

**JAPAN'S UNIQUE ECONOMIC RELATIONS
WITH CHINA: ECONOMIC INTEGRATION
UNDER POLITICAL UNCERTAINTY**

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Executive Summary

1. The Japanese economy shrank 0.6% in the second quarter of 2008. But, Japan's exports to China grew 24.5% in the first five months of 2008. The robust external demand from China is crucial to preventing the Japanese economy from slumping into another recession.
2. Sino-Japanese relations have been labeled as "cold in politics and hot in economics." Political relations were at their lowest during the Koizumi administration. The development of economic relations, however, has been smooth, healthy and immune to political uncertainty.
3. In 2007, Sino-Japanese bilateral trade rose to a new record of \$237 billion, or 17.7% of total Japanese external trade. For the first time, China surpassed the US as the No. 1 trade partner of Japan.
4. Explosive growth of Sino-Japanese trade is a two-way phenomenon. From 1990 to 2007, while China's exports to Japan grew 14.9% annually on average, Japanese exports to China grew even faster at 18.5% annual rate.
5. The rapid growth of the Chinese economy has been serving as a new growth engine for the mature Japanese economy. The growth of exports to China has been one of the critical factors driving the growth of the Japanese economy since 2002.
6. In terms of total bilateral trade, Japanese trade deficits with China actually decreased to 8% of the total bilateral trade in 2007 from 33% in 1990. The fluctuation of exchange rates between Yuan and Yen did not dominate the direction of the trade deficit.
7. In spite of having trade deficits with China since 1990, the Japanese government has rarely applied protective measures against imports from China.

Japanese politicians and business communities have been relatively silent on China's exchange rate regime.

8. Sino-Japanese trade has evolved from inter-industry trade to intra-industry trade. In 2007, about 70% of bilateral trade is intra-industry trade. In particular, machinery and transportation related equipment has merged to become the largest export commodity for both countries.
9. With outsourcing and FDI, Japanese multinational enterprises (MNEs) have integrated Chinese firms into their global production networks. The benefits derived are mutual. While Japanese MNEs can utilize China's cheap and productive labor force to strengthen their global competitiveness, Chinese firms can use the global marketing networks and Japanese brand names to sell made-in-China products in the global market.
10. Japan is the second largest source of FDI in China. Japanese cumulative FDI in China accounted for about 10% of China's FDI from 1990 to 2007. China has replaced ASEAN-4 (Indonesia, Malaysia, Philippines and Thailand) as the number one host of Japanese FDI in Asia.
11. Before 2003, Japanese FDI in China was export oriented and China was merely an export platform. Japanese affiliated manufacturers exported more than 60% of their products to the overseas market, of which 50% was destined for the Japanese domestic market.
12. After China's accession to the WTO and the rising affluence of its people, Japanese affiliates in China have transited from being export-oriented to domestic-oriented. In particular, in the transportation-related-equipment sector, local sales exceeded 90% in 2007.
13. If the Chinese economy continues to achieve high growth rates, it will serve as a critical growth source for the Japanese economy. With rising oil prices and environmental degradation, China will benefit substantially from the cooperation in energy and environmental protection technologies with Japan.

JAPAN'S UNIQUE ECONOMIC RELATIONS WITH CHINA: ECONOMIC INTEGRATION UNDER POLITICAL UNCERTAINTY

XING Yuqing*

“Cold in Politics” vs “Hot in Economics”

- 1.1 The US sub-prime loan crisis and surging oil prices have dragged the global economy to the verge of stagnation. Japan, the second largest economy, has lost the steam to grow further. In the second quarter of 2008, the Japanese economy shrank 0.6%, indicating that the longest economic expansion since 2002 was over.
- 1.2 The decline in consumer spending and domestic investment along with the slow growth of exports resulted in the contraction of the second largest economy. The slow growth of Japanese exports was mainly due to the weakened demand of the US. According to JETRO, Japanese exports to China still grew rapidly. In the first five months of 2008, Japanese exports to China grew 24.5% compared with the year before. In April and May 2008, Japanese exports to China grew 33.8% and 29.1% respectively. Hence, the external demand from China is crucial to preventing the Japanese economy from slumping into another recession. The sustained economic growth of China remains a reliable growth engine for the Japanese economy
- 1.3 Sino-Japanese political relations have been very rocky since the middle of 1990s. Relations were at its lowest during the Koizumi administration because of his annual visit to the Yasukuni Shrine. In 2004, the visit triggered a large scale anti-Japanese demonstration in major Chinese cities such as Beijing and Shanghai.

