

The Transformation in the Political Economy of China's Economic Relations with Japan in the Era of Reform

Prior to the signing of the Long-Term Trade Agreement (LTTA) in 1978, management of China's economic relations with Japan was centrally planned. The LTAA agreement, however, allowed the two countries to develop special bilateral economic relations, with China relying heavily on Japan for capital and technology to fuel its modernisation drive and Japan depending on China's energy and raw materials to enhance its economic security. But China's market-oriented reforms led to a transformation of economic relations between the two countries. Balanced bilateral trade became difficult to sustain as China's oil production stagnated, and it became impossible to meet the huge demand for purchase of Japanese capital goods. As China reoriented its development strategy to adjust the balance between its different sectors, implementation of the LTTA agreement became harder to maintain. More generally, China's global economic interdependence increased with internationalisation of the Chinese economy, contributing to Japan's relative decline as a trading partner for China. Marketisation transformed the management of China–Japan economic relations, with decentralised economic interests becoming the driving force in the pattern of bilateral trade flows. From the mid-1980s, labour-intensive products replaced energy as China's major exports to Japan. With the rapid development of Japanese foreign direct investment (FDI) in China, changes in bilateral trade patterns became closely associated with industrial restructuring in each country.

This paper focuses on how China's market-oriented reform and internationalisation led to changed economic relations with Japan. Reorientation of China's development strategy was associated with acceptance of the notion of international economic interdependence; this contributed to the

internationalisation of the Chinese economy but also to the erosion of Japan's position as China's predominant trading partner. Internationalisation also strengthened the division of labour in China based on the principle of comparative advantage and further shaped the pattern of bilateral trade between China and Japan. As China–Japan bilateral economic links expanded, adjustments to domestic interests in one country increasingly resulted in the need for adjustments in the other, at times contributing to bilateral economic friction, such as trade and FDI disputes. Dealing with these disputes tested management of the China–Japan economic relationship which became increasingly driven by decentralised market forces that made control via a centralised bilateral mechanism such as the LTTA agreement no longer feasible. The need to develop multilateral rules-based institutions to govern bilateral economic interchange became acute.

A special bilateral relationship

Under the LTTA agreement, China–Japan economic relations were regarded as unique. Japan was China's most important trading partner in the late 1970s, absorbing over 30 per cent of the latter's foreign trade. Most of China's exports to Japan were energy products and formed the bulk of Chinese energy exports, while imports from Japan constituted the lion's share of China's imports of capital goods and technology. The LTTA agreement was designed to facilitate the smooth flow of China's energy exports to, and capital goods and technology imports from, Japan.

Underlying this special relationship was mutual need. China's economic modernisation program demanded a large amount of foreign technology and Japan's strategy for economic security was aimed at diversifying the sources of its energy imports. Under China's Maoist strategy, politics were put ahead of economic development, and economic autarky was preferred to international exchanges. This strategy stalled in the late 1970s, especially when China was

forced to confront the successful economic take-off of its East Asian neighbours (Garnaut 1992). This led to a reappraisal of its Maoist strategies and recognition that international trade was vital to economic growth. China began eagerly to seek external capital and technology to promote its modernisation, for it was hampered by limited foreign reserves. Its manufacturing products generally lacked international competitiveness and thus deprived China of access to hard currency. The energy sector, however, had grown rapidly over the preceding two decades. A dramatic increase in energy exports and over-estimation of China's potential storage and production capacity coupled with rising international energy prices in the 1970s provided the Chinese leadership with an opportunity to underwrite massive imports of capital goods and technology (Harrison 1977, pp. 19–20).

As a resource-scarce country, Japan imported 70 per cent of its oil from the Middle East in the 1970s — a region beset by considerable political turmoil (Aao 1983). Japan's strategy for economic security, which involved diversifying its oil imports away from the Middle East, thus provided an opening for Chinese energy exports. Japan became increasingly interested in developing close cooperation with China given the rapid growth occurring in the latter's energy sector. A package that linked Chinese oil with the export of Japanese capital goods to China was appealing to both the Japanese government and business sectors (Lee 1984, p. 17).

As a result, Japan emerged as China's most important economic partner, lending crucial assistance to its modernisation program, while China, if to a lesser extent, was regarded as strategically important to Japan's economic security. In addition, this bilateral economic exchange was facilitated by, and incorporated into, the cooperative political relationship that developed between the two countries.

