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ARMSTRONG, Shiro
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Economic Security in Japan: Evolution, context and emerging questions^{*}

Shiro ARMSTRONG

Research Institute of Economy, Trade and Industry and The Australian National University

Abstract

Japan sits at the fault line of great power strategic competition with deep economic interdependence with, and proximity to, the Chinese economy and reliance on the United States for technology and security. Japan's integration into the global economy has underpinned its economic development and prosperity, and also its energy, food and economic security. In response to international supply chain disruptions, weaponization of trade, technology decoupling between China and the United States and greater global uncertainty, Japan has introduced new government machinery and economic security policies that aim to protect Japan's economic security interests. Increased government intervention in the market in the pursuit of economic security is not unique to Japan, especially after the global pandemic and is complicated by the imperative of the energy transition. Japan's economic security measures aim to enhance economic resilience and reduce risks but they come with their own risks to Japanese openness, competitiveness and productivity.

Keywords: Economic security, trade policy, regional integration

JEL classification: F02, F13, F5

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Introduction

Japan sits at the fault line of US-China great power strategic competition with deep economic interdependence with, and proximity to, the Chinese economy and reliance on the United States for technology and security. Japan's integration into the global economy has underpinned its economic development and prosperity, and also its energy, food and economic security. The multilateral rules-based economic order that has been central to the management of Japan's modern economic openness is under threat and risks Japan's prosperity and security.

In response to international supply chain disruptions, technology decoupling between China and the United States, energy insecurity from the war in Europe and greater global uncertainty, Japan has led the world in introducing economic security policies, appointing a cabinet Minister in charge of Economic Security and making changes to its machinery of government.

The Japanese economy is one of the largest in the world, is an integral part of the global economy with its trade and investment links. Japan is a leading middle power, consequential in regional and global affairs without being able to change the status quo unilaterally. Japan's actions and the coalitions it builds in response to US-China strategic competition matter for Japan's prosperity and security, but for broader regional stability, prosperity and security.

This chapter reviews the changes to Japan's external circumstances and the economic security policies that Japan has introduced in response. Some of Japan's new economic security policies are in direct response to avoiding secondary US sanctions against doing business with some sectors in China while other measures appear to be a direct response to the deteriorating external environment, including the weaponisation of economic interdependence and the weakening of the multilateral rules-based trading system that necessitate self-insurance measures. Those insurance — or derisking — measures include diversification of trade

partners, hedging, trade and investment restrictions, stockpiling and support for new industries such as semiconductors.

Japanese policy measures appear to be fortifying the economy in preparation for further shocks to the global economy and have been deployed in the name of economic security and resilience. These measures such as diversification, export and import controls, like insurance policies, are costly, and raise important questions for the Japanese economy and economic policy. Will these ‘insurance premiums’ increase over time? Will these measures actually make the Japanese economy more resilient and make Japan more secure? Given Japan’s consequential role in the regional and global response to deteriorating circumstances, will its national strategies contribute to a more prosperous, safer and more secure world?

The next section reviews Japan’s international economic structure of its economic and security interests. The chapter then sets out the key changes to Japan’s external circumstances that have been associated with the introduction of new economic security policies. Section 29.4 then reviews the evolution of the idea of its economic security, its different definitions and its contemporary framing. Section 29.5 details the policy reforms and changes to the machinery of government that seek to address the issue of economic security and reviews the response of the private sector to the new economic security policies. Finally, it raises questions about the future pursuit of economic security in Japan.

The structure of Japan’s international economic interests

China accounted for one fifth of Japan’s total goods trade in 2023, including being its largest source of imports at 22.3 per cent. That share has fallen from a peak for 24 per cent of total trade in 2020. The United States was Japan’s second largest trading partner in 2023, accounting for 15 per cent of Japan’s total trade, a share that’s been roughly constant for almost

a decade, and was its largest export destination, accounting for 20 per cent of Japan's total exports. Japan's next most important trading partners in 2023 were the European Union as a whole, accounting for 10 per cent of Japan's trade, Australia at 5.5 per cent, dominated by high levels of energy imports from Australia, and South Korea, at 5.2 per cent².

China has been Japan's largest trading partner for close to two decades, since around 2006. Bilateral trade shares grew rapidly as China's economy opened up and expanded, overtaking the Japanese economy in economic weight around the same time. Economic gravity — the scale and proximity of trading partners — explains the structure of Japan's trade shares. Japan's trade has been market-driven and is heavily concentrated in its own region and with other large markets.

Japan is also the largest net capital exporter and a major source of direct investment globally. In 2023 Japan's foreign direct investment (FDI) stock globally amounted to \$2.136 trillion. The largest destination was the United States with US\$726.5 billion³. Asia accounted for over a quarter of Japan's outward investment stock at \$558 billion, with China being its largest Asian investment destination with \$135.8 billion in FDI stock, down from a peak of \$148.5 billion in 2021. The fall in Japanese FDI stock in China is the result of depreciation, a fall in annual flows of Japanese foreign direct investment into China from a peak of \$12.5 billion in 2021 to \$3.8 billion in 2023, and Japanese companies shifting some operations to South and Southeast Asia. Japanese companies are the largest investors in China surpassed only by investors from Taiwan and Hong Kong.

Japanese multinationals invest abroad to access and sell into foreign markets, to produce abroad in lower cost locations, to procure food, energy and raw material imports and for other

² Source: UN Comtrade

³ Source: JETRO

commercial reasons such as brand acquisition. Japanese direct investment has been a major driver of the development of value chains in East Asia (Ando and Kimura, 2005; Fukao et al. 2003). These value chains, or supply chains, have recently become increasingly vulnerable to external shocks.

