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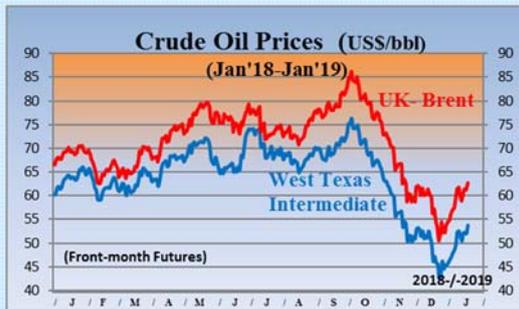
No. 153

(Based on Japanese No. 184)

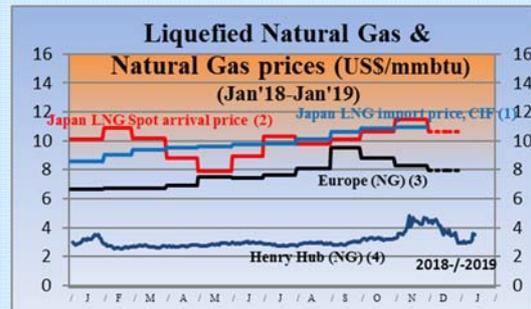
Published: January 22, 2019

The Institute of Energy Economics, Japan

(As of January 18, 2019)



Source: DOE-EIA, Financial Times, NASDAQ



Sources:

- (1) Ministry of Finance "Japan Trade Statistics"
- (2) Ministry of Economy, Trade and Industry (arrival month basis)
- (3) Estimated by World Bank (Netherland Title Transfer Facility)
- (4) DOE-EIA, NYMEX (Front-month Futures)
- (5) Investing.com



Source: x-rates.com



Source: Financial Times

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2019 New Year Message
from
IEEJ Chairman & CEO Masakazu Toyoda
“2019: Multi-faceted Energy Revolution and New Initiative”

Happy New Year.

This year, the Institution of Energy Economics, Japan celebrates 53 years since its establishment. I sincerely thank everyone for their support which has enabled our journey thus far.

The energy situation has undergone dramatic changes in the past half century. The first change was the “fluid revolution.” Japan switched its key energy source from coal to oil around the 1960s. In its early years, the IEEJ was intended to focus mainly on the government’s energy policies and corporate energy strategies for this particular transition.

The second was the “oil alternatives revolution.” The first and second oil crises, which occurred during the 7th and 13th years after the establishment of the IEEJ, tightened oil supplies and sent oil prices soaring, causing global economic turmoil. This led to greater priority on oil alternatives such as natural gas, nuclear power, and renewable energies, as well as energy conservation. The International Energy Agency was established to ensure a stable supply of oil.

The third was the “first climate change revolution.” The soaring oil prices caused by the two oil crises suppressed demand and expanded non-OPEC supplies, resulting in low oil prices which continued for about 20 years which reduced the incentive to introduce oil alternatives. However, in view of concerns that greenhouse gas (GHG) emissions from fossil fuels cause global warming, higher sea levels, and abnormal weather, the Kyoto Protocol was agreed in 1997 to reduce GHG emissions. However, it imposed reduction obligations only on developed countries, and the United States failed to ratify it in Congress.

The fourth was the “second climate change revolution.” Emerging countries have achieved remarkable growth since the year 2000. In 2010, China surpassed Japan to become the world’s second largest economy, and in 2012 became the world’s largest GHG emitter. Under such circumstances, the Paris Agreement was agreed in 2015, this time including emerging and developing countries in the GHG reduction effort. Though targets would be voluntary and non-binding, more than 190 countries were to engage in climate actions.

The fifth and increasingly visible change is what might be called a “multi-faceted revolution,” which is the simultaneous progress of various changes each of which has a significant impact on the energy situation. There are at least five changes under way.

First is “the deepening of climate change revolution.” The rulebook for the Paris Agreement has been adopted at COP24, setting the framework for steady implementation of energy reforms.

