

Japanese Economic Security as “Derisking”

By Kazuto Suzuki

Introduction

The term “derisking” has become a buzzword not only in the field of economic security but also in the discussion of international politics after Ursula von der Leyen, the President of the European Commission, the executive arm of the EU, commented that the EU should pursue “derisking” rather than “decoupling.”¹ However, derisking does not clearly define what risks are to be addressed and by what means, or how they can be eliminated. It is only used as a convenient term in a political context, and it is not certain whether it is a useful term in the study of economic security.

This paper defines derisking beyond just the perspective of economic security, examines whether derisking defined as such is a useful term for analyzing policy, and considers what the Economic Security Promotion Act (ESPA) enacted in Japan in May 2022 means from the perspective of derisking.

What is Derisking?

In a 2023 speech, von der Leyen recognized that “President Xi essentially wants China to become the most powerful nation in the world” and cautioned against China becoming a key player in the international order. At the same time, she raised a number of issues, including: China’s lack of effort to stop the war in Ukraine, and instead strengthen relations with Russia; the risk China will exert Russia-like pressure in Asia; the risk of human rights abuses in Hong Kong and the Xinjiang Uyghur region; and economic coercion against Lithuania.²

Von der Leyen stated the West’s relationship with China should be derisked rather than decoupled from the perspective that a stable dialogue with China is necessary, even though China has power and ambitions to shape the world order and its behavior is inconsistent with European values. In other words, von der Leyen brought in the concept of derisking in order to maintain the path of dialogue, rather than to separate from China altogether. Derisking is thus a concept created to avoid decoupling.

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How, then, should derisking be defined? First, derisking means risk reduction rather than risk avoidance. In President von der Leyen's speech, when she refers to derisking rather than decoupling with China, it is generally assumed that she is assuming a certain level of risk will remain.

Second, while derisking is limited to the economic sphere, it is also aimed at reducing the possibility of states trying to exert political pressure on other states by using their economic relationships, notably by stopping trade in certain goods. Although as von der Leyen has said, many goods and services are "un-risky (or risk-free)," it is important to note that at the beginning of the COVID-19 pandemic, China, where the production of masks was concentrated, could not keep up with the demand for masks.³ Many countries feared infection and worried about a shortage of masks. In response to the shortage, China used "mask diplomacy" as a diplomatic tool, in a way to stoke people's fears.⁴ It is unclear what von der Leyen meant by "un-risky," but at least it is clear that even commodities that do not require high manufacturing technology are not risk-free.

Third, the risk, if any, of daily necessities such as masks is not so high because alternative production can be started in a short period of time and recovery from the shortage is relatively less difficult. This fits with the point made by Keohane and Nye in their discussion of the concepts of "sensitivity" and "vulnerability."⁵ Sensitivity refers to the extent to which a state's economy is affected by external changes, while vulnerability refers to the degree to which it is able to recover from those changes. In the case of masks, sensitivity is high because of the heavy dependence on China, but vulnerability is low because of the relatively fast recovery from the impact. Conversely, Japan was severely affected when China suspended exports of rare earths to Japan in 2010 due to the Senkaku Islands dispute, and recovery was not easy.⁶ Therefore, Japan's vulnerability was high. Nevertheless, efforts to reduce vulnerability, such as the ability to make hybrid car magnets without using rare earths by 2016 increased Japan's resilience to the supply chain.⁷

Fourth, while increasing the resilience of supply chains to reduce the sensitivities and vulnerabilities described above underlies derisking, it is not realistic to achieve resilience in all trade items. This would require reducing dependence on China for all items, which von der Leyen calls "decoupling." Therefore, it is necessary to select those items that are strategically important, i.e., those that are both sensitive and vulnerable, and work to reduce dependence on China. To do this, it is first necessary to determine which industries are strategic to the nation and to understand the full supply chain of those industries. However, such supply chains are adjusted on a daily basis in

the course of corporate activities and are the source of competitiveness for companies. If it becomes clear from which companies in which states they procure their inputs, their competitors may also procure from the same companies, making it impossible for them to maintain a competitive edge in terms of price and performance. Therefore, discussions about supply chains tend to be based on imprecise and incomplete data, such as the share of Chinese companies in the global market share, leaving unclear which companies are at risk in the supply chain.

