

Part I: Escalating Uncertainty at a Critical Juncture of the International Economic Order

[A Vulnerable Global Economy and the Tariff Shock]

In 2024, the global economy showed a solid growth rate of 3.3%, but it was characterized by a vulnerable structure heavily reliant on U.S. growth. Amid the post-pandemic economic downturn, underconsumption in China became apparent, leading to an expansion of deflationary exports accompanied by falling unit prices and the stagnation of imports, which have become destabilizing factors for the global economy. The tariff shock in April 2025 significantly amplified policy uncertainty in addition to the hike in tariffs itself, worsening the global economic outlook. The twin deficits of the U.S. current account and fiscal balance underlie this situation.

[Heightening Uncertainty]

Besides the reduction of trade and investment barriers, one of the most indispensable values embedded in the post-war rules-based international economic order is the fundamental concept of being rules-oriented, which has dramatically improved predictability in cross-border business. In recent years, transitions in the international environment—notably 1) protectionism and trade conflicts, 2) risks of overcapacity and overdependence, 3) geopolitical risks and perceptions of economic security, 4) shifting power balances involving Global South countries, and 5) diverse responses to digitalization and green transitions—are heightening uncertainty and shaking the rules-based international economic order.

Part II: Inclusiveness, Economies of Scale and Asymmetric Dependence, and Service Value Added

Chapter 1: Structural Changes Facing the International Economic Order

[Widening Inequality and Social Divisions]

The trends mentioned above are underpinned by medium- to long-term changes in the international political and economic structure. First, dissatisfaction with globalization during the post-Cold War era has led to increased support for protectionist trade policies, as it has widened disparities within and between countries. Over the past 30 years, while global income levels have generally improved and absolute poverty has decreased, China Shock studies have pointed out that the surge in imports from China has adversely affected certain regions and workers, particularly in the U.S. Generally, technological innovation and automation have a greater impact on the labor market than trade or immigration, but dissatisfaction against the shocks brought about by globalization is often linked to the aspects of culture, values, and identity, making them more likely to lead to support for protectionist trade policies. On the other hand, attention must also be paid to domestic disparities in exporting countries. China's export-led growth has contributed to domestic inequality, which has become a foundation of the current structure of underconsumption. It is essential to enhance public support for fair trade policies and complementary domestic policies, thereby strengthening the rules-based international economic order.

[Digitalization Transforming Cross-Border Transactions of Services]

Second, digitalization is advancing the integration of manufacturing and services, as well as cross-border transactions of digital-related services, thereby changing patterns of trade and investment. Over the past 20

years, the growth rate of the services trade has outpaced that of the goods trade, driven by digital-related services. Digitalization has led to the expansion of various cross-border transactions of services including services that are intermediate inputs to goods, increasing the need for integrated analyses of trade and investment in goods and services. The location and intellectual property (IP) strategies of global Big Tech companies affect global trade flows in digital-related services. In this context, international efforts toward Data Free Flow with Trust (DFFT) and data security/cybersecurity are progressing.

[Green Transition and Trade]

Third, climate change and other global environmental issues are creating a trend toward green transitions, necessitating trade policies that contribute to these transitions. The relationship between trade and the environment has long been debated, but in light of efforts toward carbon neutrality following the Paris Agreement on climate change, trade policies are expected to play a significant role in addressing global environmental issues. Specifically, discussions are ongoing regarding the promotion of trade in environmental goods and services, trade-related climate measures such as the Carbon Border Adjustment Mechanism (CBAM), standards and regulations related to the measurement and evaluation of carbon emissions, and trade policies that contribute to the transition to a circular economy.

[Supply Chain Resilience and Critical Minerals]

Fourth, the rising awareness of economic security has created a policy need to strengthen supply chain resilience, particularly regarding critical minerals essential for green transitions. While companies face various supply chain risks, governments have been advancing initiatives to strengthen supply chain resilience to address emerging risks disrupting a stable supply, thereby affecting the entire economy. Critical minerals, which are essential for green transitions and digitalization, are often geographically concentrated for extraction, refining, and processing, leading to increased uncertainty in supply chains, in part due to strengthened control by resource-exporting countries. Various initiatives are being undertaken by interested countries and through international forums.

