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Sino-Japanese Relations: The Dimensions of Trade and FDI

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Abstract: This paper provides an extensive analysis on the Sino-Japanese trade and Japanese direct investment in China. It investigates the trend, the growth and the structure change of the bilateral trade, and examines the scale, the major characteristics of Japanese FDI in China, as well as its contribution to the Chinese economy. The analysis suggests that rising trade and FDI flows have deepened the economic relations between China and Japan. It is market forces that have been driving the economic integration between the two countries. The common interests and mutual benefits have outweighed the political disputes in the development of the bilateral economic relations.

Key Words: China, Japan, Trade and FDI
JEL: F1

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1. Introduction

Since China started its transition to a market oriented economy in the late 1970s, the development of the Sino-Japanese bilateral economic relations has been smooth and healthy. Through trade and direct investment, the economic integration between China and Japan has been increasing and deepening. The economic ties of the two countries have never been as close as today. In 2006, the bilateral trade passed the \$200 billion mark for the first time. China has emerged as the second largest trade partner of Japan and the most populous location for direct investment of Japanese multinational enterprises (MNE) in Asia. Due to the spectacular growth of the bilateral trade, it is expected that China will surpass the US in 2007, which has been Japan's most important trade partner, as the number one trade partner of Japan in 2007. On the other hand, Japan had been China's largest trade partner from 1990 to 2003. As a major player of global direct investment, Japanese MNEs' have cumulatively invested \$58 billion in China, making Japan one of the leading FDI sources for China (Japanese Ministry of Foreign Affairs, 2007). The rising economic integration between the two countries has been fundamentally driven by market forces and trade liberalization within the two countries. In fact, there exists no formal institutional agreement, such as a bilateral free trade agreement, to facilitate the economic relation. Even worse, the political relations between the two countries have deteriorated. Following the trend of globalization, the economic integration between the two countries, however, has been immune to the political disputes.

Economic relations represent one of the most important dimensions of the Sino-Japanese bilateral relations and directly affect directly the welfare of both countries. Intensified economic cooperation may solidify the foundation for the development of political relations. In addition, the sheer size of the two economies indicates that Sino-Japanese economic relations will determine the future prospects of the regional economic integration in Asia. This paper examines the evolution of the Sino-Japanese economic relations from 1990 to 2006. It focuses on the development of the bilateral trade and Japanese FDI. First, it analyzes the bilateral trade with respect to growth, structure, and the environment of trade. Then, it examines the trend and major characteristics of Japanese FDI in China.

2.1 The Robust Growth of the Bilateral Trade

Sino-Japanese trade has been the fastest growing bilateral trade in Asia. The volume of trade between the two countries was \$18.2 billion¹ in 1990. By 2006, the trade volume surged more than ten times and reached \$211 billion, and accounted for 17.2 percent of Japan's total trade. Consequently, China emerged as the second largest trade partner of Japan. It is expected that China will replace the US as the number one trading partner of Japan in 2007, despite the fact that China remains a developing country and its GDP is less than one third of the US. It is important to emphasize that the growth of the bilateral trade is not a one-way phenomenon. Both countries have experienced significant expansions in their exports to each other. While China's exports to Japan grew 15 percent annually on

¹ Unless the data sources are specified, all data cited in the paper are collected from the International Financial Statistics and the Direction of Trade Statistics of the IMF, or calculated by the author.

average from 1990 to 2004, Japanese exports to China grew even faster at an average annual rate of 18 percent. In fact, Japanese exports to China have grown much more rapidly than its overall exports. The major factors driving the robust growth of the Sino-Japanese bilateral trade include: (1) trade liberalization within the two countries and China's accession to the World Trade Organization (WTO); (2) China's spectacular economic growth; (3) the massive Japanese direct investment in China; (4) the complementary nature of the two economies; and (5) the geographic proximity between the two countries.

While both countries have gained tremendous economic benefits from trade, the paper focuses on the benefits for Japan, where China was the buoyancy of the Japanese economy and has been a crucial factor for the recent Japanese recovery. Figure 1 illustrates the trends of the Sino-Japanese trade and its weight in each country's total external trade. In 1990, China was a much smaller trade partner of Japan and the bilateral trade between the two countries represented a mere 3.5 percent of total Japanese external trade. By 2006, the figure rose to 17.2 percent, almost matching that of the US-Japanese trade at 17.4 percent. "China Threat" was a popular topic in Japanese mass media a few years ago (Abe, 2003). However, the decomposition on the growth of the Japanese economy in its current growth cycle suggests that China has been a vital source for the Japanese economic recovery rather than a "threat". The current growth cycle of the Japanese economy has continued for more than 5 years. The growth has been mainly driven by the expansion of Japanese exports, which primarily depended on the recovery of the US economy and the rapid growing Chinese economy. For instance, in 2005, Japanese real GDP grew 2.6 percent, of which 0.9

