

## CHAPTER 5

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### Toward a Stable Relationship between Japan and China: From a Bilateral to a Multilateral Approach

*TSUNEKAWA Jun*

#### Introduction

The growing influence of China is the most important geopolitical development in East Asia and beyond. Backed by rapid economic growth, China has increased its economic, political, diplomatic and military power regionally and globally, and its influence in East Asia is likely to grow more than ever. Against this backdrop, it is of great concern for the leaders of East Asian countries as to whether China will act as a responsible stakeholder of the region within the existing order or if it will move to establish a new China-centered order. Moreover, the leaders are skeptical about China's strategic intentions in its rapid military modernization. Those factors have created the "China threat" in East Asia. As China's primary goal is to achieve sustainable development, it is crucial for China to mitigate the China threat perception of neighboring countries and create an environment conducive to economic growth. Since the mid-1990s, China's foreign policy has been changed substantially to take a more cooperative approach toward neighboring countries as well as external powers.

Along with its diplomatic orientation, China has been actively involved in regional multilateral institutions, such as the ASEAN Regional Forum (ARF), ASEAN plus Three or Ten plus Three (Japan, China, and South Korea), and the East Asian Summit. In November 2002, China and the member states of ASEAN signed the "Declaration of the Conduct of Parties in the South China Sea," in which the parties concerned agreed to resolve their territorial and jurisdictional disputes in the South China Sea by peaceful means, without resorting to the threat or use of force.<sup>1</sup> China proposed holding a security policy dialogue under the ARF, organized security cooperation dialogues on preventing transnational threats and concluded defense cooperation agreements bilaterally with the major ASEAN countries. China is also extending economic cooperation to ASEAN. In November 2002, China and ASEAN agreed

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<sup>1</sup> ASEAN Secretariat, "Declaration on the Conduct of Parties in the South China Sea," <http://aseansec.org/13163.htm>.

to establish a free trade area within ten years, which is the first multilateral free-trade agreement in East Asia. Due to China's cooperative approach to Southeast Asia, ASEAN's perception of the China threat has decreased. Although the ASEAN nations have come to observe the rise of China as a challenge and not a threat, they are adopting a hedging strategy against the increasing influence of China by enhancing economic and security cooperation with Japan and other major external powers. ASEAN, as a group of small nations with a history of being controlled by major western powers, is highly sensitive to a single nation exercising outstanding influence in Southeast Asia, and enhances cooperative relationships with major powers for balancing the influence of that nation. The uncertainty of China's strategic intention is another reason for ASEAN to pursue a hedging strategy.

One of the ASEAN's major concerns in terms of international relations in East Asia is the deterioration of Japan-China relations. If the two countries' relationship were to deteriorate and come to a confrontation, ASEAN might be forced to side with Japan or China, a choice that would split ASEAN's unity. It is commonly believed that the future stability of East Asia will depend heavily on the relationship between the main regional powers, Japan and China. Establishing amicable relations between Japan and China is vitally important to creating a peaceful environment in East Asia. However, historical problems are the main elements that have frequently fluctuated Japan-China relations by encouraging fierce nationalism in both countries. They remain an obstacle for restoring cordial bilateral relations and there seems to be little possibility of resolving them in the short- and/or medium-term.

This paper analyzes Japan's relations with China, especially since the mid-1990s. It argues that despite significant improvements in the bilateral relationship after former Prime Minister Shinzo Abe visited China in October 2006, Japan remains uncertain about China's long-term strategic intentions in the region. This has led Japan to take a policy of cooperation and balancing toward China. It also discusses areas where Japan and China would cooperate in the future for creating a stable environment in East Asia, which may foster a friendly bilateral relationship between the two countries.

## Emergence of New Nationalism

Japan's relations with China have been influenced by international politics centered on China, as well as the domestic political situation in both countries. Among the issues lying between the two countries, historical problems are the most serious, and have prevailed over the bilateral relationship while even entering the 21st century. After September 1972, when Japan and China signed the "Joint Communiqué of the Government of Japan and the Government of the People's Republic of China" (the normalization agreement), the two countries enjoyed an amicable relationship for a decade. Although China restored its relationship with the Soviet Union in the early 1980s, Japan-China relations worsened from the mid-1980s. One of the major reasons for the deterioration was the high-school history textbook issue where a textbook was revised to soften the wording regarding Japan's aggression against China in World War II. Also, then Prime Minister Yasuhiro Nakasone officially visited Yasukuni Shrine, where Class-A war criminals are enshrined, in August 1985. Those events caused a surge in Chinese nationalism, and revealed the absence of broad support in China for cooperative relations with Japan.<sup>2</sup>

The generational change in the Japanese political arena has also been a critical element that undermined the friendly relations between the two countries. Mike Mochizuki states that, in the post-normalization era, powerful politicians like Kakuei Tanaka, Masayoshi Ohira, and Noboru Takeshita took the lead in managing relations with Beijing and prevented nationalistic criticisms of China from damaging the bilateral relationship.<sup>3</sup> Thus, from the latter half of the 1980s, the resolution of situations through personal channels was replaced by dialogues centered on normal diplomatic channels and summit exchanges.<sup>4</sup>

The Tiananmen Square massacre of 1989, in which hundreds of pro-democracy protestors were killed, obviously dramatically spoiled the Japanese public's perception of China dramatically. In response to the massacre, the advanced industrialized

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<sup>2</sup> Mike M. Mochizuki, "China Japan Relations," David Shambaugh, ed., *Power Shift: China and Asia's New Dynamics* (California: University of California Press, 2005), p. 136.

<sup>3</sup> Ibid.

<sup>4</sup> Benjamin L. Self and Jeffery W. Thompson, eds., *An Alliance for Engagement-Building Cooperation in Security Relations with China* (Washington D.C.: The Henry L. Stimson Center, 2002), pp. 79-112.

nations, including Japan, decided to impose sanctions against China, and the European Council agreed to impose an embargo on arms exports by European Union nations, prohibiting the export of lethal equipment and systems to China. Although Japan also imposed sanctions against China along with other industrialized nations, it was the first country that resumed providing ODA to China in 1989.

Japan-China relations became more volatile and competitive in the 1990s. In addition to the disappearance of personal channels of communication that hedged against the deterioration of bilateral relations between Japan and China, the old Japanese political regime, which the LDP dominated for 38 years, collapsed with the formation of the Hosokawa Administration in August 1993, the first non-LDP government since 1955. Ichiro Ozawa, currently the head of Democratic Party of Japan (DPJ), split from the LDP and formed the Japan Renewal Party (*Shinseitou*) that helped end the LDP's postwar monopoly of power. A well-known conservative politician, Ozawa proposed that Japan should become a "normal country," which stimulated the new nationalism in Japan and emphasized placing more importance on traditional value.<sup>5</sup> It has also provoked debates over the revision of history, and increased the number of younger politicians who assert the necessity of strengthening defense capabilities, revising the Constitution, and building a normal country.<sup>6</sup>

The effects of Japan's poorly received performance in the 1991 Gulf War is attributable to the rise of new nationalism in Japan. China's growing influence in East Asia, using the historical card as political leverage, and military behavior are other reasons for the rise of new nationalism. The Chinese economy has gained strength since 1992 when enormous foreign direct investment (FDI) from all over the world started to flow into China. The Japanese economy, on the other hand, has been stagnant because of the burst of the bubble economy in the early 1990s. While the economic influence of China increased in East Asia, Japan's economic power declined due to the substantial decrease in Japan's FDI and stagnant domestic demand.

