CHINA'S ECONOMIC RELATIONS WITH JAPAN, SOUTH KOREA AND TAIWAN SUSTAINED BY PERSISTENT TECHNOLOGICAL GAPS

CHIANG Min-Hua

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Executive Summary

1. Japan, South Korea and Taiwan are China's leading sources of imports, accounting for over a third of China's total imports in 2017. China's imports from the three economies are mainly machinery and electrical equipment.

2. These imports were a result of its efforts to attract foreign direct investment (FDI) to develop China's high technology industry in the 1990s and beyond. Foreign firms in China have relied on importing key components and capital equipment from their home countries.

3. As of 2015, Japan was the third largest foreign investor in China while South Korea was sixth and Taiwan seventh. China's wage hike since over a decade ago has been a dampener to FDI. The combined investment shares of Japan, South Korea and Taiwan in China's total FDI had clearly dropped from 21.5% in 1997 to 6.6% in 2017.

4. China's FDI in manufacturing has fallen in recent years, with Japanese investment retaining a sizeable share in machinery and transport equipment sectors. South Korea and Taiwan have been focusing on producing information and communication technology (ICT) goods in China.

5. Despite China's industrial upgrading in recent years, it has continued to run an increasingly large trade deficit with the three economies due to its lack of key technology. In 2017, China's trade deficit in machinery and electrical equipment with Japan, South Korea and Taiwan combined was US$162.9 billion, a huge jump from US$14.6 billion in 1997.

6. China has sought to move up the technological ladder by encouraging private firms in R&D spending. However, foreign firms' contribution to China's R&D activities is limited. In 2016, foreign invested firms, including FDI from Hong Kong and Macau, accounted for only 22% of China's total intramural R&D spending compared to 78% of R&D expenditure spent by China's domestic firms.

7. Joint ventures form an important source of technology transfer from foreign firms to local firms, accounting for 43.6% of total FDI in 1997 and down to 23.4% in 2017. In the meantime, the ratios for wholly owned foreign enterprises increased from 34.9% to 69.3%.

8. The ambitious "Made in China 2025" programme aims to raise the domestic content of core components to 40% by 2020 and 70% by 2025. If fully realised, Japan, South Korea and Taiwan could lose a strong engine for economic growth.

9. China's commitment to international economic rules is supposed to encourage more cooperation between Chinese and foreign firms in the high technology industry. China's weak legal framework is however a big deterrent to any technology transfer. The limits imposed on technology transfer is politically motivated to deter China from climbing the regional production network.