percent was attributed to the growth of exports (The Cabinet Office Government of Japan, 2006) and Japanese exports to China accounted for 21 percent of the overall export growth in the year. In fact, when the Japanese economy finally bottomed up from its more than ten years stagnation in 2002, the exports to China accounted for more than two thirds of Japanese export growth, which in turn contributed 0.8 percentage point to the growth of the Japanese economy (The Cabinet Office Government of Japan, 2004) while the economy grew only 0.26 percent. Unambiguously, by trade and investment, the impact of the fast growing Chinese economy has been extended into the Japanese economy. In spite of more than two and half decades of high growth, the gross national income per capita in China was only \$2010 in 2006 (The World Bank, 2007). There is still a long way to go for China to achieve industrialization. If the current high growth continues for another twenty years, it will take at least another two decades for China to become a high income country. The future growth potential will provide enormous opportunities for Japan.

Figure 1



Source: DOTS of the IMF and the author's calculation

2.2 The Dynamic Changes of the Bilateral Trade Pattern

China has abundant labor and relatively rich natural resource endowments. Japan is scarce in natural resources and labor. The declining and aging population has intensified the labor-shortage in Japan, especially in agriculture and labor intensive sectors. On the other hand, Japan is the world leader in manufacturing industries, in particular electronics, machinery and transportation. Japan is one of the largest capital exporting countries in terms of direct foreign investment. The comparative advantage between China and Japan determine that China exports labor and resource intensive products to Japan, while Japan exports capital and technological products to China.

Table 1 illustrates the patterns of the bilateral trade in 1990 and 2006. The trade pattern of the Sino-Japanese bilateral trade in the early 1990s followed exactly the prediction of the comparative advantage theory. In 1990, the leading exports of China to Japan were miscellaneous manufactured products categorized in Standard International Trade Classification (SITC) 8, which comprise most of labor intensive products, such as clothing and accessories, furniture, bedding, travel goods and handbags, etc. Miscellaneous manufactured products accounted for 27.5 percent of Chinese exports to Japan, the largest among all nine commodity groups defined by one-digit SITC. Fuels, mainly consisting of crude oil, ranked second and accounted for 24 percent of Chinese exports to Japan. Before 1994, China was a net petroleum exporting country and had a long-term oil supply agreement with Japan. Oil had been one of the major commodities exported to Japan. Food and animal represented the third largest commodity group with a 15.7 percent share. The

top three export commodities primarily reflected Chinese comparative advantage in labor and natural resource endowment.

Table 1 The Structure of Sino-Japanese Bilateral Trade

COMMODITIES	1990				2006			
	Exports to China		Imports from China		Exports to China		Imports from China	
	Value	Share	Value	Share	Value	Share	Value	Share
FOOD AND LIVE ANIMALS	25.1	0.41	1,877.3	15.65	414.3	0.45	7,854.4	6.63
BEVERAGES AND TOBACCO	0.7	0.01	30.0	0.25	8.6	0.01	94.5	0.08
Crude Materials, inedible, except fuels	211.4	3.46	1,159.0	9.66	3,242.7	3.50	1,874.5	1.58
FUELS, LUBRICANTS, ETC	65.8	1.08	2,963.8	24.70	1,371.9	1.48	3,012.6	2.54
ANIMAL, VEG. OILS, FATS, WAX	0.9	0.01	12.5	0.10	6.7	0.01	47.5	0.04
CHEMICALS, RELTD. PROD. NES	749.18	12.25	549.2	4.58	12,161.7	13.11	5,162.5	4.36
MANUFACTURED GOODS	1,918.9	31.38	1,583.1	13.20	14,972.6	16.14	14,659.8	12.37
MACHINES, TRANSPORT EQUIP	2,676.5	43.77	457.0	3.81	48,057.1	51.80	44,537.5	37.58
MISC MANUFACTURED ARTCLS	376.3	6.15	3,30.0	27.50	7,852.8	8.46	40,271.5	33.98
GOODS NOT CLASSD BY KIND	90.2	1.47	65.4	0.54	4,680.9	5.05	1,011.3	0.85

Sources: UNCOMTRDE database and Author's calculations.

Japanese exports to China basically concentrated in machines, transportation related equipment and high-value added manufactured goods. In 1990, the exports of machines and transportation related equipment categorized in SITC 7 amounted \$2.7 billion, about 44 percent of total Japanese exports to China, the largest among the nine commodity groups. The second largest commodity group was manufactured goods included in SITC 6, which comprise of iron, steel, metals, textile yarn, etc. The exports of these goods accounted for 31 percent of Japanese total exports to China. Similarly, the structure of Japanese exports

followed Japan's comparative advantage. Sino-Japanese trade patterns suggest that the two economies are essentially complementary rather than competitive.

