"The Impact of China's Rise on Sino-Japanese Economic Relations," The Rise of China and a Changing East Asian Order; (ed. Kokubun Ryosei and Wang Jisi), Tokyo: Japan Center for International Exchange, 2004, pp. 175-193.

11

The Impact of China's Rise on Sino-Japanese Economic Relations

Ohashi Hideo

The rise of China affects Japan's economy and Sino-Japanese economic relations considerably. Bilateral trade between the two countries is growing very fast, with China's rapid economic growth providing a number of opportunities for Japan, which has struggled with prolonged recession. In fact, many Japanese companies now rely on China's huge, growing market for their economic well-being. At the same time, there is unease in Japan, as some attribute Japan's economic difficulties to China's rise. Those who express this view suggest that increased Chinese imports have damaged Japan's domestic industries, that massive Japanese investment in manufacturing in China has led to rising unemployment and the hollowing out of industries in Japan, and that China is exporting deflation to Japan.

The focus of this chapter is the wide-ranging impact of China's economic emergence on Japan's economy and on Sino-Japanese economic relations. The chapter considers the influence of growing Chinese imports and expanding Chinese exports on the Japanese economy, and whether or not there is a causal relationship between China's rise and Japan's slump. It examines how China's rise has changed the nature of East Asia's economy, and how China's accession to the World Trade Organization (WTO) has affected Sino-Japanese economic relations. Finally, it looks at how China's rise has affected Japan's foreign economic policy.

Deepening Economic Interdependence

Increasing Imports from China

Japan's imports from China are growing very rapidly. In 2002, when Japan's overall imports dropped minus 0.6 percent from the previous year because of its sluggish economy, imports from China recorded 9.9 percent growth.[1] That year, China also became Japan's largest import partner.[2] Japan's imports from China exceeded those from the Association of Southeast Asian Nations (ASEAN) four countries of Indonesia, Malaysia, the Philippines, and Thailand in 1991; the newly industrializing economies (NIEs) of Hong Kong, Singapore, South Korea, and Taiwan in 1997; the European Union in 2000; and the United States in 2002. Japan's imports from China accounted for 18.3 percent of its total imports in 2002. Among China's major trading partners, such as members of the Organisation for Economic Co-operation and Development (OECD) and East Asian countries, with the exception of Hong Kong, Japan is most dependent on its imports from China.

Most of Japan's imports from China are manufactured goods. The ratio of manufactured goods to Japan's total imports from China rose to 84 percent from 58.1 percent during 1991–2001. The percentage of textiles and clothing remained relatively unchanged at 29.7 percent in 1991 and 29.1 percent in 2001, while the ratio of machinery rose considerably to 28.5 percent from 5.8 percent in the same period. In 2001, import items recording the highest growth rates over the previous year were mostly information technology (IT) products. These included telephone and facsimile machines (HS 8517),[3] that grew 98.2 percent; telecommunications equipment and television parts and accessories (HS 8529), that grew 81.4 percent; computers (HS 8471), 67.1 percent; game machines (HS 9504), 53.4 percent; televisions (HS 8528), 51.3 percent; and photocopy machines (HS 9009), 49.9 percent.

Textiles and clothing, footwear, and travel goods were the main imports from China in the 1990s. Among these labor-intensive products, suits for women recorded the highest import growth in 2001, yet this was only 5.8 percent. The import penetration rate[4] of clothing[5] rose to 87.7 percent from 51.8 percent during 1991–2001. In Japan's import clothing market, Chinese products increased their share to 87.3 percent from 53.8 percent in the same period. This is remarkable, since Japan's clothing market is mature, and it is very difficult for imported products to increase

their market share. Chinese telephones, facsimile machines, and computers accounted for a mere 12 percent of Japanese imports of these products in 2001. There is much room for such Chinese-made products to expand their market share in Japan. In the near future, Chinese products are expected to dominate Japan's IT markets.

Increasing imports of manufactured goods from China suggest that Sino-Japanese trade is now specializing horizontally, across a wide range of industries, rather than vertically. At the same time, intra-industry trade between the two countries is on the rise. The high intra-industry trade index[6] of Japan's major imports from China—such as air-conditioners, refrigerators, and pumps (HS 841), and calculators, personal computers, and parts (HS 847)—means that imports and exports are almost evenly balanced.

