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Economic diplomacy and economic security under Abe

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Economic diplomacy and economic security under Abe

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Abstract

As Japan's longest serving Prime Minister, Abe Shinzo, brought political stability to Japan and regional and global leadership on trade and economic diplomacy at a time of great uncertainty. Abe led the conclusion of the Trans-Pacific Partnership agreement after US withdrawal and a more strategic approach to international economic diplomacy. Repair of the China relationship culminated in a state visit to Beijing in 2018 and agreement to cooperate on joint infrastructure investment projects. The trade and political dispute with South Korea and new economic security policies now erode Japan's openness and are a challenge going forward.

JEL Codes: F13, F15, F21, F23, F53

Keywords: Japan, trade policy, Trans-Pacific Partnership, economic security, Abenomics

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Economy first from rhetoric to action

In 2012 Prime Minister Shinzo Abe campaigned for the leadership of the Liberal Democratic Party (LDP) and prime ministership on an economic revitalisation platform with a strategy that became known as Abenomics. That was half a dozen years after his aborted first term as prime minister in which national security ambitions were prioritised over the economy. Japan had experienced two decades of economic stagnation after the bursting of the asset bubble in the 1990s and, during that period, trade and economic diplomacy emphasised expansion of Japanese multinational enterprises abroad without liberalisation at home.

Expansionary monetary policy that was the first arrow of Abenomics helped rapid depreciation of the Japanese yen against the dollar, from roughly 80 yen per US dollar in December 2012 to 125 yen per dollar in late 2015, before it appreciated again to 100 yen per dollar in 2016. The depreciation of the yen did not result in any real expansion of exports or a large shift in the trade balance because of the nature of Japanese supply chains and the vast operations of Japanese firms outside of Japan (Shimizu and Sato, 2015). Boosting the productive capacity of the Japanese economy and the competitiveness of Japanese industry depended on the third arrow of structural reforms in Abenomics.

The structural reform agenda required opening up Japan's protected and uncompetitive sectors — primarily agriculture and services — to international competition. Japan was the largest net foreign asset holder globally, including via a large stock of Japanese foreign direct investment spread globally. With a shrinking and ageing population, much of Japanese corporate dynamism derived from its performance in external markets.

The objective of this paper is to assess the international economic diplomacy of Japan, and how trade and international economic policy connected to the openness and competitiveness of the Japanese economy for the duration of Mr Abe's prime ministership. Abe was active diplomatically with a focus on national security and geopolitical issues but he emphasised and prosecuted economic engagement alongside his security interests.

International economic diplomacy is closely connected to national security and geopolitics. Japan's economic and national security depends on managing its economic, political and security relationships with its security guarantor and ally, the United States, and largest trading partner, China. The other security and foreign policy priorities under the second Abe administration— the North Korean abductee issue and nuclear threat, resolution of disputed territory with Russia and interests in Iran and the Middle East — are beyond the scope of this paper, primarily focused as it is on managing Japan's economic security and the connection of international economic policy to Japanese prosperity.

The political stability that Abe brought as leader from 2012 for close to 8 years after a revolving door of 7 prime ministers in 7 years, combined with proactive diplomacy internationally from the world's third largest economy meant that Japan was a positive and stabilizing force in global economy policy. Japan stepped up to an unfamiliar leadership role in multilateralism when the world needed it the most. The resignation of Abe as prime minister in 2020 has seen an outpouring of warmth and accolades from many foreign leaders in contrast to the mixed reactions it has received in Japan. Internationally the highlight of Abe's legacy as Japan's longest serving prime minister is seen as Japanese international leadership in the face of the policy uncertainty surrounding US President Trump's America First agenda and the difficulties in dealing with a rising and more assertive China.

This record is far from unblemished though with Japan-South Korea relations at their lowest point since relations were normalised in 1965 because of highly politicised trade tensions. And under the threat of tariffs on its automobile exports to the United States, Japan has acquiesced to signing a trade agreement that offends against its commitment to multilateral rules and norms.

In addition, the challenge of maintaining and managing Japan's openness and competitiveness have entered a new phase with increased uncertainty in the external environment from the entanglement of economics and national security. Deployment of economic policies and tools for geopolitical and security purposes by China and the United States has led to a new focus on 'economic security' across the Japanese government that has implications for Japan's openness.

The next section reviews the state of Japan's international economic engagement in the first three years of Abe's prime ministership, including what he inherited from the previous government and with a focus on trade policy and openness to foreign investment. The paper then examines the Japanese response to the uncertainty caused by the American First agenda and Japan's leadership role in multilateral trade, including repairing of the important Sino-Japan relationship. Finally, the paper assesses the economic security policies that were introduced in the last year of Abe's prime ministership and looks at the challenges Japan faces following Abe's resignation.

Economic partnerships to freer trade

By the end of 2012 Japan had economic partnership agreements (EPAs) in place with Singapore, ASEAN, India, Indonesia, Brunei, Thailand, Chile, Philippines, Switzerland, Vietnam, Peru, Mexico and Malaysia. Japan shifted from the priority it attached to non-discriminatory multilateral trade to the pursuit of bilateral preferential agreements in the late 1990s, without clear strategic purpose (Drysdale and Armstrong, 2015; Solis and Urata, 2018).

