

White Paper on International Economy and Trade 2021 (Outline)

Part I. Global economy recovery from Covid-19 outbreak

Chapter 1. Economic Situation Surrounding Japan and Trends that will shape Trade

Section 1. Global economy after COVID-19

The year 2020 was marked by a major global recession, also called the "Great Lockdown." The cause was a new kind of economic crisis brought on by the spread of COVID-19, which has led to restricted face-to-face communication and constraints on both supply and demand. The year 2021 saw the global economy take its first faltering steps toward recovery. According to the IMF, the global real GDP growth rate in 2021 is expected to recover to 6.0 percent. This will only make up for the fall in 2020. The pace of recovery in each industry, country, and region is very different. While PMI and goods trade indices have also indicated recovery in the manufacturing industry, service industry is lagging behind and has also seen a significant decline in employment. This is particularly true of the business areas based on face-to-face and direct-contact interactions. Economic recovery in each country will continue to be strongly affected by its own situation regarding infection, preventive measures, and availability of vaccines.

Global trade and investment also declined significantly in 2020. Concerns about free trade systems were also wide-spread. For example, as many as over 70 countries introduced export restrictions in medical sector. On the other hand, demand for medical products and products whose demand is likely affected by the need to stay at home underpinned the global trade value amid the COVID-19 crisis. Consequently, trade is showing a recovering trend along with the global economic recovery. Although growth in foreign direct investment flows is sluggish, companies are expected to become more willing to invest, especially in the fields of digitization and green society by receiving support from government policies.

Section 2. International trend that will shape trade

For the time being, the world must unavoidably continue to live with COVID-19. Under these circumstances, tectonic changes in the geopolitical landscape have been growing more active in response to the policy changes of the new U.S. government, and Japan's international political environment is entering a new phase. Given the uncertain future regarding the global economy and the new international political situation, stated below are four major international trends that Japan should assume exist when considering future trade policies and corporate activities.

The first trend is toward a larger economic role for governments. As the impact of the COVID-19 crisis drags on, countries are taking active economic measures, with a particular focus on industry and households, areas of concentrated economic damage from the pandemic, on a scale that exceeds the response to the global financial crisis. Governmental economic countermeasures include not only relief, but also support for transition and adaptation to the post-COVID-19 economic structure, such as the digitalization of society and the achievement of a green society. Large governmental moves like these can also be viewed as moves to qualitatively strengthen the role of governments. In other words, they are moves to place more importance on the role of governments in terms of, for example, active governmental participation toward swiftly achieving a digital society to address the COVID-19 crisis effectively, and making the future more foreseeable for companies by presenting clear policies and support measures, in order to encourage private investment toward achieving carbon neutrality.

The second trend is toward strengthened economic security in each country. In recent years, major countries have been strengthening their efforts toward economic security, and the impact of this on companies' business activities has also been increasing. In this context, the COVID-19 pandemic has made manifest the vulnerability of supply chains. In response, major countries are working to strengthen economic security, including making supply chains more resilient. It is important to note that there is a growing trend toward seeking cooperation among like-minded countries regarding developing and managing advanced technology and working to strengthen supply chains. It is becoming increasingly important for companies to develop business strategies that reflect a strong awareness of the countries' diplomatic positions and economic security policy trends.

The third trend is toward increased interest in common values in international economic activities. As the U.S. rejoins the Paris Agreement and starts to cooperate with Europe following its change of administration in January 2021, there is steady intensification in the moves to strengthen international cooperation based on common values. With more and more companies setting goals of reducing greenhouse gas emissions (SBT) that are consistent with the levels required by the Paris Agreement, some aspects of human rights due diligence legislation in the U.S. and Europe will need to be accommodated by companies outside those regions, as well. While there is a growing risk that certain constraints will be imposed on business activities that do not suit internationally shared values, contributing to solving social issues with more awareness than ever of these common values could hold new business opportunities.

The fourth trend is toward the digitalization of business. The COVID-19 pandemic has accelerated the progress of digitalization. The march of digitalization had advanced throughout the 2000s. This is also evident in the global flow of funds, and while payments for intangible assets such as royalties and licensing fees have increased significantly, the flow of direct investment has only increased moderately. This is a manifestation of the fact that the mainstream business model overseas is one in which companies can utilize alliances to gain what their intellectual assets are worth, and not have to invest any capital to do so. On the other hand, Japan's

model can be said to be one in which direct investment flows and payments such as royalties are growing in a similar way, and companies can gain what their intellectual assets are worth while also maintaining strong relationships through capital relations. In the with-COVID world as well, it will be essential to construct business models and social infrastructure that are adapted to digital technology in order to continue to enjoy the benefits of international trade. At the same time, it will be important to change how companies' bases are located and change the international division of labor, and urgently necessary to develop international rules that will simultaneously ensure both reliability (such as privacy protection and information security) and the smooth flow of data.