Increased intra-industry trade is also reflected in China's high ratio of processing trade to total trade. According to Chinese customs statistics for 2002, the respective ratios are 55.3 percent for China's total exports and 47.6 percent for its total imports.[7] These ratios are higher for Sino-Japanese trade for 2002, with 58.2 percent in exports and 56.2 percent in imports. Most foreign-invested enterprises (FIEs) are engaged in processing trade in China. FIEs accounted for 51.7 percent of China's total exports and 54 percent of its total imports in 2002. These figures are much higher for Sino-Japanese trade in 2002, with 61.8 percent in exports and 66.9 percent in imports. Nearly two-thirds of Sino-Japanese trade is apparently in the form of intra-industry and intra-firm trade.

Expanding Exports to China

In 2002, Japan's exports to China expanded substantially and recorded 32.3 percent growth over the previous year, mainly because of China's trade liberalization due to its WTO accession and its "positive fiscal policy" to stimulate domestic demand. In the 1980s, Japan was a major supplier of final goods, such as electronics appliances and automobiles, to China. In the 1990s, a number of Japanese manufacturers started production in China. As intra-industry trade has expanded between the two countries, Japan's exports of intermediate input goods to China are increasing steadily.

This change can also be seen in China's domestic consumer market. In the 1980s, for example, Japanese manufacturers of color televisions

exported their final products to China, and they predominated in the local market. Most Japanese manufacturers had embarked on local production of color televisions in China by the early 1990s, when the Japanese subsidiary companies in China such as Shanghai Sony, Dalian Toshiba, Shangdong Matsushita (Panasonic), Shenzhen Huaqiang Sanyo, Nanjing Sharp, and Fujian Hitachi dominated the Chinese market.[8] Since 2001, however, China's color television market has been shared with major Chinese manufacturers, such as Changhong, TCL, Konka, Haixin, RGB, and Haier. Foreign subsidiary companies now try to supply differentiated products such as large flat monitor televisions. Foreign companies also supply some key components and parts of color televisions. China's top manufacturer of cathode-ray tubes (CRTs) is Caihong, a state-owned enterprise with technology-sharing relationships with Japanese manufacturers such as Hitachi, Toshiba, and Asahi Glass. Other major CRT manufacturers are all foreign companies, including Shenzhen Samsung; Beijing Matsushita; Shanghai Yongxin, a Hong Kong affiliate company using Toshiba technology; Philips (Huafei); Hitachi (Saige); and LG (Lejin).

Most Chinese manufacturers have not acquired a core technology. They seemingly have little interest in developing core technologies themselves; rather, they pay close attention to product design.[9] Chinese manufacturers and consumers generally favor low prices, so every effort is made to reduce the price of components and parts by making suppliers compete against each another. In sales promotions, after-sales and repair services for consumers are regarded as important. So foreign suppliers of components and parts have great business opportunities in China.

Japan has been a main supplier of capital and intermediate goods to East Asian manufacturers. As intra-industry trade increases between Japan and China, Japanese exports of intermediate input goods to China are also growing steadily. Asian input-output (I-O) tables compiled by the Institute of Developing Economies (IDE) and the Japan External Trade Organization (JETRO)suggest that China uses more domestically sourced intermediate goods than other East Asian countries because of its comprehensive industrial structure. An I-O table shows that 95.4 percent of intermediate input goods were domestically sourced in China in 1995 (see table 1). The machinery and transport equipment industries were, however, more dependent on imported intermediate input goods. Their domestic dependence ratios were somewhat lower, at 91.1 and 91.6 percent, respectively. In other words, their foreign dependence ratios were about 9 percent. Of this 9 percent, 5 percent reflects dependence on Japan.

With more than half of the imported intermediate input goods in these industries being made in Japan, the supply role of Japanese manufacturers can be said to be key.

Table 1. China's Dependence on Domestic Intermediate Input Goods, 1995

	Whole Industry	Machinery	Transport Equipment
China	95.4	91.1	91.6
Japan	1.8	5.1	4.8
United States	1.0	1.4	1.5
Korea	0.7	1.1	0.9
Taiwan	0.3	0.6	0.6
Indonesia	0.3	0.1	0.1
Malaysia	0.2	0.2	0.2
Singapore	0.2	0.3	0.2
Thailand	0.1	0.1	0.1
Philippines	0.0	0.0	0.0
Total	100.0	100.0	100.0

Source: Okamoto (2001, 14–15).

Again using the machinery and transport equipment industries as an example, for every 100 units produced by China's machinery industry in 1995, 82.2 of the units were Chinese intermediate input goods, and eight units were Japanese components and parts. Similarly, for every 100 units produced in China's transport equipment industry in 1995, 83.9 of the units were Chinese-made intermediate input goods, and 7.5 units were made in Japan (see table 2).