Next is the full-fledged implementation of market reforms. While the market goals of promoting competition in the energy sector and lowering energy costs are important, this might conflict with taking climate actions and securing stable energy supplies. A “reform of



market reforms” is currently under way in Europe as countries including Japan continue to explore possibilities to make a fine-tuning of the market reform to address this trilemma.

“Instability in the Middle East” is another change.

The reaction to the Arab Spring movement for democracy has set in. Furthermore, order in the Middle East is being profoundly disrupted: there is confrontation between Saudi Arabia and Iran, conflict between Qatar and other major Gulf countries, uncertainty and volatility over Saudi Arabia triggered by the Khashoggi case, civil wars in Syria and Yemen, and more.

Meanwhile, “a once -in a-century reform of the auto industry” is advancing. The shift to zero emission vehicles (ZEVs) including electric and fuel cell vehicles is accelerating in response to climate change and the drive to prevent pollution. The way in which cars are used is also expected to change greatly, including automated driving and car sharing. The speed of this reform will determine when oil demand will peak.

Last is “the economic war between the two great economies of the United States and China”. This war started as a conflict over the trade balance but is gradually turning into a battle for technological hegemony and competition between systems. This could lead to the end of post-war Pax Americana in which stability and order were maintained, based on the United States as the superpower.

What do we need in response to this multi-faceted revolution? We need an initiative to build a new order through an alliance of like-minded countries.

For climate actions to be truly effective, renewable energies and nuclear power alone are not sufficient; international cooperation for innovative technologies such as zero carbon hydrogen is essential. Further, to achieve complete market reforms, it is essential for countries to learn about each other’s successes and failures and to make practical efforts while considering the characteristics of each country. As for establishing order in the Middle East, assistance for economic development through economic diversification, and not military support, is indispensable. The transformation of the auto industry will require stronger alliances across national boundaries to cover the enormous research and development costs. Regarding the confrontation between the US and China, it is crucial to establish a common understanding that imposing high tariffs and shifting from “rules to deals” hurts the economies of not only the US and China but also the world. It is crucial to reverse this to “deals to rules.” If multilateral rules involving all of the more than 160 member states of the WTO hamper progress, one option is to start with plurilateral rules that apply to multiple countries, based on a US-Europe-Japan collaboration framework, and then later to invite major emerging countries including China to join.

Which country might take the new initiative? There are increasing expectations for Japan which will host this year’s G20 meetings. Japan is one of the world’s most politically stable countries and is also building up its soft power. Japan also has outstanding political and diplomatic leaders. In addition to the LNG Consumer-Producer Conference which has already been running for seven years, the first Hydrogen Energy Ministerial Meeting was held in Japan last year. Japan’s active initiatives are starting to bear fruit.

The IEEJ will continue to deepen its collaboration with key research institutes in and outside Japan and actively present policy and strategy proposals not only in Japan but to the world.

In closing, I would like to take this opportunity to wish everyone a prosperous new year.



Special Feature: Key Points for 2019 [3]

Summary

IV. International Politics, Geopolitics, and Energy

1. US: Trade and Other Key Policies of the Trump Administration

With the primary elections due to start in February 2020, the domestic political situation and President Trump's domestic and foreign policies will be important. Trade policy with China is the main focus, but policies toward Japan must also be watched.

2. EU: Brexit and the European Parliament Election

With Brexit scheduled for the end of March, the world awaits the UK parliament's decision in January. The nomination of a candidate for the next European Commission President in the five-yearly European Parliament election is also awaited.

3. China: All Eyes on US-China Relations on China's 70th Anniversary

Maintaining stable growth remains China's top priority in 2019, its 70th anniversary. As US-China relations remain a key topic, Xi's leadership will face the challenge of making critical and irreversible decisions to protect China's non-negotiable interests.

4. Russia: Rising Tensions Anew with Ukraine amidst the Prolonged Economic Sanctions

Russo-Ukrainian tensions are rising once again after Russia's capturing of Ukrainian ships. While the West's sanctions against Russia have remained unlifted, the Russian people are gradually frustrated with the Putin government.



