Roundtable with Prof. Fukunari Kimura, Prof. Junko Shimizu & Kayo Matsumoto

Roundtable Discussion on the White Paper on International Economy & Trade 2021: Trade Policy at an Historical Turning Point

By *Japan SPOTLIGHT*

A Roundtable on METI's White Paper on International Economy & Trade 2021 was organized on Aug. 4, 2021. Kayo Matsumoto, the representative author and director of the Policy Planning and Research Office at the Trade Policy Bureau of the Ministry of Economy, Trade and Industry (METI) at the time of its drafting, showcased the highlights of the White Paper and moderated the discussion following it. She is currently working as counsellor to the Cabinet Secretariat in charge of infrastructure issues related to economic cooperation.

Prof. Fukunari Kimura of Keio University and Prof. Junko Shimizu of Gakushuin University joined the discussion. Prof. Kimura is a distinguished trade policy economist, a dedicated advocate for a multilateral trading system based on free trade. With his expertise and interest in the Asian economy, he is also working as chief economist for the Economic Research Institute for ASEAN and East Asia (ERIA), a Jakarta-based Asian think tank.

Prof. Shimizu is also a distinguished economist with expertise in international finance and currency systems, as she had more than 10 years' working experience as an exchange dealer at international banks before becoming an academic. Her interest is a common currency in Asia, such as an Asian Monetary Unit (AMU). Both academics are very keen on policy-oriented issues and have been active in publishing their views.

(Online Roundtable on Aug. 4, 2021)

Participants

Prof. Fukunari Kimura

Prof. Junko Shimizu

Kayo Matsumoto

Introduction of the Highlights of METI's White Paper on International Economy & Trade in 2021

Matsumoto: In drafting this White Paper, we had in mind that we were now at a time of big changes that require us to reconsider our trade policy. Early in 2020 when the White Paper for 2020 was being drafted, METI officials at the Trade Policy Bureau began discussing what the economy in a post-pandemic would look like and what policies would be needed in responding to the disruption of global supply chains due to the pandemic. You can see the analysis of the pandemic's economic impact on both the demand and supply side in last year's METI's White Paper reflecting those discussions. This analysis led to a policy of lowering the concentration of supply chains in certain places or nations to reduce risk. Providing subsidies for diversifying supply chains was one of the policies, including subsidies to transfer production bases from China to other nations. The same discussion continued in the second half of 2020. Regarding wider trade policy, before the US presidential election last November, it was hard for us to get a clear prospect of the future economy and policies in the United States. But as we see from international leaders' meetings and their statements after President Joe Biden's administration was formed, we have begun to get a clearer idea of the policy environment.

The first thing to be noted as a key policy that affects trade is "the enhanced interest in common values in international economic activities". Increased interest in the global environment is the leading issue. In Europe, for example, they have been engaged in what we call sustainable finance along with a large-scale action program to promote a green economy since around 2018. In my view, their policies for reorienting financial flows towards sustainable economic activities as defined by themselves could change the competitive environment in their favor, with the alleged objective of achieving green growth in a sustainable environment.

This growing interest in common values is not limited to Europe. In the US as well, Securities and Exchange Commission (SEC) consultations for potential new disclosure requirements related to climate change were held recently. This is a further step after the report of the Task Force on Climate-related Financial Disclosures, established in 2015. The Biden administration is also strengthening efforts to encourage businesses to respect human rights, another important issue of common values.

Another key change in the policy environment is the expanded role of the government. The expansionary fiscal policy adopted during the pandemic to compensate for the economic damage it has caused has not been a mere remedy for suffering industries or people but a further active policy to encourage green and digital growth.

The urgent need to strengthen efforts to protect economic security is also crucial today as a key change in the policy environment. Though it has been observed for several years, and in 2019 in particular, it was argued as a sensitive issue mostly in the context of the US-China conflict, but today it is considered to be a key issue in promoting alliances, such as between the US and Europe or the US and Japan, in order to protect national security.

These changes in the policy environment will affect businesses, with regard to both global common values and global supply chains. We confirmed in this White Paper that Japanese business supply chains in Asia, which have long been far too dependent upon China, gradually started becoming more diversified around 2011 or 2012, though little by little, with a slightly lower share in China in terms of Foreign Direct Investment (FDI) or the number of production sites as well as imports of principal parts and components among Japan's major trading partners in Asia.

