US. And finally, what would happen in Taiwanese domestic politics with such actions is another key question.

Bearing these points in mind, how can China create a power vacuum that excludes the US as a leader? For example, with cooperation from Russia or North Korea, it could provoke confusion in northern Japan so that the US and Japanese defense forces would have to deal with it and at the same time threaten the Senkaku Islands so that US and Japanese defense forces are obliged to protect them. In such a situation, if the US aircraft carrier task force happens to be in the Middle East, this would create a power vacuum that China could take advantage of to make a surprise attack on Taiwan having already prepared for the campaign.

Anyway, the challenge for Japan would be in terms of defense of the southwest region if China achieves unification with Taiwan and has occupied the island. It would be extremely important for the US to deter the Chinese military by keeping a forward deployment strategy.

In this regard, even though it appears that what Japan can do has been mostly covered by the security bills of 2015, this is not the case in reality. There are still many things Japan can do if its very existence is under threat. Japan's limited execution of the right of collective self-defense was presented to the Diet, but what can be done by Japan under the threat to national existence covers a wide range, and security bills do not touch upon them explicitly.

Security bills would clearly change role sharing between the US and Japan: namely, Japan would concentrate its efforts on defense

campaigns, unable to use counterattack forces and leaving all the offensive campaigns to the US. Any time when both the US and Japan feel it necessary, I think they will have to work on revising the Guidelines for Japan-US Defense Cooperation.

On economic sanctions, having seen the sanctions against Russia discussed for a long time in the US and Europe, I guess China would think about creating a situation in which all the issues are settled before discussions by the Western allies on possible economic sanctions are concluded – so that with a short-term decisive war it would seem pointless to impose any sanctions because “everything is over” already.

I conclude that the Chinese Communist Party will not change its resolution to achieve unification with Taiwan as an historical mission whatever the outcome of Ukraine war may be. We must be well prepared for this crucial moment and think about our national security.

Toyoda: Prof. Matsuda, could you explain what can be done to avoid a Taiwan war? And Mr. Ito, could you tell us how we can minimize the economic damage from the war?

Matsuda: I think there are many things to be done by Japan. First, the Japanese Self-Defense Forces have been accommodating self-defense powers without assuming a large-scale attack from the major powers, and thus Japan is extremely vulnerable to substantial attacks like ballistic missiles. It is most important to strengthen its self-defense capacity fundamentally and this can be done on our own.

If Taiwan is attacked by China, the US military is assumed to be activated in general and Japan is expected to support the US. It is also necessary to be ready to make a counterattack if the US or Japan is being attacked, but if Japan is attacked in earnest, with the current military capacity of Japan, its air and naval forces could be completely destroyed in the initial stages of the attack. In other words, the current situation of the Self-Defense Forces gives China an incentive to launch a devastating initial attack which would enable it to cause continuous damage. Japan needs to change this situation.

For example, Japan needs to contain its vulnerability by building up air force bases underground or increasing bunkers and shelters.

If ammunition runs short in three days or a week of fighting, as in the current situation, and Japanese forces cannot continue to fight, however good its defense facilities may be will be almost meaningless. So, Japan would need to make it possible for its forces to continue a war for at least several weeks, at maximum several months, without provision of ammunition from its allies. It will be, above all, important for Japan to strengthen the Self-Defense Forces and acquire a counterattack capacity in order to avoid giving China the belief that it could have enough time to attack Taiwan with an initial devastating attack on Japan and the US military.

Next, on the issue of strengthening the US-Japan alliance, first, it is extremely important to ensure the US commitment. If the US decides not to join in the war against China, this war will end with a Chinese victory. Unless Japan continuously reminds the US of the importance of Taiwan for Japan and the US, the US could be more seduced by the concept of “America First” and the US-Japan alliance would be politically destroyed all at once.