Table 2. China's Dependence on Japanese Intermediate Input Goods, 1995

Machinery (100)		Transport Equipment (100)	
China (82.2)	Japan (8)	China (83.9)	Japan (7.5)
Machinery (36.3)	Machinery (5.8)	Transport Equipment (26.0)	Machinery (2.9)
Metal (30.2)	Metal (2.2)	Metal (23.6)	Metal (2.4)
Chemical (8.3)		Textile (8.1)	Transport Equipment (2.2)
Textile (7.4)		Chemical (6.7)	

Source: Okamoto (2001, 15).

Since compiling an I-O table requires considerable time and effort, there is usually a time lag of several years.[10] Even the latest I-O tables cannot reflect current industrial structures. Considering the large-scale nature of Japanese manufacturers' investments in China after 1995, one could say

though that China's dependence ratio on Japanese industries has, in all likelihood, only increased further.

As the local subsidiaries of Japanese companies grow in China, the role of exports is also changing. Exporting is no longer the only profitable business for many of these companies. According to financial statements of some leading Japanese companies, local sales by their Chinese subsidiaries are even larger than their exports to China. For an increasing number of Japanese companies, China is their main profit source (*Nihon Keizai Shimbun* 15 January 2003). For example, the profits of the China subsidiary of Komatsu, a construction equipment giant, increased 63 percent in the 2002–2003 financial year. The profit attributable to activities in China reportedly equaled nearly 40 percent of total profit for the whole company. For Fanuc, a top manufacturer of computer numerical control (CNC) machine tools, the profit from its Chinese subsidiary accounted for 30 percent of the profit increment for the 2001–2002 financial year. China business is contributing significantly to the performance of Japanese companies facing a sluggish domestic economy.

Japan's External and Internal Economic Conditions

The Fall of the Flying Geese?

The rise of China has changed the pattern of economic development in East Asia. Economic development in East Asia has often been explained as a "catch-up" process, with changes in comparative advantage among countries in the region reflecting shifts as less developed countries catch up with more developed countries in certain industries. This is also called the "flying geese" pattern of development. The rise of China has brought about a new pattern of economic development in East Asia. This new pattern is quite different to the previous pattern in which Japanese industries took the lead and to which Japanese have become accustomed.

First, the foreign investment-trade nexus has changed the development pattern. Foreign direct investment (FDI) has contributed greatly to East Asia's rapid economic development since the mid-1980s when Japan and the NIEs began investing massively in the region to cope with their highly appreciated currencies. There is also a virtuous cycle between FDI and foreign trade. Excellent economic performance in East Asia achieved through export-oriented industrialization has attracted sizable FDI from

abroad. FDI increases foreign trade, which eventually accelerates economic growth in the region. This FDI-trade nexus realized the rise of China in the late 1990s.

As the traditional Ricardo and Hechscher-Ohlin foreign trade models suggest, differences in production technology or factor endowment create the international exchange of tradable goods, and FDI is a transfer of a cluster of managerial resources beyond international borders. Yet an FDI-trade nexus is not assumed in traditional foreign trade theories. FDI is fundamentally altering production technology and factor endowment in China, with new technology or production factors easily being transferred from Japan to China in the form of FDI. There seems to be little time lag now between the first goose (Japan) and the last goose (China) developing and mass-producing a new product. For example, a new-generation television with plasma or liquid-crystal display panels was developed and commercialized in Japan early in 2000. Just a year later, major manufacturers of this new-generation television started production at their Chinese plants. Due to FIEs bringing new technology and production factors into China, a giant Chinese "goose" flies high, ahead, as it were, of the NIEs and the ASEAN countries. FIEs have upgraded China's industrial and trade structure, showing that less developed countries can manufacture advanced and sophisticated products by absorbing new technology and production factors through FDI.

Second, agglomeration of industries has changed the East Asian "flying geese" development pattern because more FDI is attracted. Agglomeration of FDI undoubtedly reduces uncertainties about a host country's FDI policy, as a sizable amount of FDI testifies to an evidently favorable environment for FDI. The Pearl River Delta in China's Guangdong Province is a good example of the agglomeration of industries, especially the IT industry. In the delta, any components and parts of computers and photocopy machines are reportedly available within an hour's drive. Agglomeration of industries enables information sharing, promotes industrial linkages, and reduces transaction costs. Assemblers are motivated to invest by an aggregate of parts manufacturers, while parts manufacturers are encouraged to invest by an accumulation of assemblers. As a group of industries becomes agglomerated, effective infrastructure needs to be provided and human resources become well equipped.

