Introduction of the White Paper on International Trade and Economy 2018

Part I Global economy

■Chapter 1 Trends in the global economy and Japan’s external trade and investment

□ According to the International Monetary Fund (IMF), the real growth rate of global GDP in 2017 was 3.8%, the highest since 2011, mainly due to the recovery in global trade . Regarding future risks for the global economy, the IMF expresses concern over negative effects of the introduction of protectionist measures on trade and investment.

□ According to the World Trade Organization (WTO), the “slow trade” phenomenon (which refers to trade in goods growing at a lower rate than the real GDP growth rate) continued from 2011 to 2016, but has resolved in 2017, and the growth rate of trade in goods is expected to continue to be higher than the real GDP growth rate in 2018.

□ There are concerns that due to of the narrowing of the interest rate spread between the United States and emerging economies due to the normalization of the U.S, and European monetary policies, capital flight from emerging economies will accelerate, leading to a slowdown of emerging economies. However, unlike the time of the taper tantrum in 2013, a rapid change in the market cannot be observed. The reasons include (A) that based on the lesson of the taper tantrum, the Federal Reserve Board (FRB) is carefully implementing its monetary policy while maintain sufficient communication with the market and (B) that the fundamentals of emerging economies have stayed stable. However, a careful watch needs to be kept on future developments.

□ In 2017, Japan recorded a current account surplus of 21,951.4 billion yen, the second largest ever after the surplus in 2007. The main factors behind the growing surplus are the steep increase in the surplus in the primary income balance and the smallest-ever deficit in the services account balance.

■Chapter 2 Economic trends and external economic policies in major countries/regions

< United States >

□ The U.S. economy is recovering steadily, as indicated by the fact that the U.S. real GDP growth rate in 2017 accelerated by 2.3% compared with the previous year.

□ Because of the steady recovery in the U.S. economy and the moderate recovery in the global economy, the value of U.S. trade increased in terms of both imports and exports, with the goods and services trade deficit in 2017 rising to the highest level since 2008. Some of the trading partners which the United States has trade deficits are, China, Mexico, Japan, Germany, and Viet Nam. China accounted for around half of the overall U.S. trade deficit, and was a record high.

□ In February 2018, the Office of the U.S. Trade Representative announced the “2018 Trade Policy Agenda”. This features the following five pillars: (A) a trade policy supporting national security, (B) strengthening the U.S. economy, (C) negotiating better trade deals that benefit all Americans (including renegotiating NAFTA), (D) aggressive enforcement of U.S. trade laws (Section 301 of the Trade Act, Section 232 of the Trade Expansion Act, etc.), and (E) reforming the multilateral trading system.

< Europe >

- □ The euro-area economy is steadily growing against the backdrop of the firmness of domestic demand and the global economy. In 2017, the real GDP growth rates of all major European countries were higher than 1%, and the euro-area economy as a whole recorded an annual growth rate of 2.4%, higher than that of the previous year.
- □ In order to mitigate the effects of tariffs and non-tariff barriers to be caused by Brexit, business communities in various countries are calling for the governments of the United Kingdom and other EU member countries to take actions. According to a questionnaire survey conducted with Japanese companies operating in Europe, more than 80% of manufacturing companies are concerned about the effects of the tariffs. Around 40% of manufacturing companies are concerned about non-tariff barriers and around 30% are concerned about standards and certification.
- □ The EU are making active efforts to conclude trade agreements with countries/regions outside the EU region. Among those efforts are the EU-Canada Comprehensive Economic and Trade Agreement which started in September 2017 on a provisional basis, and the Japan-EU Economic Partnership Agreement (EPA) which the negotiations were concluded in December of the same year. The Japan-EU EPA promotes high-level, mutual liberalization regarding tariffs and non-tariff barriers and commits to the protection of workers' human rights and environment. Amid the spreading of protectionism, these agreements are expected to serve as role models for open and fair trade and investment rules.
- □ The EU places emphasis on free trade and also maintains an open approach to inward direct investment in principle. However, against the backdrop of an increase in investments by countries outside the EU region to obtain important technologies and infrastructure in the region, , the European Commission proposed a directive in September 2017. This directive aims for the establishment of a framework for exchange of information between member countries and the submission of opinions concerning foreign direct investments in the EU region.