Hamstrung by vested agricultural protectionist interests at home, trade and economic diplomacy was focused largely on expanding Japanese corporate interests and market access abroad with little effect on liberalisation at home. The free trade agreement (FTA) label was eschewed in favour of EPAs. Of the countries Japan had bilateral agreements with, only two were developed countries, Switzerland and Singapore, with Switzerland's not being a major trading partner of Japan and Singapore's lacking an agriculture sector. Such a tactic was reflected in the performance of Japanese sectors, with manufacturing internationally competitive and agriculture and services shielded from international competition (Drysdale and Armstrong, 2015). This stands in contrast to South Korea's trade policy strategy that had secured agreements with the United States in 2006 and later the European Union in 2011 (coming into force in 2015) that involved significant liberalisation of Korean agriculture and services.

When prime minister Abe's administration was formed in 2012, Japanese economic diplomacy was still adrift with agricultural protection preventing the conclusion of trade negotiations with Australia, and preventing Japan from joining the then 9-member Trans-Pacific Partnership (TPP) negotiations that were already underway. Japan formally joined the TPP negotiations in July 2013 (along with Canada and Mexico)[2]. In the two decades after the bubble burst in the early 1990s there was little coherence in Japan's international economic policy (Drysdale and Armstrong, 2015). Whether with strategic purpose or not, the Abe administration moved, in its rhetoric at least, to connect international economic diplomacy with national economic challenges.

The centralisation of power and decision making in the *kantei*, or the Prime Minister's Office, shifted power to elected policymakers away from the bureaucracy. That reconfiguration had started clumsily under the Democratic Party of Japan and was consolidated after the LDP regained power in 2012. With the new emphasis on economic revitalisation and the new locus for coordination and implementation of policy allowed prime minister Abe eventually to sign the Japan-Australia EPA in 2014 and the TPP in February 2016.

The agreement with Australia was the first that Japan had signed with any significant commitment to liberalisation of agriculture, even though liberalisation was limited. Japanese Tariffs were cut on frozen beef imports from 38.5 percent in 2014 to 19.5 percent by 1 April 2031, much less liberalising than the other two major deals Australia secured that year with China and South Korea where commitment was to zero tariffs on a faster timetable.

The TPP was associated with the third arrow of structural reform of Abenomics and symbolically the leading edge of liberalisation and reform. The agreement was seen as an important beachhead for opening up protected agriculture and services sectors. But the importance of TPP for the third arrow was more symbolic than substantial since it failed to address the larger domestic reform agenda. The TPP mobilised domestic opposition from vested interests and required the expenditure of significant political capital to carry forward as it was seen as pressure from the outside — *gaiatsu* — and especially from the United States.

The TPP was an opportunity to make progress in reforming and liberalising agriculture but the opportunity was largely missed (Honma and George Mulgan, 2018). Of the 12 members, Japan was the only country that failed to commit to eliminate tariffs on 99 percent or all tariff

[2] For detailed analysis and discussion see Solis and Urata (2018).

lines, with 19 percent of agricultural products remaining protected, falling short of the stated objective of the Abe administration (Solis and Urata, 2018).

Successfully negotiation of the TPP laid the ground for prime minister Abe to lead the TPP members to conclusion of the deal after US withdrawal from the agreement, and to signing the US-Japan Trade Agreement.

Japan’s commitment to multilateralism and reliance on international markets was crucial to its rapid economic development after World War II. The regional cooperation arrangements that involved Japanese initiatives like APEC helped reinforce Japan’s multilateral interests. The turn to preferential bilateral agreements marked less proactive support for multilateral rules, and increased emphasis on building negotiating experience and capacity that would become important for bottom up rule-making later on.

Reforms to agriculture, although limited, allowed trade policy, with its previously defensive stance, to become a more important policy instrument for the Abe government. Opening up to foreign capital also brought more international competition into Japan’s domestic economy.

Invest Japan

Japan is relatively closed to foreign investment and therefore foreign competition. The stock of foreign direct investment relative to the size of the economy is very low in Japan. In 2012 the stock of FDI as a share of GDP was 3.32 percent, the lowest since 2007 when it was 2.94 percent[3]. That share was the lowest by far among OECD countries which had an average share of 30.6 percent in 2012 and it was lower than that of the BRICS countries.

Attracting more foreign investment was one of the goals of the structural reform arrow of Abenomics that set a goal of 35 trillion yen (US$329 billion) of FDI stock in Japan by 2020 (Hoshi and Kiyota, 2019). The stock of FDI in Japan increased from US$206 billion in 2012 to US$310 billion by the end of 2019, having only recovered to the 2012 level in 2015 after falling in 2013[4]. Japan’s FDI stock as a share of GDP was 4.34 percent in 2019 according to OECD data and 5.6 percent in 2018 according to the latest data in JETRO’s annual report (JETRO, 2019). The growth of FDI into Japan in value and as a share of GDP point to some success at the ‘Invest Japan’ policies of Abenomics, despite the slow trend growth to 2015 (Hoshi, 2018), but stand in contrast to its more rapid growth in the rest of the world. In 2019 Japan still had by far the lowest stock of FDI as a share of GDP in the OECD, where it averaged 45 percent, and lower than the BRICS countries (see Figure 1). India’s FDI stock as a share of GDP had grown from 12.3 percent in 2012 to 14.5 percent in 2019, and China’s was 20 per cent in 2019, down from 24 per cent in 2012.