The important change in the overall trade pattern in Asia during the 1980s was the shift in the relative position of Japan and China. Today, China represents one half of

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<sup>5</sup> Kazuko Mouri, *Nichuu Kankei –Sengo kara Shinjidaihe [Japan-China Relations-From the Post War to a New Era]* (Tokyo: Iwanami Shinsho, 2008), p. 146.

<sup>6</sup> *Ibid.*

developing East Asia's gross domestic product (GDP) and one third of its exports.<sup>7</sup> Against this background, the China threat theory emerged in Japan's political and business circles. They came to believe that Japanese aid, trade, investment, and technological transfer would help expand China's economic, political and military influence in the region and the world in ways contrary to Japanese interests.<sup>8</sup>

In addition to the shift in the trade structure in East Asia, several events occurred in the 1990s which heightened the Japanese public's anti-Chinese sentiment. China conducted nuclear testing in May and October 1995 and also conducted military exercises against Taiwan in March 1996, which highlighted the possibility of a military clash between China and Taiwan. The Senkaku Islands territorial dispute between Japan and China flared again in July 1996. In response to the nuclear tests, Japan froze ODA as a sanction against China. Anti-Chinese sentiment in Japan has been bolstered by China's increased military strength and the threat displayed against Taiwan.<sup>9</sup> Anti-Chinese hardliners in the LDP have gained power and demanded that the government take tougher policy toward China. It also allowed for a strengthened pro-Taiwan faction among the LDP parliamentarians.<sup>10</sup> The influence of "China School," made up of a group of officials who are China specialists and a group of bureaucrats who formerly served as ambassadors in China, began to fade off in the Japanese Ministry of Foreign Affairs. Japan has reinforced its security relationship with the United States. In April 1996, U.S. President Bill Clinton and Prime Minister Ryutaro Hashimoto signed the "Japan-U.S. Joint Declaration on Security-Alliance for the 21st Century" and agreed that a continued U.S. military presence is also essential for preserving peace and stability in the Asia-Pacific region. The leaders shared the common recognition that the U.S.-Japan security relationship forms an essential pillar which supports the positive regional engagement of the United States.<sup>11</sup> In September 1997, Japan and the United States issued a new "Guidelines for Japan-U.S. Defense Cooperation" at the Japan-U.S. Security Consultative Committee meeting in New

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<sup>7</sup> Indermit Gill and Homi Kharas, *An East Asian Renaissance-Ideas for Economic Growth* (Washington D.C.: The World Bank, 2007), p. 5.

<sup>8</sup> Robert G. Sutter, *Chinese Foreign Relations-Power and Policy since the Cold War* (Lanham, MD: Roman and Littlefield Publishers Inc., 1998), p. 223.

<sup>9</sup> Masahiko Sasajima, "Japan's Domestic Politics and China Policymaking," Benjamin L. Self and Jeffery W. Thompson, eds., *op. cit.*, p. 80.

<sup>10</sup> *Ibid.*, p. 85.

<sup>11</sup> FAS News, April 17, 1996, <http://fas.org/news/japan/11318448-11333165.htm>.

York.<sup>12</sup> The new guidelines outline ways in which Japan would cooperate with the United States in response to a “situation in areas surrounding Japan.”<sup>13</sup> China was increasingly alarmed by the two developments in security relations between Japan and the United States.

Thus, in the 1990s, relations between Japan and China fell into a downward spiral because of declining Japanese economic strength and rising Chinese economic and military power and caused mutual distrust between the two countries. New nationalism gained clout in the political arena in Japan, and Japan's policy toward China has shifted from a friendly approach to balancing China by strengthening the U.S.-Japan Alliance.

It was expected that Chinese President Jiang Zemin's visits to Japan in November 1998 would restore the deteriorated bilateral relations. However, the result was contrary to the expectations of Japanese policymakers and the public. President Jiang took the opportunity to emphasize historical issues between the two countries and demanded a written apology from Japan. Some argue that one of the reasons for President Jiang's use of historical issues was to lessen political pressure, especially from the military which he could hardly control. Since his visit, anti-Chinese feelings among the Japanese public have run strong, and endorsed the revision of Japan's ODA policy toward China. Mike Mochizuki states that the visit of President Jiang was the end of the friendship framework between Japan and China.<sup>14</sup>

## From the Koizumi Administration to Reconciliation

In April 2001, Mr. Junichiro Koizumi, who won the primaries among the LDP members by an overwhelming majority, was inaugurated as the 87th Prime Minister of Japan. Supported by his high popularity, Prime Minister Koizumi carried out major structural reforms in order to revitalize the Japanese economy, as well as political reforms to end factional politics within the party. Mr. Koizumi's landslide electoral

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<sup>12</sup> The Ministry of Foreign Affairs, *Diplomatic Blue Book 1998*, <http://www.mofa.go.jp/policy/other/bluebook/1998/I-b.htm>.

<sup>13</sup> Hirotaka Watanabe, “Japan in a Changing World,” *Japan Echo- The Polarization of Education*, Vol. 29, No. 4, June 2002, <http://www.japanecho.co.jp/su/2002/290409.html>.

<sup>14</sup> Mike M. Mochizuki, op. cit., p. 138.

victory in the primaries in spite of the fact that he did not hesitate to pledge to visit the controversial Yasukuni Shrine on August 15, the anniversary of the end of the war, was attributable to the generational change of the politicians in the ruling party. Due to Prime Minister Koizumi's persistent visits to Yasukuni Shrine and the approval by the Japanese government of a controversial nationalistic history textbook,<sup>15</sup> Japan-China relations took a turn for the worse since the inauguration of the Koizumi Administration. It became difficult to hold reciprocal summit conferences between the top leaders of both countries.

Prime Minister Koizumi surprisingly visited the Yasukuni Shrine on April 21, 2002 and, in turn, China postponed acceptance of Minister of State for Defense Gen Nakatani's visit to China and the first visit of Chinese naval vessels to Japan which were planned for May 14, 2002.<sup>16</sup> Opposing the Japanese government's approval of history textbooks, massive anti-Japanese demonstrations in China broke out in spring of 2005. The demonstrators attacked Japanese embassy and consulates and firms in major cities, and Japanese firms began to review their investment policies, refraining from concentrating investments in China. China also carried out internet petition campaigns to prevent Japan's effort to secure a permanent seat on the U.N. Security Council. As Robert Sutter states, by mid-2006, Japan-China relations had reached their lowest point since the normalization of diplomatic relations in 1972.<sup>17</sup>

A reversal of the unfavorable relations between the two countries occurred when Prime Minister Shinzo Abe suddenly visited Beijing in October 2006. This was the first official visit by a Japanese prime minister since Prime Minister Obuchi went to China in July 1999. Shinzo Abe, known for his conservative views about Japan's history, was elected president of the LDP on September 19, and a week later, he became the prime minister of Japan. He is the first prime minister who chose Beijing as the first destination for an official visit. Below are several reasons for Prime Minister Abe's visit to Beijing:

- 1) Need to forge common ground in handling North Korean issues among the three nations of Japan, China and South Korea;
- 2) Avoiding "Japan passing" in dealing with North Korean issues;
- 3) Keeping up with the improvements of bilateral relations between the United States and China;

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<sup>15</sup> Benjamin L. Self and Jeffery W. Thompson, eds., *op. cit.*, p. 81.