I believe that businesses are now increasingly taking account of common values like the global environment or due diligence on human rights in their management, with pressure from capital markets as well; and it is also noteworthy that digital technology will be useful for businesses to meet these new requests and challenges regarding the environment and human rights.

"Trustworthy global supply chains" could be constructed by relevant trade policies that reflect these new values. We highlighted a wide range of rule-making venues and accords where such trade policies could be discussed and achieved, such as the WTO, a variety of Economic Partnership Agreements (EPAs) such as the EU-Japan FTA or the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), the OECD and APEC. Among these, the OECD is utilized as a venue for discussions on frontier policies among like-minded countries, while APEC can be a venue for more practical discussions. In addition, the Supply Chain Resilience Initiative (SCRI) launched by the Australia-India-Japan Economic Ministers' Meeting in April 2021 to create a virtuous cycle of enhancing supply chain resilience and the Dialogue for Innovative and Sustainable Growth initiated by the ASEAN-Japan Economic Ministers in August 2020 are also relevant venues for discussing new issues. Our trade policy has been these several years to utilize plural venues for discussions to establish rules to achieve trade policy goals. We will continue using these venues to achieve rule-making that reflects the new values in trade policy. I think even the rules among private businesses rather than an official treaty would affect business behavior or capital flows and eventually the business competition environment. If so, could Japanese businesses create their own values by such rules that would be accepted by the rest of Asia? This is a difficult question. We cannot make it clear exactly what would be a unique value created by a Japanese business as a tangible concept, though the White Paper introduced some specific examples of Japanese firms' efforts to create values for local communities and for themselves as private corporations.

I would like to end my introduction here and move on to the discussion session. On the issue of supply chains, I would like to ask Prof. Kimura for his views on supply chain resilience or connectivity with regard to ASEAN, and in particular could he please give his thoughts on what the notion of "service link" means in this context?

To Achieve Resilient Supply Chains

Kimura: How excessively Japanese businesses depend upon Chinese industries in their supply chains certainly needs to be examined, but it is also true that China is still important for Japanese businesses. So I believe that it is not necessary to even ask Japanese companies to leave China. Meanwhile, however, it is important for Japanese businesses to diversify their overseas production sites. In diversifying them, they will find a clear distinction between nations where they could possibly have an elaborate production network based on robust connectivity and others where they could not. I believe that what matters most is to expand the working environment to enable businesses to develop elaborate production networks in as many countries or regions as possible. Asian nations like Cambodia, Laos, Myanmar or India do not yet have working environments to accommodate such production networks. This is certainly due to those nations' investment environment but also to the lack of robust connectivity from hardware to software. For example, in operations to transport parts and components in a supply chain, what matters is not only the pecuniary cost but also time efficiency and reliability of logistics. Unless those are guaranteed, production networks cannot be expanded to such nations. Assuming that the manufacturing industry is still a key to growth among these nations, there will be so many things that need to be improved in them.

In thinking about Japan's economic cooperation on infrastructure which could improve the environment of production networks, its strength has been well noted. From the project in Laem Chabang Port and the Eastern Seaboard in Thailand to the infrastructure building around Hanoi in Vietnam, Japan has carried out systematic cooperation on infrastructure. The strength of this approach is seen in economic infrastructures such as electricity supply. Whether or not China provides a wide range of economic support to ASEAN nations, Japan has its own strengths in infrastructure building, not least in a variety of urban amenity-related infrastructures such as water and sewage plants, which Asian countries also need.

Apart from manufacturing production networks, how it would be possible to take advantage of disruptive innovation is also important for ASEAN countries. In order to achieve this, there will be a need for highly qualified experts or for people returning from studying abroad to start a variety of innovative businesses. Urban amenities are a key area for such innovation and ASEAN cities are competing for such experts. They are competing with each other in urban amenities, just as in the US where cities compete in an attempt to achieve a virtuous cycle of qualified experts and more innovation leading to improved amenities.

ASEAN nations are currently facing difficulty in proceeding with international division of labor beyond the manufacturing industry, such as in services, without urban amenity-related infrastructures. So Japan could increase its contribution to the development of ASEAN nations by providing high-quality urban amenity-related infrastructures.