Part II. Challenges Regarding Trade and How to Overcome Them

Chapter 1. Toward Building Resilient Supply Chains

Section 1. Asia-wide changes in supply chains

Last year's White Paper revealed that the concentration of import sources in Japan's supply chains has increased in recent years. On the other hand, in terms of the medium-term trend, Japanese companies' setting up locations in China peaked in 2012 and is now shrinking, both in terms of the number of companies doing so and their share of the remaining balance of direct investment. From a macroeconomic perspective, production bases in Asia are becoming more diversified, albeit in a moderate way. As a result, for some of major mechanical parts, the share of imports from China has hit the ceiling, and of imports from Thailand, Vietnam, Indonesia, etc. have increased. This could also be getting influenced by the widespread adoption by Japanese companies of "China +1" initiatives whereby in selecting new bases, they take into consideration the overall cost and the stability of the business environment.

Section 2. Supply chain risks and recovery from the crisis

The disruption to supply chains caused by the COVID-19 crisis has once again made clear the necessity of understanding the whole of a multi-level supply chain, and not just the direct suppliers. Unanticipated risks could also disrupt supply chains in the future. In fact, some assessments conclude that existing BCP (Business Continuity Plan) did not work. There is increasing awareness of the importance of formulating BCP and managing supply chains in ways that address a wide variety of risks, not just transient disasters.

Section 3. Additional considerations in supply chain management

Amid an international trend toward increasing interest in the calls for and value of economic security, the matters to consider in supply chain management are becoming more complex and sophisticated. First, with many countries around the world looking likely to advance their efforts toward zero net greenhouse gas emissions, further spreading is predicted regarding moves among companies toward managing not just their own CO₂ emissions, but also those from the whole of their supply chains, including their suppliers. Furthermore, Japanese companies operating in foreign countries are already taking steps to accommodate the human rights due diligence legislation of the countries in question, and more and more countries are establishing such legislation, particularly in Europe. In addition, given that some goods and sectors require compliance with the relevant countries' export and procurement regulations established from the viewpoint of economic security, companies are facing stronger calls than ever to understand the circumstances surrounding their supply chains and take action accordingly. The first step toward responding to this situation is to understand the supply chains beyond the primary suppliers. Moreover, companies are being called on to recognize that common values such as the environment and human rights are being incorporated into the competitive environment, and to deepen their efforts in light not only of the law but also of the expectations of the stakeholders that surround them.

Section 4. Increasing supply chain resilience through digital technology

Given these changes, "visualizing" supply chains through digital technology will contribute to their resilience by enabling alternative production, increased production, and flexible sales strategies that can accommodate natural disasters and geopolitical influences. Besides that, its importance is also increasing because it can make it easier to respond to demands regarding issues such as the environment and human rights. Technology such as block chains is beginning to be used in the pharmaceutical and other sectors to manage supply chains, and there are also examples of supply chain situations being voluntarily ascertained by end-product manufacturers on multiple levels with regard to so-called "integral" products, as well. Advancing these efforts will require companywide sharing of awareness in all the companies that make up the supply chain, as well as introducing technology. It will also be necessary to establish a global data governance framework in order for information sharing between companies in the supply chain to be smooth and reliable.

Section 5. Facilitating and digitalizing international trade procedures

Efforts to digitalize and facilitate international trade procedures complement the supply chain management conducted by companies mentioned above. Traditionally, trade procedures have been recognized to account for a certain percentage of the cost of trade, and the WTO Agreement and various Economic Partnership Agreements have included efforts to improve the transparency of customs clearance procedures and promote

computerization in order to make trade procedures smoother. In recent years, trade platforms with new functions have emerged worldwide. In Japan, a trade platform has emerged from cross-sectoral corporate consortiums, and the government has also been making efforts, for example, digitalizing port procedures and the procedures for origin certification required when applying an economic partnership agreement. These efforts by companies and governments to facilitate and digitalize trade procedures are expected to serve as a control tower to contribute to making supply chain management more resilient.

Chapter 2. New Model for Growth That Incorporates Common Values

Section 1. Growing expectations regarding corporate behavior toward a sustainable and inclusive future society

Interest in "common values" such as the environment and human rights has recently been growing into a major international trend. Here are three things that express it manifestly.

First, ESG investment is expanding, as seen in the 2006 Principles of Responsible Investment (PRI) and the adoption of the ESG Index by the GPIF. Given the expansion of the scope of information disclosure by capital markets and overseas regulatory authorities, it is also important for companies to view the expansion of requests for information disclosure as not only "accountability" to the market, but also as an opportunity to transform corporate management.

Second, interest in addressing social issues is growing in ways that also affect companies' competitive environments. The more people empathize with the globally shared values of SDGs and sustainability, the larger the markets those values create will be. Given that young generations are clearly showing a tendency to place importance on these "common values" not just in Japan but also globally, in order for companies to secure a competitive advantage, it is essential that they position common values appropriately in their business management when it comes to gaining market opportunities and acquiring human resources in the labor market.