[Industrial Policy and the International Economic Order]

Fifth, there is a need to promote new industrial policies that connect efforts to address the aforementioned socio-economic challenges to industrial development, while also addressing the impact of certain industrial policies on trade and investment relations, and ultimately on the international economic order. New industrial policies that view government and market as complementary and address socio-economic challenges, including through horizontal policies, are being discussed and formulated in Japan and other major countries. This trend is partly underpinned by the awareness that the current international economic order is unable to address issues such as market-distorting measures, non-commercial behavior of state-owned enterprises, and the weaponization of economic dependencies. In light of the potential negative externalities of certain industrial policies, it is important to enhance transparency in industrial policies, promote constructive policy discussions, build trust, and foster international cooperation among countries to strengthen the rules-based international economic order.

Chapter 2: The Impact of China's Industrial Development on Trade and Investment

[China's Industrial Fundamentals]

During the era of globalization after the Cold War, China has had the most significant impact on the transformation of the global trade and investment structure. China's rapid industrial development across a wide range of sectors is supported by industrial fundamentals reflected in economic scale (market and production capacity), industrial sectors and enterprise attributes, competitive environments, technologies, and industrial financing. China's manufacturing value added is now overwhelmingly the highest in the world, and Guangdong and Jiangsu provinces alone generate manufacturing and mining value added equivalent to that of Japan.

[China's Industrial Development Mechanisms / Case Studies of Specific Industries]

The three aspects of China's industrial development mechanism—a political-economic model, competition among local governments, and market characteristics—play different roles depending on the industry. This can be observed in industries that have developed, such as *shanzhai* (unofficial imitation) mobile phones, wind power, solar power, and electric vehicles. At the market level, it is argued that economies of scale are constructed through active corporate entry and competition, efficient supply chain construction, and social implementation and learning effects. At the same time, while the reality of China's industrial policies remains largely unclear, they are estimated to be broader in scope and larger in scale compared to other countries. Despite ongoing debate over whether China's industrial policies have improved productivity, there appears to be a shared understanding that they have created international negative externalities.

[The Impact of Industrial Development on Trade and Investment]

China's industrial development progressed alongside a rapid expansion of exports until the global financial crisis, and export volumes have continued to increase since then. During this period, economies of scale have been established in various industries, leading to the creation of new export items. Additionally, while China's foreign direct investment (FDI) in developed countries has stagnated, there has recently been a rapid increase in FDI toward ASEAN countries and countries along the Belt and Road Initiative. The expansion of China's exports has led to international trade frictions in recent years. To improve this situation, it is crucial to make constructive efforts to enhance transparency in industrial and trade policies, to promote international trust-building, and to ensure fair competition conditions. Issues such as the lack of transparency in policies and government support, the scale of industrial policies, non-commercial behavior of state-owned enterprises, the preferences for domestic production and products (e.g., government procurement, standards and certification), and concerns relating to intellectual property should be addressed. The requests for improvements regarding fair competition environments, market access, predictability and transparency and so forth from the Japanese, U.S. and EU chambers of commerce in China should be taken into account.

[Trade and Investment Relations of the Republic of Korea, ASEAN Countries, and India]

In response to environmental changes such as the expansion of China's exports and FDI and U.S.-China trade friction, neighboring Asian countries, including the Republic of Korea (ROK), ASEAN countries and India, have shown different responses. The ROK has shifted its exports and FDI toward the U.S. ASEAN countries have generally maintained an omni-directional posture and experienced economic growth. India aims to nurture domestic manufacturing through protectionism but struggles to balance trade and investment relations. A common trend among neighboring countries is the deepening dependence on imports from China.

Chapter 3: The Transformation of Japan's Trade and Investment Structure

[International Balance of Payments Structure / Trade in Goods]

Amid changes in the international political and economic structure, Japan's trade and investment structure is also transforming. The trade balance has become more susceptible to fluctuations in raw material prices and exchange rates. Over the medium- to long-term, Japan's share of global goods exports has gradually decreased, and recent export volumes and dollar-denominated export values have also declined. Furthermore, there have been no significant changes in major export items, and nearly all of them have seen a decrease in global market share. It is necessary to create innovations achieving higher value added and develop new export products, companies and markets, thereby improving the terms of trade.

[Cross-Border Transactions of Goods and Services]

When looking at the overall exports of goods and services based on value added in 2020, the value added from domestic service industries, such as wholesale and retail, specialized business services, and information and communication, accounts for 46.4%, which is larger than that from domestic manufacturing, which accounts for 38.2%. As the integration of manufacturing and services progresses, enhancing the service value added, such as software, as an intermediate input for goods contributes to exports of both goods and services. Additionally, non-manufacturing overseas local subsidiaries established by Japanese manufacturing companies account for about 30% of the sales of overseas local subsidiaries, indicating that service value added is becoming increasingly important in the overseas expansion of manufacturing. It should be noted that the digital trade deficit is on the rise not only with the U.S. but also with countries like Singapore, where local subsidiaries of global Big Tech companies are located.