1. US: Trade and Other Key Policies of the Trump Administration

Ayako Sugino, Senior Researcher
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The United States celebrated Christmas amid a government shutdown and plummeting stock prices. Parts of the federal government have been shut down since December 22 due to a stand-off between the President who is demanding \$5 billion for the wall on the Mexican border and the Democratic Party, which would only approve \$1.6 billion. The conflict has once again highlighted the rising public support for stronger border security, as well as the divide that separates mainstream Democrats and Republicans, who do not consider that building the wall is important, and the 35% core support base of the President who refuses to compromise. In 2019, the United States will enter the election season heading toward the primary elections scheduled to start in February 2020. President Trump can afford to clash with Democrats or be isolated from fellow Republicans thanks to his core supporters, and his attitude will impact both the country's domestic politics and foreign policy.

The key topic is trade policy. Of particular interest is the United States–Mexico–Canada Agreement (USMCA), which will be deliberated in Congress with a Democrat-majority House of Representative, as its tightened rules of origin for automobiles will affect the Japanese auto industry. The Japan-US trade talks due to start in January will focus on automobiles, agriculture, and exchange rates. Regarding its relations with China, the US is seeking not only to resolve the current trade imbalance but is also demanding that China change its course of action, designating China's forced transfer of cutting-edge technologies in automobile and high-tech areas and its use of state-owned enterprises for national development as a national security concern. The two countries reportedly sparred at the World Trade Organization (WTO) conference in December 2018 over US protectionism and China's state capitalism. This is a conflict between two world views and is unlikely to be resolved soon.

Demanding that China cede ground by imposing additional tariffs in the escalating US-China trade war and pressuring Congress to approve the USMCA by suggesting withdrawal from NAFTA without an alternative agreement are characteristic of President Trump's approach. Meanwhile, it is true that the United States has long underpinned the post-war development of the world economy by opening up its domestic market. The world has been struggling to find a new order during the last 15 years, a turbulent time that saw the end of the Cold War and the emergence of new countries. The frustration with the "post-war order" that has grown in American society during this period cannot be ignored.

In 2019, the United States and the world will continue searching for a new order. However, US leadership in addressing this challenge is fragile. President Trump will face tougher investigations on allegations of election law violation and tax fraud while his team of advisors and cabinet members remains unstable. Further, there is fear that the US economy and jobs, which are likely to determine the outcome of the election, will slow down in 2019 and 2020. The President's criticism of the Federal Reserve Board (FRB)'s tight monetary policy has also made markets concerned about the FRB's independence, making economic prospects even more uncertain. Frustration is mounting even within the Republican Party against the President's policies in general, including the budget negotiations mentioned earlier.

Regarding energy policy, regional interests have traditionally mattered more than party affiliations, and the Trump administration's deregulation policy is being cautiously welcomed by industry. Regarding the environment and climate, state governments, companies, and industries are steadily working on decarbonization efforts. However, even for the single issue of climate action, the United States should not be seen simply as an aggregate composed of states and municipalities, corporations, and citizens. The direction of the entire country established jointly by the President and Congress through numerous confrontations and compromises remains significant.

(as of 12/28/2018)



2. EU: Brexit and the European Parliament Election

Kei Shimogori, Senior Researcher
Global Energy Group 1, Strategy Research Unit

Brexit, scheduled for the end of March 2019, is fast-approaching. The parliamentary vote on the withdrawal agreement originally scheduled for December 2018 was postponed as it was highly likely to be rejected. Prime Minister May subsequently announced in Parliament that discussions will resume from the week starting January 7, for a vote the following week. This vote will be just 12 weeks before exit, so Parliament will most probably have to choose between the currently proposed agreement and a no-deal exit. The prime minister once again rejected the possibility of another referendum and is discussing with her cabinet whether to speed up preparations for a no-deal Brexit.

Meanwhile, the EU reconfirmed the conclusions reached last November (approval of the draft agreement and the political declaration) and clarified that the agreement is not for renegotiation at the European Council meeting held at the end of 2018. The vote in Parliament is key, but if the draft agreement is rejected, which option will Britain choose: a no-deal Brexit, a Norway-type membership of the European Economic Area, or another referendum?