I found the chapter on the resilience of supply chains in this White Paper very useful and enlightening. I believe supply chain management itself may as well be left to private businesses and what the government needs to do first is to increase the alternatives for private businesses to enhance their resilience. I think it is very important for the government to improve the investment environment and the connectivity of supply chains among ASEAN nations and South Asian nations.

Matsumoto: A smart city, another urban amenity-related infrastructure, is one of the focused infrastructures in the Infrastructure System Export Strategy and is said to be difficult to monetize from an exporting side's perspective. I regarded it as providing sustainability values. But as you said, we would need to take into account the needs of the host nation in terms of attracting talented people.

I would like to ask Prof. Shimizu about selection of the currency for procurements of parts and components in supply chains. In our White Paper, we referred to a survey on diversification of supply sources in supply chains conducted by the Japan Bank for International Cooperation and the Development Bank of Japan. The results were that a large percentage of the companies surveyed responded affirmatively to diversification of supply sources immediately after the pandemic. This was probably, as we had expected in advance, because it would be much easier to change supply sources rather than changing production sites. Apart from the electric and electronic appliances industry where nearly all settlements are done in dollars, in the case of diversifying supply sources, when Japanese firms procure similar parts and components from among plural nations, what would be the implications for the selection of currencies used for settlements by businesses?

Selection of Currencies in Diversifying Supply Sources

Shimizu: Even before the pandemic, with intensified US-China trade friction as well as natural disasters, Japanese manufacturing companies with production bases in Asia were thinking about further diversification of production sites in terms of their business continuity plans. The pandemic accelerated this trend. They are now seriously thinking about moving some of their production or procurement sites from China to Southeast Asia, although maintaining business in China.

On the question of selection of currencies for settlements, thanks to the internationalization of the Chinese yuan, transactions of Asian currencies including the yuan are much more easily done and the costs are much lower. Thus we have seen the percentage of yuan-based transactions in Japan-China trade increasing recently. The local subsidiaries in China and Thailand are freed from foreign exchange risks by being able to use their local currencies for their cross-border transactions. On the other hand, businesses have to move to less developed nations such as Vietnam, Indonesia or Cambodia and there they have no choice but to use the US dollar for international trade. However, these countries have regulations to enforce all domestic transactions to use the local currency. In this case, Japanese subsidiaries have to manage transactions between the dollar and the local currency, and therefore diversification of production bases to less-developed nations would make it more difficult to manage currency transaction risks.

Another issue is trade finance. In less-developed countries businesses would often have to use a more expensive method, such as a Letter of Credit (L/C), and costs would be high. We would need a solution to this.

I am very impressed that this White Paper mentions this issue, in particular the “Trade Waltz”, a trade-related information connecting platform using blockchain technology. This platform would play a key role in Japanese companies’ attempts to diversify supply networks in Asia and prepare to replace a production site in any country exposed to a certain risk with another site somewhere else, because they would need to be supported comprehensively in terms of currency, customs clearance systems and trade finance. Recent innovations of digital technology will support further diversification of Japanese companies. This is as important as the question of urban amenities that Prof. Kimura mentioned.

On possible future development in this regard, the Nippon Automated Cargo and Port Consolidated System (NACCS), a Japanese online customs clearance system for imported and exported cargo now introduced in Vietnam and Myanmar, would be expanded to other countries and certificates of origin would be issued more easily than ever by taking advantage of NACCS. Eventually, the Authorized Economic Operator, a system adopted by the World Customs Organization allowing businesses with the capacity for security management of cargo and law observance to modify and simplify customs clearance, may also be expanded. Thus, with the “Trade Waltz” service, we would be able to achieve digitalized customs clearance. In the White Paper, I think this would have been more convincing with a clear explanation of why the “Trade Waltz” and NACCS will be needed in the expansion of supply chains. It is clear that there will be enormous differences in cost and the time needed for procedures between a case where trade finance is done simply through an account by an online network like the Society for Worldwide Interbank Financial Telecommunication (SWIFT) and a case where the finance has to be done with an L/C because the business partner is not to be fully trusted. This is a vital issue in building up supply chains in the new less-developed trading partners.

Future Outlook for the Global Economy

Matsumoto: I would like to further discuss a little beyond the scope of the White Paper.