Third, the fragmentation of production processes has also modified the "flying geese" development pattern. Multinational corporations (MNCs) and international production chains account for more than half

of China's exports and imports. As mentioned, intra-industry trade is increasing in China's foreign trade. The "flying geese" development pattern has been argued on the basis of an international division of labor for whole industries, with most MNCs engaging in specialized production activities at particular stages in the production process. The IT and transportation revolutions have made it possible for MNCs to fragment production processes around the globe, and to utilize the best location for each individual production process in order to minimize total production costs.

FDI is now an essential factor in China's economic growth, and it has become a main determinant of its foreign trade. The massive inflow of FDI into China since the mid-1990s has led to China's rise in East Asia, and has changed the East Asian "flying geese" development pattern, as well as Sino-Japanese economic relations.

The Hollowing Out of Industries in Japan

Increasing imports from China have put immeasurable pressure on industrial adjustment in Japan. Throughout the "lost decade" of the 1990s, bankruptcies and unemployment increased and the hollowing out of Japan's industries proceeded unabated. A deflationary spiral set in, which is considered a main cause of prolonged recession. Many also blame Japan's economic difficulties on the rise of China. Many Japanese reflect this viewpoint, partly because they have lost confidence in Japan's economy, which used to be Japan's strongest point, and partly because of some jealousy over China's current economic success.

There is concern about increasing imports from China as well as Japan's massive investments in China. Both of them are seen as having led to the hollowing out of Japanese industries. A wide range of Japanese industries, especially those long protected by the government, perceive China to be an economic "threat." These sentiments have been organized into powerful political pressure, which, in April 2001, for example, induced the Japanese government to adopt measures against a few agricultural Chinese imports. Yet, instead of seeing increasing Chinese imports as damaging to Japanese industry, the huge inflows of low-priced products from China should be recognized as providing Japanese industries with great opportunities to reform less efficient sectors and to create more value-added industries.

There is a tendency to attribute rising unemployment to the hollowing out of industries in Japan. Yet the high unemployment rate merely reflects

the current economic slump in Japan. Most industries are obviously contributing to the increased unemployment rate, but, in some emerging industries such as IT, there is a serious short supply of labor. Therefore, some of these problems reflect a mismatch between supply and demand in Japan's transitional labor market.

It is difficult to discern a causal relationship between increased outward investment in China and the hollowing out of industries in Japan. A survey of the overseas activities of Japanese firms by the Ministry of Economy, Trade and Industry found that sales by foreign subsidiaries of Japanese manufacturers increased sharply in the late 1980s when their overseas investments unexpectedly expanded due to the highly appreciated Japanese yen. Their sales surpassed exports from Japan in the mid-1990s. The ratio of manufacturing industries to the total working population and to total Japanese gross domestic product had fallen drastically in the 1990s. The electric machinery and transport equipment industries, which created many jobs in Japan until the mid-1980s, began to absorb more workers abroad in the 1990s. These phenomena help explain the hollowing out of industries in Japan.

However, there is a connection between increasing outward investment and the hollowing out of industries in Japan. First, export industries in general tend to have a positive attitude toward FDI. Japan's leading companies with subsidiaries abroad are also very competitive in exporting.

Second, FDI substitutes for exports, and it increases imports from overseas plants. As a result of outward FDI, in the mid and long term, factor prices are adjusted, and factors are transferred between industries in Japan. However, there is no denying the possibility that the unemployment rate would rise, temporarily, in the process of restoring economic equilibrium.

Third, local areas in Japan compete intensely with foreign countries for investment. Most Japanese firms remain headquartered in Tokyo or other business centers in Japan, but domestic plants have been closed and transferred to foreign countries. In this way, Japanese FDI has negatively impacted the local economies of specific regions in Japan. Since local interests are overrepresented in Japan's political process, stagnant economic conditions in local areas are likely to become politicized.

An empirical study on FDI and the hollowing out of Japanese industries (Fukao and Yuan 2001) estimated the loss of domestic manufacturing jobs due to Japan's export-substitution and import-expansion type of FDI to East Asia to be 577,000 during 1987–1998. Unemployment in the

textiles and clothing, electronics, and telecommunication equipment industries was particularly notable. This study also estimated that Japan's overseas resource and market-development type of FDI created 514,000 new domestic jobs in the same period. Job opportunities created by the latter almost cover job losses caused by the former.

The rising Japanese yen directly affected the increase in outward investment, although it had little direct relevance to industrial hollowing out in Japan. Fundamentally, the services economy accelerated the hollowing out of Japanese industries, with most Japanese spending less on manufactured goods and more on services. It is virtually impossible to demonstrate a causal relationship between Japanese FDI in China and the hollowing out of Japanese industries.