< ASEAN and India >

- □ In 2017, ASEAN marked the 50th anniversary since its foundation , and is promoting systems and policies to achieve further economic integration in order to maintain and increase its presence as a competitive regional economy. Although intra-regional trade and direct investments are growing steadily, growth is weakening in some areas.
- □ Vertical trade (division of work) accounts for a large portion of trade between ASEAN and China, but horizontal trade (division of work) in IT-related products has rapidly developed since the beginning of the 2000s. In particular, ASEAN's exports to China are heavily dependent on electrical machinery parts. The trade structure may further change significantly if in-sourcing proceeds in China in the future.
- □ The Indian government led by Prime Minister Modi is promoting an ICT policy called "Digital India" as the centerpiece of its structural reform. As a result of the abolition of high-denomination banknotes, cashless payment has spread widely among the Indian population along with various e-payment services.
- □ The market for "m-commerce" (e-commerce using mobile equipment) is also rapidly expanding. In 2024, India is expected to overtake Japan and become the second largest e-commerce market in the

Asia-Pacific region and the fourth largest in the world.

< Central and South America >

□ The "Pacific Alliance" and "Mercosur", which are regional economic unions in Central and South America, together account for around 80% of the population in this region and around 90% of both GDP and the value of exports.

□ One distinctive feature of the Pacific Alliance is member countries' strong intentions towards free trade. In March 2017, in order to strengthen its partnership with Asia-Pacific countries, the Pacific Alliance announced of giving the status of "associate member" to countries wishing to realize high-level agreements with the Alliance at an early time. Negotiations started with the first "associate members" namely Canada, Australia, New Zealand and Singapore, which are member countries of TPP11.

□ Mercosur was lagging behind the Pacific Alliance in free trade agreements with countries and regions outside Central and South America. However, as governments changed from left to center-right for Brazil in 2016 and Argentine at the end of 2015, there are moves to expand and deepen trade relationships. This move is represented by the resumption of free trade agreement negotiations with the EU in October 2016.

< Russia and Central Asia >

□ In 2017, the Russian economy grew 1.5%, recording the first positive growth in three years, mainly due to a recovery in oil prices. Russia's economic conditions are prone to be affected by oil price movements, as mineral fuels account for around half of the country's exports. For this reason, Russia is strengthening its economic relationship with the Asia-Pacific region from the viewpoint of foreign policy, and also to increase sales channels of mineral fuels in expanding markets, shifting away from the mature market of Europe.

□ In 2000, Central Asian countries' trade structure was strongly linked with Russia, and depended around 20% of their export on Russia. However, since 2009, their export dependency on China has been higher than that of Russia. The dependence on China has also increased regarding inward foreign direct investments to Central Asian countries.

< Middle East and Africa >

□ The oil-producing countries of the Middle East, whose economic structure continues to depend on mineral fuels, have been saddled with a large budget deficit in line with a rapid decline in the trade surplus since 2014, when crude oil prices fell steeply. Although crude oil prices are gradually recovering since 2016 mainly due to the OPEC agreement on oil production reduction, many countries/regions have not yet achieved budget surplus. The oil-producing countries are carrying out reform initiatives, including Saudi Arabia's "Saudi Vision 2030", to realize an industrial structure to avoid being dependent exclusively on oil so that they can establish sustainable economic and social systems.

□ In Africa, we can see vigorous movements to promote intra-region trade. This is represented by the initiative to establish the African Continental Free Trade Area (AFCFTA), which would be comprised of 55 countries/regions affiliated with the African Union. The negotiations launched in 2015, and an agreement on the establishment of AFCFTA was reached at the 10th negotiating forum in March 2018, with a view to putting the agreement into effect by the end of 2018.

Part 2 Analysis: Significant shift in the global economy

■Chapter 1 Expanding digital trade

□ The scale of the global cross-border EC market, which was 236.0 billion dollars in 2014, has continued expanding since then and is expected to reach 994.0 billion dollars in 2020. The number of cross-border EC users, which was around 300 million in 2014, is expected to approximately triple to 900 million in 2020.

□ In line with the expansion of digital trade, global companies providing IT platforms for EC and cloud computing services are increasing their presence. In 2008, telecommunications companies, as well as banks, and oil and gas companies, dominated the top 10 rankings of companies in terms of market capitalization. As of January 2018, however, six of the top ten companies are IT platform giants.