<sup>16</sup> *Ibid.*, p. 82.

<sup>17</sup> Robert G. Sutter, *op. cit.*, p. 217.

- 4) Being under pressured from the United States to improve relations;
- 5) Coping with strong demand from economic circles to restore bilateral relations with China; and
- 6) Consolidating his political status.

China, expecting restoration of relations with Japan under the post-Koizumi administration, accepted Prime Minister Abe's visit to Beijing, although he did not clarify whether he would go to the Yasukuni Shrine or not. On October 8, 2006, Prime Minister Abe had talks with President Hu Jintao, Premier Wen Jiabao, and Chairman Wu Banguo of the Standing Committee of the National People's Congress.<sup>18</sup> Abe and Hu agreed to build a "mutually beneficial relationship based on common strategic interests."<sup>19</sup> Both leaders also agree to address the difficult issues of history and the exploration of oil and gas field in the East China Sea by setting up expert panels to explore ways to resolve them. Regarding the East China Sea, Abe and Hu agreed to accelerate the process of consultation toward the objective of "joint development" and "a resolution acceptable to both sides."<sup>20</sup> They shared the view that they would promote exchange and cooperation in areas such as politics, economy, security, society and culture at various levels, and that they would strengthen coordination and cooperation on international and regional issues.<sup>21</sup>

In response to Prime Ministers Abe's invitation, Premier Wen Jiabao paid an official visit to Japan in April 2007. Both premiers agreed on the basic spirit of the "mutually beneficial relationship based on common strategic interests," that both countries would develop mutually beneficial cooperation for the future at various levels while contributing constructively to the peace, stability and development of Asia and the world. As for defense exchange, both countries agreed to realize the visit to Japan by Chinese Navy vessels and the subsequent visit to China by Japanese Maritime Self-Defense Force vessels. Moreover, Japan and China agreed to enhance cooperation on

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<sup>18</sup> The National Institute for Defense Studies, ed., *East Asian Strategic Review 2007* (Tokyo: The Japan Times, 2007), p. 101.

<sup>19</sup> Ibid.

<sup>20</sup> James. J. Przystup, "Japan-China Relations: Ice Breaks at the Summit," *Comparative Connections*, CSIS Pacific Forum, 4th Quarter 2006.

<sup>21</sup> The Ministry of Foreign Affairs, "Japan-China Joint Press Statement, October 8, 2006," <http://www.mofa.go.jp/region/asia-paci/china/joint0610.html>.



environmental protection and energy.<sup>22</sup>

Mr. Yasuo Fukuda took over premiership from Mr. Abe in September 2007 and followed the same policy toward China as Prime Minister Abe. In his initial speech delivered to the Diet in October 2007, the Prime Minister stated “With China, we will establish a mutually beneficial relationship based on common strategic interests, and work together to contribute to the peace and stability of Asia.”<sup>23</sup> His pro-China stance and commitment not to visit Yasukuni Shrine were welcomed by China. When he visited Beijing on December 27, 2007, he received an enthusiastic welcome and his speech to a Beijing University audience was televised nationally. This was only the second time that a speech by a foreign leader has been given such coverage, the first being President Bush’s speech in 2005.<sup>24</sup>

Prime Minister Fukuda and Premier Hu pledged that the both countries would work together for the future of Asia and the world, and they agreed to bring the concept of a “mutually beneficial relationship based on common strategic interests” into more concrete terms in a broad range of areas. They also agreed on areas in which the two countries could cooperate which included energy, the environment and climate change, and the promotion of personnel exchanges, including military officers.<sup>25</sup> On December 28, 2007, Japan and China issued the “Joint Communiqué on Promotion of Cooperation in the Field of the Environment and Energy,” which emphasized the necessity of enhancing the transfer of environmental technologies to China.<sup>26</sup> Regarding the controversial issue of the East China Sea, both leaders shared the determination to settle the issue and agreed to continue discussions aiming at a resolution as early as possible.<sup>27</sup> Prime Minister Fukuda indicated that Japan’s position is, as stated in the Japan-China Joint Communiqué, that Japan hopes for a peaceful resolution and cannot support any unilateral attempt to change the status

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<sup>22</sup> See, the Ministry of Foreign Affairs, “Japan-China Joint Press Statement, April 11, 2007,” <http://www.mofa.go.jp/region/asia-paci/china/pv0704/joint.html>.

<sup>23</sup> James. J. Przystup, “Japan-China Relations: Politics on Command, Part 2,” *Comparative Connections*, CSIS Pacific Forum, 4th Quarter 2007.

<sup>24</sup> Ibid.

<sup>25</sup> Ibid.

<sup>26</sup> The Ministry of Foreign Affairs, “Visit by Prime Minister Yasuo Fukuda to the People’s Republic of China (Overview and Evaluation),” <http://www.mofa.go.jp/region/asia-pacific/china/pmv0712/overview.html>.

<sup>27</sup> Ibid.

quo, and that Japan does not hope for any situation that would heighten cross-strait tensions through the holding of the referendum in Taiwan, and if the referendum would lead to the unilateral action to change the status quo, Japan cannot support it.<sup>28</sup>

In response to an invitation extended by the Japanese government, Chinese President Hu Jintao paid an official visit to Japan from May 6 to May 10, 2008. During his visit to Japan, he met with His Majesty the Emperor of Japan, and also had talks with Prime Minister Fukuda. They reached a common understanding on various points related to the comprehensive promotion of a mutually beneficial relationship based on common strategic interests, issued a joint statement and held a joint press conference. In the press conference, both sides recognized that the Japan-China relationship is one of the most important bilateral relationships, that they are partners and are not threats to each other, and that they would resolve bilateral issues through consultations and negotiations. Following the visit to Japan by the PLA naval vessels in November 2007, Japan promised that Japan Maritime Self-Defense Force vessels would visit China. Japan and China also decided that mutual visits between young officers of the PLA and the Self-Defense Forces would be stepped up for deepening mutual understanding between the defense authorities of both countries.<sup>29</sup>

It is of overriding importance that China takes a future-oriented stance to its relations with Japan in the summit. Despite Tibet, poisoned gyoza, and the gas development in the East China Sea, all disputes set on the pre-summit agenda, the summit itself was rated highly in general. Although the summit did not produce any concrete solutions to the issues, both leaders renewed commitment to cooperate in resolving the issues. Moreover, the summit meeting made the mutually beneficial relationship based on common strategic interests comprehensive, including not only energy and environmental cooperation, but various areas such as politics, military issues, society, and culture. As for the issues of the East China Sea, Japan and China announced agreement on a plan for joint development of oil and gas fields in the East China Sea.