China's Export of Deflation

There are also suggestions in Japan that China is "exporting" deflation. Kuroda Haruhiko and Kawai Masahiro, a former Japanese vice minister and a former deputy vice minister of international finance, have charged China with exporting deflation and have urged the Chinese government to take measures to counter domestic deflation or to appreciate the yuan (*Financial Times* 2 December 2002). Japan's Finance Minister Shiokawa Seijuro followed suit at a meeting of the Group of Seven industrialized countries in February 2003. Their remarks suggest that China's booming economic growth, driven by low-priced exports, is occurring at the expense of Japan and other neighboring economies.

It is a fact that low-priced imports from China are decreasing prices in Japan, especially those of textile and electronics products. It is also true that there is room for China's monetary authorities to better manage the Chinese currency. However, it is impossible to demonstrate that China is exporting deflation to Japan. Yes, both countries are suffering from deflation, but this is rooted in different causes in the two countries.

In Japan, deflation has its origin in the sharp drop of the assets market (real estate and stocks). After the bursting of the "bubble economy," most Japanese companies sold assets in order to reduce their heavy debt burdens. The assets market turned into a buyers' market as prices dropped drastically. As deflation swelled the debt burden, Japanese companies accelerated selling goods on hand—at a loss. In short, this has been the process of debt deflation in Japan. Another serious problem in Japan has

been that of financial institutions' nonperforming loans. Once they fell into the deflationary spiral, Japanese companies had increasing difficulty funding operational costs and making long-term business decisions. In this way, the real economy became stagnant and the economic slump prolonged. Japan's deflationary problems are by no means imported from China.

In China, deflation reflects oversupply as a result of excessive investment in plants and equipment in the 1990s. There is much industrial overcapacity in China. The former State Economic and Trade Commission reckoned that, in 2002, 88 percent of the 600 types of goods it surveyed were in excess supply (*Zhongguo Jinjishibao* (China Economic Times) 26 December 2002). Furthermore, uncompetitive state-owned enterprises with little prospect of being restructured continue to manufacture and supply products to the saturated Chinese market.

Thus, oversupply worsens deflation in China, while the shrinking of domestic demand after the bursting of the assets bubble triggered deflation in Japan.

Imports from China accounted for less than 2 percent of Japan's GDP. Imported products from China, mostly labor-intensive products or processed and assembled products of high-tech components and parts, are mostly complementary to Japan's current industrial structure. The sharp drop in prices is most remarkable in domestic or non-tradable services in Japan. There is little evidence to support the idea that China is exporting deflation to Japan.

Trade Friction and Rules-based Settlements

Friction in Sino-Japanese Trade

Deepening economic interdependence between Japan and China inevitably entails trade friction, but China's accession to the WTO has paved a new road of rules-based settlement of issues between them.

In response to a rapid surge in some agricultural imports, in April 2001 the Japanese government imposed provisional safeguard measures to curb imports of leeks, fresh shiitake mushrooms, and rush mats for tatami flooring. Since these items were mainly imported from China, the safeguard measures primarily targeted Chinese products.[11] Although Japan had imposed safeguard measures on pork imports in 1997, it had not previously

invoked general safeguards or made special efforts to restrict imports of textiles. The Chinese government retaliated by imposing a 100 percent special tariff on imports of Japanese automobiles, cellular phones, car phones, and air conditioners in June 2001. At the time, China was not constrained by WTO rules as it was not yet a member, but, following its accession to the WTO in November 2001, it would not be able to adopt such measures.

After negotiations, the governments reached an agreement in December 2001. The Japanese government would not invoke full safeguard measures and the Chinese government would withdraw its countermeasures. At the same time, Japanese and Chinese nongovernmental bodies would establish a new trade council for agricultural products, and both governments would maintain orderly trade by exchanging information on the supply and demand of agricultural products, and on their price fluctuations.

The safeguard issue highlighted serious problems with Japan's trade policy. First, it became obvious that trade friction or conflict was inevitable with the broadening and deepening of Sino-Japanese economic relations. In the 1990s, Japan had undertaken protective measures against Chinese products. In February 1992, the Japanese government imposed, for the first time, an antidumping duty on imported Chinese ferroalloy. A number of Japanese firms also urged the Japanese government to take action against Chinese textile imports. The Japanese government repeatedly pressed the Chinese to adopt voluntary export restraint measures. In April 2001, under political pressure because of upcoming Upper House elections, the Japanese government took the mentioned provisional safeguard measures against the three agricultural products. Meanwhile, some industrial associations were requesting Japanese government action against other Chinese imports.