By 2006, the structure of Japanese exports remained similar to that in 1990. The notable difference was that the exports concentrated further in machines and transportation related equipment. The exports of these goods jumped to \$48 billion, about 52 percent of Japanese total exports to China. The rising demand for automobiles and related goods in China has been a major driving force behind the rapid growth of Japanese exports in the sector. China has become the third largest automobile market, with the highest growth in the world. The surging demand for automobiles gives rise to a new growth source for Japanese automobile makers and related firms. The pattern of China's export to Japan, however, has changed dramatically. Coping with rising domestic demand for oil has forced China to reduce its oil exports to Japan. Both oil and food have no longer been the leading export commodity. In 2006, the exports of the goods in these two categories were only 8 percent of China's total exports to Japan. Instead, machines and transportation related equipment surpassed miscellaneous manufactured products and became the number one exported commodity to Japan. The exports of machines and transportation related equipment jumped to \$44.5 billion, almost one hundred times higher than in 1990, and accounted for 38 percent of China's total exports to Japan. Manufactured goods in SITC 6 emerged as the third largest item exported to Japan. The exports of SITC 6 reached \$14.7 billion, about 12.4 percent of the total exports. The changing export pattern indicates that the economic integration with the world economy and the rapid economic development in the last two decades have

greatly enhanced China's production capacity and its competitiveness in manufactured products; gradually improving the value added of China's exports.

It is worthy to emphasize that machines and transportation related equipment have become the top exported goods for both countries. China exported \$44.5 billion while Japan exported \$48 billion, thus the intra-industry trade index of machines and transportation related equipment reached 96 percent, suggesting that the two countries simply exchanged similar products in the category. Trade in the same product category is called intra-industry trade and traditionally considered as a phenomenon between two similar trade partners, such as industrialized countries. Countries with substantial differences in factor endowments, such as income level and technology, are assumed to mainly engage in inter-industry trade, which is trading in different commodities (Helpman and Kurgman, 1985). It is well known that Japan is the world leader in the machinery and automobiles industries. How could we explain the reasons for China's ability to catch up so quickly to Japan in such a manner that it is able to export almost the same amount of products in which Japanese firms have world leaders for so long? The answer lies in Japanese multinational enterprises and their direct investment in China. Intra-firm trade between Japanese parent companies and their subsidiaries in China have greatly enhanced intra-industry trade between China and Japan. Intra-firm trade between parent firms and their foreign affiliates usually fall into same industry categories because of specific capital and technology available in both parent firms and their foreign affiliates. Moreover, FDI also increases the number of product varieties that host countries are able to produce. Specific technology and

capital transmitted via FDI generally enlarge production capacities and product varieties of host countries. For instance, SONY's subsidiaries in China can produce SONY branded products, which can be sold in the global market and compete with products that belong to the same categories but different brands. Without outsourcing/FDI from SONY, it would be impossible for China to do so. Technology spillovers, a positive externality of FDI inflows, upgrade qualities and varieties of domestic firms and improve the competitiveness of those firms in the global market; thus augmenting intra-industry trade. Technology transfers from parent firms to their foreign affiliates mitigate technology gaps between the two, and facilitate intra-firm trade, consequently stimulating intra-industry trade between FDI host and source countries (Xing, 2007). The close to 100 percent intra-industry ratio between China and Japan is a clear example of the economic integration between China and Japan. It shows how the two economies have been mutually benefiting from the integration.

2.3 The Environment of the Bilateral Trade

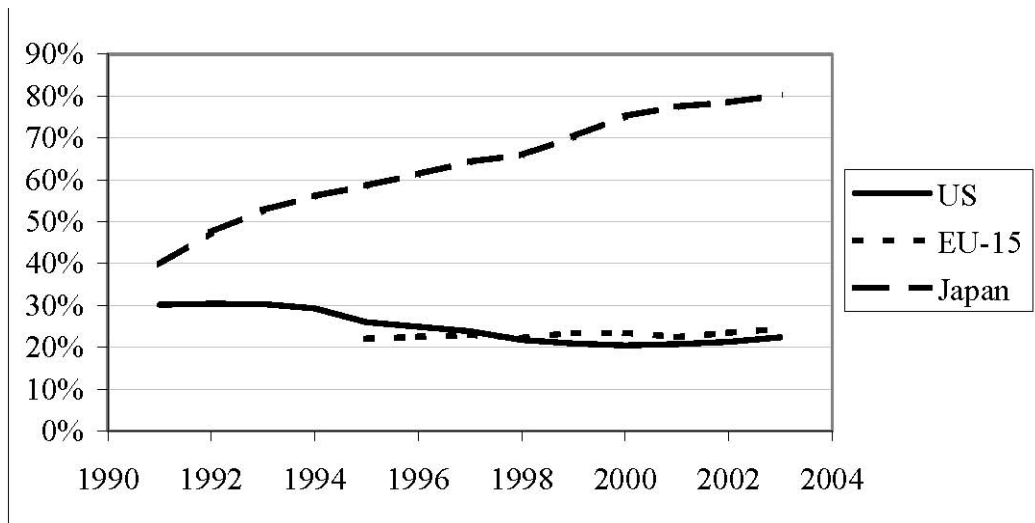
After almost three decades of rapid growth, China has evolved as the third largest trade economy, just after the US and Germany. It has become not only the leading exporter in traditional labor intensive goods such as clothes, shoes, toys, travel gears, etc., but also the number one exporter of information communication technology products (OECD, 2006). As more and more made-in-China products have been occupying the global market, China has been under the siege of the global protectionism. Developing countries which compete with China in the third market are worried that made-in-China may crowd out their exports (Shafaeddin, 2004), while industrialized countries are fearful that trade with China would