Japan's food self-sufficiency is 38 per cent and energy self-sufficiency is 12 per cent, with heavy reliance on imports to feed its people and power the country. Japan's rapid postwar economic growth and current prosperity have relied on its ability to procure food, strategic raw materials like iron ore, and energy from the lowest cost sources in the global market. This was made possible by the confidence and commitment that Japan and others placed on the open, multilateral rules-based economic system, with the General Agreement on Tariffs and Trade (GATT) and later the World Trade Organization (WTO) at its core.

Global markets stayed open to Japanese exports as Japan's economy grew rapidly in the postwar period and disrupted established markets in the United States and Europe, thanks to the disciplines of the multilateral trading system and diplomacy to reinforce the system. In recent decades, Japanese Economic Partnership Agreements (EPAs) and trade agreements helped further Japanese FDI, exports and secure further access to natural resources.

The high trade shares Japan enjoyed within East Asia, and especially with neighbours China and South Korea, were market-led and were not derailed by the vagaries of the political relationships and unresolved history with its neighbours, disputed territory and regional rivalry. Japan achieved high levels of economic interdependence with China, South Korea and the region because of its and their commitment to the rules and norms of the multilateral trading system (Armstrong, 2012). That brought mutual prosperity and was a source of security for Northeast Asia.

Until the East Asian Regional Comprehensive Economic Partnership (RCEP) agreement

centred on ASEAN came into force in 2022, the Northeast Asian economic relationship was conducted and managed under the WTO framework without a free trade agreement or EPA⁴, with more modern rules and standards relevant to commerce in the 21st century. Because of this, RCEP utilisation has been high for China, Japan and South Korea, expanding Northeast Asian trade, while utilisation rates of RCEP has been low for the rest of its membership (Australia, ASEAN and New Zealand) because of existing bilateral and regional agreements. The WTO system still plays an important role for Japan in managing Northeast Asian economic interdependence.

The big change to Japan and the region's external circumstance that threatens the status quo equilibrium of economic integration and economic security has been the steady weakening of the WTO and the multilateral trading system more broadly. China and the United States, the world's largest economies and trading nations, have increasing disregard for the existing multilateral rules and norms.

Global uncertainty and the economic security imperative

The global economy has been on a trajectory of rising uncertainty in the context of a major shift in global economic power. Economic and political power is now more dispersed globally, and the transition to a multipolar world brings major risks. The challenges include the rise of a more assertive China; a more inward-looking United States that has gone from enforcer to spoiler in the international trading system; the United States and China locking into zero-sum strategic competition; accelerating climate change; new digital technologies like artificial intelligence that bring significant opportunities but also major risks; hot wars in Europe and the Middle East; and an outdated and weakened multilateral trading system. These risks and developments are correlated and describe the poly-crisis that Japan and the global system face

⁴ Except for a shallow China–South Korea agreement.

today.

The disruption of supply chains of critical imports during the Covid-19 pandemic, Russia's invasion of Ukraine and Chinese attempts at economic coercion have led Japan and many others to prioritise policies that might help to achieve supply chain resilience (LDP, 2024).

The US security system and US leadership on global economic norms and rule enforcement were critical to Japan's economic security. The US retreat from leadership in the rules-based international economic order to being a source of its uncertainty is a risk to Japan. So too is a more assertive China that has shown willingness to weaponize its economic weight and interdependence against Japan and other countries.

Japan has played a leading role in navigating the new circumstances. Japan showed international leadership in its initiative to conclude the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) in 2018 after the United States withdrew from the Trans-Pacific Partnership in 2017, in negotiating the Japan-EU EPA in 2018 and successfully hosting the G20 summit in 2019 in the middle of an accelerating US-China trade war (Hughes 2021). More recently Japan successfully hosted the G7 summit in Hiroshima with strong support for the multilateral system and a rules-based order (*East Asia Forum*, 2023).

Trade policy uncertainty

The open multilateral trading system is under threat, facing the biggest challenge since its creation in the immediate postwar period. While previous economic downturns did not substantially undermine faith in multilateral trade, the 2008 global financial crisis marked a turning point, causing a notable surge in protectionist policies, particularly in the United States and Europe (Evenett, 2019), and posing a significant threat to the established international

trade order.

The postwar economic system has, paradoxically, become a victim of its own success. Global power dynamics have shifted dramatically, largely due to Asia's economic ascent, particularly China's. China's 2001 accession to the WTO was a pivotal moment for global trade, propelling the nation to become the world's largest trading nation and second-largest economy within just ten years. China's trade grew most spectacularly with Japan and its neighbours, as regional value chains deepened economic interdependence in East Asia. While China's economic reforms and transition from central planning accelerated, progress stalled in crucial areas such as the relations between the state and market and state-owned enterprise reform.

China's weight in the global economy means that the uneven playing field in China has significant spill-overs internationally. While not all nations view China's policies as economically threatening, and the world has reaped substantial benefits from China's growth, some developed economies like Japan and the United States have come to see China's forced technology transfers, industrial subsidies, and intellectual property infringement as direct threats to their interests.

China has also deployed economic leverage and weaponized interdependence against other countries aimed at achieving political concessions, shaking the confidence of many countries in China's commitment to the spirit and rules of the multilateral trading system (Miller, 2022).