Fifth, in order to proceed with derisking, it is necessary to analyze the supply chain of individual companies, as discussed above. Consequently, derisking at the level of government is different from derisking at the level of companies. For a state, trying to reduce its dependence on another risky state with which it has a strategically antagonistic relationship would require violating the economic rationale of procuring the best product at the lowest cost for the firm. For a company, it is difficult to act contrary to economic rationality, and if a company were to take measures such as relocating production or changing suppliers at high cost in the name of derisking, it would be unable to explain its actions to shareholders. Therefore, the government must make it clear that some actions must be taken, even at the expense of the company's profits, in order to derisk, and provide incentives to do so. Such measures can be a negative incentive in the form of regulation, or a positive incentive such as a subsidy. In either case, this strategy will be difficult to achieve unless companies are in sync with the derisking strategy.

Finally, economic risks are not limited to supply chain risks. Another risk could be the loss of market share of a home state's firms due to the increased competitiveness of other states' firms and increased dependence on other states due to technology outflows and technology theft. Therefore, in addition to preparing for cyberattacks, which are a channel for technology leakage, we must also be concerned about technology leakage associated with the movement of people (e.g., headhunting as in China's "Thousand Talents Program") and technology leakage through corporate acquisitions.⁸ In the United States, the concern is not only about technology outflows, but also about investments in Chinese companies that will enhance the activities of those companies. A presidential decree was issued in August 2023 to regulate investment in China.⁹ Although the recognition that the transfer of technology and capital through these economic means could be a security risk does not appear in von der Leyen's speech, such recognition is growing in the discussion about economic security in the United States.

Thus, taking the concept of derisking a little further, there are many measures that are difficult to implement in practice, and the difficulty of coordination between companies and governments stands out in particular. In the face of these problems, how can states make derisking possible? Japan provides one example.

Japan's Economic Security Promotion Act Shows Derisking

In Japan, the term “economic security” has been widely discussed after a group of politicians in the ruling Liberal Democratic Party (LDP), led by then LDP Secretary General Akira Amari, released its recommendations for the “Formulation of an Economic Security Strategy” in December 2020.¹⁰ Based on these recommendations, the “Basic Policies for Economic and Fiscal Management and Reform 2021 was released in May of that year.¹¹

The LDP proposal defines economic security as “ensuring Japan’s independence, survival, and prosperity from an economic perspective,” and outlines two means of achieving this: 1) “ensuring strategic autonomy” by 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 by “maintaining, strengthening, and acquiring strategic indispensability and acquisition.”¹²

In order to realize these objectives, the report also states that the vulnerabilities of “strategic industries” will be identified and analyzed, and necessary measures will be taken to ensure their strategic autonomy and strengthen their strategic indispensability. In addition, five domains are designated as “strategic industries”: energy, information and telecommunications, transportation, healthcare, and finance, and their respective risk analyses and vulnerability countermeasures are discussed.¹³

In the National Security Strategy approved by the Cabinet in December 2022, Japan’s security challenges include “issues that have not necessarily been recognized as security targets in the past, such as weak supply chains, increasing threats to critical infrastructure, and the struggle for leadership over advanced technologies.” The report explicitly states that the threat is that “some nations are trying to expand their own influence by economically coercing other nations through such means as restricting the exports of mineral resources, food, and industrial and medical supplies, as well as providing loans to other nations in a manner that ignores their debt sustainability.”¹⁴

In response to such threats, the Japanese government has already passed the Economic Security Promotion Act in May 2022 and has taken various legal measures, which are again introduced in the National Security Strategy. First is the strengthening of supply chains. This means avoiding over-dependence on specific states and diversifying procurement to stabilize the supply of strategic goods. In particular, this aims for the development of semiconductor development and production bases to maintain technological superiority in emerging technological fields, as well as the stable supply of critical commodities such as rare earths. As a means of achieving these goals, a support system will be established, including the use of loans to help private companies strengthen their domestic production. Eleven items are designated as critical commodities, including antimicrobial agents, fertilizers, semiconductors, storage batteries, permanent magnets, critical minerals, machine tools and industrial robots, aircraft parts, crowd computing programs, natural gas, and ship parts. However, even for antimicrobial agents, only beta-lactam antimicrobial agents, which are 100% dependent on overseas sources for their raw materials, are specifically mentioned, and the specific commodities are expected to be narrowed down in the future.¹⁵

Second is the protection of critical infrastructure. The continuity of services provided by critical infrastructure is essential for the stability of the economic and social order. If such stability is disturbed by interference from other states and affects people's lives and property, it is a security issue. ESPA designates 14 areas as critical infrastructure, including electricity, gas, oil, water, railroads, motor freight transportation, ocean freight, aviation, airports, telecommunications, broadcasting, postal services, finance, and credit cards. In the construction and maintenance of critical infrastructure facilities that may affect human lives, the government reviews the plans submitted by the operators of these facilities for outsourcing maintenance and other services to external contractor and procurement of parts and other items necessary for these facilities. The purpose is to eliminate untrustworthy vendors and operators and reduce the risk of critical infrastructure being hijacked or otherwise attacked.¹⁶