While strategic realignment in the Asia Pacific region symbolised by Sino–US rapprochement set the parameters that led to normalisation of diplomatic relations between China and Japan in 1972, China developed closer political relations with Japan than with the United States in the years immediately thereafter. The Chinese leadership felt confident in relying on Japan, rather than on the United States, as the major source of its imported capital products and technology. China and Japan both perceived the Soviet Union as posing a strategic threat, which led them to sign the Treaty of Peace and Friendship in 1978. Their bilateral economic relationship became part of their political relationship, which was perceived as strategically vital to stability in the Asia Pacific region.

In the late 1970s, both China and Japan romanticised their relationship and their shared sense of cultural affinity. It was often said that sharing the same script and same race would ease communication during this era of intense economic interchange, despite the fact that there had been little contact between the two countries for two decades (Lee 1984, pp. 27–9). Many of the officials in charge of economic diplomacy, and business leaders engaging in bilateral trade, were familiar with the other's society from the past, and felt nostalgia toward each other. On the Japanese side, there was also a sense of guilt towards China because of the war. China's modernisation drive, as well as providing business opportunities, brought to mind Japan's own recent experience of economic catch-up.¹ Thus rather than depicting China as a communist country, Japan regarded its neighbour as a latecomer in economic development.

China's marketisation and internationalisation

After Deng Xiaoping consolidated his leadership in the late 1970s, the Chinese pursued a policy of economic reform. In its quest for economic modernisation, China proceeded to remove the ideological components contained in its foreign economic relations policy and sought to encourage exports, to open up to

foreign capital and investment and to foster extensive economic links internationally. As a result, China's economic relations with Japan also underwent transformation.

The changes in China's foreign economic relations can be better understood by looking at the reorientation that took place in China's development strategy. Prior to economic reform, China tried to minimise its economic links with the world. As discussed later in this section, economic interdependence was regarded as ideologically taboo, not only as a result of China's historical experience of foreign exploitation (Howell 1993, pp. 44-6) but also because of an adverse international environment, featuring US strategic containment and the imposition of economic embargoes before 1972 and an increasingly hostile Soviet Union after 1960. A lack of confidence in the global division of labour based on comparative advantage caused China to look inward and to strive for economic self-sufficiency.

While the Dengist reformist leadership was mindful of the risks in developing extensive international economic links, it saw that the costs of persisting with an inward-looking development strategy would be even higher (Frieman and Robinson 1992, p. 731). To minimise the political risks associated with international economic interdependence, the Chinese leadership made efforts to improve political relations with its capitalist neighbours (Sutter 1992). As links with the global economy generated increasing benefits for China, the Chinese leadership became more willing to expose its economic decision making to foreign influence and to accept international business norms and practices as benchmarks for China's reform (Kim 1984; Clarke 1992, pp. 5-6; Feeney 1992). It eventually became more willing to forego political opportunity costs to maintain beneficial international economic interchanges, as exemplified by its efforts to retain most-favoured-nation (MFN) trading status with the United States after the Tiananmen Incident of June 1989.

Thus China adopted an outward-looking development strategy. Instead of viewing exports narrowly as an avenue for financing imports (Eckstein 1966; Weil 1992, p. 770), it began to see them as a way of stimulating competitiveness among domestic firms and thus as a means of generating economic growth (Sheehan 1986; Fischer 1992, pp. 785–7). To provide incentives to export, considerable managerial autonomy was delegated to local authorities and enterprises (Lardy 1992a, pp. 39–41). To create a beneficial macro environment for exports, China gradually diminished the scope of its national foreign trade plan (Sun 1989, pp. 53–4). It also devalued its currency against the US dollar on a number of occasions throughout the reform era, bringing it in line with real demand and supply prices to boost the competitiveness of Chinese products in overseas markets (Lardy 1992a, pp. 66–9). Moreover, the Chinese authorities provided export companies and enterprises with tax rebates, tariff reductions or exemptions for imports which were used as parts or materials in exports (Lardy 1992a, pp. 79–81; Nolan 1995, p. 189). These measures were adopted to correct price distortions that disadvantaged goods that could be exported.