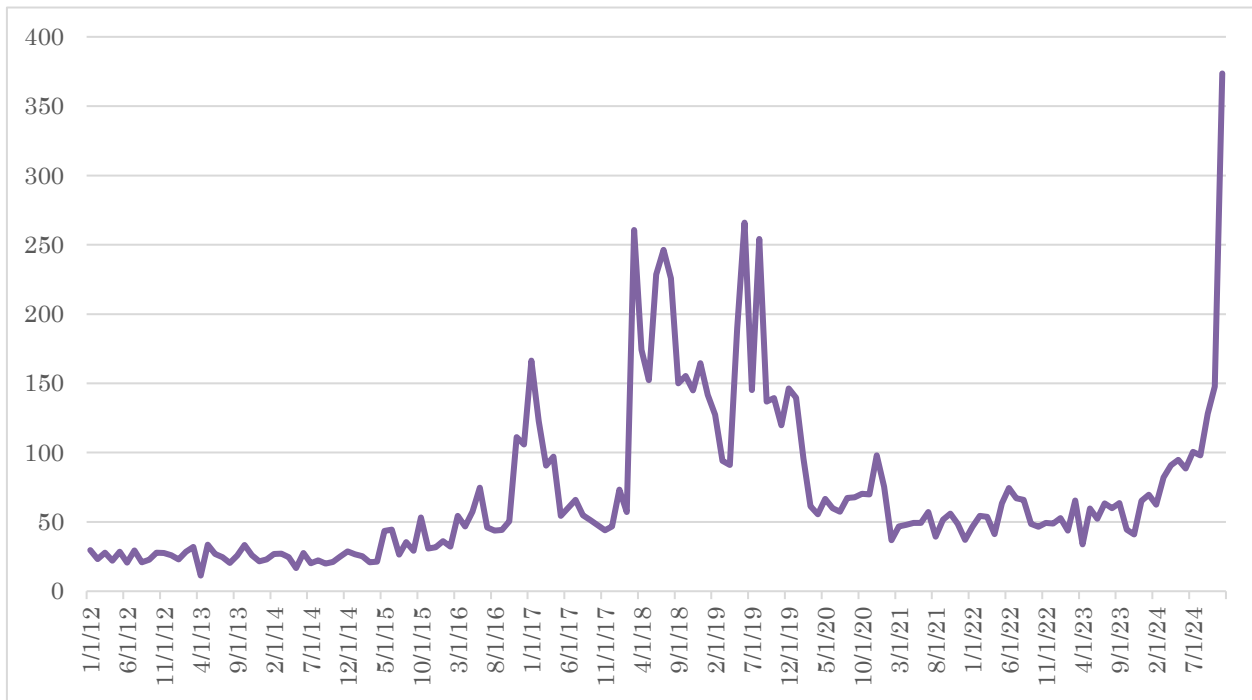
Multilateral trade rules have struggled to keep pace with the evolution of modern commerce. Advancements in rules and norms have primarily occurred through bilateral, regional, and plurilateral agreements rather than multilateral ones. The mosaic of regulations stemming from these agreements are limited in membership and inconsistent in issue coverage.

The most significant direct challenge to the multilateral trading system has emerged from

protectionist policies in the United States. This shift can be attributed to growing inequality in the United States, which intensified in the aftermath of the 2008 global financial crisis; as well as escalating strategic rivalry with China. These circumstances have been mobilised politically around a protectionist agenda and have led the United States to actively undermine the WTO. The root causes that paved the way for Donald Trump's presidency — including increasing inequality, deterioration of social safety nets and failing trust in the social contract, coupled with a national psychology shaped by the relative decline of US global influence — are deep-seated issues that will require considerable time and effort to address. This complex set of domestic and geopolitical pressures has led to a dramatic shift in U.S. trade policy, and poses a substantial threat to the established global trading order.

The uncertainty in global trade policy during the Trump presidency is captured in the Trade Policy Uncertainty Index by Caldara et al. (2020) that tracks trade policy and uncertainty terms in newspapers, in Figure 1. The monthly index averaged 28 during the global financial crisis, or 'Lehman shock', between January 2008 to December 2009, and did not rise over 37 in that period. The index did rise significantly during Donald Trump's campaign for the US presidency and period of Brexit in 2016 before increasing further during the Trump presidency. The index has spiked since Donald Trump has been re-elected in November 2024 and in December 2024 promised much higher tariffs once he is in office.

Figure 1 Trade Policy Uncertainty Index, 2012–2024



Source: Caldara et al, 2020; data from <https://www.matteoiacoviello.com/tpu.htm>

President Trump's 'America First' policy led to unilateral trade actions against China and other trading partners, sparking a trade war with China and prompting managed trade deals with Europe, Japan and other countries that contradict free trade principles. The US veto of WTO appellate judge appointments crippled the organisation's dispute settlement mechanism, rendering it ineffective since 2019. In 2023 Japan eventually signed onto the Multi-Party Interim Appeal Arbitration Arrangement (MPIA) that was created in 2020 to enforce WTO trade rules for the 56 or so WTO members that signed up to it (Pomfret, 2024).

The United States has now abused the national security exception in the WTO and trashed the WTO ruling against its protectionist tariffs in the name of national security. The WTO ruling is not enforceable against the United States given the malfunctioning dispute settlement system. This shift represents a dramatic reversal in US economic strategy and a major setback to the rules-based economic order that the United States had long championed.

Weaponised trade and economic coercion

Japan's reliance on the international market for procuring strategic raw materials was tested in 2010 when Beijing imposed an informal embargo on rare earth minerals over an incident in the East China Sea. A Chinese trawler had collided with a Japanese Coast Guard vessel near the Senkaku/Diaoyu islands and the captain of the trawler was arrested by Japanese authorities.

At the time, China had a near monopoly, producing 97 per cent of global rare earth supplies despite only having an estimated one third of global reserves. Rare earths are a group of 17 minerals that are essential for manufacturing smartphones, electric vehicles, military weapon systems and other high-tech products. Japan was the largest global customer, followed by the United States and the European Union. The alleged ban on rare earths exports is now commonly cited as an early example of China's attempted economic coercion for geopolitical purposes, although there were export restrictions leading up to the incident, casting doubt on the coercive nature of the measures (Armstrong and King, 2013).

