Japan’s Unique Economic Relations with China: Economic integration under political uncertainty

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This paper provides an analysis of the economic integration between China and Japan since 1990. It investigates the trend, growth and structural changes of Sino-Japanese bilateral trade, and examines the major characteristics of Japanese direct investment in China. The analysis suggests that rising trade and Japanese direct investment have deepened economic relations between the two countries. It is the market force that has been driving Sino-Japanese economic integration. The common economic interests and mutual benefits have outweighed the political disputes and immuned economic relations from the political uncertainty.

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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 visits to the Yasukuni Shrine. Despite deteriorating political relations, the development of Sino-Japanese economic relations has been smooth and healthy in the last two decades. Through trade and direct investment, the economic integration between China and Japan has been increasing and deepening. Economic ties of the two countries have never been as close as today.

In 2007, bilateral trade between the two countries rose to US$236.6 billion or 17.7% of total Japanese external trade. For the first time, Sino-Japanese trade exceeded American-Japanese bilateral trade; China surpassed the US and emerged as the largest trading partner of Japan. Japanese multinational enterprises have been actively engaging in direct investment and established massive production capacities in China. From 1990 to 2007, cumulative Japanese direct investment amounted to US$64 billion or 10% of total FDI stock in China. Japan ranks second in terms of total FDI stock in China, just after Hong Kong, while China has replaced ASEAN-4 as the top destination of Japanese FDI in Asia.

There exist no formal institutional arrangements, such as a bilateral free trade agreement, to facilitate the economic integration between the two countries. Even worse, the political relations between the two countries substantially deteriorated during Koizumi’s terms in office. The intensified economic cooperation has been fundamentally driven by market forces and trade liberalisations. Japan is a market economy and China is in the transition of transferring itself into a market economy. Individual consumers and firms in both countries do not follow the wills of politicians, but their own economic interests. Therefore, the economic integration between the two countries has been primarily immune to the political disputes.

Major 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 liberalisation within the two countries and China’s accession to the World Trade Organisation (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 complementary nature of the two economies; and (5) the geographic proximity between the two countries.

Explosive Growth of Sino-Japanese Bilateral Trade

The scale of Sino-Japanese bilateral trade was relatively small in the past. In 1990, the bilateral trade amounted US$18 billion, about 3.5 percent of total Japanese external trade (Table 1). By 2007, Sino-Japanese bilateral trade reached US$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 to emerge as the largest trade partner of Japan. This represents a new milestone in Sino-Japanese bilateral trade.

The growth of the bilateral trade is not a one-way phenomenon. It is driven by not only China’s dramatic export expansion to Japan, but also the rapid increase of Japanese exports to China. From 1990 to 2007, Chinese exports to Japan grew on average
14.9 percent annually, jumping to US$127 billion from US$12 billion, with 14.9 percent increase. On the other hand, China’s rapid economic growth has created a huge market for Japanese products; Japanese exports to China surged to US$109 billion from $6 billion at the same time, with an annual growth of 18.5 per cent, much higher than China’s exports to Japan.

“China threat” was a popular topic in Japanese media a few years ago. Deciphering the sources of Japanese economic growth, however, suggests that China has been a vital factor for the Japanese economic recovery rather than being 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 percent. 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.

**Dynamic Changes in Trade Structure**

Besides the rapid expansion of the trade volume, the structure of Sino-Japanese bilateral trade has experienced dramatic change in the same period and the share of intra-industry trade has increased substantially. Table 2 compares the trade structure in 1990 and 2007. The bilateral trade in the early 1990s followed exactly the prediction
of the theory of comparative advantage. While China exported labour and resource intensive products to Japan, Japan mainly exported capital goods to China. In 1990, for example, 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%).

By 2007, the pattern of China’s export to Japan had changed substantially. Machinery and transportation-related equipment surpassed miscellaneous manufactured products to become the number one exported commodity to Japan, amounting to US$45 billion in exports, and about 38% of China’s total exports to Japan. Manufactured goods emerged as the third largest export to Japan with US$15 billion exports. The changing export pattern indicates that the rapid economic development in the last three decades

| TABLE 2 THE COMMODITY STRUCTURE OF JAPAN’S TRADE WITH CHINA (US$ MILLION) |
|-----------------|--------|--------|--------|--------|--------|--------|--------|--------|
| Commodities     | 1990   | 2007   |
| Exports to China| Volume | Share  | Volume | Share  | Volume | Share  | Volume | Share  |
| 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, rel. 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 Goods not classed | 376.3  | 6.15   | 3,299.8 | 27.50  | 8,373.9 | 7.66   | 42,731.1 | 33.40  |
|                          | 90.2   | 1.47   | 65.4   | 0.54   | 7,004.4 | 6.41   | 1,471.3 | 1.15   |

Source: UNCOMTRAD and Author’s Calculations
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 MNCs 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. In fact, based on three-digit SITC categories, the overall intra-industry between China and Japan rose to 34 percent in 2004 from less than five percent in 1990.

**Little Protectionism and No Yuan-bashing from Japan**

After almost three decades of rapid growth, China has evolved as the third largest trading economy. It has become not only the leading exporter in traditional labour intensive goods such as clothes, shoes, toys, travel gears, etc., but also the number one exporter of information communication technology products. As more and more made-in-China products have been flooding the global market, China has been under the siege of global protectionism.