Firstly, could you both please tell me your views on the future outlook for the global economy?

International cooperation is now under progress to reduce the economic gaps between the developed nations where more people have been vaccinated against Covid-19 and the developing nations where fewer people have, as vaccination is at this moment the only means of stopping the spread of the Delta variant and economic recovery thus depends upon the progress of vaccination. What do you think will be the key issues in reviving the global economy while US or European monetary policy gradually returns to normal?

The second question is about the possibility of introducing private finance for economic cooperation on infrastructure projects. As for financing for infrastructure in general, 90% is from private finance and 10% from public finance. Do you think there is more room for private financing to be introduced in infrastructure projects under economic cooperation?

Kimura: It is truly amazing to see that national governments, in particular those in developed nations but also emerging economies and developing ones as well, have been taking unprecedentedly large-scale macroeconomic mitigation policies. In the first half of last year, we worried about a possible global depression and extremely strong negative shock on the demand side of the global economy with a damaged financial sector and the collapse of asset markets. But the negative shock was truly small.

Looking at trade data, though we see a negative demand shock on the whole economy continuing, all nations’ GDP growth bottomed out in May or June in 2020 and is now coming back to normal. This is a truly phenomenal and revolutionary performance achieved by macroeconomic policy.

Vaccination is a key to the restoration of the economy and there will be a big time lag in the recovery between nations making good progress in vaccinations and nations failing to do so, as the direction of economic recovery will depend upon the virus variants. It should also be noted that the fiscal situation among Southeast Asian nations including Indonesia is not damaged yet. But we will need to watch carefully the macro balance of emerging economies and developing economies as developed nations start raising interest rates in accordance with their own economic recovery.

Over the mid-term, there will be a divide in the economic recovery among sectors in ASEAN. Some are steadily recovering but some are not. In general, the sector of goods trade is steadily getting better, in particular goods that had a positive demand shock from the pandemic such as those linked with remote working, as ASEAN nations' exports are very competitive and their exports of goods to Europe and the US have returned to normal very quickly. But there are some sectors which cannot recover well, such as transportation, tourism and face-to-face services, and they will still have much difficulty recovering. Such sectoral division will be seen as a key characteristic of the future recovery process. Whether a sector or business can adjust well to the digital economy or not could make a clear difference in its performance as well.

According to an Internet questionnaire survey by ERIA, more than 2,000 companies in ASEAN responded by Internet, and those companies with high IT literacy have a record of good business performance, as shown in that more than half of them saw a positive increase in sales even last year. This means that companies using the Internet are exploring for business opportunities everywhere and thus show a good performance. Nonetheless, there is still uncertainty about their recovery due to political instability. We are not sure yet if we can truly draw a rosy picture of recovery for these nations.

On the question of private finance for economic cooperation in infrastructure, ASEAN nations have tried to introduce it these last 10 years, in particular under the scheme of Public-Private Partnerships. But their optimism about it has now gone after seeing its failures, like the one by India which was very positive about it and announced it was introducing private finance for two-thirds of infrastructure investment. Because of this, they have been proceeding little by little with caution in introducing private finance.

It is certain that the easiness of private finance introduction differs by sector. For example, in large-scale power plants, private finance introduction is now confirmed, but it would be difficult to introduce it in sectors like transportation, urban infrastructure or public services. We need to think about how to finance projects that do not pay well and make up for their low profitability. We cannot recommend the introduction of private finance without consolidated governance on private and public finance in projects in developing and emerging economies. It is too risky to promote such projects by collaboration between the public and private sector without fixed rules in those nations. We will need to promote it as carefully as possible, step by step.

Shimizu: Japan seems to have failed to secure imports of vaccines or Personal Protective Equipment (PPE) and other essential goods at the beginning of the pandemic. I think the government should have taken greater initiative in this rather than leaving it all to private business. We should examine policy measures in this regard. Though Japan concludes bilateral or regional and multilateral EPAs, all nations naturally take actions in favor of their own country in emergencies like this pandemic. I do not think there is any rule on cooperating in such actions in any of the EPAs. We should also examine how helpful EPAs could be in responding to such unexpected emergencies.