Combined with the increased price for rare earth minerals, due to the perceived shortages and uncertainty of Chinese supply and Japanese efforts to diversify import sources, Japan's dependence on Chinese supplies fell from over 95 per cent to around 50 per cent by 2012, within two years. Japan, joined by the United States and European Union, launched a successful case against China in the WTO in 2015 with China accepting the ruling.

Since then, the low cost of rare earth minerals from China has meant Japan's dependence on China for rare earth minerals has climbed again to over 70 per cent, with even higher dependence for some rare earths. Japanese trading houses are known to be stockpiling up to 3 years worth of rare earth minerals as insurance against future supply stoppages. The Chinese government is implementing export control measures on gallium and germanium-related items,

in what appears to be retaliation against US restrictions on technology sales to China⁵. Since August 2023 China has imposed an import ban on Japanese seafood products in response to fears of contaminated water from the damaged Fukushima nuclear plant being discharged into the Ocean.

A more recent and blatant case of attempted Chinese economic coercion was in 2020 with restrictions and embargoes on Australian imports. Chinese trade measures against Australia affected exports valued at A\$17 billion or 12.3 per cent of Australian exports to China (and 4.7 per cent of global Australian exports). Although these measures were ostensibly taken on anti-dumping, phytosanitary or technical grounds, they were clearly aimed to punish Australia for political reasons.

China's attempt at economic coercion against Australia was unsuccessful both economically and politically. The economic measures China employed were largely neutralised by the multilateral trading system, which, despite its flaws, enabled Australian exporters to find alternative markets and ultimately pursue recourse through the WTO (Armstrong, 2023). The multilateral trade rules were enforceable for both Australia and China because of their common membership of MPIA.

These trade coercion measures would have inflicted significant economic damage in a world of closing markets with fewer alternative buyers or sellers. That was the world of the beggar-thy-neighbour protectionism of the 1930s where trade restrictions fed aggression, insecurity and ultimately war. The postwar economic order, negotiated in the closing stages of World War II at Bretton Woods, included the GATT to avoid a repeat of the beggar-thy-neighbour policies and weaponisation of trade of the 1930s. For both Australia and Japan, the WTO provided the exit ramp from trade coercion by China.

⁵ 'China limits exports of chipmaking metals in trade spat with U.S.', Nikkei Asia, July 4, 2023.

The politicisation or weaponisation of trade is not limited to China, however, with the United States increasingly deploying tariffs or the threat of tariffs to extract concessions from other countries. The threat of tariffs on Japanese automobiles entering the American market forced Japan into a trade agreement with the United States in 2019.

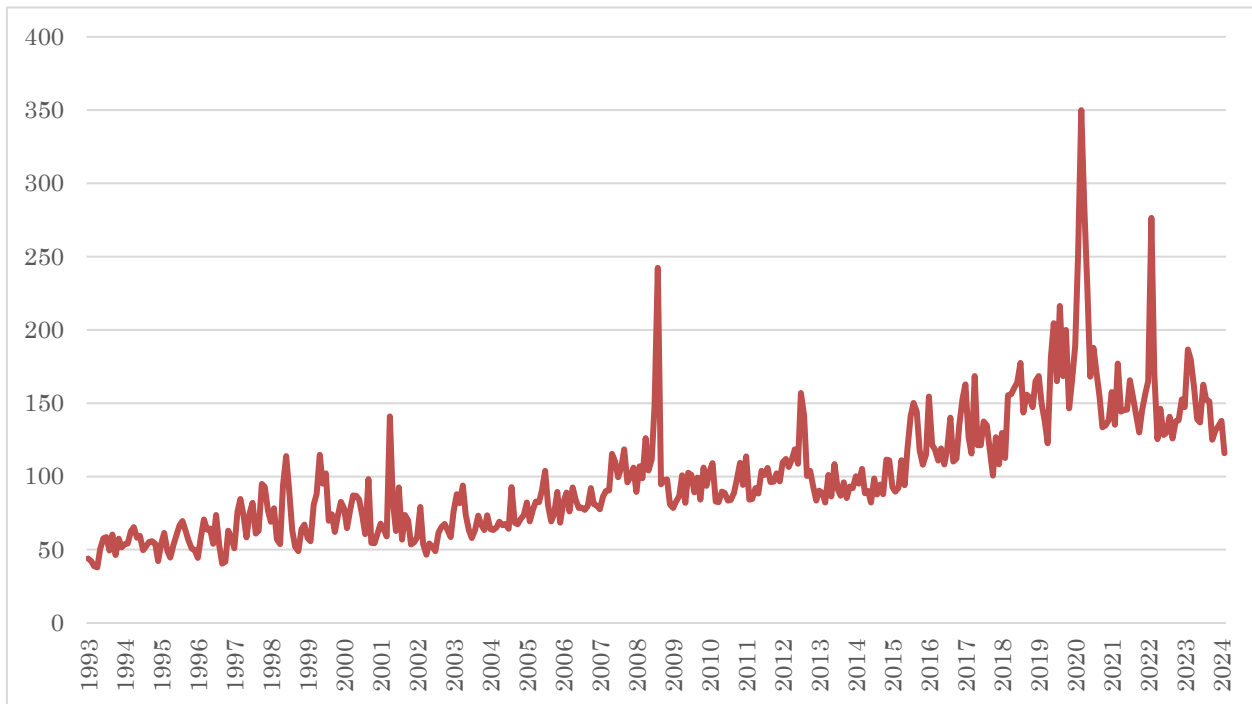
Japan is itself not entirely innocent, having tightened export control measures against South Korea in 2019 for three inputs important for Korean manufacturing of semiconductors and smartphone screens, in a manner that was widely recognised as politicised. The delisting of South Korea from a Japanese export 'whitelist' was seen as retaliation in South Korea to a South Korea Supreme Court ruling over wartime forced labour compensation, potentially impacting Japanese companies. The Japanese measures against South Korea largely backfired as some Japanese firms shifted production to South Korea and elsewhere to supply into the Korean market and the Korean government introduced measures to diversify away from Japanese supply.

