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# Japan's Economic Cooperation with China in the G-2 Era and Its Implications for Korea

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## 1. China as a G-2 Pillar and Japan-China Economic Relations

China's status in the international community continues to climb, and this has inevitably led to conflict with Japan, and even some Southeast Asian countries, in political and diplomatic matters. Japan is focusing its economic radar on the globalization of the Chinese currency yuan, FTA negotiations with East Asian countries, and regional financial cooperation within East Asia.

To start off with the globalization of the Chinese yuan, the general public opinion in Japan is that only around 2020 will the yuan enter the regionalization stage, centered on the ASEAN. Judging by estimates that the percentage of trade settled in yuan amounted to less than 10 percent of China's total trade volume, it may indeed be early days to talk about globalizing the currency. Japanese scholars say it is a must for China to ease regulations on capital transactions and leave the yuan exchange rate to be determined by the market if the yuan is to earn trust as a global currency. Despite such opinions, the Japanese government considers the globalization of the yuan to be a threat to the international standing of the Japanese yen, especially in the ASEAN region. In response, Japanese government is expanding yen currency swaps and samurai bond issuances.

Second, Japan and China are keeping a close eye on the other in the course of pursuing FTAs in the East Asian region. China's preemptive proposal for FTA negotiations with the ASEAN in the early 2000s, the conflict between the two countries as China pushed for an East Asian FTA (EAFTA) within the ASEAN+3 circle and Japan argued for the wider framework of ASEAN+6 (CEPEA), and China joining RCEP talks in November 2012 are all examples that display the intense competition between Japan and China to have the upper hand in the East Asian region.

Third, Japan's Asian Monetary Fund proposal in 1997, the conception of the CMI focusing on bilateral currency swaps in 2000, and the multilateralization of the CMI (CMIM) in 2007 are all cases of financial cooperation in East Asia that show how China is gaining a stronger economic foothold. Such regional financial cooperation is expected to contribute a great deal to financial stability in East Asia. However, Japanese scholars are pointing out that the reason the CMIM has not been able to expand and develop into a financial supervisory organization for the region, for instance by introducing a supervisory mechanism for the region's economy and finance, is because China is reluctant when it comes to sharing information.

We can detect a transition toward a stronger dependence by Japan on the Chinese economy, especially in trade and direct investment since China joined the WTO in 2001. While trade with Japan in proportion to China's total trade volume has dropped from 17.5 percent in 2000 to 9.5 percent in 2011, Japan's trade with China compared to Japan's total trade volume has doubled from 10 percent in 2000 to 20.5 percent in 2009. Even so, Japan is yet in a position that cannot easily be ignored, as seen in the fact that China still imports high-technology products from its rival.

The same applies to Japan's FDI in China. Japan's share of 8 to 9 percent of total investment in China in the early 2000s has since fallen considerably, to 4 to 5 percent. However, Japan still remains one of the top three direct investors in China, from which we can infer that Japan still maintains a respectable presence on the economic stage.

If we take these changes into account to take a look at the future Japan-China relationship, the general direction of keeping politics separated from the economy is expected to stay in place. Of course, it will not be easy to forejudge how the relationship will be affected by the diplomatic friction that has been continuing since the mid-90s. However, the basic framework of the Japan-China relationship is complementary. That is, China still finds Japan's technology necessary and China provides a much-needed large market to Japan. Therefore, even if diplomatic conflict spills over to trade, a worst-case scenario of this leading to a severance of private-sector economic cooperation is highly unlikely to occur.

## 2. Changes in the Japan-China Trade Structure

Japan's growing trade dependence on China has led to more intense competition in industries that China is gaining a competitive edge in, while trade between industries that are highly complementary have helped form a division of labor between the two countries. The Japan-China trade structure is a complex mutual relationship of competition and complementation, and can be defined by three characteristics.

First, the characteristic blend of competition and complementation can be found in the changes in items, and in processing stages. In terms of items, coupled with Japanese companies' investment in China, a vertical trade structure between raw materials and processed goods has transitioned into a horizontal trade structure between processed goods. In terms of processing stages, Japan has well fulfilled the position of a supply base for intermediary goods exported to China, and in the aftermath of the global financial crisis, China is making a noteworthy transition into an export target for Japan's end goods.

