

How to Overcome the Gap between Geopolitical Tension and Economic Reality

By KIMURA Fukunari

(1) Geopolitical Debate and Economic Reality

The confrontation between the United States and China or between the G7 and both China and Russia is intensifying along three dimensions: ideology, the economy, and power. Against such a backdrop, the movement of supply chain decoupling is also progressing. At the same time, economic activity is thriving. Economic ties between the G7 and China, as well as developing regions that remain “neutral,” have not been severed. The disconnect between business activities and geopolitical policy discussions within government circles in the United States, Japan, and the G7 is becoming more prominent. When considering partnership with Asia and developing regions, it is important to take both sides into account.

(2) COVID-19 and Supply Chain Disruption Fallacy

There is a widespread discourse to the effect that “the vulnerability of supply chains exposed by the arrival of COVID-19 needs to be amended.” However, I believe that East Asian supply chains were not that vulnerable. East Asia has developed international production networks (IPNs) centered on the machinery industry. This is East Asia’s greatest strength. Private companies have demonstrated resilience in the face of past natural disasters and economic crises. IPNs overcame the “negative supply shock” and “negative demand shock” caused by the COVID-19 pandemic within a few months, and East Asian IPNs in particular returned to a growth trajectory early after experiencing a “positive demand shock.” The rhetoric of “vulnerable supply chains” provokes geopolitical debate.

(3) Current Status of Trade and Investment Controls and Trade Trends

Exports and imports are controlled according to different systems depending on the country, such as by item, by related technology, by trading partner country, and by trading partner company. Since the boundary between military and civilian use tends to be unclear, the scope of “security” is considered to be wide. At the same time, it is a system that proactively issues export/import permits, and even if trade is placed under government control, that does not mean that it will be totally banned. In fact, trade is still thriving at an aggregate level, with US–China trade and Japan–China trade hitting all-time highs in 2021. The US government also describes China as both a partner and a competitor, and it is highly likely that decoupling will be partial.

The same is true for Japan. Japanese companies are also rethinking their supply chains, but

in many cases, this is not because trade controls are tightening. Since 2010, Japanese companies have been promoting the “China +1” strategy, and voluntary decoupling has already progressed to a considerable extent.

(4) Japan’s Economic Security Debate

In May 2022, the Economic Security Promotion Act was enacted and promulgated. The act consists of four pillars: support for supply chain resilience, security of fundamental infrastructure, non-disclosure of patents for sensitive technology that can be diverted to military use, and R&D promotion for advanced technologies. Among these, “specific fundamental materials” are designated in the support for supply chain resilience. There are four conditions for such designation: supply is essential to the survival of the nation; supply is biased to specific countries and overly dependent on external resources; supply may be disrupted due to export suspension; and supply is deemed especially necessary due to a track record of supply disruption. As this designation aims to prevent supply disruptions, distribute supply sources, and offer support, it can be considered a so-called “defensive decoupling,” and its conditions are believed to be reasonable. On the other hand, under the fourth pillar, research will be conducted in 20 technical areas to narrow down the “specific important technologies”; such an effort presumably includes offensive decoupling.

(5) Latest Economic Situation

Amid heightened geopolitical tensions, it is also necessary to pay attention to recent changes in the global economy, such as the soaring prices of food and energy, inflation, rising interest rates, deterioration of macro-fundamentals, and possible recession. The US economy is still strong, but China’s growth is clearly slowing. There are also signs of a slowdown in trade and direct investment. G7 countries are looking more inward, and their interest in developing regions is waning. Hence, it is especially necessary to pay close attention to trends in the poorest countries. Rising uncertainty increases the risk of slowing growth not only in supply chains but also throughout the global economy.

Meanwhile, the ASEAN economy is currently doing well even against such a backdrop. This is because it is closely linked to both China and the West. While ASEAN countries are enjoying the “positive trade and investment diversion effect,” they are afraid of being forced to take sides.

(6) Partnership with ASEAN and Asia

Japan needs to firmly recognize shifts in the economy and take balanced measures while preparing for security. The scope of trade and investment management should be clarified; in particular, efforts should be made to avoid giving uncertainty to private companies, and efficient operations should be carried out to prevent the economy from shrinking on its own.

It is important to keep the “rest of the economy” under a rules-based international trading system. For example, we want to reduce policy risks using RTAs (Regional Trade Agreements) such as the RCEP (Regional Comprehensive Economic Partnership), in which China also participates, and CPTPP (Comprehensive and Progressive Agreement for Trans-Pacific

Partnership). In addition, efforts should be made to revive the dispute-settlement mechanism through addressing problems surrounding the WTO Appellate Body, participation in the provisional MPIA (Multi-Party Interim Appeal Arbitration Arrangement), and utilization of RTAs for dispute settlement. Japan should avoid violating WTO rules inadvertently.

Meanwhile, with respect to third countries, the importance of preserving the rules-based international trade order and maintaining a vibrant international economy must be emphasized while respecting self-judgment in terms of security. Third countries also need to take a certain level of countermeasures against rising geopolitical tensions.

Regarding the Indo-Pacific Economic Framework (IPEF), it is necessary to consciously separate the “economic agenda” and the “economic security agenda” and incorporate them. The “economic agenda” could include, for example, the digital and green economy, which are of particular interest to ASEAN. In addition, Japan should seize the opportunity of India’s non-participation in Pillar 1 to advance the establishment of rules for e-commerce. In the “economic security agenda,” we should start with the creation of a policy system for economic security.

Discussions about security stand out in Japan, but other Asian countries are actually undergoing economic shifts. Partnership with Asia and developing regions can work as a valuable balancer for Japan.

(This is an English translation of an outline of the lecture delivered by KIMURA Fukunari, Professor, Keio University / Chief Economist, Economic Research Institute for ASEAN and East Asia (ERIA), at the 92nd Policy Plenary Meeting of CEAC on October 18, 2022.)