Great Power strategic competition

The world's two Great Powers are locked into zero-sum strategic competition. The United States is now concerned about relative gains, trying to maintain primacy in the face of a rising challenger in China. The absolute gains of growing the US economy from trade and investment with China no longer appear acceptable to Washington if China's economy also benefits. Since President Trump's trade war with China was initiated in 2018 and saw Chinese retaliation, the trans-Pacific relationship has further deteriorated.

Rising tensions between China and the United States can be seen in Figure 2 where Rogers et al. (2024) track coverage of the bilateral relationship in leading US newspapers.

Figure 2 US-China Tension Index



Source: Rogers et al. (2024)

The Biden Administration expanded the measures aimed at slowing China’s economic rise from tariffs on Chinese imports — and in some cases expanding the scope and magnitude of those — to restrictions on access to US technology. Another imperative for the United States was to accelerate the energy transition to a decarbonised economy, and in the process out-compete Chinese progress in green technologies. In August 2022 the Biden Administration introduced the Inflation Reduction Act (IRA) and the CHIPS and Science Act, both of which affect the US economy, its engagement with the global economy and, given the size of the US economy, will reshape global trade and investment patterns. Japan, of course, was affected in a number of ways.

The IRA introduced large-scale industrial subsidies in the United States — exactly what it had been criticising China for — to develop new green technologies. These subsidies have significant global spillovers. They were discriminatory and accessible to companies from countries that had a free trade agreement with the United States, so long as the Chinese input was limited. They

are likely inconsistent with established rules in the WTO. US industrial subsidies had their economic justification given the positive externalities from renewable energies in the context of the United States not having a price on carbon. But the scale and character of the subsidies that tilted the playing field against Japanese and other automobile makers, for example, by subsidising electric vehicle manufacturing in the United States, threatened a race to the bottom. Chinese industrial subsidies already meant the lack of a level playing field for Japanese manufacturing but now US and European subsidies were threatening Japanese advanced manufacturing. Japan's response was to introduce new industrial policies with substantial subsidies.

The CHIPS and Science Act was announced to strengthen supply chains, counter China and boost the US semiconductor industry. The Act aimed at curtailing Chinese involvement in the complex global supply chains for advanced semiconductor manufacturing. This legislation marked a clear departure from previous ambiguity, explicitly forcing countries to choose between China and the United States in the semiconductor sector. US allies continuing semiconductor business with China now face the threat of sanctions. By 2022 Japan had developed the policy infrastructure to avoid being caught in secondary US sanctions against China. This was motivated by the bitter memory of heavy fines in 1987 when Toshiba was found to have violated regulations set by the US-led Coordinating Committee for Multilateral Export Controls (COCOM) against the Soviet Union.

Japan held a strong position in semiconductor materials, with an estimated global market share of 56 per cent, and in manufacturing equipment with 32 per cent of the global market in 2022 (WEF, 2023). China was the largest market for Japanese semiconductor materials and equipment exports but so far the CHIPS and Science Act sanctions appears to have had a limited effect on Japanese supply, even though it has affected Dutch and Korean supply into Chinese semiconductor supply chains (Hayakawa et al, 2022; Hayakawa, 2024).

China and the United States have embarked on decoupling that thus far has been limited to high tech sectors like semiconductors and electric vehicles, but the bounds of that decoupling are not clear and the rest of the world is being forced to make choices between China and the United States in those areas. Global supply chains have restructured with Chinese goods and capital, cut out of the US markets, now increasingly finding their way into third markets such as Mexico, India, Vietnam and Thailand and then being exported to the United States with some value-add. Other countries have seen their trade and investment with China and the United States grow as a result, with Japan and South Korea seeming to be the exceptions with their trade shares with China having fallen in 2022 and 2023.

The Japanese meaning of economic security

Increased global uncertainty and the more blatant use of economic tools and leverage by countries for political and security, or non-economic, purposes has led to the entanglement of economics and national security. This has led to the widespread use of concepts like ‘geoeconomics’ and ‘economic security’. These concepts are not new but their meanings and invocation are, with considerable confusion and inconsistency in their use. It is important to define these terms here, with a focus on the nebulous, or at least evolving, idea of economic security.

Geoeconomics is often used as a catch-all for the interplay between the economic dimensions of geopolitics as well as the recognition that both economic statecraft, global politics and national security appear increasingly inseparable. The term initially came to prominence with Luttwak (1990) describing the separation of geoeconomics from geopolitics with the relative decline in importance of military power relative to the growing importance of international commerce globally as the Cold War ended. The most widely used definition of geoeconomics is ‘the systematic use of economic instruments to accomplish geopolitical objectives’, articulated in Blackwill and Harris (2016). That provides a more precise definition that is narrower in scope

within the overlap and interplay of economics and security.

The evolution and different uses of the idea of economic security in Japan helps us understand the policy changes that are taking place today. The most fundamental meaning of economic security, while having no agreed definition, is the security of living standards, with access to income and basic needs such as health, education, dwelling, information, and social protection⁶. A more useful set of definitions for understanding Japan's economic security policies is the idea of *national* economic security which is the 'ability of a country to follow its choice of policies to develop the national economy in the manner desired'⁷. More practically, this means the protection from manipulation by other states and managing economic interdependence with caution; and management of the risks of unexpected shocks and economic volatility (Kahler, 2004).