Thanks to the two successive Japanese administrations, the bilateral relationship

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<sup>28</sup> Ibid.

<sup>29</sup> See the Ministry of Foreign Affairs, "Joint Press Statement on the Strengthening Exchange and Cooperation between the Government of Japan and the Government of the People's Republic of China," <http://www.mofa.go.jp/region/asia-paci/china/pv0805/press.html>.

with China has been realigned, but it is just a starting point for establishing mutually beneficial relations. There are many issues that are yet to be resolved between the two countries, and the friendly relations would be easily influenced by domestic political elements in both countries. We can not be optimistic about the future of Japan-China relations. China has expanded its defense budget dramatically in the past two decades, but the transparency of the budget, force structures, and strategic intention is still lacking. The PLA is still exerting strong influence over decision-making on domestic and foreign policy. It is not easy for neighboring countries to guarantee that China would become a status quo power in the region. Therefore, Japan's dualistic policy of engaging and balancing China will be maintained in the foreseeable future.

### **Economic Cooperation as a Safety Valve**

No one can deny that volatility still prevails over the future relationship between Japan and China, despite the restored bilateral relations in the Abe-Fukuda era. As Japan-China relations have been described as “politically cool, but economically hot,” economic ties have worked as a kind of safety valve, even when relations are disturbed by political problems, enabling the two countries to avert potential disasters and restore cooperation. It is true that closer economic ties do not always nurture better feelings among trading partners. It might cause multiple economic frictions between them. However, the two economies are more intertwined than ever, and political leaders on both sides should realize the heavy cost of a disruption of cooperative relations. It is relatively easy for both countries to recognize the mutual benefits from their economic relations. Along with rapid economic development, China has been more and more integrated into the web of regional and global economic networks. Therefore, it has become more difficult not only for China, but also other countries to take adventurous or unilateral actions to gain egoistic economic benefits. The primary objective of Japan's economic cooperation toward China is to enhance China's economic development and deepen economic interdependence, which would steer China to play more important economic roles as a responsible stakeholder. Most important of all, China's stable development is extremely important for the peace and prosperity of the entire Asia-Pacific region.

*Japan's Stagnation and the Rise of "China Threat"*

Postwar Japan-China economic relations started with private sector-oriented trade during the 1950s and 1960s. After the normalization of diplomatic relations were realized in 1972, Japan and China officially signed the Japan-China Trade Agreement, followed by the Japan-China Aviation Agreement in 1974, and the Fishery Agreement in 1978. In the private sector, Japan and China concluded the Japan-China Long Term Trade Agreement in 1978, which established the basic framework for the development of bilateral economic relations. As Xu Xianfen states, Japan-China economic relations can be divided as follows: the 1970s were marked by the increase in bilateral trade of goods; the 1980s by Japan's direct investment and monetary loans, enabling the establishment of China's economic infrastructure; and the 1990s by the rise of a market economy in China based on the consolidation of trade, investment and government sponsored ODA.<sup>30</sup>

Japan has consistently supported China's reforms and opening policies through measures such as ODA, which has been provided since former Prime Minister Ohira's visit to China in 1977. It is obvious that Japan's ODA has played critical roles in building necessary infrastructure, such as transport systems, for the economic development of China, which has been induced by massive inflows of foreign direct investment (FDI) from all over the world in the 1980s and 1990s. It was in the 1990s that Japanese FDI to China dramatically increased and has promoted China's industrial development. Although the accumulated value of Japan's FDI is relatively small compared to the total amount of investment received by China, it is clear that China's increasing trade with Japan is driven by Japan's foreign investment. China became Japan's largest trading partner in 2004.

Since the implementation of reforms and opening policies, China's economy has achieved dramatic growth and development by introducing market mechanisms and attracting huge direct investment from abroad. Entering the 1990s, China has become a major economic player in the world, which reversed the positions of Japan and China. In 1993, the World Bank and the International Monetary Fund (IMF) published new projections based on purchasing power parity that showed that China

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<sup>30</sup> Xu Xianfen, "The Study of Sino-Japanese Relations in Japan and China, 1990-2005," *Modern Asian Studies Review* (Tokyo: Toyo Bunko, 2007), Vol. 12, 2007, p. 87.

was on the verge of replacing Japan as the world's second-largest economy.<sup>31</sup> While the Japanese economy had plunged into a long recession since the early 1990s, the Chinese economy has continued at a high rate of growth. The total external trade of China, Taiwan, and Hong Kong, disregarding trade amongst themselves, amounted to US\$810 billion in 1999, surpassing Japan's total of US\$731 billion.<sup>32</sup> On the other hand, Japan's FDI to China and the rest of Asia declined after 1995, which indicates the waning of Japanese influence.<sup>33</sup> Moreover, China today is the world's third largest trader, and it is the largest trader in East Asia, having overtaken Japan in 2004.<sup>34</sup>

Against this background, the perception of a China threat has mounted in Japan, even in economic circles. The most serious threat was the hollowing out of Japanese industry that increased unemployment. Another threat was a boomerang effect, whereby technology transfer would lead to the creation of strong rivals. However, these threats seem to be invalid. Japanese entrepreneurs and politicians possessed similar concerns when huge direct investment went to Southeast Asian countries after the Plaza Accord in 1985, though those concerns proved unfounded. When the Japanese economy recovered slightly in 2003 by the expansion of exports to China, the threat perception in regards to China decreased. Therefore, Japan's stagnated economy seems to be attributable to the rise of the China threat. China is an inevitable trading partner for Japan's economic development. Increasing economic dependency between the two countries could revive the Japanese economy and nurture friendly and stable bilateral relations, which would lead to the prosperity of the Asia-Pacific region.

### *Development of the Trade Structure and FDI*

Integration of China into the world economy is one of the most important developments affecting the structure and evolution of the global and regional trading system.<sup>35</sup> Driven by the development of a modern export-oriented industry, the Chinese

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<sup>31</sup> See the World Bank, *World Development Report 1993*, and the International Monetary Fund, *World Economic Outlook 1993*.

<sup>32</sup> Andrew Macintire and Barry Naughton, "The Decline of a Japan-Led Model of the East Asian Economy," T. J. Pempel, ed., *Remapping East Asia-The Construction of a Region* (Ithaca: Cornell University Press, 2005), p. 88.