Second, an analysis of competitiveness by industry shows that competition between the two countries is spreading to industries where China is displaying increased competitiveness. Japanese companies, however, hold an unmatched competitive advantage in components and materials, so China is not expected to escape its dependency on Japan any time soon. Another interesting fact is that while Japan's competitive advantage in both intermediary and end goods is dropping, China's once lagging competitiveness in electric and general machines is beginning to shine. Consequently, more and more industries in Japan are losing competitiveness to China. However in the electrics and electronics sector, the two countries are forming a new complementary relationship centered on components and materials amid high competition.

Third, by analyzing the division-of-labor structure by industry, we found that inter-industry trade between Japan and China is declining, and giving way to increased intra-industry trade. The process has involved a rapid expansion of intra-industry trade based on vertical, rather than horizontal, division of labor. Due to income gaps between the two countries, intra-industry trade based on differentiated products accounted for a low share up until now, but on the back of China's rising income level, horizontal intra-industry trade is expected to further develop. If Northeast Asian and regional FTAs enter full-fledged discussions, the expansion of mutually complementary intra-industry trade is expected to help relieve the burden of adjustment costs following trade liberalization.

## 3. Japanese Companies Investing in China and Their Strategies

Japanese investment in China can be defined by the following. First, by period, after expanding investment in China over three different periods since 1985, Japan is now the largest investor in China aside from Hong Kong. Second, by industry, while general, electric, transportation machinery as well as chemicals and medicine all witnessed rising investment in China in the late 2000s, increased investment in wholesale and retail sales, real estate, finance and insurance is pulling up the share of non-manufacturing industries to total investment. Third, by region, while East China (eastern coastal area) is a predominant target, accounting for 80 percent of investment from Japan, investment is gradually spreading to the central and inland regions. These regions are expected to enjoy more investment in the future by the Chinese government's efforts to promote investment in less dynamic areas.

An analysis of business performance in Japanese companies' investment in China has led to the following findings. First, the continued expansion of new establishments and equity participation is being accompanied by record turnovers. With new investment in China doubling and tripling every year, sales also hit a five-year high at 34.7 trillion yen in 2010.

Secondly, Japanese companies investing in China have advanced considerably in terms of localization. The local sales share in 2010 stood at 66.1 percent, a roughly 20 percentage point increase compared to ten years ago, and the local procurement ratio was 61.2 percent in the same year, up 18 percentage points from 2000. Third, it is evident that Japanese companies are faring quite well in doing business in China, considering the upward trend in ordinary profit and net profit ratios. In the case of the ordinary profit ratio in particular, the figure stood at 5.5 percent, which is nearly double the domestic figure of 3.2 percent in Japan.

Meanwhile, the foreign investment environment in China has been undergoing some big changes. Some good examples are stronger regulations against foreign companies and rising labor costs. Such changes are acting as risk factors for foreign investors considering China as a target.

For Japanese companies, the China risk is emerging as an even larger threat not only because of these changes, but due to the added pressure of the recent Senkaku Islands dispute. As a way to mitigate and disperse this risk, Japanese companies are managing their investment by pursuing the optimum system for global labor division, for instance through the China+1 strategy.

Lastly, the investment promotion incentives that the Chinese government provides in specific industries will open up opportunities for companies looking to invest in China. Japanese companies are especially interested in next-generation automobiles, for the Chinese government has taken up the development of this industry as a priority agenda, with the aim of curbing oil consumption. Conditions for subsidizing next-generation automobiles in China include local production by the automobile company, and there are also the issues of import barriers like tariffs, or cost reduction through localization. Considering these factors, it will be best if Japanese companies opt for local production of chassis and key auto parts in China.

## 4. The Japanese Government's Economic Cooperation with China

Japan and China first established diplomatic relations in 1972, and as of 2012 it has been 40 years since the Japanese government engaged in economic cooperation with China. Japan's China-bound ODA first began in 1980, as a result of the Yoshida Doctrine, a realist foreign policy that capitalized on economic relations with China while remaining allies with the U.S.