Third, protection of data and information has become an important issue. In the past, the Specified Classified Information Protection Act stipulated the protection of data and information concerning important secrets related to defense security. Today, technologies related to security are becoming increasingly dual-use for both the military and civilian sectors, with private companies playing a central role in the development of such technologies, especially in the fields of artificial intelligence (AI), quantum computers, and robotics. These so-called emerging technologies are likely to be applied to improve military capabilities, and

maintaining technological superiority in emerging technologies is important for security. However, private companies do not have a confidentiality protection mechanism such as the Specified Classified Information Protection Act, and furthermore, there is a possibility of technological leakage as a result of exports to foreign states or the transfer of production bases. Moreover, there is a possibility of technology transfer, such as personnel involved in the research and development of emerging technologies moving to other states. Therefore, how to protect sensitive information on important technologies is both an economic and a security issue. Japan is currently considering the introduction of a security clearance system. In addition to this economic security context, Japan's lack of a security clearance system also makes it difficult to develop and procure technologies and equipment essential to its security, such as joint development of defense equipment with foreign states.¹⁷

Thus, Japan's ESPA represented a paradigm shift insofar as it was one of the first instances in the world of economic security legislation and the creation of a specific set of policies for it. Compared to other states, Japan's measures listed as economic security measures are basically defensive in nature. Since the objective is to counter the threat of economic coercion from other states, the measures that can be taken to protect one's own economic and social order, such as the strengthening of supply chains and protection of critical infrastructure, are available. However, security also requires tools to deter the actions of others and prevent conflicts by having the ability to counterattack or to have a certain level of offensive capability, which Japan lacks.

Another characteristic of the Japanese approach to economic security is that it focuses on preparedness against economic coercion but does not include unintended supply chain disruptions, such as those resulting from natural disasters. The United States, Europe, and other states, often strengthen supply chains in response to supply shortages due to a lack of manpower in distribution that occurred during the pandemic, or the shortage of strategic supplies as a result of factories not operating due to China's zero COVID policy. In contrast, the Japanese conception of economic security does not primarily address these unintentional events. Nevertheless, measures taken to strengthen supply chains to address intentional acts of economic coercion can also address unintentional distribution disruptions.

How to Prevent Economic Coercion

The concept of derisking in Japan assumes intentional coercion. It is important, then, to understand how economic coercion is used. This section examines the structure in which economic coercion is implemented.

Conditions under which Economic Coercion is Established

First, economic coercion is implemented when the party to be coerced is not only sensitive to disruption or coercion but also high vulnerable to it. In other words, economic coercion is most effective when the coercing state has an overwhelming advantage in a particular item, which, when restricted, the coerced state cannot immediately recover from (either in the case of export or import bans). A prime example would be the oil shocks of the 1970s. As a result of the Yom Kippur War, Western states that were dependent on Middle Eastern crude oil were forced to change their support for Israel to a neutral or Arab-friendly stance after Arab states implemented a suspension of crude oil exports, thereby causing panic in Western states and wreaking social and economic havoc.¹⁸

From this, we can equate vulnerability with a high degree of dependence. If a particular state's degree of dependence for a particular item is high, the vulnerability of that item will increase. Therefore, reducing such dependence is of primary importance in order to promote derisking. Such dependence is more dangerous for highly strategic products such as crude oil, but at the same time, economic coercion can be effective temporarily even for general-purpose products. For example, as noted above, in the first half of 2020, when the COVID pandemic began, global demand for non-woven masks increased. China, which accounted for most of the production, could not keep up with demand and a global mask shortage occurred. This was not an intentional act of economic coercion, but because of China's overwhelming superiority at the time, it became an act of economic coercion by developing "mask diplomacy" as a diplomatic tool.¹⁹ However, the economic coercion by China was only temporary, since a versatile product like masks was not so high in terms of vulnerability, as it was relatively easy to boost production and substitutes such as cloth masks were available.

Deterrence by Denial Against Economic Coercion

How, then, should Japan counter such economic coercion? First of all, if some states intentionally apply economic coercion, there are ways to work to influence such intent and to change their course of actions. In this regard, deterrence by denial may be applicable to economic coercion as well.