On the question of the global macroeconomy affected by the pandemic, the damage was much less than we had thought, as Prof. Kimura mentioned. Though there is a significant divide in damage among sectors, the economy as a whole is coming back to a normal track. We will need policies to support the seriously damaged sectors and businesses after finding out how best to help them from now on.

On the question of the introduction of private finance into economic cooperation projects in infrastructure, I think we need to have a scheme in which Japanese overseas subsidiaries with excess liquidity could invest in those projects. Urban amenity-related infrastructures will be very important in ASEAN countries. In Thailand or Indonesia, which have heavy traffic jams and high temperatures, frozen storage of vaccines is difficult and thus vaccinations are not progressing very well in those countries. Economic cooperation in building up urban infrastructures for those nations would have benefits not only for those nations but also for the Japanese working for the subsidiaries in the local economy. It is often said that some Japanese production subsidiaries have excess liquidity after remittance of patent royalties or dividends to their headquarters and it does seem to be difficult for them to find a good and safe destination for investment. With a scheme for those subsidiaries to invest their money in economic cooperation projects in urban infrastructures, there would be a very positive benefit in the long run for those companies as well.

Matsumoto: Though we mentioned the advanced aspects of digitalization in Asia in the White Paper, such as Grab or Gojek, taxi dispatch applications in Singapore and Indonesia, I find now that we did not think well enough about the sectors of the Asian economy that do not enjoy the benefits of digital technology. There must still be a great need for economic cooperation or private business to help in those sectors.

Kimura: There seems to still be a gap in capacity for using basic IT in Southeast Asia. For example, there are some who can take advantage of e-commerce and some who cannot. There are also some who can easily do work connected with the Internet and some who cannot. So there remain many gaps in capacity for using simple technology in Southeast Asia. What matters is not to slow down the introduction of technology creating gaps in the economy but to encourage it in a wide range of businesses.

Meanwhile, there are also many areas with more progress in utilization of digital technology than in Japan, such as the introduction of digital ID for promoting the availability of a variety of public services. In this light, it would be possible for their digital economies to make great leaps after deployment of basic IT in these nations.

Matsumoto: How can the government and private sector in these nations reduce such gaps in the capacity for using digital technology?

Kimura: We will need to wait and see how governments could get involved in it. In the case of developed nations, with government regulations, any digital infrastructure such as the Internet or broadband would be accommodated with private funding. But in emerging or developing economies, how quickly it could be achieved needs to be examined. Anyway, a tremendous amount of government expenditure on highway or port construction would not be necessary. So it is important for the governments not to hesitate to spend money on digital infrastructure building.

On the question that Prof. Shimizu mentioned about whether EPAs should be equipped with rules on a cooperation framework for providing essential goods less restrictively among the member nations or not, there were certainly many countries that restricted exports of PPE, medical goods, food or other essential goods at the beginning of the pandemic. This was a big issue. Temporary export restrictions could be GATT-consistent. This issue, however, was fortunately fixed at a rather early stage, within several months after the pandemic started. On the other hand, I think India's policy to start imposing tariffs, contrary to trade liberalization, is clearly violating GATT articles and should be properly addressed. EPAs would play a role in stopping such an abusive industrial policy.

Matsumoto: We would need to use a dialogue venue and international rules as in the SCRI or EPAs to address issues like the "Make in India" initiative. With a bigger role by government in trade policies, I guess there may be an increasing number of policies combining some that promote national interests which are not protectionist with some that are protectionist. We had a warning against it in the White Paper.

On the issue of large retained earnings by Japanese overseas subsidiaries that Prof. Shimizu mentioned, I thought they were aiming at good investment targets with those earnings in overseas markets that are growing more rapidly than the Japanese market, where finding financing would be easier. Would there not be many investment opportunities for them?

Shimizu: There are certainly some companies holding a good amount of retained earnings in Singapore and such subsidiaries are increasing. They would be ready to buy bonds with government guarantees for big infrastructure projects, if this investment would be to their benefit and raise Asian growth. In recent years, Japanese insurance companies have also expanded overseas business into Asia. For them, the expansion of the local currency bond market is essential.