Third, moves in Europe and the U.S. toward building institutional frameworks for achieving common values across the supply chain as part of governments' foreign economic policies are becoming more pronounced. European countries and the U.S. regard basic values such as human rights and democracy as elements of their foreign economic policy. Their moves are intensifying regarding making the above-mentioned human rights due diligence and related disclosure obligations also apply to companies other than ones established within their own borders, and establishing sanctions of their own.

Looking at the moves among Japanese companies, while awareness of SDGs is spreading, there can hardly be said to be adequate recognition that the risks and opportunities for companies are changing amid a trend of placing increasing importance on common values, or adequate investment in intangible assets that support the creation of corporate value. With the influence of the future-oriented values of sustainability growing, it is now necessary to recognize intangible assets that will contribute to sustainability, and invest in them more than ever before. In addition, it is also important to "express" the fact that these factors will contribute to improving corporate value in order to be rated appropriately by the capital market.

Section 2. Meeting sustainable and inclusive growth needs

When concretely considering SDGs and ESG investment, it is meaningful to look at the approaches to "sustainability" and "inclusion" being taken by the emerging Asian countries (India, ASEAN, etc.), which are facing many social, economic, and environmental challenges. Exploring local needs in emerging Asian countries in detail, taking steps toward solving various issues and achieving value, and seeking new alliances can be expected to also contribute to the development of new relationships between emerging Asian countries and Japanese companies.

Section 3. Toward corporate behavior that creates sustainable value

Achieving well-being, including escape from poverty, is an urgent social issue in many countries. In those kinds of countries, achieving well-being will be helped both by direct contributions by companies through their core business activities if these are things like healthcare and education, and by indirect contributions such as employment and contribution to local economies. However, in order for companies to continue those kinds of business activities locally in the long term, it is essential that they have a common sense of purpose with local people, including sharing awareness of problems with them. There are also examples of companies sharing values with local people as part of their own business activities. On the other hand, there are various barriers to conducting business on long-term time scales, and will be necessary for both the public and private sectors to devise and implement infrastructure strategies in cooperation with a diverse range of partners and institutions, and approaches to creating direct and indirect "value" both at home and abroad.

Chapter 3. Taking Measures toward Building a Global Value Chain with "Trust"

What should trade policy be like in the world of living with COVID-19—a world where the role of governments is expanding, taking measures toward economic security is becoming more common, and interest in common values is increasing? The sections below present major directions.

1. Momentous changes progressing all around the global

Managing global value chains is becoming increasingly complex, with increasingly many variables to consider, such as economic security and how to address growing interest in common values such as the environment and human rights. In response to this increasing complexity, establishing value chains using digital technology and data has become a major strategic issue in corporate management and policy. In addition, there is a growing need to upgrade free trade in order to maintain and develop liberal and open economic and social systems. In other words, in addition to creating a business and investment environment that will support the free movement of goods and multi-tiered supply chains that transcend national borders, another challenge is to develop norms in order to achieve sustainability, fairness, and social justice.

2. Action toward strengthening economic security and industrial competitiveness

In order to ensure Japan's economic security, it is important to reduce the level of concentration on suppliers for important goods that are heavily overseas-dependent, and to build global supply chains based on "trust" with the U.S. and other countries, expressed in ways such as supporting the diversification of production bases and forming strategic alliances with overseas companies.

3. Challenges and initiatives in the digital field

It is important to prevent the expansion of digital protectionism (which can hamper corporate business opportunities) and to develop international rules that will ensure both free distribution of data and trust in privacy protection, security, etc. In other words, it is important for Japan to take the lead toward achieving DFFT, and thereby contribute to the creation of new value that data will bring about, and to economic development.

4. Addressing common values (environment, human rights, etc.)

Based on the "Green Growth Strategy through Achieving Carbon Neutrality in 2050," it is important to be on the side that leads strategic competition surrounding green growth, work with the U.S. and Europe to reify cooperation, and at the same time, progressively form international rules and steadily advance industrial policies both internally and externally. In addition, global corporate management urgently needs to adapt to international trends by incorporating into its management strategy responses to social issues including "human rights." It is important to encourage Japanese companies to understand "business and human rights" (by, for example, making the "National Action Plan" formulated last October widely known among them), and to foster an environment where strengthening measures like these will lead to improved corporate value.

5. Upgrading the free trade systems

In order to make global value chains even more advanced by leveraging Japanese companies "strengths," it will be necessary to form an economic order that addresses the current challenges, and to have strategic partnership between the public and the private sectors. Specifically, the issues are as follows: 1. continuous trade restrictions to prioritize and protect the home country, such as export restrictions on vaccines, etc., and increased tariffs to protect industries in the home country; 2. defamation of "level playing field" caused by market distorting measures by foreign governments and enterprises; 3. lack of development of international rules that can accommodate the digitalization of economic activities. For this reason, a multi-tiered approach is important. This includes creating rules (e.g., data governance) as soft laws (for example with the OECD and APEC) and not just hard laws such those of the WTO and the EPA, and creating public-private value chains that leverage Japan's strengths (e.g., initiatives to strengthen supply chains, cooperation with the U.S. and Europe).