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- 1.4 The dispute over the sovereignty of Diaoyu/Senkaku island occasionally threatens the stability of Sino-Japanese relations. With surging oil prices, securing energy supply has become the top priority of both China and Japan. China's oil exploration in the East China Seas becomes a new dispute between the two countries. The approval of the history textbooks which play down the atrocities of the Japanese often reminds the Chinese public of Japan's continual attempt at distorting history.
- 1.5 Despite deteriorating political relations, the development of Sino-Japanese economic relations has been smooth and healthy. The integration of the two economies has not been affected by the deteriorating political relations. Japan was the number one trade partner of China from 1990 to 2003. China is now the top export customer for Japan¹. In 2007, bilateral trade between the two countries reached \$236.6 billion or 17.7% of total Japanese external trade. For the first time, Sino-Japanese trade exceeded that of American-Japanese bilateral trade; China emerged as the largest trade partner of Japan, even though the size of the Chinese economy is less than a quarter of the US economy.
- 1.6 The Japanese have been very active in investing in China directly. As a result, Japan has become the second largest source of FDI in China. From 1990 to 2007, cumulative Japanese direct investment in China amounted to \$64 billion or 10% of total FDI in China. China has replaced ASEAN-4 as the top host of Japanese FDI in Asia.
- 1.7 Through direct investment and outsourcing, Chinese and Japanese firms have integrated production chains with the participation of the Chinese labor force in labor-intensive segments of high-value added manufactured products. Intra-industry trade between Japanese parent firms and their affiliates in China greatly contributed to the intra-industry trade of the two economies.

¹ *Financial Time*, Aug 22, 2008

- 1.8 Technology transfers and spillovers associated with Japanese direct investment in China have improved production capacities and varieties of Chinese industries. Through cooperation with Japanese MNEs, Chinese firms are able to utilize the distribution network and brand names of Japanese companies to sell made-in-China products to Japanese and other overseas markets.
- 1.9 How can Sino-Japanese economic cooperation be immune to political tensions? First, Japan is a market economy and China is in the transition of transforming itself into a market economy. Individual consumers and firms will not follow the wills of politicians, but their own economic interests. Second, the two economies are highly complementary. Japan is rich in capital and technology which are highly demanded by the rapidly growing Chinese economy. China's sustained high growth has provided a new growth source for the Japanese economy and tremendous opportunities for Japanese multinational enterprises. The economic cooperation has created a win-win scenario, generating tremendous economic benefits to both sides. For instance, China's demand for Japanese exports was considered a critical factor for the Japanese economy when it finally moved out of its decade-long economic stagnation in 2002.
- 1.10 The factors driving economic integration of China and Japan include (1) China's spectacular economic growth, which stimulates demand for Japanese exports and promotes China's exports to Japan; (2) trade liberalization within the two countries and China's accession to the World Trade Organization (WTO); (3) the massive Japanese direct investment in China, integrating the Chinese industries in Japan's global production chains, enhancing significantly intra-industry trade between the two economies and reverse imports; (4) the complementarity nature of the two economies; and (5) the geographic proximity between the two countries.

Explosive Growth of Sino-Japanese Bilateral Trade

- 2.1 In 2007, Sino-Japanese bilateral trade reached \$236.6 billion, about 17.7% of total Japanese external trade, and exceeding the trade volume between Japan and the US. China surpassed the US as the largest trade partner of Japan. It represents a new milestone in Sino-Japanese bilateral trade.
- 2.2 It is important to emphasize that the growth is driven not only by China's dramatic export expansion to Japan, but also by the rapid increase of Japanese exports to China. Since the beginning of the economic reform in late 1970, China has been following the export-led economic growth strategy. Promoting exports to Japan, the second largest economy, has been given a high priority by the Chinese government and firms. It may not be a surprise to observe that Chinese exports to Japan grew 14.9% annually on average from 1990 to 2007 and jumped to \$127.7 billion.
- 2.3 On the other hand, China's rapid economic growth has created a huge market for Japanese products; Japanese exports to China grew on an annual average of 18.5% from 1990 to 2007, much higher than China's exports to Japan. "China threat" was a popular topic in Japanese media a few years ago. Decomposing the sources of Japanese economic growth, however, suggests that China has been a vital factor for the Japanese economic recovery rather than a "threat." In reality, when the Japanese economy finally bottomed out from its more than ten years of long stagnation in 2002, the exports to China accounted for more than two thirds of Japanese overall export growth, which in turn contributed 0.8 percentage point to the growth of the Japanese economy though the economy grew only 0.26 percent². In other words, without the robust export growth driven by rising demand from China, the Japanese economy might not have been out of its economic stagnation (Table 1).