lower their wages, thus hurting their living standard (Samuelson, 2004). Among all of the WTO members, China has become the number one target of anti-dumping cases. From 2000 to June 2002, 113 anti-dumping cases were filed against China while only 47 anti-dumping cases against the second leading target, South Korea. Back in the 1980s, Japan was the leading target of global protectionism (2006, Prusa).

Even though China has been running a trade surplus against Japan since 1990 and the trade surplus rose from \$5.9 billion to \$25.7 billion (figure 3), the Japanese government and domestic business organizations have not taken major protective measures against Chinese imports; and none of the anti-dumping cases were filed by Japan. The only major trade friction between China and Japan was the provisional safeguard measures taken by Japan on 23 April, 2001. These measures were against the imports of Welsh Onions, Shiitake Mushroom and Tatami Mats, 99 percent of which were from China (Kuno, 2006). Textiles are another example suggesting that the Japanese market is relatively more open to Chinese products compared with the US and EU markets. China is well known for its competitiveness in textiles. Before the Multi-Fiber Agreement was abolished, both the EU and US applied strict quotas to control the textile imports from China. As a result, from 1991 to 2003, China's market share in the EU remained constant at about 22 to 24 percent while China's market share in the US shrunk from 30 to 21 percent before increasing again in 2002 and 2003. In 2005, upon a request by the EU, China agreed to limit its textile export growth to the EU market for three years. On the contrary, China's textiles exports to Japan have grown rapidly. China's share of Japanese textile import market rose from 40 to

80 percent in 2003. But, the Japanese government has never resorted to countervailing duties or transitional safeguard measures under the agreement on textiles and clothing (Tan, 2005).

Figure 2: The market Shares of China's Textiles in the US, EU and Japan



Source: Tan, 2005.

China's exchange rate regime has been the focal point of debates on the global imbalance. The "under-valued" Yuan has been accused as the root of the huge deficit between the US and China. The US government, politicians and industrial organizations have been trying to press China to revalue Yuan (Yan, Yin and He, 2007). However, except for former Japanese minister Masajuro Shiokawa, who openly accused China of "exporting deflation" to Japan and criticized China's exchange rate regime (McGoregory and Philling, 2003), the Japanese government and business communities have been primarily silent about Yuan's

evaluation. Xing and Zhao (2007) argued that Japanese MNEs have been benefiting from Yuan's devaluation because of their direct investment in China and extensive reverse importing activities. The Yuan's revaluation will hurt rather than benefit the Japanese economy.

Figure 3



Sources: DOTS and IFS of the IMF and the author's calculation

Figure 3 shows the trends of China's trade surplus against Japan and the real exchange rate between Yuan and Yen. A higher real exchange rate index means that Japanese Yen appreciates against Chinese Yuan in real terms. From 1990 to 1993, Japanese Yen showed real appreciation against Yuan. China's trade surplus, however, decreased from \$5.9 billion to \$3.3 billion. From 1993 to 2006, Japanese Yen actually depreciated against Chinese Yuan about 50 percent in real term because of China's high inflation, Japan's deflation and Japanese Yen's nominal depreciation against the US dollar. The depreciation failed to reduce the trade surplus. On the contrary, China's trade surplus rose to \$25 billion, almost

five times as much as that in 1990. The special relationship between the exchange rate of Yuan and Yen and the Sino-Japanese trade balance offers a case against the current bashing on the Yuan.