China has abundant labour relative to capital and technology and thus enjoys comparative advantage in labour-intensive industries. The Maoist strategy of self-sufficiency, however, gave priority to the development of capital-intensive industry, thus retarding the development of labour-intensive industry. An outcome of abandoning this strategy was the rapid rise of labour-intensive production (Lin et al. 1994, pp. 172–5; Naughton 1995, p. 86). Following China's internationalisation through foreign trade reform, there was a strong surge in labour-intensive Chinese exports to the world market. Labour-intensive exports grew more than sixteen-fold between 1980 and 1993 to over US\$98 billion, equivalent to 56 per cent of China's total exports in 1993, compared with only 29 per cent in 1980.²

An associated outcome was a decline in the relative share of China's energy exports and, after 1985, in their absolute value. Energy exports accounted for 12.9 per cent of China's exports in 1978, equivalent to US\$1.2 billion. In 1985 they rose to US\$7.2 billion, or 25.6 per cent of total exports, due to the fact that there were virtually no alternative products that could replace energy exports. As economic modernisation accelerated, domestic demand for energy increased dramatically, but energy production stagnated (Naughton 1995, pp. 71–3) and thus severely constrained exports. As costs rose to maintain a high level of energy exports, friction developed between export and domestic consumption, challenging the wisdom of exporting oil in exchange for foreign capital goods and technology. This constraint had a significant impact on China–Japan trade relations as defined by the LTTA agreement.

Reform also led to inflows of foreign capital. With only a few exceptions, China declined either official or private foreign loans in the pre-reform era as a matter of principle. Even in the 1970s, China took pride in the fact that it had no external or internal debt. This attitude changed dramatically after it launched its economic reforms with the realisation that it needed foreign capital to compensate for its own capital shortage in order to promote development. China then began eagerly to seek official and private foreign loans. Through its official development aid and private loans, Japan became one of the most important external financial sources for China's program of modernisation.

The Chinese government has generally preferred foreign investment to loans since the early 1980s (Yeh 1993, p. 136) for the following reasons: direct investment facilitates technology transfer; the provisions for the repatriation of capital and earnings are less rigid than is the case for foreign loans; and foreign investors often have well-developed marketing channels and management experience, an area in which the Chinese lacked expertise (Nolan 1995, pp. 184–5). To encourage FDI, China gradually changed its centrally- planned

institutional setting and separated out the domestic and external sectors of its economy (Feinerman 1992). The first foreign investment laws only governed equity joint ventures and were little more than broad statements of principle. Gradually, additional detail was provided as regulations were implemented. Efforts were also made to enact basic laws on contracts, taxation, foreign exchange and other matters. Legal and administrative regulations governing FDI have increasingly been brought into line with international practice in relation to transparency and non-discrimination, although progress has been gradual and incomplete.

As marketisation proceeded, the Chinese economy was increasingly, if reluctantly, opened to foreign products. The Chinese leadership regarded this as the price it had to pay for access to foreign markets and for foreign companies transferring technology to China and contributing to export growth, though it sought to ensure that this cost did not outweigh the benefits of access to foreign markets and technology. At the same time, it was also obvious that a command economy that was technologically backward, that had not established a structure of modern firms, and that had not completely dismantled its material balance planning system nor reformed its social security system could not possibly compete effectively in open competition on world markets (Nolan 1995, p. 190). Whenever surging imports contributed to a balance of payments crisis — which was most likely to happen when China implemented expansionary macroeconomic policies in its push for reform — restrictions on imports were one of the first austerity measures to be adopted to address economic overheating.

However, a steady implementation of liberal policies occurred throughout the reform period even in the import sector, although progress tended to be slower than in China's export sector (Lardy 1992b, pp. 146–7). The pace of import sector reforms was also uneven, largely because of the gradualist nature of

domestic reform. By the mid-1990s China had lowered its tariff rates for imports to the average level for developing countries, slashed its imports quotas and licences, and made commitments to phase out most of its non-tariff barriers (Sun 1995). This kind of liberalisation was closely associated with China's efforts to become a member of the General Agreement on Tariffs and Trade (GATT)/World Trade Organisation (WTO) (Becker 1995; Kohli 1995).