From May 23 to 26 this year, the ninth election of the European Parliament will be held. This election is held every five years in all member states according to the European Parliament election rules of each country, and a major focus is who will be nominated for the next President of the European Commission based on the election. In accordance with the Treaty of Lisbon, the European Council will propose to the European Parliament a candidate for the next President based on a qualified majority (needing 55% of member states, representing at least 65% of the EU population for a decision), taking into account the election results for the European Parliament and following due consultations. Under this system, each major political party in the Parliament will nominate their candidate for Commission President and run a campaign.

The rise of anti-EU populist forces is a concern for the European Parliament election. France and Germany, which have led the reforms for closer integration of the EU, are facing waning support in their own countries. France is now more likely to breach the EU fiscal rules as President Emmanuel Macron has decided to freeze the increase in fuel tax for one year in response to anti-government rallies. Further, in Germany, Chancellor Angela Merkel is due to resign as party leader following successive defeats in regional elections in October 2018. The weakening leadership of France and Germany may accelerate the division of the EU and affect the EU's global leadership in the fight against climate change.

According to a June 2017 survey report published by the Pew Research Center, a majority of respondents in Spain, France, Greece, and Italy would support a referendum on EU membership, with 80% in Spain, more than 70% in France, and around 60% in Greece and Italy answering that they would vote to remain in the EU. However, a number of countries are considering leaving the EU following Britain. The EU is on track to meet its 2020 energy target and has completed revisions to major directives in 2018 to meet the 2030 targets. It also announced in November 2018 a long-term strategy of becoming a climate-neutral economy by 2050. Now that the long-term direction of the EU is set, the key is how the member states will overcome their differences and work toward the goal. (as of 12/28/2018)



3. China: All Eyes on US-China Relations on China's 70th Anniversary

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2018 was the start of the “new Xi Jinping era” with a mandate for long-term rule. At the National People’s Congress in March, the constitution was amended and a political thought named after the President titled “Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era” was added as the national guide for action. The limit on the number of presidential terms was also removed, and it was stated in the constitution that China aims to become a “great modern socialist country” with the world’s greatest national strength and international influence by mid-century.

2018 also witnessed the US-China trade war. US President Donald Trump, the self-styled “Tariff Man,” imposed an additional 25% tariff on \$34 billion worth of Chinese goods on July 6, and China immediately added a tariff of the same rate on the same amount of American goods. The US then imposed additional tariffs of 25% on \$16 billion of goods on August 23 and 10% on \$200 billion of goods on September 24. China retaliated by imposing additional tariffs of 25% on \$16 billion and 5-10% on \$60 billion worth of American goods. China made it clear that it will not yield to the pressure of tariffs and took it as an opportunity to accelerate efforts to deepen reforms and open up, including easing foreign investment regulations, strengthening IP rights protection, and lowering import tariffs. China further used every diplomatic occasion including the APEC and G20 summit to call on the international community to oppose protectionism and maintain free trade.

As the US-China trade war deepened, the Chinese government lowered taxes, reduced electricity tariffs by liberalizing the electricity market, and accelerated public infrastructure improvements in an effort to expand domestic demand. As a result, GDP growth remained at 6.7% to Q3 and 6.6% full-year, and is thus likely to exceed the target of 6.5%. However, there were negative impacts including plunging share prices, weakening of the renminbi, and capital outflows. Meanwhile, in January through September, the contribution of consumption to economic growth increased to 78.0% (up 14.0 points year-on-year), the ratio of the tertiary industry in GDP rose to 53.1% (up 0.3 point), and per-GDP energy consumption dropped by 3.1%. New energy vehicles (NEVs) designated as a focus area under “Made in China 2025” sold 1.03 million units by November (up 68%), surpassing one million units for the first time in the world.

2019 marks the 70th anniversary of the country’s founding. The Xi leadership continues to hold “seeking progress while maintaining stability” as its top priority, and so the most important issue is surely US-China relations. The two leaders met on December 1 last year for the first time in a year and agreed to temporarily halt the tariff war, not raise the current tariffs further, and start talks on structural changes with a 90-day time limit.