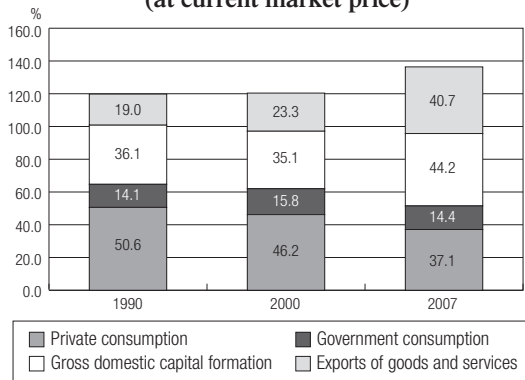
<sup>33</sup> *Ibid.*, p. 86.

<sup>34</sup> Indermit Gill and Homi Kharas, *op. cit.*, p. 5.

<sup>35</sup> *Ibid.*, p. 98.

economy has grown at nearly 10% annually over the past two decades. Figure 1 shows the structure of demand as percentage share of China's GDP. Between 1990 and 2007, the dramatic change is the increase in exports from 19% to more than 40%. Gross fixed capital formation also rose from 36% to 44%, while private consumption relatively decreased from 50% to 37%. Thus, exports have been the largest factor for China's economic development, and domestic investment has reinforced that growth by supplementing the fluctuation of exports from the international market situation. Imports also followed a similar trend, sustained by continuous industrial development.

**Fig. 1 Structure of Demand in China: as percentage of GDP**  
(at current market price)

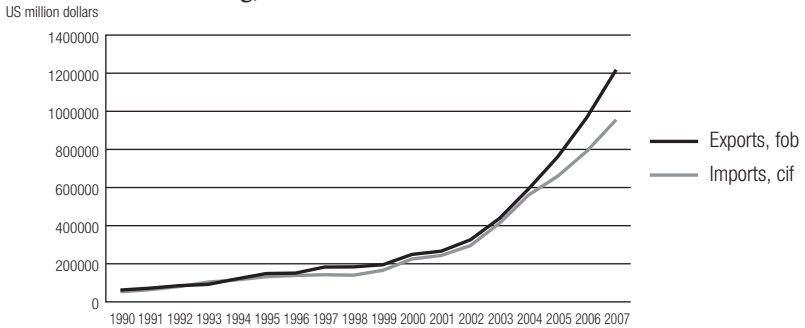


Source: ADB, *Key Indicators for Asia and the Pacific* 2008.

China's exports have seen a dramatic expansion since 2000, recording more than 1.2 trillion US dollars in 2007 (Fig. 2). China's entry into the World Trade Organization (WTO) in December 2001, which further enhanced China's credibility, has also sustained this increase. In 2007, China was the largest contributor to world export development. World trade increased 4.9% in 2007 compared to the previous year, and China's contribution to the increase was 23.4%, followed by the United States' 9.7%.<sup>36</sup> As a result, China became the second largest exporter in the world in 2007 after Germany.<sup>37</sup>

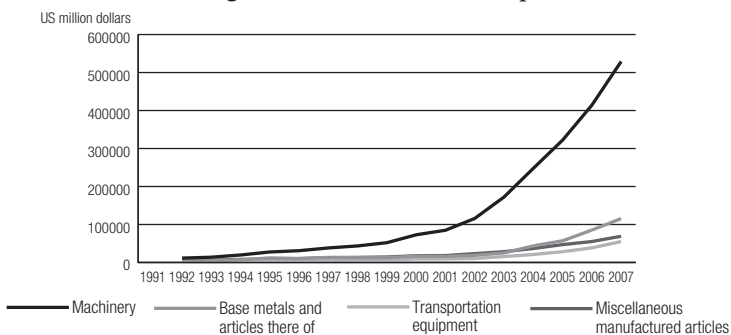
<sup>36</sup> Japan External Trade Organization (JETRO), *Boueki Toushi Hakusho*, 2008 [White Paper of Trade and Investment, 2008], p. 1.

<sup>37</sup> *Ibid.*, p. 8.

**Fig. 2 Trends of China's Trade**

Source: ADB, *Key Indicators for Asia and the Pacific 2008*.

In addition to the expansion of export volume, China has upgraded its export structure. Since 2000, exports of machinery have been registering powerful development (Fig. 3). Although China used to be an exporter of miscellaneous articles, it has increased in industrial materials and capital goods exports, such as base metals, machinery and transport equipment. China emerges as a major competitor to other East Asian exporters in sectors such as office machines, electric machinery, chemical materials, and non-metallic products.<sup>38</sup> This reflects China's industrial advancement. It is a characteristic of China that the products of foreign affiliated corporations have contributed much to the upgrading of China's export structure. In fact, the exports of foreign firms in China constituted about 57% of total exports in 2007.<sup>39</sup>

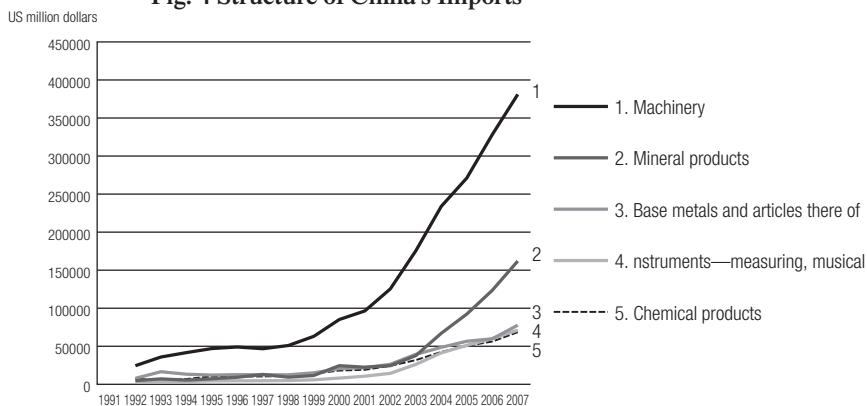
**Fig. 3 Structure of China's Exports**

<sup>38</sup> Indermit Gill and Homi Kharas, *op. cit.*, p. 98.

<sup>39</sup> Japan External Trade Organization (JETRO), *op. cit.*, p. 163.

Along with export and industrial development, the structure of imports has also evolved. Like the export structure, imports of capital goods have increased remarkably since the early 1990s (Fig. 4). Among others, machinery, including transport equipment and spare parts, has been recording outstanding increases. Imports of machinery occupied a 43% share of China's total imports in 2007. Imports of industrial intermediates, base metals and chemical products have also expanded. Those structural changes indicate that China has developed its industries to produce and export high-tech manufactures, which necessitate imports of capital goods and intermediates.

**Fig. 4 Structure of China's Imports**

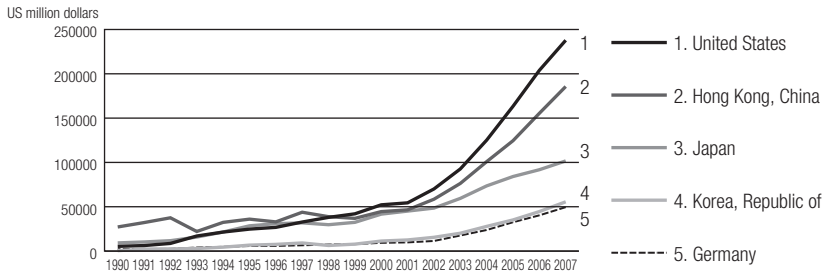


Source: ADB, *Key Indicators for Asia and the Pacific 2008*.