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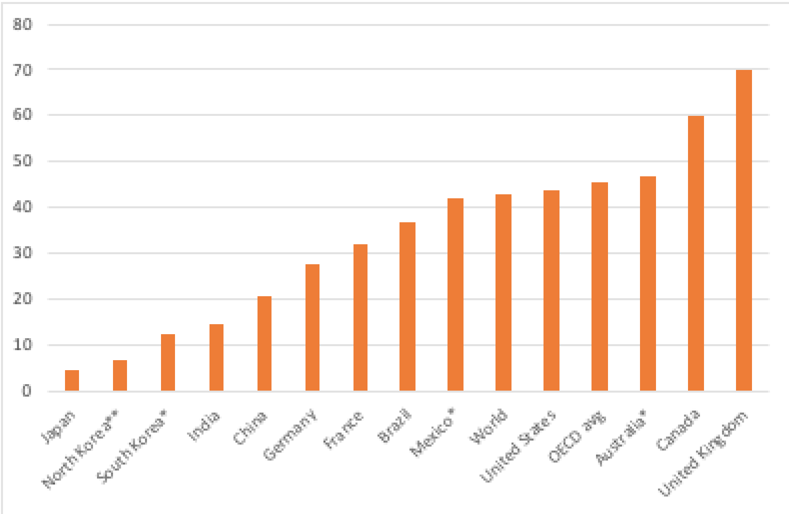
[3] Data are from OECD.stat. Data from the Ministry of Finance and Bank of Japan’s “International Investment Position of Japan” and “National Accounts of Japan” data from the Japan Cabinet Office produce similar ratios. Note a ratio of stocks as a share of a flow (GDP) measure is used to demonstrate the realised foreign investment position relative to the size of the economy. FDI flows are notoriously volatile from year to year.

[4] Source: JETRO.

Figure 1 Inward FDI stock as a share of GDP, 2019



Source: OECD.stat “FDI positions as a share of GDP”; North Korea data from CIA Factbook.
Notes: * signifies data for 2018, the latest available; ** signifies data for 2015. FDI stock as a share of GDP does not change rapidly from year to year.

Japan appears open to FDI, at least on paper, scoring favourably in the OECD’s FDI restrictiveness index. There is no improvement in the measured restrictiveness from 2012 to 2019 with the score steady at 0.052 (0 is completely open and 1 closed). On average the OECD is more restrictive than Japan with restrictiveness indexes of 0.065 in 2012 and 0.064 in 2019. This *de jure* measure of FDI restrictiveness is not highly correlated with realised FDI in Figure 1. On these measures, Australia and Canada appear much more restrictive towards FDI with measures of 0.128 in 2012 and 0.149 in 2019 for Australia and Canada even more restrictive at 0.161 in 2019, improving from 0.173 in 2012. But their foreign investment shares are much higher.

The measured barriers at the border and the FDI regulatory regime that the OECD restrictiveness index captures do not explain the low level of foreign investment in Japan. The main barriers to FDI in Japan appear to be domestic institutional barriers. These relate to starting and conducting business and regulation of the cross-border labour mobility that accompanies FDI. METI’s annual survey of foreign affiliates in Japan has 71.9 percent of respondents citing the ‘high cost of doing business’ as the top reason inhibiting business expansion in Japan, down from 78.6 percent in 2012. In the most recent survey, 57.6 percent cite the difficulty of securing personnel as the second most frequent response, with that factor becoming more important over time. Other common factors are the ‘exclusivity and distinctiveness of the Japanese market’, ‘high standard that users demand from products and services’, ‘complicated administrative procedures’ and ‘strict regulations, permits and license system’. These responses are consistent with other indicators, such as the World Bank’s Ease of Doing Business index that ranks Japan 106th out of 212 countries for ease of starting a business, where it ranked 107th in 2012.

The ‘Invest Japan’ campaign and the policy measures to meet the Abenomics goal of an FDI stock of 35 trillion yen by 2020 appear to have succeeded to some extent in increasing FDI. Japan was on track to hit the goal but the COVID-19 pandemic is likely to affect FDI inflows significantly. Another factor that is likely to reduce FDI inflows are the restrictions introduced in the 2020 revision of the Foreign Exchange and Foreign Trade Act, the topic of discussion below.

International uncertainty and Japanese leadership

Responding to America First

Japan’s national security is deeply linked to US extended nuclear deterrence and the US security umbrella. That reliance on the United States has grown as China’s power and assertiveness and the North Korean nuclear threat have increased, even as Japan’s self defence forces have expanded their role and capabilities. Management of the US relationship is a top strategic priority.