It is clear that the pace and scope of China's internationalisation depended on its market-oriented institutional reform, which hinged, in turn, on both the gradualist process of domestic reform and China's international commitment to economic liberalisation. Because of the gradualist approach taken in domestic reform and opening up, China's internationalisation through foreign trade and investment proceeded gradually (Howell 1993). Over time, however, foreign trade and FDI became the most important avenues linking China to the global economy. In the mid-1990s foreign trade accounted for 45 per cent of China's GNP, measured in conventional terms, which indicates the increasing reliance of the Chinese economy on the global economy. After 1993 China also became the largest FDI recipient in the developing world, second only to the United States among all the world's capital importers.

China's international economic interdependence has taken place predominantly within the Asia Pacific region. Japan, the United States and the East Asian economies now account for the greatest share of China's foreign trade (Table 1) and are also its major sources of FDI (Table 2).

Table 1 China's trade by country/region (per cent share of total)

	Exports				Imports			
	1978	1985	1992	1994	1978	1985	1992	1994
Japan	17.6	22.3	13.8	17.8	28.4	35.7	17.0	22.8
Hong Kong	26.0	26.2	44.1	26.7	0.7	11.2	25.5	8.2
Taiwan	na	na	0.8	1.9	na	na	7.3	12.2

ROK	na	na	2.9	3.6	na	na	3.3	6.3
ASEAN	5.8	10.3	5.0	5.3	2.6	2.7	5.2	5.9
Australia	1.2	0.7	0.8	1.2	6.6	2.6	2.1	2.1
US	2.8	8.5	10.1	17.7	6.6	12.2	11.0	12.1
EU (12)	12.3	8.4	8.9	12	18.5	14.5	12.2	14.6
Rest of the World	34.3	23.7	13.6	13.8	36.6	21.3	16.4	15.8

Note: na — not available.

Source: IMF, *Direction of Trade and China Customs Statistics*.

Table 2 FDI in China: sourcing countries (US\$100 million)

	1993			January–September 1994			January 1979–September 1994		
Country/ region	No. of projects	Contracted value	Actual value	No. of projects	Contracted value	Actual value	No. of projects	Contracted value	Actual value
Hong Kong/ Macau	49,134	739.39	172.75	18,664	346.82	140.75	131,077	1,828.01	525.93
Taiwan	10,948	99.65	31.39	4,656	36.68	22.91	25,638	221.05	73.47
US	6,750	68.13	20.63	3,020	85.15	14.15	15,039	181.75	66.52
Japan	3,488	29.6	13.24	2,106	26.58	13.88	9,288	115.92	65.91
ROK	1,748	15.57	3.74	1,312	9.72	4.33	4,003	31.45	9.83
Canada	959	11.84	1.37	450	3.61	1.47	1,990	24.76	4.07
Australia	769	6.38	1.1	n.a	n.a	n.a	1,310 ^a	12.45 ^a	3.38 ^a
UK	348	19.88	2.21	265	18.57	4.61	881	48.69	10.4
Germany	320	2.49	0.56	218	5.56	1.38	787	20.14	6.65
France	305	2.36	1.41	n.a	n.a	n.a	547 ^a	9.20 ^a	6.02 ^a
Singapore	n.a	n.a	n.a	1,035	25.83	6.17	n.a	n.a	n.a
Rest of the world				300	5.26	1.56			
Total	83,437	1,114.35	275.14						

Notes: a Numbers or values only cover years between 1979 and 1993.
na — Not available.

Source: Data from Ministry of Foreign Trade Economic Cooperation, China

Internationalisation has meant that China has developed high economic interdependence within the Asia Pacific region. With China increasingly becoming an integral part of the Asia Pacific economy, changes in China's industrial structure and foreign trade pattern can only be fully understood in the

context of the economic restructuring of the Asia Pacific region on the basis of comparative advantage.

Integration of the Chinese economy into the Asia Pacific region and the world has not been entirely smooth. At least three closely interrelated issues within and outside China have influenced this process.

The first issue relates to China's distrust of international economic interdependence. Historically, China has been very wary about relying on foreign countries to enhance its economic welfare. This is partly because of China's insularity, the 'middle kingdom' mentality which led China to see itself as a self-sufficient economic entity. Its modern historical experience of exploitation by foreign powers when it was politically vulnerable reinforced this traditional wariness. Its central planning mechanisms also discouraged economic interdependence with the outside world. China is not yet comfortable about relying on external sources for goods which it deems to be strategically important, such as grain or energy imports (Garnaut and Ma 1992, pp. 125–33). These perceptions of economic insecurity were strengthened by post-Tiananmen Western economic sanctions. China's strained political relations with the United States resulting from the annual review by the US Congress of China's MFN status and US tactics which delayed China's entry to the WTO reinforced these perceptions. China's lack of confidence in international economic ties also arises from rising protectionist sentiments and actions initiated against its exports in general and labour-intensive products, particularly in Western markets.