3. Japanese FDI in China

3.1. The Growth of Japanese FDI in China from 1990 to 2004

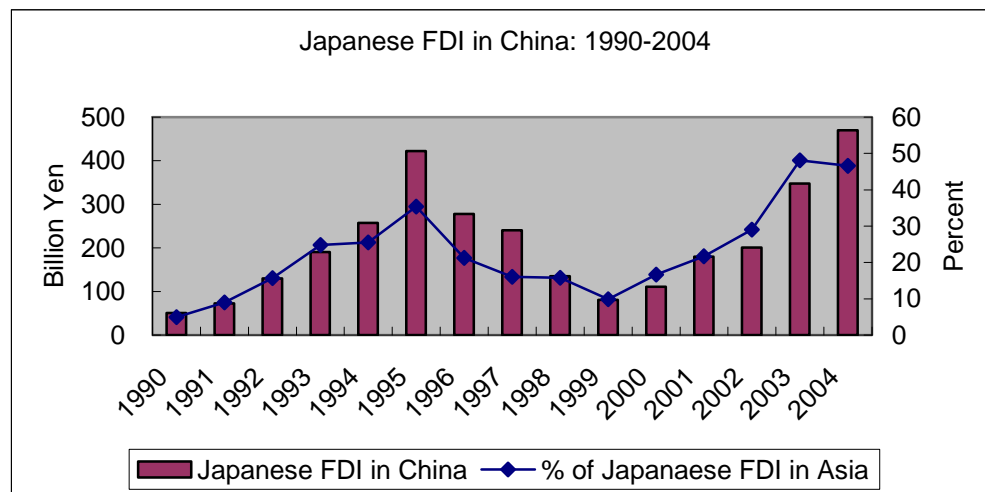
Foreign direct investment in China has contributed significantly to the rapid economic growth in China. It has not only provided capital but also transferred advanced technology, production know-how and management skills to China. Furthermore, the inflows of FDI have greatly increased the utilization of China's abundant resources such as labor. The subsidiaries of multinational companies in China have been a critical vehicle for made-in-China available in the world market. Foreign invested firms in China accounted for 60 percent of China's exports in 2005.

As the largest capital exporting country in the world, Japan has been one of the leading FDI source countries for China. Figure 4 shows the trends of Japanese FDI and China's share in Asia. From 1990 to 2004, Japanese FDI in China accumulated 3.2 trillion Yen, of which 2.5 trillion, about 78 percent, was invested in China's manufacturing industry (the data does not include the reinvestment made by existing Japanese subsidiaries in China)². Before 1991, the scale of Japanese FDI in China was relatively small and China was not a prime location for Japanese FDI compared with the ASEAN-4 (Indonesia, Malaysia, Philippines and Thailand). For instance, in 1990 Japanese MNEs directly invested 50.7 billion Yen in

² Unless specified, FDI data is from the database of the Japanese Ministry of Finance.

China, less than 5 percent of Japanese FDI in the whole of Asia. Starting from 1990, Japanese MNEs have accelerated their direct investment. In 1995 Japanese FDI jumped to 422 billion Yen, which was more than 80 times that of the investment in 1990 and about 35 percent of Japanese FDI in Asia. As a result, China replaced the ASEAN-4 as the number one location for Japanese firms' overseas investment. According to the survey of JETRO (2001), among the Japanese firms with overseas production facilities, 54.4% of them have production facilities in China. The ratio was the highest among all foreign countries hosting Japanese FDI.

Figure 4



Source: The Japanese Ministry of Finance and the author's calculation

Japanese FDI in China from 1990 to 2004 shows a cyclical pattern. The annual inflow in 1995 represented the first peak. After that, it started to fall and the decline continued until 1999, in which the direct investment shrank to 81 billion Yen, about 20 percent of its peak value in 1995. Meanwhile, China's share dropped to 10 percent. The economic stagnation in Japan during this period, the Asian financial crisis and the sharp depreciation of Japanese Yen against the US dollar together was responsible for the decrease. From 2000, Japanese

FDI started a new rising cycle. In 2004, it reached a new record 470 billion Yen, which accounted for 47 percent of total Japanese FDI in Asia, the highest among all Asian countries. The fast growing Chinese economy, the revival of the Japanese economy and China's entry to the WTO propelled the growth of Japanese FDI in this period. In particular, China's rising demand for automobiles significantly stimulated the rapid expansion of Japanese automakers in China. They accelerated their direct investment right before China's entry to the WTO, becoming the leading sector in terms of FDI in both 2003 and 2004.

3.2 The Structure of Japanese FDI in China

Coinciding with the robust growth, the sectoral composition of direct investment from Japan changed substantially. Table 2 summarizes Japanese FDI from 1990 to 2004 in nine manufacturing sectors: food, lumber and pulp, chemical, metal, textile, electrical, machinery, transportation equipment and others. Over the period, FDI in China's manufacturing accumulated to 2.5 trillion Yen, indicating that Japanese manufacturers have established mass production capacity in China for serving both global as well as China's markets. The Japanese electrical industry, which has been the leader of engaging in FDI in Asia, also took the lead in China. It invested 585 billion yen during the period, accounted for 23.4 percent of the total investment. Transportation related equipment ranked second with 479 billion Yen, and machinery ranked third with 306 billion Yen of cumulative investment. It is well known that the Japanese electrical, machinery and transportation industries are very competitive and export most of their products to the world market. The

huge investment in China has further strengthened the competitiveness of Japanese MNEs in these industries. Additionally, technology transfers and spillovers associated with the inflows of Japanese FDI have greatly strengthened the competitiveness and expanded the product variety of China firms. By the alliance with Japanese MNEs, Chinese manufacturers have also benefited from the established brand names and global distribution networks of their Japanese partners.