American leadership of the global rules-based order and the US security network have been the twin foundations upon which Japan and its region have prospered. The support for global economic commons like the WTO has allowed countries, like China, to commit to opening their economies and integrate into the international economy. The large China-Japan relationship is managed within the framework of the multilateral trading rules of the WTO (Armstrong, 2012).

The election of President Donald Trump in 2016, the rise of protectionism in the United States and its retreat from an international leadership role was a shock to Japan and the global economy. The United States went from a source of stability to a source of instability and uncertainty. President Trump withdrew the United States from the TPP immediately after assuming office in early 2017 and raised questions about the value of America’s security alliances in his campaign for the White House. Prime minister Abe managed to build a strong personal relationship with President Trump and secure assurance of the US security umbrella.

On economic policy, Japan’s response to the new uncertainties in its external environment was to shift from passive to proactive foreign economic policies to protect and shape the multilateral trading system (Urata, 2020). Abe’s active diplomacy and coalition-building from the beginning of his return to the prime ministership in 2012 set the groundwork for a leadership role in international economic policy.

The US withdrawal from the TPP created great uncertainty for the remaining members but also for the global trading system. Trump had made other promises that threatened the trade regime during his election campaign. They included threats of high tariffs on Chinese and Mexican imports as well America First rhetoric that signaled retreat from multilateralism and global leadership in trade policy (Productivity Commission, 2017). With uncertainty about whether the US Congress and the Washington establishment would constrain the Trump Administration from its more extreme threats on trade and alliance management, Japan led the conclusion of the Comprehensive and Progressive Agreement for the TPP (CPTPP) with the remaining 11 members. Australia, New Zealand and Singapore were key partners in pushing its conclusion but it was the economic weight of Japan and its leadership that made the difference (Terada, 2019). The CPTPP keeps open the option of eventual US membership in the original TPP, unlikely though that is in the near future, and maintains almost all of the original TPP commitments.

Prime Minister Abe expended significant political capital in concluding TPP. The achievement was a key to the structural reform arrow of the Abenomics reform strategy, both symbolically and as a beachhead in liberalisation (Solis, 2017 and Solis and Urata, 2018). Japan's leadership role in the conclusion of the CPTPP was important for the direction and momentum of reform of the Japanese economy and for the signal it sent internationally: the eleven members, led by Japan, effectively declared a stand for rules and liberalisation even in the face of the US ally retreat from globalisation.

Under pressure from the United States, in September 2019 Japan agreed to purchase corn and other agricultural produce to reduce the bilateral trade imbalance between the two. Japan had resisted a bilateral deal with the United States, preferring to try to secure US membership in the TPP but eventually acquiesced in 2019 and agreed to the US-Japan Trade Agreement that came into force on 1 January 2020, largely because of the threat of high US tariffs on automobile imports from Japan. Japan was far from alone as other countries, like South Korea, Canada and Mexico, worked to negotiate deals including voluntary export restraints and other measures like the 'poison pill' provision in the renegotiation of NAFTA in the form of the USMCA (that would allow the US to hold the deal hostage to Canada or Mexico negotiating with China) to avoid US tariffs. These measures were also all outside the existing multilateral rules, and some like VERs had been ended when the Uruguay Round had been completed. Other countries like Australia negotiated exemptions from US steel and aluminium tariffs, agreeing to VERs.

Repairing the China relationship

Uncertainty from Washington followed a period in China of the consolidation of power by President Xi Jinping and coincided with the growth of Chinese assertiveness. China's rise was causing strain on the established order. The existing multilateral trade rules were out of date and those still relevant covered a smaller proportion of international commerce. Digital trade, investment, services and other areas had rapidly become more important. The existing trade rules remained relevant and important for peacefully resolving trade disputes. Japan, alongside the United States and European Union, won a case against China in the WTO in 2014 for restricting the exports of rare earth elements earlier that decade — for which China was then the dominant global supplier and Japan the largest importer. China accepted the ruling against it.

The China-Japan relationship had been gradually improving from the middle of the decade following a low point in 2012, prior to both Abe and President Xi coming to power within the span of four months. The large and complementary economic relationship between China and Japan which had developed and was managed under the framework of the multilateral trading system had played its part in keeping the political relationship from deteriorating (Armstrong, 2012). The underlying economic interdependence between the two countries was a powerful incentive to better manage the political relationship.

Japan was gradually able to repair its relationship with China after Abe's visit to Yasukuni Shrine in December 2013 which was met with strong protest from China (and the United States), reflecting the mutual interest in managing the large economic relationship. Some have argued that improving the relationship with China was part of a strategic hedge against a more unpredictable United States (Sahashi, 2017).