Economic security has preoccupied national governments, particularly in Asia, due to severe and unexpected economic shocks that threaten existing social and political arrangements (Kahler, 2004). Given Japan's natural resource scarcity, the idea of economic security has long been associated with energy, resources and food dependence and security (Okita, 1978). The 1973 and 1978 oil shocks and high inflation elevated the idea of economic security in a broader conception of national security beyond military security (Satake, 2022). The Ohira government produced a report in 1980 on the idea of 'comprehensive security', acknowledging the importance of economic, food and energy security and the need for coordinated policy (Satake, 2022).

The idea of economic security in Ohira's comprehensive security report was:

1. preserving the free trade system and solving the North-South problem,

⁶ This definition is adapted from Hacker (2018).

⁷ https://en.wikipedia.org/wiki/Economic_security

2. ameliorating diplomatic tensions with some key trading partners, and
3. maintaining energy and food security.

The term economic security was explicitly being used in the 1982 Ministry of International Trade and Industry (MITI)'s Industrial Structure Council report titled 'Towards the Establishment of Economic Security.

The concept of 'economic security' appears in various editions of the *Diplomatic Bluebook*, such as Chapter 3 (b) of the 2007 publication and Chapter 3 Section 3 (d) of the 2008 version, where it addresses energy and food security concerns. Starting from the 2011 edition, 'economic diplomacy' was elevated to a full section. In 2017, MOFA, under the primary supervision of its Economic Affairs Bureau, began issuing an additional annual report titled 'Japan's economic diplomacy', complementing the *Diplomatic Bluebook*. MOFA outlines three key focus areas for Japan's economic diplomacy:

1. rule-making to bolster free and open global economic systems,
2. supporting the overseas business expansion of Japanese companies through promotion of public-private partnerships, and
3. promoting resource diplomacy along with direct investment toward Japan.

The oil shocks of the 1970s led to the diversification of energy sources for Japan away from the heavy dependence on Middle Eastern oil. More recently it has been Chinese attempts at economic coercion, first against Japan in 2010 and more blatantly against South Korea in 2016 and Australia in 2020, that has encouraged efforts to diversify trade away from high levels of interdependence with China.

The use of the term 'economic security' increased as the US-China trade war, that started in 2018, escalated. Policies and machinery of government changes in the name of economic security required a framing and definition that came in the form of a "Formulation of an Economic Security Strategy" by the then Secretary General of the ruling Liberal Democratic

Party (LDP), Akira Amari, in December 2020. The LDP formulation defined economic security as "ensuring Japan's independence, survival, and prosperity from an economic perspective" and outlined two means of achieving this: 1) strengthening the foundations essential for maintaining Japan's socioeconomic activities and ensuring that Japan is not overly dependent on other states; and 2) expanding areas in which Japan's presence is indispensable to the international community (Suzuki, 2023). Japan's economic security strategy was, as a result, organised around the two pillars of *strategic autonomy* and *indispensability*.

Policy and governance changes

The Japanese government has led other countries in explicit economic security policies and machinery of government changes to respond to the new external circumstances. The Kishida government created a Minister of State for Economic Security in August 2022 to coordinate government policy.

Changes in government machinery

Since 2019, the Japanese Government has made concerted efforts to integrate economic and national security considerations within its bureaucratic structures and decision making processes. This integration began in the Ministry of Economy, Trade and Industry (METI) that established an Economic Security Division in June 2019, led by the Director General of the Trade and Economic Cooperation Bureau. Concurrently, the Ministry of Foreign Affairs (MOFA) reorganised its National Security Policy Division under the Foreign Policy Bureau in October 2019. The National Security Secretariat (NSS) of the Cabinet Secretariat formed an Economic Security Division in April 2020. The Public Security Intelligence Agency (PSIA) created a new Project Team on economic security issues such as technology and data transfers in February 2021 (Igata and Glosserman, 2021).

The most important motivating factor for the creation of the new economic security division in the NSS was to break down compartmentalisation within the Japanese government and to facilitate a more cohesive strategy, particularly in collaborating with international partners like the United States. It was designed to provide comprehensive oversight of economic security matters across all government ministries and agencies. The economic security division is one of seven in the NSS and staffed by approximately 20 individuals from various government agencies. It was created partly in response to the need to coordinate tighter export controls on advanced technology, mirroring similar US policies.

One example of the fragmented approach to policy that prompted the establishment of the economic security division within the NSS was in assessing foreign investment where there were overlapping responsibilities and lack of coordination. The responsibility for overseeing and evaluating various technologies is distributed across different ministries. The Ministry of Finance, which oversees the Foreign Exchange and Foreign Trade Act (FEFTA), lacked the capability to assess technologies from a national security standpoint. The Ministry of Internal Affairs and Communication handled information technology, while the Ministry of Health, Labour and Welfare was in charge of regulating medical and pharmaceutical technologies.

In July 2024 METI changed the name of the Trade and Economic Cooperation Bureau to the Trade and Economic Security Bureau, and established the Economic Security Policy Division to coordinate METI's economic security measures.

Political leaders have been involved in the bureaucracy's reorganisation efforts. The LDP stated in their Basic Policy on Economic and Fiscal Management and Reform 2024 that positions related to economic security within the government should not be cut. Every five years a personnel rationalisation target will be set by the Policy on Organization and Personnel Management of National Administrative Organs (Liberal Democratic Party of Japan, 2024, p. 5). Economic security-related positions will be prioritised and this policy will be managed

separately from each ministry's personnel quota and is specifically overseen by the Cabinet Office (Liberal Democratic Party of Japan, 2024, p. 5). The National Security Secretariat leads a government effort to implement risk scenario checks across ministries through the 'Economic Security Priority Issues Study Meeting' composed of Director-General level officials from relevant ministries. The aim is to identify risks faced by Japan's important industries and check corresponding countermeasures, in order to ensure readiness in case of disruptions and overcome vulnerabilities in normal times (Liberal Democratic Party of Japan, 2023, p. 10).

