

Rebuilding Trust in a Rule-based Trade Order

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The rules that govern trade are in dire need of repair. President Trump imposed a stress test on the trading system when he raised tariffs in the name of national security and tightened export control regimes as part of his *America First* agenda. The system has barely survived. Countries from China to the EU retaliated in tit-for-tat reaction to the U.S. measures. Faced with U.S. refusal to appoint justices, the top court of the World Trade Organization ceased operation a year ago. Members remain deadlocked in their negotiations over new rules.

Yet there are also signs of resilience. Other countries led mega free trade agreements that set new rules. The recent APEC Ministerial statement affirmed "support for agreed-upon rules of the WTO in promoting the stability and predictability of international trade flows." Even in the United States, public opinion remains positive toward the benefits of free trade.

The election of Joe Biden will shift the tone but not end the trade war between the United States and China. In significant steps to restore the WTO, we can expect the new administration to accept the appointment of Nigeria's Ngozi Okonjo-Iweala as the next WTO director-general and to work sincerely with other members for reforms of the appellate body and appointment of new judges – both personnel matters were blocked by the Trump administration. Yet Biden is unlikely to remove tariff walls built by Trump that now cover more than \$300 billion worth of products because they enjoy bipartisan support in Congress. Indeed, Congress is nearing approval of the Uyghur Forced Labor Prevention Act that would ban import of goods produced by forced labor in the Xinjiang region of China. The US-China trade agreement phase 1 targets have not been met.

Japan will be a critical partner to rebuild the trade order. By concluding the CPTPP and RCEP along with free trade agreements with the EU and United States, Japan is connected to all of the major economic powers in a network of agreements. CPTPP is important for new standards in e-commerce, competition policies, and restraint on illegal fishery subsidies; RCEP goes far to lower tariffs in a region including 30 percent of world population and GDP with simple rules of origin that support regional production networks. Bringing the best of these agreements into a new consensus to update WTO rules would revitalize the trade regime.

The biggest challenge lies in digital trade governance. Information technology goods enjoy zero tariffs under the WTO information technology agreement. But digital trade rules remain an ongoing topic of discussion with divergent national regulations. IP and digital services like cloud storage and e-commerce represent significant sectors for creating jobs and economic growth. To support an open digital economy, countries will need to achieve objective criterion to limit arbitrary restrictions while preserving autonomy over core interests. Reciprocity and

transparency must govern digital trade as it has long governed goods trade. On this front we see a battle of standards between those in CPTPP and RCEP. The former prohibits restrictions on data flows while the latter provides broad discretion for governments to require data localization.

Can countries bridge the gap between standards to build consensus for an agreement at the WTO? If not, rival standards could divide the internet into a Chinese and American sphere. Rapid digitalization means more than just big tech firms will lose out. As a country deeply invested in both the US and China with a large digital economy, Japan has much to lose from the scenario of competing blocks. During 2019 as leader of the G20, Prime Minister Abe initiated the Osaka track negotiations on digital trade with a call to establish “data free flow with trust.” Japan along with Singapore and Australia have convened negotiations in Geneva among WTO members to consolidate a text for e-commerce rules on matters such as electronic signatures and personal information/data protection. Prime Minister Suga is promoting the digitalization of Japanese society and government. As part of building Society 5.0, Japan and other countries need an innovation ecosystem for creative applications and development of technologies and digital services. This will require global scale.

Revision of the rules alone is insufficient. States must also rebuild trust. Trade rules promise stability, which matters even more than lower tariffs. Firms don’t want to worry about new costs and broken supply chains every time political relations between countries worsen. Fundamentally, the trade regime is based on trust among countries that they share the goal to enjoy mutual gains from trade.

The erosion of trust is most obvious in the trend to limit trade in the name of national security. Until recently, states did not invoke the national security exception clause in the WTO. Now the Trump administration appeals to this defense for its tariffs on steel and aluminum imports, and Japan defends export control inspections of goods to Korea as measures necessary for national security. Withdrawing such measures and issuing a joint leaders statement could reaffirm that national security restrictions should be rare and based on investigation of specific security risks. New rules on the digital economy need to reach agreements on encryption and privacy rules that defend against cybersecurity attacks. This could be accomplished by a common standard or flexibility to recognize different national standards so long as they do not force companies to share the algorithms and data that are valuable commodities. Only then will consumers and businesses trust governments enough to fully utilize a digital environment.

Interruptions from the pandemic and trade wars highlight the vulnerability of global supply chains. One response is reshoring production. This would substantially increase costs and upend entire industries. Closing economies would create new risks from reliance on smaller home markets. Another response to the vulnerability of interdependence is diversification. Building redundancy in supply chains across countries would provide more resilience at only slightly more cost. The “China plus one” strategy had already become a mantra for Japanese firms after earlier rounds of boycotts revealed the risks of dependence on China. This approach

offers a model for how to hedge risks of reliance on China without turning away from the opportunities.

Both the US and China are on the brink of a technology cold war. Decoupling of production and a 'splinternet' with national regulations fragmenting the use of data are a significant threat. After cutting off supplies from U.S. makers to China's leading IT firm Huawei, the Trump Administration announced a "Clean Network Policy" in August to ban Chinese firms from any role participating in U.S. telecommunications systems. The incoming Biden administration calls for a democratic alliance to coordinate trade rules and domestic policies to spur investment in AI and 5G could be taken as preparation for a new cold war fought on the economic front. Leaders in China fear they cannot assume ongoing interdependence. With the 'dual circulation' strategy in its latest five-year plan released in November, China wants to build its own capacity and domestic demand along with international competitiveness. Encouraging domestic demand helps balance China's role in the global economy but may also change the role of foreign firms. Already one sees declining shares of imports from China that are sourced from subsidiaries and related parties (see figure).

As the country most engaged in trade with both the US and China by firms deeply embedded in global supply chains, Japan has every reason to help the US and China stand down from the brink of a technology cold war. When the US tries to globalize its own restrictions against China, Japan will be forced to choose sides. This has happened already for Huawei equipment use in telecommunication networks. The US Clean Network policy announced in August pushes further against any form of Chinese participation in US telecommunications from 5G to app stores and cloud servicing. Some Japanese firms benefit as they receive the label of 'clean' telecom companies allowed to participate in U.S. networks. But the Japanese government has been correct to resist taking such broad actions. In a worst-case scenario, further escalation could lead the United States to demand that its allies join its sanctions against China proceeding to semiconductors and eventually all the way to autos. Let us hope that Japan can persuade the Biden administration to focus its containment policies against China in a more constructive direction by investing in multilateral trade rules to bind all countries – including the United States and China.

Data sources for figure of imports from Chinese-based subsidiaries of US and Japanese firms:

- US data from Census Bureau from <https://relatedparty.ftd.census.gov/>
- Japan data from Research and Statistics Department, Minister's Secretariat, METI. <https://www.meti.go.jp/english/statistics/tyo/gaisikei/index.html>