Prime Minister Abe's state visit to Beijing in October 2018 was his first bilateral state visit (although he had visited China for APEC in 2014 and the G20 in 2016) since he made the historic 'ice-breaking' trip in 2006 in his first trip abroad during his first term as prime minister. In the October 2018 trip, China and Japan agreed to 52 joint infrastructure projects in third countries, elevating cooperation in a potentially important area on which it had been difficult to find common ground as competitors in infrastructure investment in Asia. The joint infrastructure projects were not agreed under the umbrella of China's Belt and Road Initiative (BRI) but they potentially play a significant role in shaping China's approach to the BRI (Armstrong, 2018). Japan had not signed an MOU with China to join the BRI, and like other G7 countries, had been reluctant to engage with China's BRI. Italy was the first G7 country to sign an MOU to cooperate with China on BRI in 2019. The 2018 initiative defined a way to work with China on a policy priority for both countries and to influence Chinese policy development through engagement. The theatre of infrastructure investment in developing countries and improving connectivity with China has been seen as a threat to the existing US-led order by many in the West.

Chinese agreement to joint infrastructure projects with Japan, including state participation in these projects, meant that projects that were largely in Southeast Asia would not proceed without agreement on standards, largely set by Japan. This demonstrates an interest from Chinese authorities to improve standards in their investment projects that had seen some commercial failures and a spectacular international political backlash. Notably, China adopted the same language and principles as the Japanese-led G7 Ise-Shima Principles for Promoting Quality Infrastructure Investment in its BRI Summit in May 2019. For Japan, the initiative furthered a common interest with China that would help improve the bilateral relationship, without compromising any interests. The MOU for joint infrastructure projects that was signed mirrored the language Japan had used in an MOU on joint infrastructure projects with the United States and Australia only months before. Japanese experience of failed projects and geopolitical pushback from its forays into infrastructure investment in Southeast Asia in the 1980s gave Japanese policymakers an understanding of the economic and political challenges faced by China.

China was Japan's largest trading partner prior to Abe's prime ministership. The stock of Japanese foreign direct investment in China was US$123 billion at the end of 2019, having grown an average of rate of 15 percent a year (including with depreciation and divestment) since China joined the WTO in 2001[5]. In 2019 the flow of Japanese FDI to China was US$14.37 billion. Japan is the largest non-Chinese source of foreign direct investment in China.

In managing the relationship with an increasingly unpredictable Trump Administration and the increasingly assertive Xi Jinping, Prime Minister Abe and Japan found itself in an unusual leadership position.

Regional leadership and its challenges

President Trump's election promises on trade were gradually delivered throughout 2017, and escalated in 2018, as it became clear the extremes of his administration were not going to be reigned in by the US Congress or other interest groups.

As a US ally, Japan had deferred to US leadership — as had much of the rest of the world — in regional and global economic initiatives. Even major domestic reforms were driven importantly by US pressure, or *gaiatsu*, including the pressure for agricultural reform in the TPP negotiations. After successfully leading the conclusion of the CPTPP, the Japan-European Union economic partnership agreement was concluded, coming into force in February 2019. That was at the time the largest bilateral economic agreement globally. In July 2018 Japan also elevated the priority of the Regional Comprehensive Economic Partnership (RCEP) agreement between the 10-member Association of Southeast Asian Nations (ASEAN), Australia, China, India, Japan, Korea and New Zealand, by hosting the first ministerial meeting outside of ASEAN where the agreement had been conceived. Japan had become the de facto leader of multilateralism.

Japan was G20 president in 2019 and navigating the China-US trade tensions in the Osaka G20 Summit while protecting the multilateral system was the top strategic priority, as outlined by Abe at the World Economic Forum in Davos earlier in 2019. While the Osaka Summit did not produce a significant breakthrough, the leaders' statement did include defence of the multilateral trading system, building on a window created at the previous summit in Buenos Aires. There was no guarantee of a leaders' statement after the APEC summit in Papua New Guinea in 2018 had failed to produce a leaders' communique for the first time in APEC's history, primarily because of the Sino-US tensions.

The expectations for the G20 summit in 2019 were not high given the China-US trade war and the unpredictability of the US president. The summit failed to avoid the expected US veto of judges to the appellate body of the WTO's dispute settlement system in 2019 which meant that the multilateral trading body could no longer enforce trade rules. The Multi-Party Interim Appeal (MPIA) plurilateral arrangement was launched in early 2020 and in September 2020 it comprised 22 members including the European Union, China, Australia, Mexico and Canada. Japan was not an initial member and has not yet joined.

[5] Source: JETRO

On the sidelines of the G20 Summit Japan launched its Data Free Flow with Trust (DFFT) initiative that aims to set governance standards in digital and cyber commerce. This is an area where global rules and norms do not yet exist but is important in the determination of the competitiveness of the countries and firms. The 'Osaka track' is a rule-making initiative that is attempting to make progress on international data governance and to contribute to the WTO's e-commerce negotiations by building principles for cooperation with other countries on cyber security and privacy issues.

The trade war between Japan's two largest trading partners and the world's two largest economies proceeded in fits and starts throughout 2018 and 2019. The US-China Phase One trade deal brought a truce with agreement by China to purchase US$200 billion of agricultural goods and energy from the United States over 2 years. The agreement that was primarily about the volume of US imports that China committed to and moved the trading relationship between the world's largest economies and traders towards managed trade, outside of the existing rules and norms of the WTO. The implications for energy importers like Japan were significant, as they were for energy and agriculture exporters like Australia.