In December 2020, the LDP's Policy Research Council, through its Strategic Headquarters on the Creation of a New International Order, released a set of proposals for developing Japan's 'Economic Security Strategy'. This document outlined 16 specific policies centred around economic security concerns (Igata and Glosserman 2021, 30).

Economic security policies

In 2020, Japan revised its FEFTA, intensifying scrutiny of incoming FDI. The amendment reduced the threshold for stock acquisition triggering pre-investment notification from 10 per cent to 1 per cent in designated sectors. While exemptions were provided based on investor type and level of managerial control, the reform significantly expanded oversight of foreign investment, affecting 56 per cent of listed Japanese companies operating in these designated sectors (Armstrong and Urata, 2021). This heightened screening aimed to serve two purposes. First, it aimed to protect sensitive technologies from foreign acquisition that could pose national security risks, and second, it aimed to align Japan's regulatory framework with similar regimes of partner nations⁸.

This policy shift reflects Japan's efforts to balance openness to foreign investment with growing

⁸ The new regulations have been applied to designate 7 and i Holdings, the owner of the 7 Eleven convenience stores, as 'core' to national security to raise the hurdles of potentially being acquired by a Canadian company.

national security concerns, mirroring similar trends in other advanced economies. The Japanese economy has low levels of foreign direct investment, ranking close to last globally with inward FDI stock relative to the size of its economy. Increasing FDI has been a policy priority to encourage economic dynamism. The reforms to tighten FDI screening fell short, however, in securing Japan the status of an "exempted foreign state" under the Committee on Foreign Investment in the United States (CFIUS), highlighting the challenges in implementing such policies effectively and consistently with international partners (Armstrong, Solis and Urata, 2024).

In May 2022, the Japanese government passed the Economic Security Promotion Act to extensively and actively promote 'economic measures for national security' (Koyu et al. 2022). The purpose of the Act was to prevent 'economic activities that cause harm to the security of the nation and its citizens' and covered a wide range of economic activities. The Economic Security Promotion Act consists of four pillars:

1. Framework for Ensuring Stable Supply of Key Products
2. System on Ensuring the Stable Provision of Essential Infrastructure Services
3. Framework for Enhancing Development of Advanced Critical Technologies
4. Non-Disclosure of Selected Patent Applications

The first pillar introduced new legal provisions within the National Security Strategy framework designed to reinforce supply chain resilience and reduce excessive reliance on particular countries for critical resources and technologies (Suzuki, 2023). A support framework was introduced, which includes financial assistance through loans to aid private sector companies in bolstering their domestic production capabilities, the most prominent thus far are the subsidies for the semiconductor industry. The first pillar identifies 11 key items as critical commodities, encompassing semiconductors, storage batteries, permanent magnets, and components for aircraft manufacturing, and had private sector and academic input into the

drafting of the Act (Suzuki, 2023; Vekasi, 2023). One of the main purposes of the Act is to protect Japan from economic coercion to avoid a repeat of the 2010 informal rare earth mineral export embargo by China, or more recent episodes globally. Companies in the 11 sectors have access to government financial assistance if they submit plans to diversify sources or stockpile goods.

There is, however, no Japanese policy aimed at decoupling from the Chinese economy, with regional integration continuing to deepen economic ties with China through participation in agreements like RCEP, while economic security policies attempt to achieve diversification away from China (Vekasi, 2023). Economic security policies are also not explicitly or exclusively about China, with Japan's unprecedented sanctions on Russia in response to its invasion of Ukraine coinciding with increased use of export controls and restrictions on investment.

In 2024 Japan was still heavily reliant on Chinese sources, like much of the rest of the world was, for rare earth minerals, and had a higher reliance on China than the G7 average for machinery, organic chemicals, and electric products (Armstrong, Solis, Urata, 2024; METI, 2024). That high reliance is unlikely to change, due to the concentrated nature of the industry and Japanese firms' close relationships with their Chinese suppliers, even as the Japanese government works with other governments to create alternative supplies.

The 'critical infrastructure' second pillar requires new pre-screening and notification before the installation of key facilities or outsourcing of key maintenance or management in sectors ranging from electricity distribution; railways and cargo transport; air transport and airports; telecommunications; banking, fund transfer, insurances and financial markets; and payment systems.

The third pillar, to enhance the development of advanced critical technologies, has seen a new 'mission oriented' industrial policy implemented by METI to achieve former LDP Secretary

General Amari's goal of making Japan *indispensable* globally. In October 2022 the Japanese government identified 20 technologies as critical in areas ranging from biotechnology; artificial intelligence and machine learning; cyber security; and transport technology. One of the critical technologies is microprocessor and semiconductor technology, also specifically listed in pillar one of the Act, where most of the subsidies have thus far gone.

Over a three-year period ending in April 2024, subsidies totaling 3.9 trillion yen (approximately US\$25.5 billion) were allocated to the semiconductor industry, which is the equivalent of 0.71 percent of Japan's GDP. Over half of the Japanese government subsidies have gone to two initiatives: bringing the world-leading Taiwan Semiconductor Manufacturing Company to Kumamoto in Kyushu, Japan (1.2 trillion yen, or US\$7.8 billion) and the creation of Rapidus, in partnership with eight existing Japanese companies (920 billion yen, or US\$6 billion). TSMC will manufacture legacy semiconductors while Rapidus aims to manufacture cutting edge semiconductors thus far only made in Taiwan by TSMC, by 2027. These are some of the largest government subsidies to the semiconductor industry globally and there is no guarantee of success, especially for the unproven Rapidus (Armstrong, et al. 2024).