Second, adopting the safeguard measures further worsened Japan's image as a reluctant liberalizer of its agricultural sector. In another example, Japan was reportedly responsible for the unsuccessful Asia-Pacific Economic Cooperation (APEC) initiative on Early Voluntary Sectoral Liberalization (EVSL) because of its uncompromising attitude toward liberalizing its forestry and fishery markets. Agricultural trade was also shelved in negotiations with Singapore around the Japan-Singapore Economic Partnership Agreement (JSEPA), which was signed in January 2002. The JSEPA is Japan's first free trade agreement (FTA).

Third, the social costs of protecting the agricultural sector are increasing tremendously. The repercussions of safeguard measures extended from

Japanese consumers, who paid for the additional protection costs, to those industries on which the Chinese government imposed retaliatory duties. The Japan Automobile Manufacturers Association estimated that losses due to China's retaliatory measures amounted, in 2001, to ¥51.2 billion in the automobile industry alone, and that this figure would have ballooned to ¥420 billion if the retaliatory measures continued into 2002 (Honma 2002). Moreover, import restrictions on rush mats for tatami flooring caused serious damage to those domestic manufacturers who used imported Chinese rush mats.

Rules-Based Settlements

With the invocation of safeguard measures, a new trend seemed apparent in Sino-Japanese economic relations. The Japanese government, in accordance with WTO rules, adopted safeguard measures against agricultural products imported from China, which was about to accede to the WTO. The case was finally brought to a rules-based conclusion. Previously in Sino-Japanese relations, any economic friction between the two countries became politicized. When such friction occurred, the Chinese government criticized Japan, and the Chinese media or the Beijing-supporting Hong Kong media would carry on a campaign against Japan. So-called friendly personages or business leaders with a stake in amicable relations between the countries would appear on the scene and would endeavor to resolve the dispute through their own personal contacts. Human factors dominated easing economic friction in bilateral relations. In invoking the safeguard measures and in taking retaliatory measures, the actions of both governments took on a different, more businesslike tenor.

There are considerable economic issues awaiting resolution between the two countries. One of these is infringement of intellectual property rights in China, including violations of patent, copyright, and registered design rights. A number of Japanese companies are struggling to eliminate imitation products in China and other third-country markets. Bilateral negotiations over such issues are now based on WTO rules. As China is integrating into the global economy and as Sino-Japanese economic relations mature, rules-based settlements will be the means for resolving economic conflicts.

Changes in Japan's Trade Policy: Multilateralism and Regionalism

China's FTA Proposal

At a summit meeting in Phnom Penh in November 2002, the leaders of ASEAN and China's Premier Zhu Rongji signed a comprehensive economic framework agreement, the core of which was the establishment of an FTA.[12] Zhu had initially suggested an ASEAN-China FTA (ACFTA) at the summit in 2000, and then he formally proposed it at the 2001 summit.

By proposing the ACFTA, China, the region's political power, embarked on very active economic diplomacy. And this initiative was a significant shock to Japan, the region's economic power, because it was directed at ASEAN. Japan maintains friendly relations with ASEAN, and it regards its relations with ASEAN as the keystone of its Asia diplomacy. The Japanese perceived China's proposal as a challenge to the economic order it built in East Asia with ASEAN's cooperation, and as an irritant that highlighted Japan's inadequate foreign economic policy because of its prolonged recession, its protected agricultural sector, and its delayed structural reforms.

Regionalism in the form of FTAs dominates the world economy today. When Zhu proposed ACFTA, there were no FTAs in East Asia, home to some of the major trading countries of the world. His proposal was put forward before any of the other FTA ideas that were beginning to be considered in East Asia. Japan and South Korea had started a feasibility study for an FTA in October 1999 at the suggestion of Korea's President Kim Dae Jung, and Japan and Singapore took the same road at the suggestion of Singapore's Prime Minister Goh Chok Tong in December 1999. Zhu's proposal could be explained in terms of a "policymaking reaction function" or "not wanting to miss the bus." The concept, put forward by Horaguchi (2001), refers to attempts to minimize the limits of one's own country's policymaking by responding to other countries' policies by following suit. From the timing, China's proposal was not put forward for simple economic benefits and cooperation, but in pursuit of more comprehensive national interests in the region.

Japan's Attitude toward the ACFTA

China's FTA proposal had considerable impact on Japan's foreign economic policy. Japan's Prime Minister Koizumi Jun'ichiro signed the JSEPA in Singapore during his ASEAN tour in January 2002. After the joint study was completed between Japan and Singapore, it took only a year of speedy negotiations to conclude the JSEPA. Japan would not have taken such quick action without China's ACFTA proposal.