Japan also pursued an active diplomacy of strengthened political relations with other countries. Australia, Southeast Asia, India, Canada, Europe and the Middle East were targets. There was diplomatic failure in some key relationships, with efforts to improve relations with Russia on territorial disputes and the deteriorating bilateral relationship with South Korea conspicuous examples.

In April 2019 Japan signalled a shift in immigration policy by opening up its labour market to more skilled and unskilled foreign workers in response to labour shortages across Japan. The objective was to attract up to 345,000 foreign workers over five years on two types of specific skill visas that allow families and longer term settlement in Japan. Opening up Japan to immigration required political capital. It will potentially change the way Japan engages with neighbouring countries that are sources of migration. Thus far the main target countries for foreign workers are in Southeast Asia.

The new economic security posture

'Protecting' technology and innovation

The increasingly complex international environment has seen economics and security become more entangled because of strategic competition and technological decoupling between the United States and China. The lack of multilateral rules in the digital and cyber domains combined with the United States' and China's increasingly seeing economic interdependence through a security or zero-sum prism has changed the operating environment for countries navigating their economic and security interests between the two big powers. This challenge is particularly acute for US allies, almost all of whom have China as their largest trading partner. In navigating the uncertainty, countries like Japan have sought to develop their 'economic security' policies[6].

Japan's National Security Secretariat has established an economic security division, as have METI and the Ministry of Foreign Affairs in 2020[7]. US policies in 2018 to tighten export controls of technology as part of its technological decoupling from China had meant Japan had to respond[8]. METI had been sensitive to the US policy on export controls since its bitter experience in the case of Toshiba's violation of the US Coordinating Committee for Multilateral Export Controls (COCOM) in 1987[9]. US sanctions on Chinese tech giant Huawei will mean Japanese telecommunications and other tech firms that use Huawei equipment will risk sanctions unless they extract Huawei equipment at great cost.

One of the goals of Japan's economic security policy is to prevent the outflow of 'critical technology' to non-allies, most prominently China[10]. The types of technology that are likely to be targeted for acquisition by non-allied countries include artificial intelligence and 5G communication technology, core technology for the development of a digital economy, as well as robotics and bio-technology[11]. The means by which another country may acquire critical technology from Japan have been identified as collaborative university research, cyber theft and acquisition of Japanese companies that own the technology through foreign direct investment.

US allies have been put under pressure by the United States to restrict exports of dual use technology, protect against the theft of sensitive technologies and protect other cyber assets from China. Japanese firms are not new to protecting their intellectual property, and much technology transfer to China is done in exchange for access to the Chinese market and commercially. Pressure from the United States on its allies like Japan is increasing to enact extreme measures. Japan has an interest in finding a way to avoid the US extreme of technological decoupling and continuing to benefit from Chinese innovation and technology. This balancing act will become more difficult as China becomes an even larger source of innovation and technology if the United States continues down a path of technological decoupling.

The Japanese government has also tightened the regulation on inward FDI with revision of the Foreign Exchange and Foreign Trade Act (FEFTA) that came into effect in May 2020. The objective was to promote inward foreign investment that would contribute to Japan's

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[6] For a full analysis and discussion of Japan's economic security policies, see Armstrong and Urata (2020).

[7] There are discussions of MEXT and other ministries creating economic security divisions, and there has been some reorganisation of MOFA's division from its initial establishment.

[8] Nobukatsu Kanehara, former deputy director for the NSC, quoted in an article in Yomiuri Shimbun, May 20, 2020

[9] Toshiba and Kongsberg, state-owned Norwegian enterprise, sold $17 million worth of computer-controlled machine tools to the Soviet Union in a period from 1981 through 1984, in violation of the Coordinating Committee for Multilateral Export Controls (COCOM), which was established during the Cold War to put an embargo on Western exports to East Bloc countries.

[10] Minute of a committee under the Industrial Structure Council [Sangyou Kouzou Shingikai] (October 2019)

[11] Nikkei Shimbun, June 4, 2020

economic growth while restricting investment that may undermine or damage national security. The trend towards a more restrictive foreign investment regime is a trend mirrored in other Western countries[12].

The new FEFTA introduces significant complexity into the FDI screening regime (Pesek, 2019). The prior-notification threshold has been lowered from 10 percent ownership to 1 percent with many exemptions and sectoral rules. Fifty-six percent of listed companies are subject to prior-notification and there is a lack of transparency and clarity about how these companies have been chosen[13]. There is also the problem of administering a complex system that requires the screening of so many financial transactions.

The new restrictions on foreign investment threaten to undo much of the recent progress in attracting FDI that brings foreign competition, capital, links to other markets, technology and know-how. For Japan, as well as the rest of the world, FDI from China is a source of new technology. Protecting companies from foreign takeover risks reduced asset values and can divert capital and technology elsewhere.

Export controls and South Korea

METI and more recently the economic security division of the NSS oversee export controls of advanced technologies that could end up in a country or actor under sanctions from Japan or the United States, or that can be used to undermine Japan's security[14]. There is a concern about advanced technology ending up in North Korea or in the Chinese military. There are also fears of being caught in US-China technological competition and technological decoupling.