² The Cabinet Office of Japan, 2004

TABLE 1 JAPAN'S TRADE WITH CHINA: 1990-2007 (US\$ BILLION)

Year	Exports to China	Imports from China	Total trade	As % of Japanese total trade	As % of China's total trade
1990	6.1	12.1	18.2	3.5	15.6
1991	8.6	14.2	22.8	4.1	16.9
1992	12	17	29	5.1	17.3
1993	17.4	20.7	38.1	6.3	19.5
1994	18.7	27.7	46.4	6.9	19.6
1995	21.9	35.9	57.8	7.4	20.6
1996	21.8	40.4	62.2	8.2	21.4
1997	21.7	41.8	63.5	8.4	19.5
1998	20.2	37.1	57.3	8.6	17.7
1999	23.5	43.1	66.6	9.1	18.5
2000	30.4	55.2	85.6	10.0	18.0
2001	30.9	57.8	88.7	11.8	19.0
2002	40	61.8	101.8	13.5	16.4
2003	57.5	75.6	133.1	15.6	15.6
2004	73.9	94.3	168.2	16.5	14.6
2005	80	108.4	188.4	17.0	13.2
2006	92.8	118.4	211.2	17.2	12.0
2007	109.1	127.6	236.7	17.7	10.9

Source: Direction of Trade by the IMF and Author's Calculation

Dynamic Changes of Trade Structure: from inter- to intra-industry Trade

- 3.1 Sino-Japanese bilateral trade has evolved from inter-industry trade to intra-industry trade. Sino-Japanese bilateral trade in the early 1990s followed exactly the prediction of the theory of comparative advantage. While China exported labor and resource intensive products to Japan, Japan mainly exported capital goods to China. For instance, in 1990, the leading exports of China to Japan were miscellaneous manufactured products (27.5%), fuels of mainly crude oil (24%), and food and animal (15.7%).

**TABLE 2 THE COMMODITY STRUCTURE OF JAPAN'S TRADE
WITH CHINA (US\$BILLION)**

Commodities	1990				2007			
	Exports to China		Imports from China		Exports to China		Imports from China	
	Volume	Share	Volume	Share	Volume	Share	Volume	Share
Food and Live Animals	25.1	0.41	1,877.3	15.65	378.2	0.35	7,662.0	5.99
Beverages and Tobacco	0.7	0.01	30.0	0.25	14.1	0.01	92.7	0.07
Crude Materials, inedible, except fuels	211.4	3.46	1,159.0	9.66	3,890.9	3.56	1,837.2	1.44
Fuels, Lubricants, Etc	65.8	1.08	2,963.8	24.70	1,877.0	1.72	2,803.4	2.19
Animal. Veg. oils, fats, Wax	0.9	0.01	12.5	0.10	7.1	0.01	36.5	0.03
Chemicals, reld. Prod. nes	749.18	12.25	549.2	4.58	15,261.7	13.97	6,576.1	5.14
Manufactured goods	1,918.9	31.38	1,583.1	13.20	16,792.4	15.37	15,725.9	12.29
Machines, Transport RT Equip	2,676.5	43.77	457.0	3.81	55,665.8	50.94	44,986.2	38.29
MISC Manufactured	376.3	6.15	3,299.8	27.50	8,373.9	7.66	42,731.1	33.40
Goods not classed	90.2	1.47	65.4	0.54	7,004.4	6.41	1,471.3	1.15

Source: UNCOMTRAD and Author's Calculations

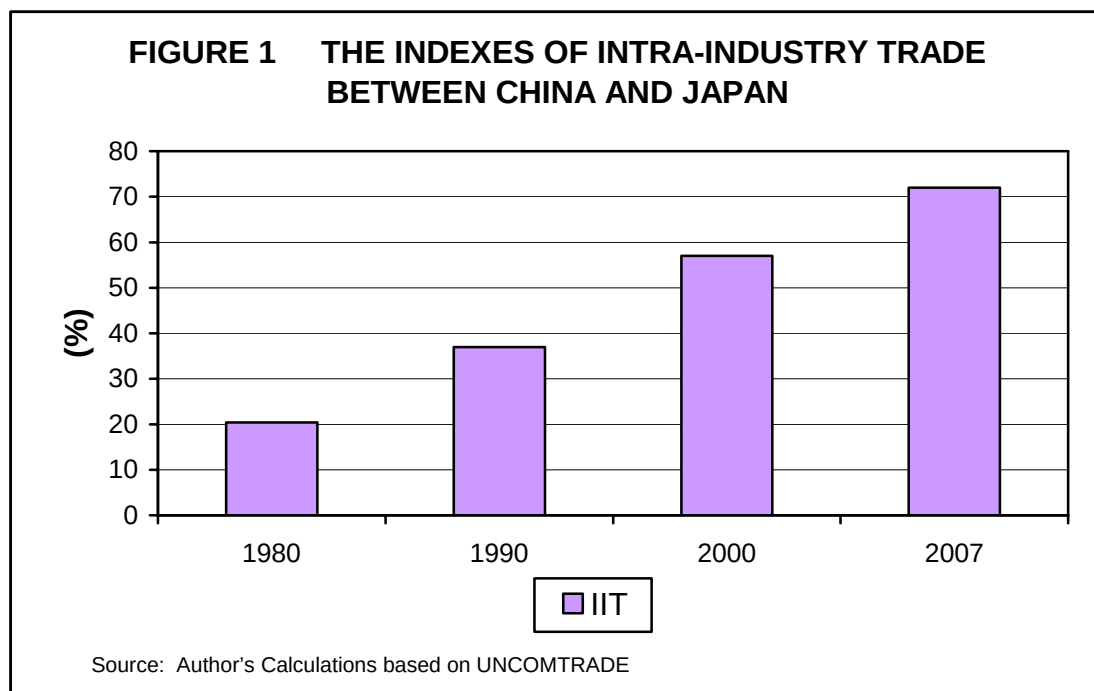
3.2 By 2007, the pattern of China's export to Japan had changed dramatically. Machinery and transportation related equipment surpassed miscellaneous manufactured products and became the number one exported commodity to Japan. The exports of machinery and transportation related equipment jumped to \$44.5 billion and accounted for 38% of China's total exports to Japan. Manufactured goods (SITC 6) emerged as the third largest export to Japan. The changing export pattern indicates that the economic integration with the world economy and the rapid economic development in the last three decades have greatly enhanced China's production capacity and its competitiveness in manufactured products, gradually improving the value added of China's exports.