Since the 1990s, however, as the post Cold-War era dawned, with China conducting nuclear tests and joining the WTO in 2001, the Japanese government found less room for economic cooperation with China. In the end, in March 2005, the government decided to halt ODA to China from 2008.

Upon ending ODA support, the Japanese government had to find a new way to engage in economic cooperation with China, and the answer was reinforcing industrial cooperation in the energy conservation-environment sector. Also, since 2011, financial cooperation between the two countries has been emerging as a new agenda for economic cooperation.

In the energy conservation-environment sector, the Japanese government has been helping Japanese companies expand business in China by promoting their strengths in high-efficiency power generation technology, energy efficiency technology and environment technology. Japan's Ministry of Economy, Trade and Industry, along with China's National Development and Reform Commission and Ministry of Commerce, has been holding the Japan-China Forum on Energy Conservation and Environment Protection since 2006 to support companies by selecting agendas for cooperation projects. This is followed up by the Japanese government making suggestions to its Chinese counterpart on any institutional obstacles Japanese companies may face in the course of conducting business in China. Moreover, agreements on creating a fund were confirmed by the MOU signed in December 2011, providing the opportunity for Japanese companies to move ahead in joint investments with and technology transfers to China.

Japan's Ministry of Economy, Trade and Industry and Ministry of the Environment have been subsidizing funding for project feasibility studies by Japanese companies in the infrastructure export and recycling industries, for instance those involved in coal thermal power generation-coal gasification plants and smart grid-smart community. The Ministry of Economy, Trade and Industry is adding to these efforts by supporting overseas feasibility studies through NEDO. Local governments, in cooperation with government agencies like the Ministry of Economy and Ministry of Environment, are also supporting local SMEs on their China-bound investment.

The first matter of note in Japan's cooperation with China is that concerning cooperation in the energy conservation-environment sector, which is centered on the 218 agenda items agreed upon at the above-mentioned forum, it is yet a little early to evaluate any overall performance. However, by taking the successful cases of Kawasaki Heavy Industries and the Hitachi Group as examples, it can be inferred that cooperation in this sector ultimately aims for the Chinese domestic market, that the NEDO feasibility studies are proving useful in localizing Japanese technology to the Chinese environment, and that Japanese companies can use the opportunity to expand their initial projects to other areas.

Second, on the joint development of eco-cities, there has been little progress on the Lianyungang and Caofeidian eco-industrial park projects agreed upon in 2006 and 2012. This may in some part be blamed on the short period of cooperation, but the biggest reason has been pointed out as the incapability of Chinese local governments to present a clear development vision, therefore being unable to attract the interest of Japanese companies.

Third, the Tianjin and Dalian Eco-Town Projects, led by Japan's Kitakyushu since 2009, have been cited as exemplary cases of Japan helping local SMEs in the recycling industry enter the Chinese market. The city of Kitakyushu helped draft development master plans for China's eco-towns, supported inter-company exchanges like Japan-China business matching and seminars, and conducted project feasibility studies on the local government level. A few SMEs from Kitakyushu have already moved in to Tianjin Eco-City as pilot projects. It is highly evident that Kitakyushu has laid the cornerstone for economic cooperation with China by building up self-acquired know-how, since 1997, on developing eco-towns, though undeniably with the Ministry of Economy's support.

Last of all, the Japanese and Chinese government's plans to expand mutual government bond purchases and to push for direct yen-yuan trading in trade transactions are still in their early stages, and have yet to yield any tangible achievements. The Japanese government's announcement in late 2011 on purchasing Chinese government bonds stated an amount less than one percent of Japan's foreign exchange reserves, and China, the largest holder of outstanding Japanese government bonds, allocated a mere seven percent of foreign reserves, as of the end of 2011. The same applies to direct yen-yuan trade transactions, which began on June 1, 2012, as yuan-denominated trade accounts for less than one percent of Japan's trade with China, and yen-yuan trading on the Tokyo foreign exchange market amounts to only 1/2000th of the U.S. dollar. KIEP