Developing countries which compete with China in the third market are worried that made-in-China may crowd out their exports, while industrialised countries are fearful that trade with China would lower their wages, thus hurting their living standard. Among WTO members, China has become the number one target of anti-dumping cases. From 2000 to June 2002, 113 anti-dumping cases were filed against China while there were only 47 anti-dumping cases against the second leading target, South Korea. Back in the 1980s, Japan was the leading target of global protectionism.

Even though Japan has been running a trade deficit with China since 1990, with the trade deficit rising to US$18 billion in 2007, the Japanese government and domestic business organisations have not taken major protective measures against Chinese imports, and 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 Apr 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 removed soon after China threatened to impose high tariffs on Japanese automobiles and others.

Textiles are another example suggesting that the Japanese market is relatively more open to Chinese products, compared with the US and EU markets. Before the Multi-Fibre Agreement was abolished, both the EU and US applied strict quotas to control textile imports from China. As a result, from 1991 to 2003, China’s market share in the EU remained constant at about 22 to 24 percent while China’s market share in the US shrank from 30 to 21 percent before increasing again in 2002 and 2003. In 2005, upon a request by the EU, China agreed to limit its textile export growth to the EU market for three years. On the contrary, China’s textiles exports to Japan have grown rapidly. China’s share of Japanese textile import market rose from 40 to 80 percent in 2003. But, the Japanese government has never resorted to countervailing duties or transitional safeguard measures under the agreement on textiles and clothing.

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 organisations 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 criticised China’s exchange rate regime, the Japanese government and business communities have been primarily silent about Yuan’s evaluation.

Figure 1 shows the trends of Japanese trade deficit with China along with the index of real effective exchange rate (REER) between yuan and yen. A higher REER index means that the Japanese yen appreciates against the Chinese yuan in real terms. From 1990 to 1993, the REER index rose from 76 to 142, representing 87 percent real

![Figure 1: Japan’s Trade Deficits with China and the Real Effective Exchange Rate Between Yuan and Yen](image)

Source: Direction of Trade (IMF, Japan is the reporting country). International Financial Statistics and Author’s Calculations
appreciation of Japanese yen against Chinese yuan. During this time, Japanese trade deficit did not increase but decline to US$3.3 billion from US$5.9 billion. In 2007, the REER dropped to 63.5, implying a 55 percent real depreciation of Japanese yen compared with 1993. Japanese trade deficit, however, jumped to US$18 billion during the period. The simply descriptive analysis suggests that, the “under valued yuan” did not affect the 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 of the Chinese yuan.

Japanese FDI in China

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 US$64 billion, about 10% of total FDI in China. Figure 2 shows the annual Japanese FDI in China from 1991 to 2007. The scale of Japanese FDI in China was very limited in the 1980s. In 1990, a mere US$0.5 billion flowed to China. It surged to US$4.4 billion in 2004. Due to the Asian financial crisis and the economic stagnation of the Japanese economy, FDI inflow decreased to US$3 billion in 2000. China’s accession to the WTO stimulated FDI significantly. In 2001 FDI from Japan jumped to US$4.4 billion again and reached a new peak of US$6.5 billion in 2005.

China has replaced ASEAN-4 (Indonesia, Malaysia, Philippines and Thailand) as the top destination of Japanese FDI. ASEAN-4 had been the leading host of Japanese FDI in Asia before the early 1990s. Figure 3 shows that in 1992 only ten percent of Japanese direct investment in Asia ended in China while 52 percent went to ASEAN-4. The distribution had changed drastically. By 1995, the share of China jumped to

![Figure 2: Annual Japanese Direct Investment Into China: 1991-2007](image)

Source: China Statistics Yearbooks and JETRO
36% and that of ASEAN-4 dropped to 33%. China’s WTO membership revitalised 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 to ASEAN-4.

**Japanese FDI and China’s Exports**

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

Figure 4 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%.

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 labour cost in China. In the foreseeable future, domestic market oriented FDI from Japan will be dominant.

A New Forward-Looking Era

In the “warm spring” visit to Japan in April 2008, President Hu Jintao defined Sino-Japanese relations as “strategic and mutually beneficial”. Under the new leadership of both countries, Sino-Japanese political relations are moving to a new forward-looking era.

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 US$3.4 trillion in 2007. The room for further expansion is huge. In spite of the fact that Japan is a mature economy, exports remain a critical factor for the growth of the Japanese economy. Hence, China will continue to serve as one of the most important growth sources for the Japanese economy in the next two to three decades.

On the other hand, a modern manufacturing industry is key to China’s industrialisation. Compared with high-tech and finance sectors, the manufacturing industry produces more jobs, which are crucial for employing millions of Chinese rural migrants. Japan remains a world leader in automobile, machinery and electronics. Technology and capital from Japan will be critical to the Chinese industry in its efforts to improve its production capacity, product variety and productivity.
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.

To further enhance the mutually beneficial Sino-Japanese relations, formal bilateral institutional arrangements between the two countries are imperative. Globalisation characterises the main theme of the world economy while regionalism represents an alternative trend of economic integration. The European Union (EU) and the North American Free Trade Agreement are two typical examples that have been leading the global trading system. A free trade agreement between the two giants China and Japan will not only benefit the two economies, but also anchor economic integration in Asia, eventually balancing the power of the EU and the US in the global trading system.