3.3 It is worthy to emphasize that machinery and transportation related equipment have become the number one export for both countries. In 2007, China exported \$49 billion to Japan while Japan exported \$55.7 billion to China; thus the intra-industry trade index of machines and transportation related

equipment reached 96 percent, suggesting that the two countries simply exchanged similar products in the category.

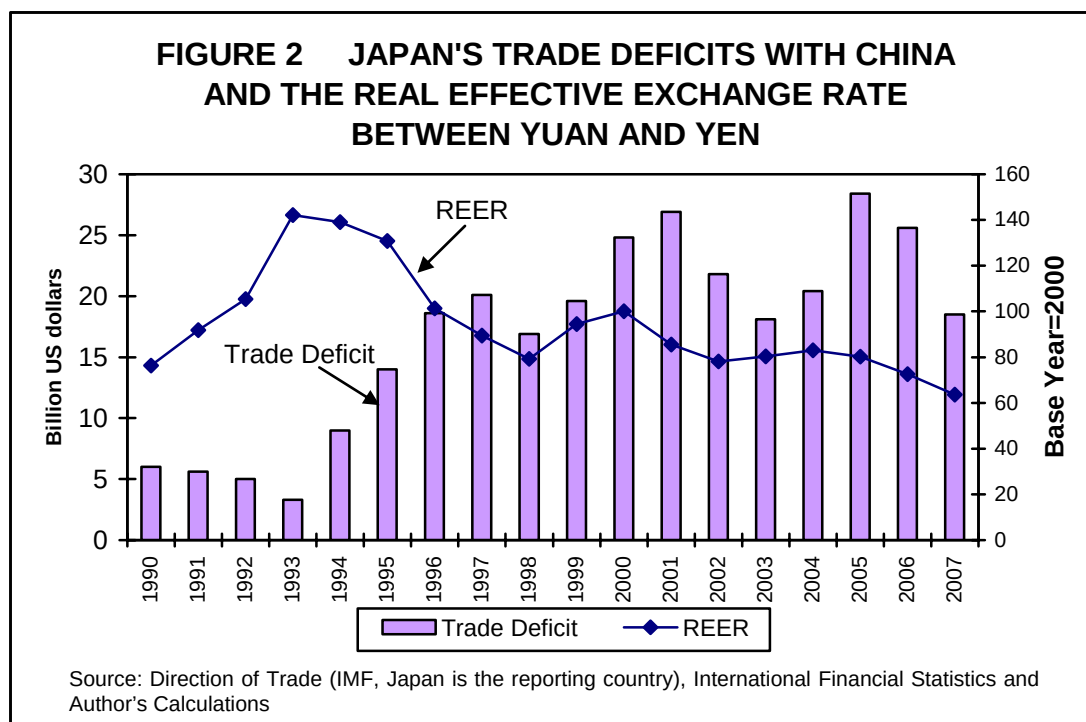
3.4 How did China manage to catch up so quickly with Japan in such a manner that it is able to export almost the same amount of products as Japan, a long-serving world leader in the field? The answer lies in Japanese MNEs and their direct investment in China. Intra-firm trade between Japanese parent companies and their subsidiaries in China has greatly enhanced intra-industry trade between China and Japan. Intra-firm trade between parent firm and their foreign affiliates is usually in products of the same industrial categories because of the sharing of specific capital and technology of both parent and affiliated firms.

3.5 In fact, the overall intra-industry trade between China and Japan has exceeded inter-industry trade. In 1990, the intra-industry trade accounted for 37 percent of the overall bilateral trade. By 2007, it surged to 72 percent, suggesting that the two countries exchange more and more goods in the same categories. Production fragmentation, outsourcing and Japanese direct investment in China have been driving the rapid growth in intra-industry trade (Figure 1).