As a main beneficiary of the post–World War II General Agreement on Tariffs and Trade regime, Japan has consistently favored multilateral trade liberalization based on the principle of nondiscrimination. This was so even as a number of FTAs were being concluded around the world. Hence the JSEPA marks a turning point in Japan's foreign trade policy. Japan has now embarked on a multilayered approach that includes regionalism and multilateralism, and has taken steps toward complementing WTO multilateral trade negotiations with regional FTAs (Ministry of Foreign Affairs 2002).

There are some reasons behind Japan's change of course in foreign economic policy. First, stagnant multilateral trade negotiations have changed Japan's foreign economic policy. Regionalism, as represented by FTAs, has always been viewed negatively in Japan, as it inevitably involves discriminatory treatment. It is still difficult to remove concerns that FTAs lead to the formation of trade blocs. Indeed, FTAs can create trade while simultaneously diverting trade. In practice, FTAs have a tendency to shelve opening "sensitive" sectors, to designate agricultural products as exceptions, and to leave country-of-origin rules ambiguous. FTAs involve much gray area, due to their flexibility and simplicity.

Since the WTO ministerial meeting in Seattle in late 1999, multilateral WTO negotiations have been deadlocked, and the momentum for multilateral trade liberalization has shifted. WTO consensus-based negotiations have become extremely difficult as the number of WTO members has increased and the scope of negotiations has expanded. APEC also seems to have lost its cohesive impetus after the 1997 East Asian financial crisis, and its raison d'être is being called into question. After its unsuccessful EVSL initiative, APEC handed over the task of regional trade liberalization to the WTO. After its earlier enthusiasm for trade liberalization in Asia Pacific, the United States seems to have changed course now toward a Free Trade Area of the Americas (FTAA). So Japan has embarked too on the path of FTAs, hoping to maintain momentum for trade liberalization, at least regionally.

Second, it has become disadvantageous not to participate in FTAs. As much as 90 percent of WTO members are now party to such agreements. Countries experienced in regional economic integration or FTAs are also likely to take the initiative in multilateral negotiations, and much preparatory negotiating for international agreements is based on regional economic integration or FTAs. Also, Japanese companies are increasingly at a concrete economic disadvantage by not participating in FTAs. The final report of the feasibility study for an FTA between Japan and Mexico (Ministry of Economy, Trade and Industry 2002) found that Japanese companies suffered losses as a result of the North American Free Trade Agreement (NAFTA) and the EU-Mexico FTA. First, Japanese companies lost market share to EU and U.S. companies, and ¥400 billion of export profit per year. Domestic production was reduced by ¥620 billion, and 32,000 jobs were lost. Second, Japanese firms withdrew due to import duties of about 16 percent, which made it impossible to compete with EU and U.S. firms. An example has been given of a power-generation plant that resulted in a ¥120 billion loss and over 10,000 jobs lost. Third, following country-of-origin rules, Japanese companies procured NAFTA-made parts instead of using Japanese parts. Changing suppliers for US$100 million in parts led to production losses of ¥33 billion in Japan and the loss of 1,400 jobs.

Third, FTAs are expected to provide effective external pressure for domestic structural reform. Since U.S.-Japan trade friction has abated, external pressures have not worked effectively, and it is increasingly difficult to overcome vested interests and to implement structural reforms in Japan. It is broadly anticipated that FTA negotiations will promote deregulation and competition with market-opening pressure, reflecting similar expectations to those for a "special zone for structural reform" proposed by the Koizumi administration. In the case of the JSEPA, 84 percent of trade between Japan and Singapore is already duty-free, and agricultural products are in fact excluded. So, as Japan's first FTA, the JSEPA has symbolic significance, but its trade-creating effects will be very limited. However, the JSEPA includes a variety of items that multilateral trade negotiations do not fully cover, such as investment promotion, competition, labor, migration, and environmental policies. Therefore, the JSEPA may have a significant effect on structural reform in Japan.

Conclusion

The rise of China has greatly impacted Japan's economy. Growing low-priced imports from China increase economic welfare in Japan, while China's economic growth provides a number of opportunities for Japanese industries. Examples of these are China's machinery and transportation equipment industries. As China's machinery and transportation equipment industries develop into leading industries, they could become structurally dependent on imported intermediate input goods from Japan.

Japan's FDI in China has been found to have little relevance to the loss of jobs and the hollowing out of industries in Japan. Instead, these changes reflect Japan's recession and its increasingly services-led economy. Also, the deflationary spiral in Japan has caused the current economic slump there; deflation has not been imported from China.