In regards to the direction of exports, the United States has been the largest export market for China (Fig. 5). China sent about 20% of total exports to the United States in 2007, followed by Hong Kong (15%), Japan (8%), and the Republic of Korea (5%). Hong Kong, being a major re-export port, traditionally used to be a main export market of China. However, the United States took over that position in the late 1990s. China's dramatic increase of exports resulted in expanding deficits in its trade balance with the United States, and in turn, the United States demanded an appreciation of the Yuan. China responded by revaluing the yuan upward by 2.1% in July 2005.<sup>40</sup>

<sup>40</sup> *The Straits Times*, July 22, 2005.



**Fig. 5 Direction of China's Exports**

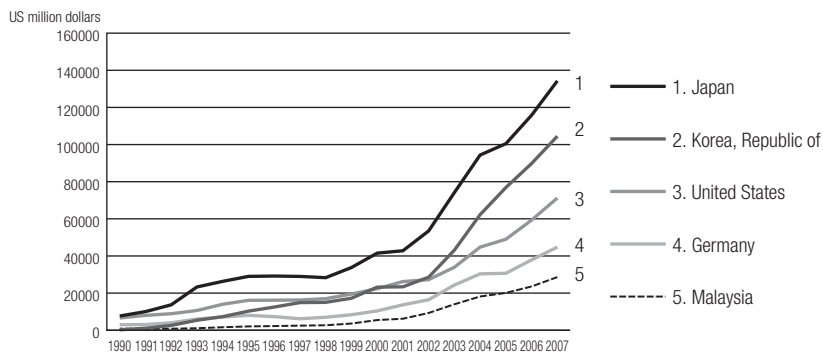
Source: ADB, *Key Indicators for Asia and the Pacific 2008*.

As for China's imports, Japan has been the largest supplier since the early 1990s (Fig. 6). Imports from Japan have indicated a sharp increase since 2001 and constituted 14% of China's total imports in 2007. Imports from the Republic of Korea, the second largest supplier, has also recorded a sharp rise, which shared 11% of the total in 2007. It seems that Japan and South Korea supply electric and electronic parts for high-tech products, such as computers and liquid crystal panels, rather than end products. It indicates China has emerged as an important assembly hub, while Japan and the newly industrializing economies (NIEs) are the major sources of innovative intermediates.<sup>41</sup> After South Korea, the United States, Germany, and Malaysia follow as major suppliers to China. Not only those five countries, but almost all countries in East Asia have boosted their share of exports to China, and at the same time, they have seen a fall in their export shares to Japan, reflecting the slower growth of the Japanese economy.<sup>42</sup> The dominant feature of the changes in the trade in machinery continues to be evidence that the increase in China's exports of finished products are linked to a substantial rise in the exports of parts and components from other emerging East Asian exporters, and this triangular trade is the most notable empirical phenomenon of the last few years.<sup>43</sup>

<sup>41</sup> Indermit Gill and Homi Kharas, *op. cit.*, p. 92.

<sup>42</sup> *Ibid.*, p. 88.

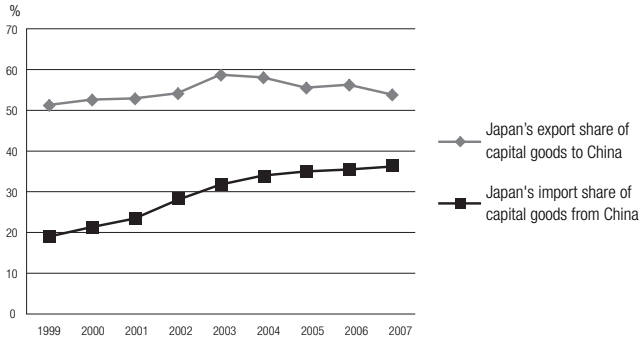
<sup>43</sup> *Ibid.*, p. 105.

**Fig. 6 Origin of China's Imports**

Source: ADB, *Key Indicators for Asia and the Pacific 2008*.

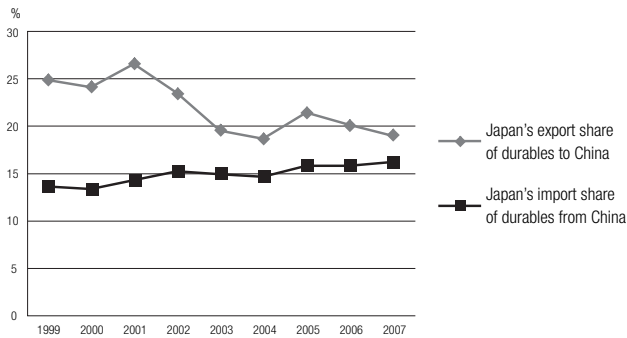
China is the largest source of imports and the second largest export market for Japan which registers a trade deficit. Bilateral trade, especially imports from China, has increased remarkably since 2000 due to the sharp increase in imports of capital and non-durable goods. The differences in percentage share of capital and durable goods in Japan's bilateral trade have been getting closer year by year, although Japan's exports still exceed imports (Fig. 7 and 8). The same tendency can be observed in trade of industrial materials (Fig. 9). The developments indicate a shift from a vertical to a horizontal division of labor in bilateral trade relations. It also threatens Japan since the expansion of Chinese imports might hollow out Japanese industry. However, Japan's trade relations with China cannot simply be interpreted by statistics. There still remain quality differences between Japanese and Chinese products. Japanese affiliated firms located in countries neighboring China are also expanding exports of industrial products, including spare parts, to the Chinese market. Trade statistics simply show bilateral trade volumes. Japan's trade with China should be interpreted in the context of multilateral economic relations, in order to evaluate the effects of production networks established in East Asia by Japanese firms.

**Fig. 7 Japan's Trade with China -Capital Goods-**



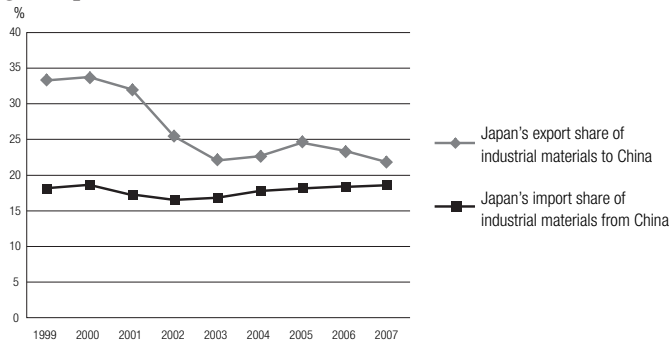
Source: JETRO.

**Fig. 8 Japan's Trade with China -Durable Goods-**



Source: JETRO.