No Protectionism and No Yuan Bashing from Japan

- 4.1 In the days of the Koizumi administration, political relations between China and Japan had substantially deteriorated because of Koizumi's annual visit to the Yasukuni Shrine. It was initially expected that the political tensions might harm Sino-Japanese economic cooperation. However, reality check suggests that the bilateral trade and Japanese FDI were immune to the political tensions. During the Koizumi administration from 2001 to 2006, bilateral trade grew continuously every year to \$211 billion from \$89 billion, or 2.6 times more. Japanese direct investment in China grew 150 percent from 2001 to 2005, declining only in 2006. This indicates that the deteriorating political relations between China and Japan had very little negative impact on their economic relations.
- 4.2 China's exchange rate regime has been the focal point of debates on global imbalance. The "under-valued" Yuan has been accused of causing the huge deficit between the US and China. The US government, politicians and industrial organizations have been trying to press China to revalue Yuan. Except for former Japanese minister Masajuro Shiokawa, who openly accused China of "exporting deflation" to Japan and criticized China's exchange rate regime, the Japanese government and business communities have been primarily silent about Yuan's evaluation. The under-valued yuan benefited Japanese MNEs which have been using China as an export platform.



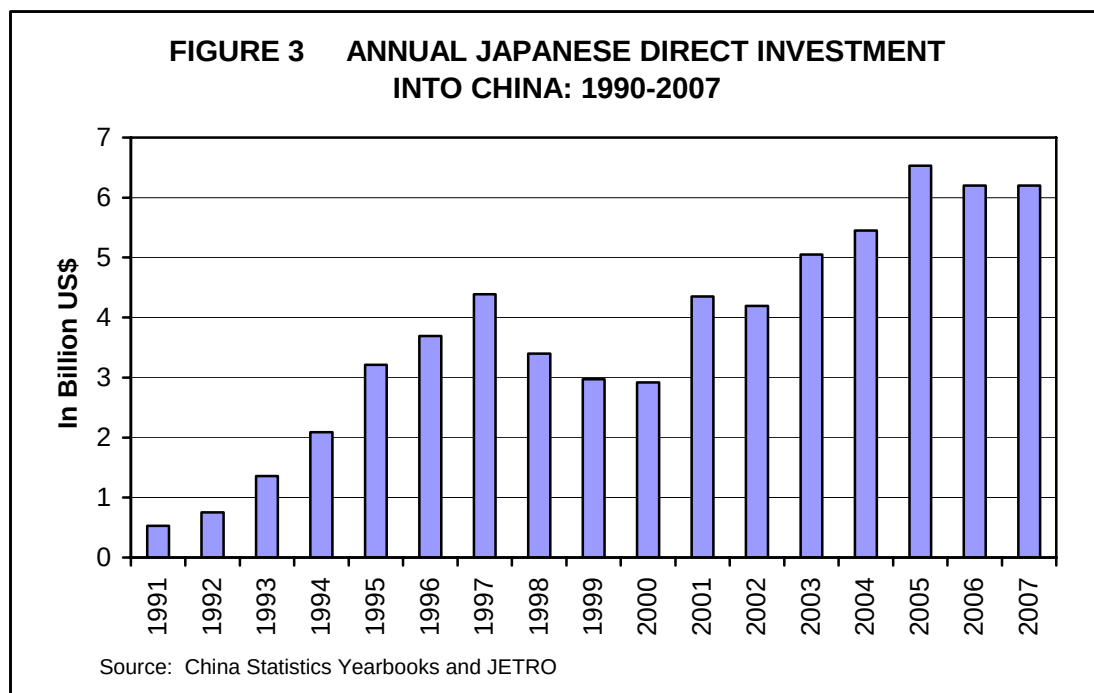
4.3 The “under-valued Yuan” has yet to widen Japan’s trade deficit with China. Figure 2 shows the trends of Japanese trade deficit with China and the index of real effective exchange rate (REER) between Yuan and Yen. A higher real effective exchange rate (REER) index means that the Japanese Yen has appreciated against Chinese Yuan in real terms. From 1990 to 1993, the REER index rose from 76 to 142, representing 87 percent real appreciation of Japanese Yen against Chinese Yuan. Japanese trade deficit not only did not increase but decline to \$3.3 billion from \$5.9 billion. In 2007, the REER dropped to 63.5, implying a 55 percent real depreciation of Japanese Yen against Chinese Yuan, compared with 1993. Japanese trade deficit jumped to \$18 billion during the period. The “under valued Yuan” did not affect trade balance as predicted by conventional economic theories. The unconventional relationship between the real exchange rate of Yuan and Yen and the Sino-Japanese trade balance offers a case against the current bashing on the Yuan.