The second issue relates to the political economy of industrial adjustment in advanced economies which import large quantities of labour-intensive products from China. Distributional politics become the norm when economic growth slows and industrial restructuring faces difficulties (Olson 1982). Although rising imports may not be the cause of economic troubles but more a symptom of the problem, market penetration by foreign goods can easily become a

scapegoat. Under such circumstances, governments face strong domestic pressures for protection against foreign commercial penetration. China's labour-intensive exports have increasingly faced discriminatory treatment in many industrial country markets. Table 3 summarises the coverage of non-tariff barriers placed on China's total exports and on manufactures in three major markets in 1990 — the United States, the European Union and Japan.

Table 3 United States, European Union, Japan: share of imports from China covered by non-tariff barriers, 1990 (percentages)

	United States	European Union	Japan
All goods	47	30	22
Manufactures	62	48	27

Source: World Bank (1992, p. 148).

It has become increasingly clear that the political economy of protection has to a great extent determined the degree of China's access to advanced markets and its economic internationalisation. It is noteworthy that Japan is China's least restrictive market, primarily because it does not subject Chinese clothing and textile exports to quota restrictions under the Multi-Fibre Arrangement (MFA), unlike the United States and the countries of the European Union. Thus China very much has a stake in whether Japan follows in the footsteps of the United States and Europe in terms of increasing protectionism.

The third issue is whether China's economic reform is proceeding in line with the direction pursued by multilateral rules-based institutions. While China has substantially marketised its economy, its gradualist approach to reform has resulted in an institutional setting in which market and centrally planned

mechanisms coexist (Nolan 1995; Naughton 1995). Thus government is still important in setting the pace and agenda for reforms and in liberalising policy regimes that govern domestic and international businesses. However, conflicts can arise as interchanges between Chinese and foreign businesses intensify, due to differences between business practices and norms prevailing in China and those prevailing internationally. In this respect, the process of China's entry into the GATT/WTO will require adaptation by domestic institutions so that they operate in accordance with international business practices. More recently, China has shown increasing willingness to accommodate the high adjustment costs of international interdependence by its concessions to secure GATT/WTO entry. This is likely to exert a significant impact on China's integration with the world economy.

In the reform era, China's marketisation, internationalisation and ways of managing its economic interdependence have become critically important in shaping developments in its bilateral economic interdependence with Japan.

Transformation of the bilateral relationship

The pattern of reform and internationalisation outlined above contributed to Japan's relative decline as China's major trading partner, as did changes in bilateral trade structures and expansion in bilateral economic links. These changes transformed the earlier special bilateral economic relationship between China and Japan into a decentralised and market-driven one.

Japan's importance as a trading partner for China has declined over the years, despite the fact that China-Japan trade relations have expanded substantially. In the late 1970s Japan accounted for over 25 per cent of China's total foreign trade. This share rose to around 30 per cent in the mid-1980s and then dropped significantly in the late 1980s. Although Japan's share rose again in the early 1990s, it was still significantly lower than it had been in the late 1970s and mid-

1980s (Table 1). At the same time, China–Japan bilateral trade grew more than ten-fold, from US\$5 billion in 1978 to over US\$60 billion in 1996.

Relative trade shares may alter because of three possible causes (Drysdale et al. 1995):

- Changes in the share of one country in world trade. As China becomes a bigger world trader, it will naturally become more important in the trade of other countries.
- Changes in complementarity. If two countries become more complementary in their trade structure, their relative trade shares are likely to rise.
- Changes in bias, or ‘resistances’ to trade. Resistances to trade result from differential transport and other transactions costs, from preferential policy measures, and from political, institutional or cultural factors which make it more or less easy to trade with one trading partner compared with another.

Taking these approaches as a starting point, Table 4 calculates the intensity, complementarity and bias in China–Japan trade.