[Global Strategies of Manufacturing and Content Industries]

A questionnaire survey of manufacturing companies with overseas bases indicates that many have investment plans in India, Japan, and the U.S. over the next three years. China, where the business environment is deteriorating, attracts fewer investment plans. In ASEAN countries, which are traditional manufacturing bases for Japanese companies, investment momentum seems to be somewhat sluggish. Large companies recognize market expansion in emerging and developing countries, along with the need to address social challenges such as decarbonization, as an opportunity for global corporate growth, drawing attention to the potential for co-creation with Global South countries. While the agglomeration of technological know-how in Japan is seen as an advantage, challenges such as capital investment costs (including construction costs) and securing human resources are recognized.

Opportunities for the overseas expansion of the content industry are further growing after the pandemic. The content business involves various cross-border transactions, which are combinations of trade in goods, services and licenses, as well as direct investments, including whether or not to engage with overseas platform companies. Japan has strengths in content production, but it is crucial to identify content that will be accepted in foreign markets and to maximize its value while managing its quality properly. There is an increasing need for policy support with regard to localization and cultural adaptation, sharing the latest overseas information, engaging with local regulatory authorities, addressing issues of counterfeiting and piracy, and supporting small businesses.

In recent discussions regarding Japan's balance of payments structure, there have been arguments that the repatriation of dividends from FDI to Japan is low from the perspective of exchange rates and international cash flows. However, the rate of dividends from FDI that is repatriated to Japan is comparable to that of other developed countries and the rate of dividends from domestic investments. This suggests that repatriation is not scarce from the perspective of the real economy or business. Additionally, the rate of profits from FDI stock, including past reinvestments, has been on an upward trend in the medium- to long-term—suggesting that the reinvestment of profits locally is also a source of future earnings. While promoting domestic investment, the benefits of FDI should be evaluated not only in terms of direct dividend repatriation but also in regard to its impact on wages and employment, the incorporation of innovation, ensuring autonomy through supply chain diversification, and building win-win relationships with partner countries.

[Co-Creation with Global South Countries]

Japan has historically built strong socio-economic cooperative relationships with ASEAN countries, contributing to local employment, industrial and human resource development, and policy formulation over the long term, thereby gaining a high level of trust. The countries referred to as the Global South are diverse, and it is important for Japan as a co-creation partner to adopt a collaborative approach to address the socio-economic challenges faced by each country. Through such co-creation, Japan can establish win-win relationships and benefit from the growth potential of these countries, gain market access for Japanese companies, enhance innovation within Japan, and strengthen supply chains.

Part III: Strategy and Policies

Chapter 1: The Direction of the International Trade and Economic Strategy

Japan's international trade and economic strategy aims to maximize Japan's value-added in the world by solving global challenges and by remaining a reliable economic partner even in an uncertain world. In light of the changes in the international environment, it is necessary to respond to fluctuations in the international economic order and ensure autonomy and indispensability amid rising protectionism. In addition, we need to take actions to explore overseas markets through exports and foreign investments to maximize Japan's value added, addressing the intensifying competition surrounding Global South countries and the advancements in DX (Digital Transformation) and GX (Green Transformation). The following three points outline the direction of international trade and economic policy.

[Response to Fluctuations in the International Economic Order Amid Rising Protectionism]

To respond to fluctuations in the international economic order, Japan will maintain its stance as a reliable partner in the international community while engaging in multi-layered economic diplomacy through building win-win relationships with various countries and working to strengthen the international economic order.

[Co-Creation with Global South and Like-Minded Countries for Incorporating Overseas Vitality and Promoting Exports]

Regardless of the status of international order, with the aim of maximizing value added through addressing global challenges such as DX and GX, and incorporating overseas vitality, Japan should focus on securing and diversifying export markets based on the enhancement of domestic investment, as well as supporting the

high value-added activities of Japanese companies through co-creation with Global South and like-minded countries via foreign investment.

[Foreign Economic Policies for Strengthening Supply Chain Resilience]

Even amid rising protectionism and the emergence of threats from overcapacity and overdependence, it is essential to enhance supply chain resilience, strengthen autonomy (e.g., ensuring a stable resource supply), and secure indispensability regarding technology and business. Japan will promote integrated efforts both domestically and internationally including policy coordination with like-minded countries, domestic institutional development, and overseas business expansion to ensure economic security.