Table 2: Japanese FDI in China's Manufacturing Industry from 1990-2004 (Billion Yen)

<i>INDUSTRIES</i>	1990-94	1995-99	2000-04	1990-04	DISTRIBUTIONS (%)
Food	29.0	59.7	38.2	126.7	5.1
Textile	89.8	103.5	39.6	233.0	9.3
Lumber&Pulp	6.7	16.1	12.5	35.3	1.4
Chemical	27.3	65.0	101.6	193.9	7.8
Metal	32.9	87.3	95.7	215.8	8.6
Machinery	58.1	117.1	130.8	306.0	12.3
Electrical	134.7	211.1	239.1	585.0	23.4
Transport	38.6	105.5	334.9	479.0	19.2
Others	85.2	126.5	108.8	320.6	12.8
Total Manufacturing	502.4	891.9	1,101.3	2,495.5	100.0

Sources: The Japanese Ministry of Finance and author's calculation.

In the early 1990s, textile was the second largest sector in terms of cumulative FDI. The accumulative FDI in textile amounted 233 billion Yen from 1990 to 2004. The investment in the textile industry basically reflects international division of labor between the two countries. Textile is labor intensive and China has comparative advantage in producing textile products due to its rich labor endowment. The most significant structure change is that transportation equipment has emerged as a leading FDI sector after 2000. From 1990 to 1994, cumulative FDI in the transportation equipment related sector was 38.6 billion Yen,

less than 8 percent of the total cumulative FDI during the period. By 2003, the annual Japanese FDI in transportation related equipment surpassed that of electrical sector; the leading sector in terms of FDI since Japanese firms started direct investment in China, amounting to 96 billion Yen. The investment almost doubled in 2004 to 179 billion yen. From 2000 to 2004, the cumulative investment amounted 335 billion Yen, almost one third of the total, and the highest among all the nine manufacturing sectors.

3.3 China as an Export Platform of Japanese MNEs

Japanese direct investment in developing countries is traditionally export oriented. By relocating their production capacities of matured industries into developing countries, Japanese MNEs are able to strengthen their global competitiveness through their advanced technology, brand name recognition, and well-established global distribution system, combined with relatively low production cost of hosting countries. One of the fundamental purposes of Japanese companies investing in China is to utilize China as an export platform for the world market. According to the survey conducted by Japan External Trade Organization (JETRO, 2003), 61.6 percent of Japanese firms operating in China stated that they exported at least 70 percent of their products. Of all Japanese affiliated manufacturers in Asia, only 55.9 percent exported at least 70 percent of their products. Thus, the export intensity of the Japanese affiliated manufactures in China was much higher.

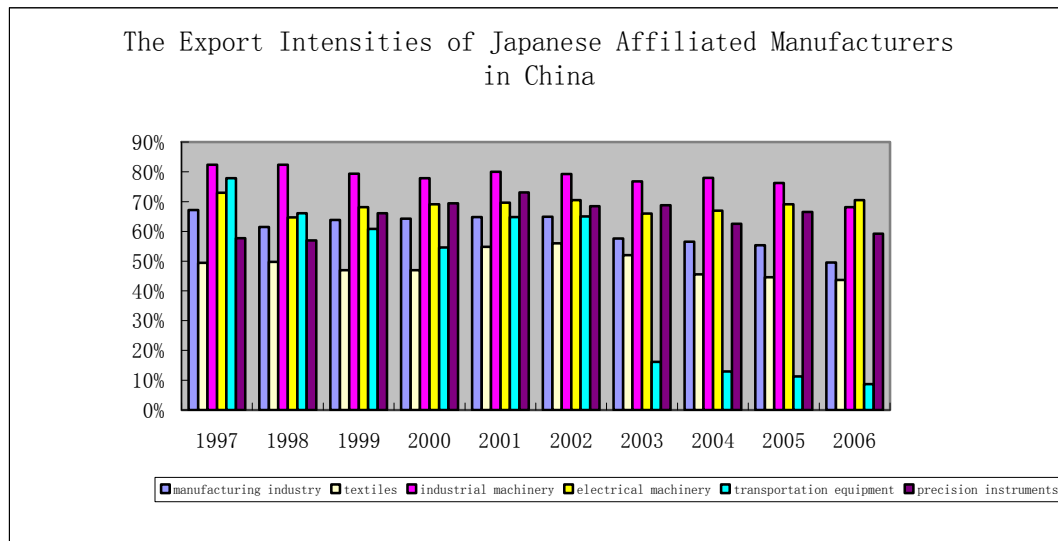
The export-oriented nature of Japanese MNEs in China can also be illustrated with the structure of their sales destinations. Figure 5 depicts export intensities of Japanese affiliated manufacturers in China in electrical machinery, industrial machinery, transport equipment,