Table 4 Intensity, complementarity and bias indexes in China–Japan trade

	1965–71	1972–77	1978–84	1985–89	1990–93
China to Japan					
Complementarity	0.98	0.93	0.99	1.11	1.10
Country bias	2.75	3.48	3.57	2.65	1.87
Intensity	2.64	3.20	3.45	2.82	2.05
Japan to China					
Complementarity	1.07	1.54	1.39	1.24	1.12
Country bias	3.98	2.93	2.67	1.94	1.40
Intensity	4.22	4.44	3.69	2.45	1.56

Note: The index of complementarity, bias and intensity explain the factors causing changes in the relative trade share between two countries (Drysdale 1988, pp. 84–8). Complementarity in bilateral trade measures the extent to which country A’s exports to country B are relatively large because the commodity composition of A’s exports matches that of B’s imports more closely than it matches the commodity composition

of world trade. The index of country bias in trade measures the extent to which, on average, a country's exports have more or less favourable access to another's import markets than might be expected simply from both countries' shares of world trade in each commodity. Complementarity and country bias together determine trade intensity, measuring the extent to which a country's share of another country's total exports is large or small in relation to the former country's share in world trade.

Source: Calculations based on UN Trade Data, International Economic Databank, Australian National University

The bias index shows that while Japan developed special links with China up to the mid-1980s, due to improvement in China's contacts with, and access to, a wider range of international markets, Japan's advantage via special links with China has since eroded. This trend coincided with China's efforts to diversify its overseas markets in the mid-1980s and to reduce its import reliance on Japan, which China perceived to be disproportionately high. These factors contributed to the diversification of China's overseas markets away from Japan.

Chinese and Japanese trade structures remain highly complementary, as the complementarity index shows. This is particularly true for capital goods and technological products in which Japan's competitiveness has remained at a very high level in the Chinese market and for labour-intensive products in which China's competitiveness has risen and Japan's has fallen throughout China's reform era. Moreover, the relatively low complementarity between Chinese exports and Japanese imports, accompanied by the high complementarity between Japanese exports and Chinese imports before the mid-1980s, means that their trade relations were prone to structural imbalance and a Japanese surplus in merchandise trade with China.

The index of intensity shows that Japan's relative importance as a trading partner for China has declined as China has established its comparative advantage in international markets, finding large outlets for its labour-intensive products elsewhere. On the other hand, trade with China has become

increasingly important to Japan, as Chinese economic growth, faster than in Japan, has opened economic possibilities for Japanese exports and investment. Chinese foreign trade has also grown faster than in Japan. This has contributed to greater balance in bilateral trade interdependence between the two countries (Drysdale et al. 1995).

The second significant change derives from the composition of China–Japan trade. Labour-intensive products have replaced energy as China’s most important export to Japan. More generally, manufacturing products have begun to dominate bilateral trade flows between the two countries (Table 5). The importance of China’s energy exports to Japan has declined accordingly. Again, this change is a result of China’s reforms and their contribution to the rise of labour-intensive production in China *vis-à-vis* other industrial sectors. The rise in China’s labour-intensive exports is an outcome of China’s involvement in the international economy on the basis of comparative advantage.

Table 5 Changes in the pattern of trade between China and Japan, 1978, 1985, 1994 (per cent)

	1978		1985		1994	
	Imports	Exports	Imports	Exports	Imports	Exports
Agriculture intensive	2.6	34.8	2.2	25.7	2.6	22.3
Capital intensive	89.4	3.7	88.6	6.0	79.9	15.7
Labour intensive	6.3	17.4	6.4	17.3	13.6	49.9
Minerals intensive	1.7	44.2	2.8	51.0	3.9	12.2
Total US\$billion	3.0	2.0	12.3	6.3	18.5	27.4

Source: Calculations based on UN Trade Data, International Economic Databank, Australian National University.

A China–Japan trade relationship primarily driven by market forces and based on comparative advantage is quite different from one based on central planning, as was the case under the LTTA agreement. While the LTTA agreement took into account economic complementarity between China and Japan, the more politically motivated and less economically calculated goals of economic security and modernisation took priority in both countries. This approach failed to take into account the considerable economic costs associated with a bilateral trade arrangement of the sort that the LTTA agreement represented. A bilateral trade pattern driven by market forces, on the other hand, is subject to constant changes in the comparative advantage of both countries. Economic interests, and costs, take precedence in shaping the pattern of bilateral trade. This means that as China undertakes marketisation and internationalisation, its trade relations with Japan are no longer unique in the sense of being centrally planned to suit the particular political needs of each country. Rather, trade relations have become increasingly decentralised and now resemble any bilateral trade pattern that is market driven, calculated more on economic costs and based on comparative advantage.