The fourth pillar on 'secret patents' restricts disclosure of patents in 25 technical fields that can be used for military purposes or that might undermine security.

In May 2024 the government established a 'security clearance' system that allows the government to classify information as critical on economic security grounds. The security clearance system allows critical government information to be shared with the private sector while preventing the information from being leaked overseas. Security clearance systems have existed in many countries and these measures are seen as catch-up measures by the Japanese government, although their implementation and maintenance will require proper governance to avoid abuse and unintended consequences.

Armstrong et al (2024) summarise surveys of firms in response to the new economic security laws of 2022 and their understanding of the risks they face. The results are mixed, with responses differing largely depending on firm size. For example, 60 per cent of larger firms reported they have ‘good understanding’ of the ESPA while 75 per cent of small and medium size enterprises indicated they are ‘not knowledgeable nor interested’ in ESPA (JCCI, 2023). Only 9.3 per cent of large firms responded that they had not implemented policies to deal with economic security risks while over half (56.5 per cent) of SMEs had not.

Many companies responded in surveys that they are interested in the government providing further information and, unsurprisingly, financial support to make their supply chains more resilient. There is no doubt a role for the government in helping Japanese companies manage systemic risks and respond to shocks, but the question is the costs to businesses and the Japanese taxpayer.

Concluding questions

It is too soon to make any comprehensive assessment of the effect of the new economic security policies on Japan’s private sector and economic openness and dynamism more generally. There is widespread acknowledgement that the measures in the Economic Security Promotion Act (ESPA) and related policy measures will be costly for business but may be necessary for national security, and some of the costs are offset with limited subsidies. These propositions should be assessed as more data become available. The costs to business, the economy and Japanese welfare could eventually be substantial if de-risking efforts to reduce economic integration with China gain momentum. And the proposition that they make supply chains and the Japanese economy more secure should be scrutinised.

Without any alternative diplomatic initiative, Japan’s uncertain external environment appears likely to continue to deteriorate. The economic security policies that have been implemented

could help Japanese companies and manage the risks and shocks, or they could exacerbate the retreat to closed markets, restrictions on commerce and further add to regional uncertainty. Japan's choices are consequential for the broader region and global order, not just for Japan.

A key question for the Japanese economy going forward, therefore, is to the extent of policy-induced reduction to interdependence with China and what costs that entails. Already Japanese FDI to China is declining and China's trade share in Japan's total trade has declined. That is due in part to several cyclical and structural factors in China as its economy matures. Trade shares were unlikely to continue to grow indefinitely but Japanese (and American) policy has likely contributed to this trend as well, with impediments and subsidies targeting diversification away from China. Chinese policies have caused uncertainty for Japanese companies investing in China, including with the detention of several Japanese nationals from business and academia on espionage and other charges. There is now a question as to whether the large and important economic relationship between China and Japan is less market driven and entering a new era of diversification away from comparative advantage and economies of scale in the name of national security.

Drastically reduced trade shares between China and Japan raises a legitimate question as to whether that reduces or increases risks in dealing with a neighbouring Chinese economy. Japan has long championed China's inclusion in the rules-based economic order to help manage the bilateral relationship and the Chinese — as the largest trading nation with no formal allies — have a demonstrated stake in that system of rules and norms, including by signing on to MPIA. Despite the challenges and threats to the WTO, it has provided the exit ramp for Japan (and Australia, another important US ally) from Chinese economic coercion.

What is not clear in Japan's new economic security policies is the priority attached to defending the 'open global economic system', an explicit goal in the MOFA diplomatic bluebook, or 'preserving the free trade system' that was central to economic security in Ohira's

comprehensive security report. The free trading system has been a critical source of Japan's economic security to date, and continues to be, but its foundational role is now little acknowledged and less emphasised.

Economics and security have always been entwined in the service of each other but the postwar trade and economic order with its organising principle of most-favoured-nation treatment and disciplines on discrimination was framed to constrain the exercise of raw political power in the conduct of international commerce. China's rise is disrupting markets and brings with it risks, but its rise has contributed to prosperity, with its raw political power constrained thus far. China's signing onto the rules and norms of the economic order in its accession to the WTO has, despite all the problems, succeeded in shaping its rise for the better.

While explicit support for the WTO and multilateralism may be missing from Japan's new economic security policies, Japan did eventually join MPIA in 2023 — effectively so that it could deal with a trade dispute with China over steel imports — and championed the open rules based system as a source of economic security when it hosted the G7 in Hiroshima in the same year. Importantly, Japan decided against a G7 anti-coercion instrument being pushed by the United States aimed at China that would have further weakened and fragmented the rules-based multilateral trading system.

The US-led rules-based multilateral trading system allowed the separation of economic and trade policy largely from considerations of national security, or at least did not allow the latter to dominate considerations of the former (Cooper, 1972). The Ohira report blurred the boundaries between 'high politics' associated with national security, sovereignty and military strategy, and 'low politics' concerned with the economy, energy supply and social affairs (Satake, 2023), to have trade and economic policies contribute to national security.

The key question for Japan now is whether its strategic approach assumes, at the margin, or in

new policies, prosperity and security are substitutes where economic efficiency has to be sacrificed for national security, as its new economic security policies appear to do for now, or whether it can instead advance a strategy and policies that see prosperity and security as complements to the achievement of both. The external environment and regime matter for a return of confidence in a rules-based multilateral trading system to mitigate risks to once again allow the separate pursuit of economic gain from considerations of national security. That would allow economic integration and high trade shares to grow without commensurate growth in security risks. But without that confidence, high trade shares (concentrated markets) are susceptible to become weaponized and may be viewed as a risk to economic security. Japan is a leading middle power that has agency and can shape its external environment with other middle powers and third nations.

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