4.4 Even though China has been running a trade surplus against Japan since 1990 from \$6 billion to \$18.5 billion, the Japanese government and domestic business organizations have not taken major protective measures against Chinese imports; none of the anti-dumping cases were filed by Japan. The

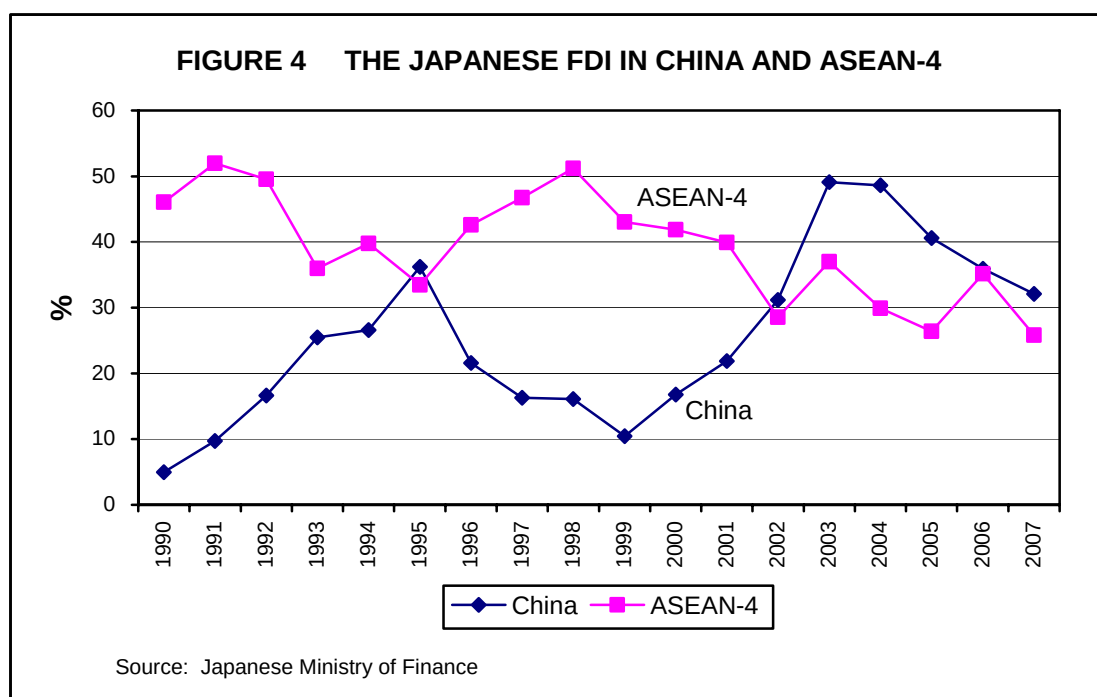
only major trade friction between China and Japan was the provisional safeguard measures taken by Japan on 23 April 2001. These measures were against the imports of Welsh onions, Shiitake mushroom and Tatami mats, 99 percent of which were from China. The measures were dropped when China threatened to impose high tariffs on Japanese automobiles and other major exports

Japanese FDI in China: Promoting Bilateral Trade and Technology Transfer

- 5.1 In terms of foreign direct investment, Japan is the second largest investor in China, after Hong Kong. From 1990 to 2007, cumulative direct investment in China amounted to \$64 billion, about 10% of total FDI in China. The scale of Japanese FDI in China was very limited in the 1980s. In 1990, a mere 0.5 billion flowed to China. It surged to \$4.4 billion in 2004. Due to the Asian financial crisis and the economic stagnation of the Japanese economy, FDI inflow decreased to \$3 billion in 2000. China's accession to the WTO stimulated FDI significantly. In 2001 FDI from Japan jumped to \$4.4 billion again and reached a new peak of \$6.5 billion in 2005. (Figure 3)