A third change relates to the broadened bilateral economic links between China and Japan through FDI. There was no room for FDI before China implemented institutional reform, and commodity trade dominated the China–Japan bilateral economic relationship. In the 1990s corporate Japan moved to China to take advantage of investment opportunities. By 1996 accumulated realised Japanese FDI in China surpassed US\$10 billion, ranging across almost all manufacturing and services sectors.

Corporate Japan was very reluctant to invest in China in the 1980s because of China's incomplete institutional reform and infrastructural problems.³ FDI in China involved enormous risks as the two countries differed substantially in values, corporate governance, macroeconomic policies and regulatory regimes.

Corporate Japan preferred to export to China since such arm's-length transactions involved less risk.

Rising Japanese FDI in China in the 1990s is a strong indication that corporate Japan has been convinced of the irreversibility of China's market-oriented reforms and of the bright prospects for Chinese economic development. China is now seen as the most promising country for investment in the medium to long term by Japanese firms, according to surveys undertaken by the Export-Import Bank of Japan (*News Release*, 1994). Corporate Japan is now prepared to take on the higher risk associated with bilateral differences to capture a share in China's rapidly growing market.

Japanese FDI has impacted on the Chinese and Japanese economies by facilitating their industrial restructuring and by transforming bilateral trade patterns. A major feature of Japanese FDI in China is that a relatively high proportion of its production is exported to Japan. According to a survey carried out by the Ministry of International Trade and Industry (MITI) (1995), 29 per cent of the production of the Japanese manufacturing subsidiaries in China was exported back to Japan. In the textile sector, the ratio was as high as 81 per cent.

Adjustment to bilateral economic interdependence

Adjustment to China-Japan economic interdependence has evolved in response to changes in the comparative advantage of both countries, driven by decentralised market forces. It has also responded to developments in the political economy of each country associated with these changes, and to China's acceptance of the role of multilateral rules-based mechanisms such as the GATT/WTO and the Asia Pacific Economic Cooperation (APEC) process in facilitating trade and investment relations and resolving bilateral economic friction.

The diminished importance of the LTTA agreement in bilateral trade is evidence of the transformation of China's management of bilateral economic relations from a centrally-planned to a market-driven approach. China and Japan have twice extended the LTTA agreement since 1978. The latest extension covers the period from 1996 to 2000, with a projected US\$8 billion of exports for each country (*Reuters News*, 19 September 1995). However, compared with China–Japan bilateral trade in 1995, which amounted to US\$56 billion, the share of bilateral trade covered by the LTTA agreement has decreased substantially.

It is noteworthy that, in spite of market-driven trade relations, the LTTA mechanism still persists (Lu 1988, pp. 11–3; Guo 1990, pp. 31–3). China's energy exports to Japan still comprise a large proportion of its total energy exports. In 1993, for instance, the share of Chinese energy exports to the world stood at 2.7 per cent, while China's share in Japan's energy imports totalled 12 per cent.⁴ These facts reflect in part the comparative advantage of each country, as well as providing a picture of their economic strategy with regard to bilateral energy trade. These figures are also testimony, in part, to the tenacity of China's the central-planning mentality in managing its bilateral trade with Japan.

Decentralisation of bilateral economic management is a direct result of China's market-oriented reforms under which decisions about foreign trade have been substantially delegated to local authorities, trading companies and enterprises. As liberalisation has proceeded, even centrally-controlled trading companies, whose relative importance has diminished substantially over the years, have found themselves having to compete in a marketplace with few of the privileges they used to enjoy. On the other hand, bilateral trade links through China's local authorities, enterprises and their Japanese counterparts have proliferated, leading different interests to compete, and sometimes to cooperate, in the marketplace. By establishing joint ventures and cooperative production, with products often aimed at the Japanese market, bilateral economic links have been further

strengthened at the local level. Thus subnational rather than national interests have become the prime motivation for the expansion of trade flows, bringing the bilateral trade pattern closely into line with the comparative advantage of each country.