The central idea of derisking is a deterrence by denial strategy that aims to reduce the effects of economic coercion implemented by other states by reducing vulnerabilities and restoring resilience, so that the costs incurred by the other states are greater. Economic coercion is the use of a state's advantages to exert political pressure on a rival country, but its implementation

carries the risk that it may also negatively affect the state's own economy and reputation. For example, the suspension of rare earth exports by China to Japan in 2010 encouraged Japan to make rare earth-free products, leading to the development of a magnet that does not use rare earths in 2016.²⁰ As a result, China's advantage in this area was lost.

Possible means of deterrence by denial could include stockpiling strategic materials, diversifying sources of supply, developing alternative materials, and developing alternative products. Such measures would be appropriate policy responses to supply chain resilience in ESPA.

However, there is another means of deterrence by denial that is not included in ESPA. The "Coordination Platform on Economic Coercion," as outlined in the Joint Communiqué of the G7 Hiroshima Summit in 2023, to enhance joint assessment, preparedness, deterrence, and response to economic coercion, could be the basis for a mutual aid mechanism. Presently, though, it is not clear that this coordination platform would go beyond being a forum for information sharing. However, if other states subjected to economic coercion worked together with the G7 and other partners it would reduce the effects of an import suspension of a particular commodity. This was the case, for example, when China imposed economic coercion by suspending imports of pineapples from Taiwan in 2021. Japan and other friendly states actively encouraged Taiwan's pineapple imports, thereby reducing pressure on Taiwan.²¹ This kind of mutual aid mechanism can be a mechanism for implementing a deterrence by denial by having a collective self-defense system against economic coercion.

Institutional Deterrence Against Economic Coercion

Japan's ESPA is certainly a derisking-oriented measure in terms of deterrence by denial. However, deterrence by denial is not the only way to reduce the risk of economic coercion. A second method is institutional deterrence, which utilizes existing international institutions. Institutional deterrence makes use of international institutions such as the World Trade Organization (WTO) to settle disputes. Institutional deterrence assumes both parties to the dispute are members of such institutions, in which case they are obligated to settle such disputes under international law.

The WTO's dispute settlement mechanism allows an aggrieved state to file a complaint if it believes another state is in violation of WTO rules. When a case is filed, a panel of third-party experts can be established to examine the case and render a decision. If the party bringing the complaint is dissatisfied, they may appeal to the Appellate Body, which is the final tribunal. If the report of the

Appellate Body finds that the actions were inconsistent with the WTO Agreement and the recommendations of the Appellate Body are not implemented, the complaining party can demand compensation. Countermeasures, which generally take the form of retaliatory tariffs against the offending state, can inflict substantial damage on a state that does not follow the recommendations of the Appellate Body.²²

Such WTO dispute settlement mechanisms were thought to have a certain deterrent effect, but the deterrent effect has now largely faded. This is because the United States, which has been calling for WTO reform on the grounds that it has failed to take concrete steps against China's unfair trade practices, has refused to appoint senior members since the Trump administration, making it impossible for the WTO to hold an Appellate Body meeting and adopt a final report. Consequently, the WTO cannot mandate countermeasures. This U.S. attitude has continued under the Biden administration, and for the time being, the WTO's dispute settlement mechanism is unlikely to resume its functions.²³ In addition, in anticipation of the Appellate Body not convening, the tactic of leaving disputes unresolved by "empty appeals" to the Appellate Body by the losing party in the initial judgement by the panel also limits the deterrent effect.

In response to the dysfunction of the Appellate Body, the EU and other states have organized the Multi-Party Interim Appeal Arbitration Arrangement (MPIA). The MPIA is a system whereby an appeal against a panel decision of the WTO Dispute Settlement Mechanism is heard in the same manner as the Appellate Body by using the arbitration system in the WTO Agreement and the hearing rules of the Superior Committee.²⁴ Japan became a member of this MPIA in 2023.²⁵ In addition to the EU, China is also a member, which should have a certain deterrent effect against economic coercion conducted by China. However, the authority of the MPIA remains controversial, with only 19 states involved and the United States not a member. With the WTO incomplete, institutional deterrence is unlikely to function adequately.

Deterrence by Punishment Against Economic Coercion

In the field of security, deterrence is usually discussed mainly in terms of deterrence by punishment, but in economic security, it is not easy to control an opponent's economic coercion through this mechanism. Deterrence by punishment is intended to deter an opposing state by making it hesitate to act by showing that the targeted state can inflict great damage by retaliating in some way. Unlike in the military domain, where damage or costs can be calculated with greater accuracy (i.e. loss of life or territory), in the realm of economic security, it is difficult to calculate clear damages. This makes it difficult to determine what form of retaliation is appropriate.