Japan removed South Korea from the 'white list' of preferred countries to which it can export high-tech materials to without licencing in August 2019 for fear that the final end-use of some of those materials are not adequately monitored[15]. This placed a new and additional burden on South Korean firms that rely on imports of those materials. The Japanese move introduced significant uncertainty for South Korean multinationals, including whether they could secure credit in Japan, and uncertainty for smaller South Korean firms as to whether they could navigate the new licencing requirements without import disruptions.

The commercial and economic implications of the Japanese moves on South Korea are significant. The tightened export controls of the three high-tech materials fluorinated polyimide, photoresist and hydrogen fluoride are key inputs for the South Korean production of memory chips (of which it is the largest producer in the world) and LCD and OLED displays. Japan is the major supplier to South Korea of these materials, accounting for 94

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[12] Ministry of Finance, "Rules and regulations of the Foreign Exchange and Foreign Trade Act", https://www.mof.go.jp/english/international_policy/fdi/kanrenshiryou01_20200424.pdf

[13] Nihon Keizai Shimbun, June 5, 2020.

[14] The difference between commercial or industrial espionage or protectionist policies should be differentiated from national security risk, although they are often conflated. The national security label can be liberally applied for protectionist and industrial policy purposes.

[15] https://www.meti.go.jp/english/press/2019/0701_001.html

percent of South Korean imports of fluorinated polyimide, 92 per cent of fluorinated polyimide imports and 44 percent of hydrogen fluoride imports[16].

The tightening of the export controls against South Korea was heavily politicised. The timing of the export restrictions tied it to the South Korean Supreme Court decision to allow the seizure of Japanese company assets to compensate victims of Japanese occupation of South Korea during World War II. That ruling was contrary to the 1965 Treaty between Japan and South Korea. The timing and politicisation of the export controls led the trade dispute to be labeled an economic or trade war that relates to history, economic competition, regional rivalry, disputed territory and existing political tension.

One year after the imposition of export control by the Japanese government, there are a number of notable developments in trade and investment relating to the three materials in response to Japanese government's export controls.

Several Korean firms began building facilities to produce these materials, including with assistance from the Korean government. Japanese firms have been trying to maintain their sales in Korea, which is a very large market for many Japanese firms in the industry. Several Japanese firms set up plants in Korea. This is an expected response from Japanese firms and this type of investment is similar to the type known as 'tariff jumping investment'. In this case, exports by Japanese firms are substituted by local production and sales in Korea by Japanese firms. Some Japanese firms have begun exporting the materials to Korea from their foreign affiliates in other countries. JSR, for example, began exporting photoresist from their joint-venture company in Belgium.

These developments have important implications for the structure and performance of the semiconductor materials industry in Japan and Korea. Production of these materials in Korea by Korean, Japanese and firms from other countries have increased, while production in Japan has been adversely affected by the export controls. The growth of production capacity in South Korea has accelerated as a result, improving the competitiveness of the Korean semiconductor materials industry vis-à-vis that in Japan.

The concern in METI appears to have primarily been the lack of capacity in South Korea's ability to monitor or control exports of those materials and stop them from reaching North Korea. In hindsight, to address that problem the Japanese government needed to work closely with the Korean government on the capacity and governance concerns. Export controls were a poorly-assigned ineffective policy instrument. The politicisation of the issue has increased uncertainty not only in the trade of those materials but also had potential spillovers to other sectors, in the Japan-Korea bilateral trade and economic relationship.

Supply chains and economic security during the pandemic

As Chinese factories shut down under the COVID-19 lockdowns across China from February 2020, supply chains globally were put at risk. Wuhan, where the virus was first discovered, is a major manufacturing hub, including for Japanese automobiles. Disruptions to the supply of medical and protective equipment in the early stages of the pandemic led many

[16] https://wccftech.com/semiconductor-import-south-korea-critical/

governments to implement emergency policies to ensure adequate supply of PPE. As the virus spread, many other countries implemented lockdowns, further exacerbating the risk to supply chains. But after the initial disruptions, many firms responded with domestic production ramping up, for example a shift by beer breweries and whisky distilleries to producing hand sanitizer, and international supply chains adjusted. Japanese domestic production of PPE increased vastly in response to the disruption of supply from China.

The Japanese government allocated 220 billion yen (US$2billion) in subsidies to onshore production and a further 23.5 billion yen (US$219 million) to strengthen supply chains with Southeast Asia. As of July 2020, 87 Japanese projects became eligible for what some in the media call “China exit” subsidies[17]. Of those, 30 projects will shift production to Southeast Asia and 57 back to Japan[18]. Bangladesh and India have been added to the list of destinations to which Japanese companies may relocate and applications have been reported to amount to 11 times the allocated budget for the subsidies[19]. The incentive created by the subsidy for Japanese companies to onshore projects or move them to Southeast Asia or South Asia appear to be popular for companies looking to shift production. The effect of the subsidies will not be known until more data are available for analysis. They could provide significant incentive to exit the Chinese market but could also help to adjust supply chains and production networks in which China is still central.