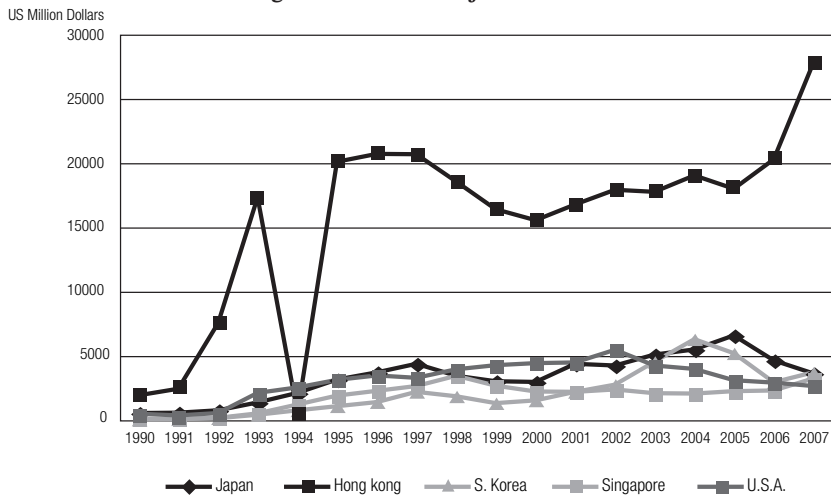
**Fig. 9 Japan's Trade with China -Industrial Materials-**



Source: JETRO.

China's rapid economic growth has been led by export expansion. However, it is obvious that the inflow of FDI has sustained the expansion and enhanced the industrial sophistication of China. The inflow of FDI from all over the world has dramatically increased since 1992 and expanded to 74.8 billion dollars in 2007, which is more than 20 times as much as 1990. China has become the largest recipient of foreign investment. Among industrial sectors, manufacturing has been the largest target of FDI. However, recent statistics revealed that the investment in the manufacturing sector show a decline in FDI inflow, while investment in the non-manufacturing sector, especially real estate, increased. In fact, the amount of FDI to the real sector was around 23% of total foreign investment in 2007 due to the Olympic effect. Although the investment in the manufacturing sector decreased, it is still the top recipient sector in value.

**Fig. 10 FDI from Major Investors**



Source: JETRO, *China Data File 2008*.

Classifying FDI by country and area, Hong Kong is the largest investor, providing 42% of total investment in 2007, followed by the Virgin Islands (a tax haven), South Korea, and Japan. Japan used to be the third largest investor in China, but South Korea surpassed Japan in 2007 (Fig. 10). Andrew Macintire states that incoming

investment from Hong Kong reflects proximity and “suburban investment.”<sup>44</sup> In contrast to Hong Kong, whose investment is concentrated in the non-manufacturing sector, Japan has invested mainly in manufacturing, which directly affected China’s industrial development. The manufacturing sector constitutes about 80% of Japan’s total FDI to China, and, in addition to electronics and machinery, Japanese firms like automobile and spare parts and food processing companies have been investing in China. According to a report published by Keizai Douyu Kai, a powerful Japanese business circle, the accumulated amount of Japanese investment in China at the end of 2005 was 53 billion dollars, and the number of Japanese firms established in China was 35,000, whose employees exceeded 9.2 million.<sup>45</sup>

However, Japan’s investments started to decline in 2006 and 2007 because of the substantial decline in investment to the manufacturing sector. Although investment in the service sector has recorded a substantial increase, it has been insufficient in covering the decline of investment in the manufacturing sector. It is argued that Japan’s FDI to China is now on a brink. Japanese investment in China had substantially increased over the past two decades, and it seems that Japan’s investment peaked in 2005. The mass anti-Japan demonstrations that took place in China in early 2005 is one of major factors that contracted Japanese investment in China. Judging from the present economic slump triggered by the financial collapse in the United States, the increase of Japanese foreign investment is unlikely for the time being.

From a long-term perspective, it is inevitable for Japan to relocate more industries abroad, due to the rapid demographic change. China will be a major host country for Japanese firm in the future as well. It will enhance further industrial development of China and Southeast Asian nations through technological transfer, which will serve as a driving force for boosting economic expansion and the dynamism of the international division of labor in East Asia. Thus, East Asian regionalism will be gradually realized. Enhanced interdependence between Japan and China, as well as among East Asian nations is unavoidable in order to establish a regional community.

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<sup>44</sup> Andrew Macintire and Barry Naughton, *op. cit.*, p. 83.

<sup>45</sup> Keizai Douyu Kai, “Kongo no Nicchuu Kankei eno Teigen-Nicchuu Ryoukoku Seifu eno Messeji [The Proposal for the Future Relations between Japan and China-A Message to the Governments of Japan and China],” 2006, p. 1.

## **New Areas for Japan-China Cooperation: Enhancement of Regionalism**

A rising China is the fundamental change in East Asia's political and economic environment. It has also developed the possibility of realizing East Asian regionalism. East Asian regionalism has gained momentum since the onset of the Asian financial crisis in 1997. The current trend of East Asian regionalism seems to be driven by deepened economic interdependence in the region. A number of free trade agreements (FTAs) have been concluded in East Asia and they serve as an accelerator in forging an integrated market in the region. There are 148 FTAs currently effective around the world as of August 2008, of which there are 28 agreements in the Asia-Pacific region.<sup>46</sup> There are several reasons for establishing free trade areas including:

- 1) Stalemate in the WTO negotiations;
- 2) The expansion of WTO membership makes it difficult to facilitate global liberalization of trade and investment due to conflicting interests among members;
- 3) A regional free trade agreement is easier for constituting nations, which have similar economic conditions, to form an integrated market;
- 4) The emergence of new mega-markets, especially China;
- 5) Existence of sufficient transport infrastructure;
- 6) Regional incentives to strengthen economic self-reliance; and
- 7) ASEAN's initiative to establish the ASEAN community in 2015.

Economic interdependence has deepened more than ever and a number of free trade areas have been established in the region since 2000. Those events underpin the process of East Asian economic integration, which leads to the growing expectation of the establishment of an East Asian community in the future. Economic integration in East Asia has been driven neither by strong leadership nor by legally binding force. It is driven by the dynamism created by the massive flows of FDI and expansion of intraregional trade. In other words, East Asian economic integration has been largely a private sector phenomenon driven by market forces, not government planning. Multinational corporations are the vital actors of the development of regional trading pattern.

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<sup>46</sup> JETRO, "WTO/FTA Column," <http://www.jetro.go.jp/theme/wto-fta/column/pdf/051.pdf>.

FDI created regional industrial networks or production linkages within East Asia and this is premised on East Asian economic integration. The ratio of regional exports to total exports in East Asia<sup>47</sup> climbed to 40% in 2007 from 31% in 1990 (Table 1). Although the percentage of China's exports to East Asia declined from 50.6% in 1990 to 28.3% in 2007, the amount of exports remarkably increased from 31.5 billion to 345.3 billion dollars in the same period. It represents the fact that China expanded its exports to other markets outside the region, particularly to the EU, which relatively reduced the ratio of regional exports. The total amount of intraregional exports also expanded to more than one trillion dollars in 2007, ten times as much as the level of 1990. It is evident that deepening economic interdependence substantially proceeded in the region, which would sustain the process of regional economic integration.