In response, China announced on December 14 that it will halt the imposition of additional tariffs on American automobiles and parts for three months starting January 1, 2019. The action came with a deadline to see whether the US will reciprocate the favor. The decision reflects public opinion which is for a ceasefire in the trade war but also that China should prepare for its resumption. Meanwhile, Meng Wanzhou, deputy chair and CFO of the world’s leading telecoms firm Huawei, was arrested by Canadian law enforcement officials at the request of the US on the very day of the US-China summit. The arrest is a sign that the trade war is now expanding to a struggle for technological hegemony and competition between systems. The Chinese government will face the challenge of making critical and irreversible decisions to protect the country’s non-negotiable interests.



4. Russia: Rising Tensions Anew with Ukraine amidst the Prolonged Economic Sanctions

Shoichi Itoh, Manager, Senior Analyst
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In September, the ruling party, United Russia, won gubernatorial elections of twenty-five federal subjects, which are equivalent to Japanese prefectures, and regional parliamentary elections of sixteen federal subjects. Overall, however, it gained fewer seats than the last time and its several gubernatorial candidates lost the elections. A poll by an independent polling organization, Levada Center, located in Moscow, of 1,600 people in fifty-two oblasts showed a sharp decline in President Putin's popularity from 59% in November 2017 to 39% in September 2018. Furthermore, 20% of the respondents expressed strong concerns about the West's sanctions against Russia in November 2018, rising sharply from 10% in July of the same year.

On November 15, 2018, President Putin held a meeting with Chinese Prime Minister Li Keqiang at the East Asia Summit in Singapore, and underlined that "relations between Russia and China are now creating a strong basis for a privileged strategic partnership" (*Eurasia Daily Monitor*, December 2018). At the end of the same month, he emphasized that the escalating friction between the US and China provides "a window of opportunity for Russia to achieve a qualitatively new level of bilateral economic relations with China" in the annual "Russia Calling!" TV program (Ibid.). However, some are still pessimistic about the development of Sino-Russian relations. While China is Russia's largest trade partner, Russia is not even among China's top 10 trade partners and accounts for less than 1% of foreign investments in the country. According to the Central Bank of Russia, Chinese commercial banks are wary of becoming embroiled in the repercussions of the West's sanctions and curbing new loans to Chinese companies in search for expansion of business with Russia.

On November 25, Russia captured three Ukrainian ships and detained 24 Ukrainian crew in the Kerch Strait (connecting the Black Sea and the Sea of Azov) near the Crimean Peninsula, which Russia annexed in March 2014, notwithstanding international criticism. In response to a breach of the Russia-Ukraine agreement signed in 2003 that provides freedom of navigation in the Sea of Azov as an inland sea of both countries, Ukraine invoked martial law, escalating bilateral tensions to a new level. In the United States, given that the Democrats regained the majority in the House of Representatives in the mid-term election in November 2018, it has become even harder for the Trump administration to strike a compromise with Russia. On December 13, the EU passed a resolution to extend its sanctions against Russia for another six months.

Gazprom is constructing the Nord Stream-2 pipeline with an aim to make it physically possible to terminate the role of Ukraine as a transit country for Russian gas exports to Europe by 2020. The United States is increasing pressure on European countries to stand against the construction of the Nord Stream-2, the second pipeline connecting to the European market, bypassing Ukraine but through Germany via the Baltic Sea. In November 2018, Gazprom completed the construction of the Black Sea seabed section of Turkish Stream, which connects to the Balkans via Turkey as a transit country. Gazprom is to decide on the route of the pipeline from Turkey soon, whereas Russia's energy strategy evoked strong suspicion on the sides of EU member states and the United States.

Ukraine is scheduled to hold presidential and parliamentary elections in 2019. The confrontation with Russia may affect the geopolitical jockeying over the European gas market, the West's economic sanctions against Russia, and in turn the overall energy strategy of Russia and Japan-Russia relations.



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