Some of these Japanese multinational corporations are likely to have been looking to reorganise their supply chains in Asia regardless of the subsidy. Japanese MNEs and the SMEs that agglomerate around them have been restructuring their supply chains in Asia and investments over time due to rising labour costs in China (JBIC, 2020). The China plus one strategy of diversifying investment has been common practice for decades. High and growing labour costs have meant that China is less attractive as a production base, especially for labour-intensive manufacturing. China has started to shift from being the factory of Asia to being a destination market for final goods with its large and growing middle class.

The stock of Japanese foreign direct investment in China was US$123 billion at the end of 2019. At the beginning of 2020 there were 13,600 Japanese firms operating in China, down from a peak of 14,394 in 2012[20]. The stock of Japanese investment in China had grown at 4.9 per cent a year from 2012 onwards despite the fall in the number of companies operating in China in the period since then. Japanese companies have been shifting low cost manufacturing out of China as Chinese labour costs have risen, and have been investing in the Chinese market to produce higher value-added manufactures and to service the expanding Chinese market. The subsidies from the Japanese government may accelerate the process of moving labour-intensive manufacturing out of China to Southeast Asia and

[17] Nikkei Asia Review 17 July 2020 https://asia.nikkei.com/Economy/Japan-reveals-87-projects-eligible-for-China-exit-subsidies?fbclid=IwAR3_vxlYSNkphsVXeUWC9NT42JBlB5-UYbn9K77Reo64HcQ91VM-dp03LlY
[18] https://www.jetro.go.jp/services/supplychain/kekka-1.html https://www.meti.go.jp/press/2020/07/20200717005/20200717005.html
[19] https://asia.nikkei.com/Economy/Japan-companies-line-up-for-China-exit-subsidies-to-come-home
[20] https://www.sn-hoki.co.jp/articles/article358702/

South Asia. Those manufacturers are, however, likely to sell into the growing Chinese market.

The legacy of Abe's international economic policy

With his election platform of economic revitalisation, Prime Minister Abe's Abenomics reform package brought strategic purpose to international economic policy. Conclusion of the Australia-Japan EPA and the TPP connected trade agreements to domestic reform for the first time, albeit with limited liberalisation. The mixed performance of Japanese industries included low productivity growth in agriculture and services that were shielded from international competition, both from imports and foreign firms in Japan. Foreign direct investment in Japan increased over time, bringing more international competition to Japan's domestic market given the notoriously low penetration of foreign firms in Japan. The policy measures to support the 'Invest Japan' campaign had Japan on track to achieve the target of FDI stock of 35 trillion yen by 2020 before COVID-19 hit and before the tightening of FDI regulations in the name of economic security. Japan still, however, has by far the lowest stock of FDI relative to the size of its economy among the OECD and BRICS countries, and the recent policy developments threaten to undo modest progress under Abenomics.

Where prime minister Abe shone was in diplomacy and foreign policy. The biggest achievements of Japan's longest serving prime minister may come to be seen as his leadership in multilateral trade and steering Japan's, and to an extent the broader region's, course through the early phase of escalating Sino-US strategic competition. Japan's leadership was necessary for concluding the CPTPP in 2018 after the United States withdrew from the TPP. Japan signed the then-largest bilateral economic agreement in the world with the European Union, elevated the importance of East Asia's RCEP agreement and also successfully hosted the G20 Summit in Osaka in the midst of the trade war between the United States and China. Yet these achievements were more defensive than decisive, with Abe appearing to do only what was just enough through defensive compromise rather than occupy the strategic frontline. The Data Free Flow with Trust initiative that Japan launched on the sidelines of the G20 was, nonetheless, an attempt at setting principles for eventual rule-making around one of the most important areas of international commerce where rules and norms do not exit.

Prime minister Abe was able to repair the fragile and difficult relationship with China while managing an erratic US President better than almost any other leader internationally. The agreement to undertake joint infrastructure projects with China meant that Japan's efforts to shape the BRI and improve infrastructure investment standards through its leadership in the G7 and G20 were consolidated and made operational.

Japan's emergence as a champion of free trade and defender of multilateralism has not meant a perfect record and developments later in Abe's tenure suggest a reversal of some of the progress and will present his successor with challenges. The increasingly uncertain external environment with the entanglement of national security and economic exchange led to a series of ‘economic security’ policies that have translated into export controls, restrictions of inward FDI and government intervention into regional supply chains with damaging or uncertain effects.

The rationale of the export controls deployed against South Korea was distorted by politics. The end result appears to be increased uncertainty in the economic relationship between Japan and South Korea, and a loss of an internationally dominant market position for Japan in the strategic materials affected. The restrictions on FDI into Japan in the name of national security threaten the reversal of the progress made in opening up Japan to further international competition. And the subsidies to onshore supply chains that divert them away from China appear to be largely corporate welfare, and perhaps a signal of a more interventionist Japanese economic diplomacy that will invite retaliation and weigh on future Japanese trade and economic growth.

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