□ The promotion of the free flow of information is developing a favorable cycle that creates new technical innovations and business models and is improving the quality of people's lives. On the other hand, data protectionist regulations that impedes free cross-border data flow have increased rapidly over the past 20 years, including data localization regulation, requirement for the adoption of mandatory security standards, and requirement for source code disclosure.

□ There are estimation showing that when a country introduces new regulations related to data, the GDP of that country is expected to be negatively impacted.

□ Other challenges include securing fair competition between IT platform providers and existing industries, and ensuring the protection and safety of consumers.

■Chapter 2 Rise of emerging and developing economies

□ The contribution by advanced economies to the real growth rate of global GDP has been gradually declining since around 2000, while the contribution by emerging and developing economies has been increasing. The share of emerging and developing economies in nominal global GDP has been increasing since mid-2000s and has recently surpassed 40%.

□ In line with the growth in fixed capital formation, emerging and developing economies have significantly increased the production capacity of the raw materials industry. For example, while production capacity for steel has stayed at around 600 million tons in advanced economies over the past 17 years, capacity in emerging and developing economies has continued to grow. In 2017, global production capacity increased to 2,300 million tons, around 2.3 times the capacity in 2000. Among emerging and developing economies, China has increased its production capacity remarkably.

□ Focusing on the Chinese steel industry as an example of excess production in emerging and developing economies, the history of the excess production in China can be broadly divided into four stages. In the first stage, mainly state-owned banks increased low-interest loans to steel producers, which expanded production capacity, leading to a rise in the return on assets (ROA). In the second stage, while excess supply arose in China, steel producer' borrowings and production capacity continued to increase, leading to a decline in the ROA. In the third stage, while many steel companies recorded operating losses, the losses were covered by significantly increased government subsidies. As the fourth stage, the central government recently set a reduction target for production equipment and strictly managed implementation of the target. The reduction target was achieved as a result.

□ Most of the support measures such as loans from state-owned banks and governmental subsidies are provided to steel companies owned/controlled by local governments, with relatively low operational efficiency.

□ The rapid expansion of capital investment from governmental support can also be observed in China's integrated circuit (IC) industry, and there are concerns of an future excess production capacity problem.

■Chapter 3　Rapid change in the Chinese economy

< Advance of new industries >

□ Looking at China's GDP from the view point of demand, the share of exports in GDP has declined since the global financial crisis of late 2000s. The share of gross capital formation has decreased since the 4-trillion-yuan economic package, while the share of final consumption has been growing moderately.

□ Breaking down the 2017 real GDP growth rate by industry in China, the information transmission, software and information technology services industry recorded an outstandingly high growth rate of 26.0%.

□ China was the global No. 1 in terms of EC transactions. Internet services for consumers are wide-ranging, but the number of users is rising at a particularly high pace with respect to travel reservations, meal deliveries, ride-sharing and financial services.

□ Since around 2014, when "Mass Entrepreneurship and Innovation," an entrepreneurship support initiative promoted by the Chinese government was announced, the number of business start-ups has increased rapidly. The business start-up rate in China is far higher than that of the United States and Japan. In terms of the value of investments made by venture capital, China was the second largest investing country with a value of 2.2 trillion yen, following the United States, where the total investment value was 7.5 trillion yen.

□ In terms of the number of international patent publications, China overtook the Republic of Korea in 2010, Germany in 2013, and Japan in 2017 to become the global No. 2, after the United States.

□ Examining the number of international patent publications in the 10 key sectors of "Made in China 2025", China has not only caught up with major global countries in the field of IT-related technology but is also leading the world in other fields, including digital communications. On the other hand, China lags behind the United States in biotechnology and medical technology and behind Japan in the field of machinery-related technology, including robotics.

□ The massive supply of highly skilled human resources is considered to be one reason for the improvement of technological capability and the entrepreneurship activity in China. Of the more than 7 million students who graduate from university every year, around 200,000 start their own business. Nearly half of Chinese students studying in the United States major in the STEM (science, technology, engineering and mathematics) fields. Until 2008, the return rate among Chinese students studying abroad was as lower than 30%. However, the Chinese government announced a series of measures to encourage Chinese students studying abroad to return to China, and as a result, the return rate has risen rapidly since then, reaching 85% in 2013.

□ It is essential to correctly recognize the advance of new industries, the improvement of innovation capability, and the vigorous entrepreneurship activity in China and to make further efforts to vitalize Japanese domestic industries.