In addition, firms' risk management covers not only foreign exchange risk but also risks of natural disasters or accidents or law suits, and they aim to be insured for those risks at minimum cost. For this, they recently started to establish their own insurance companies covering all the risks faced by their affiliated companies instead of paying fees to external insurance companies to save costs. It is so-called "Captive Insurance", and this has been the trend in Japan since 2019. This is another way to encourage them to use their retained earnings and an important business strategy for a headquarters to protect its local subsidiaries. It may not work if anything serious worldwide happens, but one small subsidiary company's risk can be covered by the company's headquarters. Furthermore, in such cases, they set up a captive independent agent from a headquarters in charge of covering all the subsidiaries' business risks. This captive agent can get all the insurance fees from the affiliates and thus this is much more cost saving, rather than asking external insurance companies to insure against those risks. How Japanese overseas subsidiaries use their retained earnings could be an interesting issue to be examined in next year's White Paper.

What Is Expected from METI's White Paper in 2022?

Matsumoto: In addition to Prof. Shimizu's comment on what is expected from our White Paper in 2022, is there anything else to be expected to be picked up as topics for next year's White Paper?

Kimura: In the light of trade policy, the biggest issue in this White Paper was how to conciliate trade liberalization with economic security or environmental and human rights issues. I think the logic of this conciliation between the two different groups of policy values could be further developed in the next White Paper. Upgrading the free trade system is mentioned in this White Paper and the question how it is to be done must be explored, but it would be a tremendous task. In my view, as the logic of international trade policy is already established as one that authorizes a rules-based trade regime based on the concept of economic efficiency or legal stability, it should not be mixed up with any other value judgement. In other words, it should not be assumed that trade policy will assess economic security or due diligence on human rights. This is beyond the scope of trade policy thinking. We trade policy people should reconcile the values of economic efficiency with non-economic values. The thought behind GATT Article 20 and 21 is that trade policy is not in a position to judge whether a specific security standard or environmental standard is appropriate or not. Instead, a trade policy must be taken to minimize the negative impact on trade of those policies that pursue the goal of a green environment or human rights or economic security. I think this perspective is very important. The mixing-up of two different values like economic security and economic efficiency would lead to the collapse of trade rules, as any trade policy could reflect security concerns. We need to make a clear distinction between the responsible domain for trade policy and others, and trade policy should pursue rules of trade and investment within a limited scope of responsibility. Without it, it will be difficult to point out even disguised protectionism. As a result, uncertainty surrounding trade regimes will rise and all kinds of unexpected policy risks could emerge, which would be the worst for private businesses.

I know we will need to listen to whatever any superpower is saying. But I believe that trade policies need to observe their own logic. Economic security or environment policies or human rights policies have values to be respected by other policies than trade policies. Trade policy people need to present their views on this as clearly as possible, considering how non-trade policy values differ from trade policy values. For example, if any superpower says we need to restrict production of automobiles for security reasons, trade policy people will need to oppose it based on their logic. I think it is still important for trade policy people to say what economics says, such as free trade almost always achieves the optimal resource allocation and the highest economic efficiency.

Shimizu: I would like METI's White Paper next year to pick up the issue of international taxation such as transfer pricing taxation, one of the challenges for manufacturing businesses operating overseas. In particular, after the global financial crisis in 2008, the decline in some Japanese companies' headquarters business was compensated for by their overseas subsidiaries with more earnings, and thus the taxation system would be very important for a variety of production bases in Asia.

In addition to international comparisons of capital regulations by host countries in the context of emphasizing the need to facilitate a business environment in favor of Japanese local subsidiaries' operations shown in this White Paper, it would be better in next year's White Paper to at least mention the importance of each host country's financial regulations for the Japanese subsidiaries' operations.

Lastly, on the question of "what would be the values that Japanese businesses can claim as specific to themselves" that Ms. Matsumoto mentioned, I have a couple of things to be noted. One is the high quality of goods and services, and the other is "continuous after-care". For example, having helped set up the stock market in Myanmar, Japan had been taking care of the market until companies got listed and market transactions started.

When bidding for large-scale infrastructure investment projects, Japanese firms could often lose out in terms of price, but with a high quality of the infrastructure and continuous after-care and management support, which are the main sales points of Japanese business, they would be highly appreciated by host nations as a result. So, in such a case, the government should support it by some kind of subsidies in order to win the project first. And these successful experiences will further enhance the credibility of Japan's infrastructure investment. JS

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