China's rise has also critically impacted Japan's external economy. The rise of China has changed the traditional development pattern and catch-up process in East Asia. By acquiring new technology and production factors through huge amounts of FDI, China is manufacturing new products ahead of the NIEs and ASEAN. The "flying geese" development pattern seems to have been replaced by a "leaping frog" pattern, in terms of which China is passing rows of geese flying ahead of it. China's accession to the WTO has turned Sino-Japanese economic relations into a rules-based relationship. China's rise is also reflected in its positive attitude toward regional economic cooperation. The ACFTA has seemingly induced Japan to adjust its foreign economic policy to encompass regionalism together with multilateralism.

In a speech to the Boao Forum in April 2002, Koizumi (2002) suggested China's rise was not a threat but a challenge and opportunity, not about confrontation but about mutual benefit, and not about a hollowing out but an expansion of Japanese industries. Considering the positive impact China's rise has had on Japan's economy and Sino-Japanese economic relations, the views of Koizumi should be widely accepted.

Notes

1. The trade statistics quoted in this chapter are Japanese customs statistics, released by the Ministry of Finance. Specifically, see the press release, "Japan's Customs Statistics 2002" <http://www.mof.go.jp> (27 January 2002).
2. From 1961—when Japan reported its trade with China for the first time in its customs statistics—until 2002, Japan's imports from China never exceeded those from the United States.
3. The figures in parentheses refer to the Harmonized Commodity Description and Coding System's four-digit definitions of trade commodities.
4. Import penetration rate = imports/(domestic production + imports – exports). The rate is calculated in terms of volume, and it is based on textile statistics from the Ministry of Economy, Trade and Industry, and customs statistics from the Ministry of Finance.
5. Cloth and knit outer and inner clothing.
6. Intra-Industry Trade (IIT) Index = [1 – (export – import)/(export + import)].
7. Processing trade mainly comprises processing and assembling (*lailiao jiagong)* and processing with imported materials (*jinliao jiagong)* in exports. It also includes equipment and materials made by foreign-invested enterprises.
8. For market surveys of color televisions in China, see "Quanqiu Caidian Zhuangye Shangwugang" (Global Color TV Special Business Network), Qinshigang <www.kitking.com.cn>.
9. Statistics of patent applications and registrations in *Zhongguo Tongji Nianjian (China Statistical Yearbook) 2001* show that more utility models and designs are registered in China than creations and inventions.
10. The latest IDE-JETRO Asian input-output tables are for 1995, yet they were only published in 2001.
11. For details of the safeguard measures, visit the websites of the Ministry of Economy, Trade and Industry <http://www.meti.go.jp/policy/trade_policy/safeguard> and the Ministry of Agriculture, Forestry and Fishery <http://www.maff.go.jp/sogo_shokuryo/sg_kanren/sg_kanren.htm>.
12. For the full text of the "Framework Agreement on Comprehensive Economic Co-operation between ASEAN and the People's Republic of China", see <http://www.aseansec.org/13196.htm>.

Bibliography

Fukao Kyoji and Yuan Tangjun. 2001. "Nihon no taigai chokusetsutoushi to kudoka" (Japan's overseas direct investment and hollowing out of industries). *Research Institute of Economy, Trade and Industry (RIETI) Discussion Paper Series* 01-J-003 (September).

Honma Masayoshi. 2002. "FTA to nogyo mondai" (FTA and agricultural problems). In Urata Shujiro and Japan Economic Research Center, eds. *Nihon no FTA senryaku* (Japan's FTA strategy). Tokyo: Nihon Keizai Shimbunsha.

Horaguchi Haruo. 2001. "Chiiki renkei no seijikeizaigaku" (Political economy of regional cooperation). In Suehiro Akira and Yamakage Susumu, eds. *Ajia seijikeizairon* (Political economy of Asia). Tokyo: NTT Shuppan.

Koizumi Jun'ichiro. 2002. "Asia in a New Century—Challenge and Opportunity." Speech at the Boao Forum for Asia. <http://www.mofa.go.jp/region/asia-pacific/China/boao0204/speech.html> (12 April).

Ministry of Economy, Trade and Industry. 2002. "Summary of the Report of the Japan-Mexico Joint Research Committee." <http://www.meti.go.jp/policy/trade_policy/l_america/mexico/j_mexico/data/jmsgreport_overviewj.pdf> (July).

Ministry of Foreign Affairs. 2002. "Japan's FTA Strategy" <http://www.mofa.go.jp/mofaj/gaiko/fta/policy.html> (October).

Okamoto Nobuhiro. 2001. "Chugoku no sangyokozo to tainichi izonkozo" (China's industrial dependence on Japan). *Ajiken Warudo Torendo* (IDE World Trend) 74 (November).