textile, precision instruments, and all manufacturing industries as a whole for the period of 1997 to 2004. The export intensity is defined as the ratio of exports to total sales. Firstly, exports of Japanese affiliates far exceeded the sales in the local market. The manufacturers as a whole exported more than 60 percent of their products to overseas market before 2003. In industrial machinery, except in 2005, exports accounted for more than 76 percent of total annual sales, the highest among all sectors. In electrical machinery, the export intensity ranged from 65 to 73 percent. The sales structure illustrated in figure 5 is actually consistent with the phenomenon, that most “made-in China” products available in the Japanese domestic market carry Japanese brands, and many products under Japanese MNEs’ brands available in the global market are made in China. These facts unequivocally indicate that, Japanese domestic investment in China’s manufacturing has been export-oriented, and using China as a production base serving both the Japanese domestic as well as the global market has been the primary objective of Japanese MNEs. The export-oriented nature implies that Japanese affiliated manufactures have contributed significantly to the rapid growth of China’s exports, in particular the fast growing bilateral trade.

Due to cumulative increases in the income of Chinese consumers and their rising demands for Japanese products such as electronics, automobiles and related products, Japanese affiliated manufacturers have started the transition towards domestic orientation in recent years. Transportation equipment is a typical example. The products of Japanese affiliated manufacturers in the sector mainly targeted overseas markets. The export intensity in the sector was as high as 77 percent in 2002, but dropped to 16 percent in 2003 and 8.7 percent in 2006. The decrease indicates the transition of Japanese MNEs in the automobile sector

from serving overseas markets to China's domestic market; the third largest and the fastest growing automobile market in the world. The overall export intensity of all manufacturing industries have also gradually decreased from 67 percent in 1997 to 49 percent in 2006, the first year in which the local sales exceeded the exports. The transition suggests that, investing in China is a win-win strategy for Japanese firms in the both short and long run. When China's income was low and the market was relatively small, Japanese MNEs benefited by using China as an export platform. Now as the market has substantially expanded after almost three decades high growth, China's domestic market has becomes a new source of profit. In addition, switching to domestic market oriented strategy can mitigate the negative impact of Yuan's revaluation and rising labor cost in China.

Figure 5.



Sources: The author's calculations based on Quarterly Survey of Overseas Subsidiaries (1996-2007 issues), Japanese Ministry of Economy, Trade and Industry.

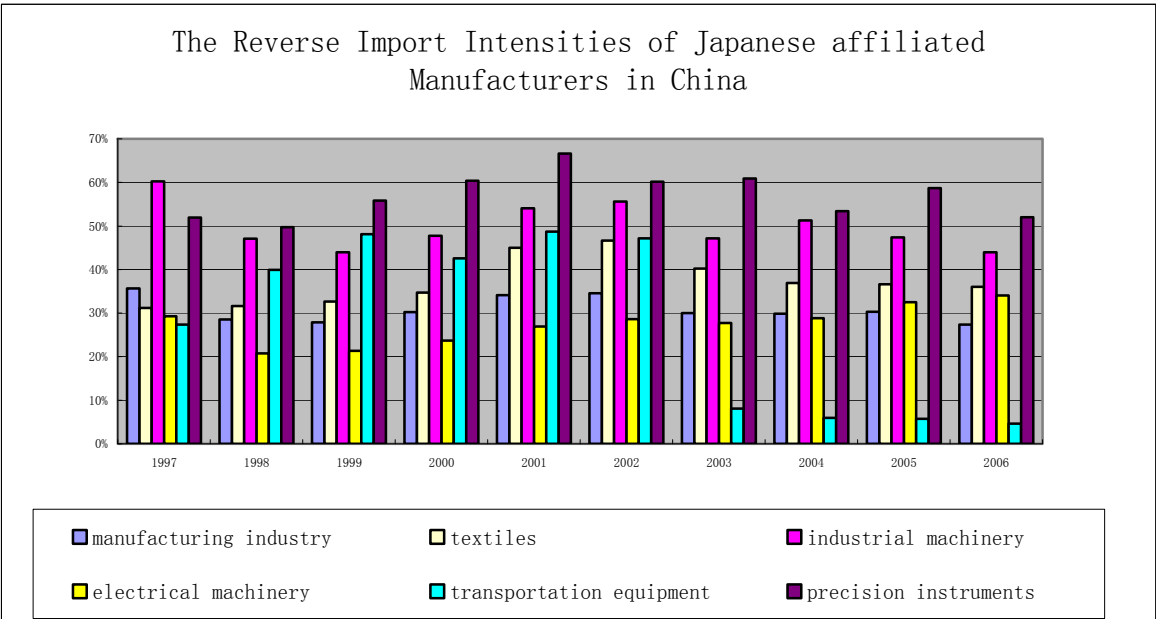
3.4 China as a Production Base for Japanese Domestic Market