**Table 1: Intraregional Exports**  
(Percentage of exports to East Asia)

	1990	2000	2007
World	11.3	15.9	18.1
Japan	29.2	39.6	46.0
East Asia	31.3	36.9	40.3
China	50.6	30.7	28.3

(unit:%)

Source: JETRO, Trade Matrix.

Note: East Asia includes China, S. Korea, Taiwan, Hong Kong, Singapore, and ASEAN 4 (Thailand, Malaysia, Indonesia, the Philippines).

It is generally believed that de facto integration is the main characteristic of East Asia's regionalism. In Asia, the regional economic community-building process has been stimulated on the basis of regional production linkages and market mechanisms. Japanese firms have played a pivotal role in establishing production linkages in the region. As of March 2006, there are 15,812 Japanese manufacturing companies operating around the world, of which 8,794 are located in East Asia, sharing around 56% of the total. China hosts the largest number of Japanese firms, absorbing 4,044 establishments.<sup>48</sup> Those Japanese manufacturing companies give the key to the

<sup>47</sup> According to JETRO's statistics, East Asia includes China, South Korea, Taiwan, Hong Kong, Singapore, and ASEAN 4 (Thailand, Indonesia, Malaysia, the Philippines). Japan is excluded.

<sup>48</sup> The Ministry of Economy, Trade and Industry (METI), *Wagakuni Kigyou no Kaigai Jigyou Katudou* [Overseas Operation of Japanese Firms], July 2007, p. 1.

establishment of production networks, which are the fundamental elements of the region's de facto economic integration. Although Japan has experienced a long-term recession since the early 1990s, its technological transfers, including managerial and trading know-how, as well as financial transfer, are absolutely essential for the development of China as well as the rest of East Asia. Japanese firms have also expanded their activities to develop local supporting industries as suppliers of components and materials, which substantially contributed to upgrading the industrial structure of host countries and expanded intra-firm trade in East Asia.

In order to enhance economic integration in East Asia, the roles played by Japan and China are critical as the total GDP of the two countries constitutes nearly 80% of East Asia. Historical problems remain an obstacle for establishing an amicable bilateral relationship between Japan and China, and there seems little possibility to resolve them in the short- and medium-term. However, China could afford a large opportunity not only to Japan but the entire region. Most Japanese have come not to see China as a threat but as a challenge and opportunity on the economic front. What concerns Japan about China is its uncertain economic and political behavior, which seem to not be following international rules and practices. Since its entry to the WTO in 2001, China has made efforts to liberalize regulations in trade, but as JETRO's White Paper points out, barriers still exist. They include: infringement on intellectual property such as counterfeit and pirate products; arbitrary use of anti-dumping measures; and subsidy measures incompatible with the WTO.<sup>49</sup> Furthermore, there are also barriers for foreign affiliated service companies operating in China, as well as for financial businesses.<sup>50</sup> From an economic point of view, both countries would mutually gain substantive benefits from the establishment of a Japan-China free trade area due to the comparative advantages of both countries. In order to establish a free trade area between the two countries, Japan should enhance economic dialogue and negotiations to further encourage China to reduce barriers in service and financial businesses.

Japan is a leading engine for the de facto integration of East Asia and has comparative advantages in trade, and financial and technological know-how. Therefore, Japan is capable of institutionalizing the rules consistent with the WTO for the promotion of

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<sup>49</sup> JETRO, *op. cit.*, p. 96.

<sup>50</sup> For instance, broker trade of A-share, which only Chinese residents can trade, is not approved for foreign affiliated companies. (JETRO, *ibid.*, p. 96.)



trade, investment and technological transfer in the region. Integrating China further into the market mechanism and international rules, would ensure the stability and prosperity of East Asia. It is the most vital task for Japan in the long-term.<sup>51</sup>

Due to rapid development, China has become a major importer of oil. However, increasing world demand for oil caused by new emerging nations and the flow of massive amounts of speculative money to the oil markets have increased the prices of energy drastically in recent years. In addition, China is now suffering from pollution and scarcity of water in the effects of global warming, which pose a serious threat to human security. China can no longer sustain its development by only securing a supply of energy. Improvement of efficiency of energy use and protection of the environment becomes more and more critical for China's development. With sophisticated technology for the efficient use of energy, Japan can contribute to improving China's environment. It would also contribute to reducing acid rain falls in Japan.

During the 1997 bilateral summit, then Prime Minister Ryutaro Hashimoto proposed the "Japan-China Joint Initiative on Environment Toward the Twenty-first Century," which consisted of two pillars: an environmental model city concept; and the development of an environmental information network.<sup>52</sup> Both Prime Ministers Shinzo Abe and Yasuo Fukuda also pledged to promote energy and environmental improvement cooperation with China. These are the frontier areas that bear mutual strategic benefits between the two countries, and bilateral cooperation would address issues of global warming and environmental protection.

## Conclusion

Japan-China relations have been sustained by economic cooperation for several decades. The Abe administration improved political and military relations between Japan and China, and the two countries pledged to foster cooperation for their mutual benefit. What is important to note is that the stance of both sides revealed in the series of the summits was a future-oriented one which placed emphasis on future

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<sup>51</sup> Younosuke Hara, *Higashi Ajia Keizai Senryaku-Bunmeino nakano Keizaitoiu Shiten kara* [*East Asian Economic Strategy-An Economic Viewpoint of Civilization*] (Tokyo: NTT Shuppan, 2005), p. 103.

<sup>52</sup> Mike M. Mochizuki and Jitsuo Tsuchiyama, eds., *Japan in International Politics-The Foreign Policies of an Adaptive States* (Boulder, CO: Lynne Rienner Publishers, 2008), p. 246.

development of an amicable relationship, leaving the difficult issues behind them. The fundamental issues, such as the historical issue and mutual antagonism, are problems that can not be solved in the short- medium-term. Therefore, both countries should look forward and deepen cooperative relations in various fields that would benefit all the countries in East Asia. This stance would work as a buffer against the emergence of threats arising from mutual distrust between Japan and China.

Energy security cooperation is one of the areas in which Japan contributes to China's development and environmental protection, as mentioned above, through providing energy-saving technologies. Japan and China are capable of establishing region-wide free trade and investment, which will activate regional flows of investment from the two countries. Both countries are also capable of building a cooperative framework in Northeast Asia for further enhancement of economic, political and defense cooperation in the region. In order to strengthen regional cooperation, the two giants should offer clear support to ASEAN's initiatives and express it in various dialogues and meetings, such as the ARF, the East Asian summit and the ASEAN plus Three. In building a regional community, it is certain to leave leadership to smaller and weaker countries. Ensuring human security is the focal area of Japan's foreign policy, and both countries should cooperate to find areas to cooperate in preventing non-traditional issues from arising. Disaster relief and peace-keeping operations are other areas in which the two should identify space for cooperation.

Thus, establishing such multilayered cooperative frameworks would promote an amicable relationship between Japan and China, as well as stability and peace for the region.