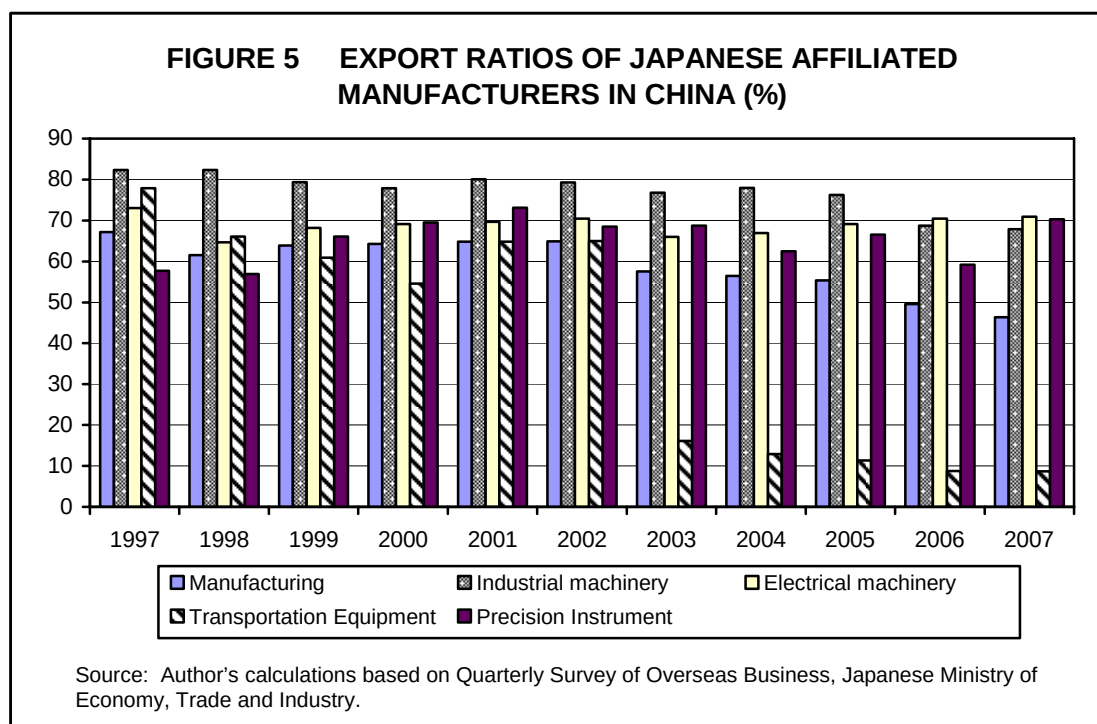
5.2 ASEAN-4 had been the leading host of Japanese FDI in Asia before the early 1990s. China has replaced ASEAN-4 as the top destination of Japanese FDI. In 1992, only 10 percent of Japanese direct investment in Asia ended in China while 52% went to ASEAN-4 (Indonesia, Malaysia, Philippines and Thailand). The distribution had changed drastically. By 1995, the share of China jumped to 36% and that of ASEAN-4 dropped to 33%. China's WTO membership revitalized another round of Japanese direct investment boom in China. In 2004, almost 50% of Japanese direct investment in Asia flowed to China while only 30% went the ASEAN-4 (Figure 4).



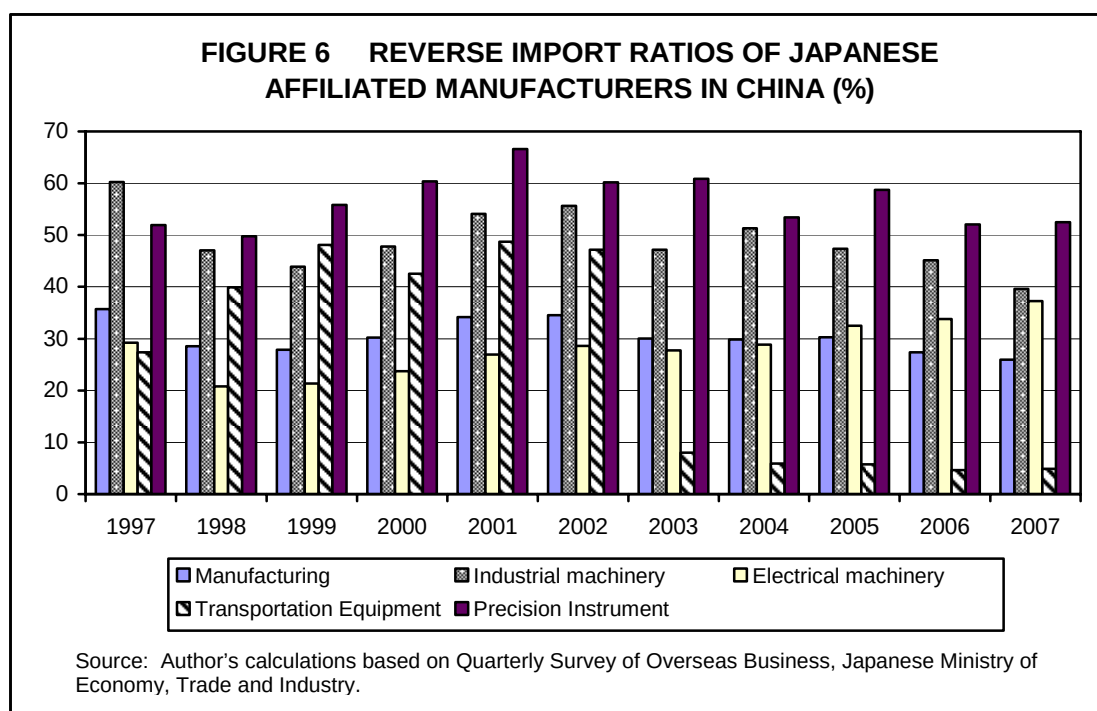
5.3 One of the fundamental purposes of Japanese companies investing in China is to utilize China as an export platform for the world market. Combining their advanced technology, brand name and well-established global distribution system with low production costs of China, Japanese MNEs are able to strengthen their global competitiveness. The export-oriented nature of Japanese MNEs is reflected in their export destinations.