Another significant characteristic of Japanese MNEs in China is that they have actively engaged in reverse imports, which refer to the products made at overseas Japanese plants and exported to the Japanese market. Coping with rising Yen and shrinking domestic demand, many Japanese firms have relocated their domestic production capacity into China, or simply outsourced their production to Chinese firms for cutting production costs. Fast Retailing Co., which markets the UNIQLO casual wear brand in Japan is a typical example. It designs, distributes, and markets UNIQLO brand products in Japan, but exclusively produces the products in its affiliated manufacturers in China, or subcontracts to local firms. Unlike the exports of Chinese domestic firms, there exist no barriers in distribution and brand name recognition for reverse imports. The rapid expansion of reverse imports has substantially facilitated the growth of China's exports to Japan.

Figure 6 shows ratios of reverse imports to total sales in selected industries. On average Japanese affiliated manufacturers sold about one third of their products back to Japan. In precision instruments, more than half of the products were exported to the Japanese domestic market either as final goods or intermediates inputs. The ratio of reverse imports rose from 52 percent of the total sales in 1997 to 67 percent in 2001, the highest among all sectors. In machinery, the ratio of reverse imports had been consistently higher than 44 percent. The ratio of reverse import in electrical actually rose from 30% in 1997 to 34% in 2006. Reverse import activities demonstrate that China has served as an important production base for final products consumed in the Japanese market and intermediate inputs of Japanese firms. The large scale of reverse imports indicates a high level of vertical

integration between Japanese and Chinese industries, thus developing a close linkage between firms in the two economies in both production chains and marketing networks, and further deepening interdependence between the two countries. The integration gives rise to a win-win scenario for industries in both countries. Japanese companies benefit from low production cost and Chinese firms take advantage of extensive marketing networks and advanced production technology of their Japanese partners.

Figure 6



Sources: The author’s calculations based on the Quarterly Survey of Overseas Subsidiaries (1996-2007 issues), the Japanese Ministry of Economy, Trade and Industry.

Similar to the export intensities, the share of reverse imports for the manufacturing industry as a whole has gradually decreased from 36 percent in 1997 to 27 percent in 2006. A dramatic change happened in the transportation sector, where reverse imports accounted for only 4.5 percent of the total sales of Japanese affiliated manufacturers in China while the

figure was as high as 47% in 2002. The change implies that the importance of the Chinese market has exceeded the Japanese domestic market and Japanese affiliated manufacturers in transportation related equipment have completed their transition from being primarily export-oriented to domestic market-oriented.

Figure 6

4. Concluding Remarks

The economic relation of China and Japan has been greatly strengthened through the bilateral trade and Japanese direct investment in China. Common interests and mutual benefits have been driving the process of the Sino-Japanese economic integration. The complementary nature of the two economies is the impetus to insure the gains from trade and investment maximized. Despite of deteriorated political relations between China and Japan, bilateral trade and Japanese FDI in China have reached their new peaks, suggesting that economic interests, rather than the wills of politicians fundamentally determine the behaviors of firms and consumers.

While the aggregate bilateral trade flows imply a comprehensive economic cooperation between the two economies at the macro level, the operations of Japanese affiliated firms in China represent an extensive cooperation and in-depth integration of the two economies at the micro level. The high export and reverse import intensities imply that the vertical integration between the industries of the two countries has been developed in production processes and extended into the distribution and marketing network.

In the next two to three decades, China's continuous economic growth will generate a wide range of benefits for Japan and continue to power the growth of the Japanese economy. Japanese advantage in technology and management know-how in manufacturing industries, energy conservation and environmental management will certainly help China upgrade its manufacturing industry toward high value added production chains and transfer its growth to an environmentally sustainable path. To further enhance the mutually beneficial Sino-Japanese relations, formal bilateral institutional arrangements between the two countries are imperative.

Globalization has characterized the main theme of the world economy while regionalism has represented an alternative trend of economic integration. The European Union and the North American Free Trade Agreement are two typical examples that have been leading the global trading system. A free trade agreement between the two giants China and Japan will not only benefits the two economies, but also anchor the economic integration in Asia, eventually balancing the power of the EU and the US in the global trading system.

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