The EU has proposed “Anti-Coercion Instruments” (ACI), which have not yet been legislated, but a political agreement is in the process of being reached.²⁶ The need for such measures was revealed by China’s economic coercion measures against Lithuania based on Lithuania’s use of the name “Taiwan” instead of “Taipei” when establishing an exchange association. China notified the EU that it would ban all products from Lithuania and all EU products containing parts and material from Lithuania, revealing the broad applicability and low predictability of China’s economic coercion measures.²⁷

Against this backdrop, the EU has recognized the need to implement the ACI. Governments have agreed to the Commission’s proposal and are moving toward ACI legislation, which includes measures such as tariff enforcement; restrictions on trade in services, foreign direct investment, public procurement, import and export licenses, research programs and certain products; tighter export controls on dual-use items; and measures on intellectual property.²⁸ It is not certain to what extent these measures would have a deterrent effect, or what damage could be inflicted on the partner state if an ACI were actually implemented. However, by preparing such measures, it would be possible to exert a certain amount of pressure on the other party by demonstrating its ability and willingness to retaliate.

Crafting the right messaging around such deterrent measures is also critical. The basis for deterrence is to demonstrate the ability and willingness to act. In the case of ACI, it is even more important to demonstrate a willingness to take firm retaliatory measures against economic coercion.

By presenting such a message, countries will be able to influence the calculations of the other party. At the same time, it will be important to determine the proper proportionality. Economic coercion and countermeasures may escalate the conflict, and risk going beyond economic confrontation to military confrontation. To address this risk, it is important to determine the extent to which retaliation against economic coercion is proportional and escalation can be controlled. In this sense, messaging is also important for economic security.

However, a difficult issue in controlling escalation is to keep in mind that the political impact of economic damage differs between authoritarian and democratic states. A democratic state is threatened by the possibility of losing power in the next election if the other party imposes economic coercion, as the injured firms and consumers become dissatisfied and critical of the administration in power. On the other hand, an authoritarian state may suffer some economic damage, but the regime’s oppressive measures will enable it

to contain domestic discontent and continue its acts of economic coercion. In this sense, the political regime of the other party must be fully considered when proceeding with derisking through deterrence by punishment.

In addition, deterrence by punishment does not necessarily mean retaliating in a tit-for-tat manner; responding to economic coercion with economic coercion. For example, Japan changed its export control regime in 2019 by removing South Korea from its whitelist for the licensing of sensitive items and moving three items, including hydrogen fluoride, from a comprehensive licensing system to an individual licensing system. The Japanese government maintains that this change in export controls was taken due to South Korea's own inadequate export controls and is not economic coercion. South Korea countered by suspending the renewal of the General Security of Military Information Agreement (GSOMIA), a bilateral military information sharing agreement.²⁹ Without norms in place to determine whether such retaliatory measures are economic measures or not, attempting to ensure economic security among nations through deterrence by punishment entails a great deal of risk.

It is also possible that a collective message of retaliation jointly made by multiple states, as in the case of collective self-defense, rather than a unilateral response by a single state, would enhance the effectiveness of deterrence by punishment. However, as already mentioned, only the establishment of a "Coordination Platform" has materialized thus far. A collective response, however, entails various problems. First, if a country's allies or partners are subjected to economic coercion, the victims of such coercion are likely to be competitors of its own companies. Even if it were possible to support allies and partners in some way, it is difficult to recognize the rationale for joint retaliation that would affect one's own businesses. Second, deterrence by punishment requires targeting the choke point of the other party, but this requires joint analysis of the other party's supply chain, which entails such issues as how to acquire information on trade secrets.

However, as a collective economic coercive measure, there is a case in which both Japan and the Netherlands agreed to take measures to strengthen export controls on semiconductor manufacturing equipment to China in response to the tightening of U.S. semiconductor export controls to China. This case suggests that collective action may be possible in some cases.³⁰

Conclusion

The concept of “derisking” has been embedded in the concept of economic security in Japan. In order to promote “derisking,” the country must not only strengthen its strategic autonomy, but also develop a deterrence strategy and prevent economic coercion from being triggered. However, there are various limitations to deterrence in the field of economic security, and it is difficult to realize such a strategy as a real policy. Furthermore, taking collective action, such as invoking the right of collective self-defense against economic coercion, will face a lot of difficulties, particularly when balancing the interests of individual countries.

Currently, the United States is considering international collective deterrence measures, modeled on the cooperation of Japan and the Netherlands in regulating semiconductor exports to China.³¹ However, from a theoretical standpoint, this is not necessarily likely to succeed. As economic security becomes more important in the future, some countermeasures will be required, but simple deterrence strategies alone will not be sufficient. New types of deterrence strategies must be considered.

Endnotes

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