In addition, Japan needs to supplement the US military capacity as its original mission. For example, Japan should have its own intermediate-range ballistic missiles not owned by the US. But I guess that cannot be done immediately. In the three government documents on national security made public at the end of 2022, high-speed missiles or hypersonic missiles are mentioned. If Japan can own such weapons, this would mean that Japan can complement the US military capacity with weapons that the US does not own at this moment.

Lastly, it is important how much Japan can attract the US allies to this region. Australia is in this region, and Japan must have closer relations with it hereafter. On the United Kingdom and France as well, their aircraft carriers stayed in this region for months in 2021, which showed us their big presence. German warships also came to Japan after 19 years’ absence. It is necessary to get support from Germany and from NATO. Germany is Japan’s important ally as well.

Japan would need the commitments of the UK, France and Germany to this region and their stance maintained of not approving any change to the current status in the Taiwan Strait. With their military presence, China would have to attack all these US allies in the event of attacking Taiwan. With this, the war could literally become a Third World War and we can expect China to refrain from it.

Besides these points, space is another key. In a NATO leaders meeting in 2021, it was concluded that assets in space being attacked would be covered by the execution of the right of collective self-defense. Thus, if China attacks US space satellites in order to attack Taiwan, this could provide an authentic reason for NATO to execute its right of collective self-defense to defend the US. In the US-Japan leaders meeting in January 2023, they agreed upon assets of defense in space. A big motivation for this agreement was to prevent China from attacking those assets. Maintaining the US military's advantage in the space domain is extremely important and supporting this is also important. For example, whether European satellites can be used to replace US satellites being attacked is crucial. So, it will be vital to supplement the function of the US alliance network worldwide and strengthen it to deter any Chinese military attack on Taiwan.

Ito: I think it is important to maintain and strengthen Japan's strategic indispensability. We must protect intellectual property rights, expand R&D investment and allocate more resources for human resource development. It is to be assumed that products considered strategically important are used well in the Chinese market to take advantage of such indispensability.

On the other hand, as the importance of the Chinese economy to the Japanese economy increases, we cannot ignore earnings from business with China as sources for increasing the indispensability of such goods.

From these two points, in order to strengthen strategic indispensability, it is necessary for us to explore stable Japan-China relations. In this regard, I believe we need to keep collaborating with China on common issues such as climate change, aging and disaster prevention and mitigation.

We also need to secure our strategic autonomy. Japanese private businesses have already started a wide range of strategies ranging from diversification of procurement of components and raising inventory levels to changing local production for local consumption-type supply chains. They are now increasingly conscious of market diversification.

However, private business involvement alone will not promote the necessary changes very smoothly. Providing hard and soft

infrastructure for the regions or countries under consideration for diversification of production bases or markets and supporting their capacity building are needed. It is also important to reduce trade barriers through the conclusion of FTAs and I believe we should redouble our efforts in this regard.

Industrial policy to secure specific important materials and technologies is also important, but more than that we need to harmonize our efforts with our allies and partners. We should pay attention to consistency with international trade rules and prevent proliferation of "my country first" policies. Through this, we should ask China to exercise discipline in its industrial policy and trade policy.

In other words, maintaining and building up a business environment to achieve fair competition will be crucial for raising the resilience of supply chains. In this light, as China's Central Economic Work Conference advocates for China's joining the CPTPP, it will be important for us to keep asking them for rules-based actions consistent with the WTO, RCEP and CPTPP.

Finally, continuous strengthening of economic, financial and fiscal foundations is recommended in Japan's recently published public document "National Security Strategy" and I think above all it is vital to clarify the route to fiscal reform for its reconstruction. Market pressures on fiscal disciplines are increasing, and we must face this issue squarely and build a solid national consensus.

Toyota: Thank you all so much for your invaluable thoughts and comments.

JS

Written by Naoyuki Haraoka, editor-in-chief of *Japan SPOTLIGHT*, with the assistance of TapeRewrite Corporation.



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