5.4 Figure 5 depicts export ratios of Japanese affiliated manufacturers in China in electrical machinery, industrial machinery, transport equipment, textile, precision instruments, and all manufacturing industries as a whole for the

period of 1997 to 2007. Firstly, exports of Japanese affiliates far exceeded sales in the local market. The manufacturers as a whole exported more than 60% of their products to the overseas market. In industrial machinery, exports accounted for more than 76 percent of total annual sales before 2005, the highest among all sectors. In electrical machinery, the export ratios ranged from 65 to 73%.



5.5 As Chinese consumers become more affluent, their demand for Japanese products such as electronics and automobiles also experienced a corresponding upsurge, leading Japanese affiliated manufacturers to move towards domestic oriented operation in recent years. Transportation equipment is a typical example. Japanese affiliated manufacturers in the sector sold more than 90% of their products in the Chinese market. The export ratio of all manufacturing industries as a whole decreased to 46% in 2007. It is the first time that the local sales of Japanese affiliates exceeded their exports. Switching to domestic market oriented operation can mitigate the negative impact of Yuan's revaluation and rising labor cost in China. In the foreseeable future, domestic market oriented FDI from Japan will be dominant.



5.6 Another significant characteristic of Japanese MNEs in China is that they are actively engaged in reverse imports, which refer to products made in overseas Japanese plants and exported to the Japanese market. Coping with rising Yen and shrinking domestic demand, many Japanese firms have relocated their domestic production capacity to China, or simply outsourced their production to Chinese firms to cut production costs.

5.7 Figure 6 shows ratios of reverse imports to total sales in selected industries. In precision instruments, more than half of the products were exported to the Japanese domestic market either as final goods or intermediate inputs. In industrial machinery, the ratio of reverse imports was consistently higher than 40 percent. The ratio of reverse import in electrical machinery actually rose from 30% in 1997 to 37% in 2007. Reverse import activities demonstrate that China has served as an important production base for final products consumed in the Japanese market and for intermediate inputs of Japanese firms. The large scale reverse imports indicate a high level of vertical integration between Japanese and Chinese industries, thus developing a close linkage between firms of the two economies in both production chains and marketing networks, and further deepening interdependence between the two countries.

- 5.8 Similar to export ratios, the ratio of reverse imports for the manufacturing industry as a whole has gradually decreased from 36% in 1997 to 26% in 2007. A substantial change happened in the transportation sector, where reverse imports accounted for only 5% of the total sales while the number was as high as 49% in 2001. The change implies that the importance of the Chinese market has exceeded the Japanese domestic market and Japanese affiliated manufacturers in transportation related equipment have completed their transition from being primarily export-oriented to domestic market-oriented.

Prospects of Sino-Japanese Economic Relations

- 6.1 In the “warm spring” visit to Japan in April 2008, President Hu Jintao defined Sino-Japanese relations as “strategic and mutually beneficial”. Recently, China and Japan have signed an agreement to jointly explore the East China Seas and China has invited Japanese oil companies to invest in the “Chunxiao” oil field. Hence, under the new leadership of both countries, the political tension has been eased. Sino-Japanese political relations are moving to a new forward-looking era.
- 6.2 It is highly likely that the high growth rate of the Chinese economy will continue for another two to three decades. China’s GDP was only \$3.4 trillion in 2007. The room for further expansion is huge. Even though Japan is a mature economy, exports remain a critical factor for the growth of the Japanese economy. As the Japanese manufacturing industry, Japan’s pillar industry, depends on the overseas market for its future growth, China will continue to serve as the most important growth source for the Japanese economy in the next two to three decades. It is expected that Japanese exports to China will continue to increase rapidly.
- 6.3 A modern manufacturing industry is key to China’s industrialization. Compared with high-tech and financial sectors, the manufacturing industry produces more jobs, which is crucial for providing jobs to millions of rural migrants to China’s urban areas and China’s industrialization. Japan remains the world leader in automobile, machinery and electronics. Technology and

capital from Japan will be critical for the Chinese industry to improve its production capacity, product variety and productivity. The industries in the two countries will be further integrated with Japanese FDI in China and the outsourcing activities of Japanese MNEs.

- 6.4 Pollution and surging oil prices have emerged as the major threats to the long term sustainability of the Chinese economy. How to improve energy efficiency and how to protect the environment while maintaining rapid economic growth are the two challenges faced by the Chinese economy. Japanese industries have advanced technologies in energy consumption and pollution control. The cooperation between Japan and China in energy and clean technology, pollution abatement, and environmental protection will further expand the scope of economic integration and provide new growth areas for both countries.
- 6.5 Rising labor costs and cumulative appreciation of Chinese Yuan will gradually erode the advantages of China as an export platform of labor intensive products. On the other hand, good infrastructure, relatively productive workers and a growing domestic market will play new roles in attracting domestic-oriented Japanese FDI. The US remains the largest host of Japanese FDI simply because it is the largest market in the world. China's potential in this regard will definitely drive a new round of Japanese FDI into China.