< Expanding external trade and investment >

□ Countries which China is the largest exporter have rapidly increased. In 2017, the number of those country was around 30% (57 countries) of all countries. China is also the largest importer for around 16% (30 countries) of all countries, the second largest after the United States, although the Chinese share is smaller than in the case of imports.

□ Electrical and optical equipment have replaced textiles as the main industry of Chinese exports.

□ Taking closer look at the domestic value-added ratio of China's export on industry basis, the share of the electrical and optical equipment industries was only around 30% in 2000. However, the share increased to around 50% in 2014, indicating progress in a shift to local procurement of parts and higher value added to each products.

□ After the establishment of the WTO, China was the most frequent target of AD measures (866 cases) in the time period of 1995 to 2016, followed far behind by the Republic of Korea (239 cases), the second most frequent target and others. Emerging economies implemented AD measures against China in more cases than advanced economies did.

□ After 2010s, Chinese companies have become active in acquiring industrial and technology companies in advanced economies. In response, the United States has strengthened regulation on foreign direct investment. For example, it has denied to approve acquisitions of U.S. companies by Chinese companies in some cases.

□ As for EU, the European Commission has proposed the establishment of a new screening framework concerning foreign direct investments to the region. Germany and some other EU member countries are also moving to strengthen their regulation on national level.

< Business opportunities for Japanese companies >

□ The value of Japanese exports to China reached a record high of around 14.9 trillion yen in 2017, making China the second-largest importer for Japan, after the United States, for which the exports from Japan was around 15.1 trillion yen. Especially, exports of consumer goods and industrial machinery increased significantly.

□ The value of cross-border EC purchases by Chinese consumers from Japan have expanded rapidly. In 2017, the value of such sales is estimated to have reached 1,297.8 billion yen (an increase of 25.2% from the previous year).

□ Between 2013 and 2017, per-capita consumption expenditure in China increased by around 40%, from 13,000 yuan to 18,000 yuan. In particular, the shares of transportation and communications, education, culture and recreation, and health and medical care expenditures in overall consumption increased.

□ In China, environmental problems has become a major challenge. The value of investments made in measures to cope with environmental pollution is on the increase. While Japanese companies also need to comply with environmental regulations, this may create business opportunities for companies with high-level environmental technologies.

- □ Manufacturing companies account for a large propotion of sales of Japanese companies operating in China. Japanese manufacturing companies are increasing both sales and profits by seizing robust domestic and external demand related to China. Although sales of private consumption-related services are also growing, the sales value is still low, at around 60 million yen compared with the sales value of the manufacturing industry, which is around 30 trillion yen.
- □ Comparing the sales of Japanese companies operating in China with those of U.S. and EU companies, sales of private consumption-related services are small. There is further room for growth in Chinese consumer markets, including markets of products for the middle class, babies, and elderly people.
- □ It is crucial to take advantage of the vitality of the growing Chinese economy for the prosperity of Japanese industries. This can be achieved through further business expansion of Japanese companies in China and cooperation between Japanese and Chinese companies in third-party countries.

Part 3　Policies

■Chapter 1　Development of free, fair and high-level trade rules

□ The global economy is undergoing a major change, and it is becoming increasingly important to establish free, fair and high-level trade rules. In 2017, Japan made significant progress in this respect, as it signed TPP11 and successfully concluded the negotiations over the Japan-EU EPA. This chapter describes Japan's initiatives to establish free, fair and high-level trade rules, including recent trends concerning mega-FTAs, the Japan-U.S. economic relationship, the WTO, G7, G20, the OECD, and APEC.

■Chapter 2　Emerging economy strategy

□ In order to gain more benefits from globalization, it is becoming increasingly important for Japan to advance into remarkably developing emerging markets. This chapter describes Japan's initiatives, mainly in fiscal 2017, concerning emerging economies, particularly China, ASEAN-Pacific, India, Russia, the Middle East and Africa.

■Chapter 3　Comprehensive trade policy

□ This chapter explains the contents of the "Comprehensive TPP-related Policy Framework", which was compiled in order to enable second-tiers and small and medium-size enterprises (SMEs) to enjoy benefits from the effectuation of the forthcoming TPP11 and the Japan-EU EPA. In addition, it describes the efforts made by the "Consortium for New Export Nation," which supports overseas expansion and food exports of second-tiers and SMEs.