Because of the decentralised nature of the management of bilateral trade between China and Japan, Chinese and Japanese strategic and international political interests have become increasingly distinct from bilateral trade relations.

Decentralised management of bilateral trade relations does not exclude consideration of political elements. It does, however, change the emphasis placed on them. In contrast to the management of China–Japan bilateral trade under the LTTA agreement, where strategic and political considerations dominated, market forces and subnational interests have resulted in domestic politics taking precedence over international politics in defining bilateral economic relations. While the strategic interests of China and Japan still have an impact on developments in their bilateral economic relationship, there has been a significant delinking of China's bilateral trade from its political relations with Japan. The Tiananmen Incident severed bilateral political contacts at high levels. The end of the Cold War triggered a strategic realignment in the Asia Pacific region; the US–Japan security alliance was reinvigorated and political relations between China and Japan were estranged as territorial disputes re-emerged between them. Yet bilateral trade between China and Japan and Japanese FDI in China continued to grow vigorously in spite of these events (Dawkins and Tyson 1996).

Domestic politics take precedence because, first of all, a bilateral trade pattern based on comparative advantage is part of a dynamic process, requiring constant industrial restructuring. The accompanying adjustment costs mobilise domestic interests in support of, or opposed to, restructuring and the deepening of bilateral economic links. The intermingling of domestic politics with bilateral trade has

become the norm rather than the exception as bilateral trade relations have become increasingly driven by market forces. At the same time, bilateral disputes arising from domestic adjustment and interests have grown in importance.

Trade friction between China and Japan was marked in the period immediately following China's reform and opening up. In 1979-81 China's terminated a number of trade contracts with Japan, which rocked bilateral relations between them. In the mid-1980s a huge trade imbalance in Japan's favour derailed the growth of bilateral trade flows. Then, in the early 1990s, Japanese attempts to protect domestic textile producers threatened China's biggest exports. All these events were to a large extent associated with domestic politics, although they took place in different institutional settings. Contracts were terminated at the beginning of China's reform as an effect of China's economic restructuring. A bilateral trade imbalance developed when China began to decentralise its foreign trade system, which contributed to an upsurge in its imports from Japan. Textile disputes flared up when marketisation and internationalisation pushed China to follow its comparative advantage in the export of labour-intensive products, exacerbating the difficulties faced by Japanese textile producers undergoing industrial adjustment.

This bilateral trade friction posed a challenge to the effective management of China-Japan trade relations. China's reform through decentralisation has made it difficult to manage its increasingly market-driven bilateral economic interdependence with Japan. This points to the close link that exists between China's domestic institutional reform and the management of its foreign economic relations.

There are similarities in the bilateral trade disputes between China and Japan, and those between China and the United States, or the United States and Japan. In each case, disputes are associated with economic costs and are driven by

domestic interests. The successful resolution of disputes between China and Japan depends on their adherence to the principle of comparative advantage and to international business norms and practices.

Japan's growing FDI in China was based on decentralised decision-making at the corporate level. FDI injected new elements and showed the importance of China's reform and internationalisation in shaping the management of bilateral economic interdependence (Nagaoka 1996).

Since the commencement of reform, the Chinese government, at least at the central level, has seen Japanese FDI as providing an important contribution to technological progress as well as a means of introducing capital, new ways of management and avenues for accessing overseas markets (*Japan Economic Journal*, 2 April 1984, 6 April 1984). Japanese manufacturing firms initially saw cheap labour as the major attraction, using China as an export basis for the world market (Ono 1990, pp. 24–5). The Chinese often expressed dissatisfaction over Japan's lack of enthusiasm for technology transfer while the Japanese complained that China's preferences discouraged labour-intensive Japanese FDI.

China and Japan devised bilateral mechanisms to handle friction over FDI. Under the terms of the China–Japan Bilateral Investment Protection Pact signed in 1988, Japanese firms operating in China were treated the same way as their Chinese counterparts. In 1991 the two governments endorsed the establishment of bilateral investment promotion organisations with the aim of improving China's investment environment at the international level and coordinating the exploitation of business opportunities and the resolution of conflicts. Beijing and Tokyo were also engaged in the settlement of intellectual property rights issues, as these had become an obstacle to Japan's growing FDI in China.⁵ These mechanisms helped China and Japan to manage Japanese FDI in China and provided increasingly important avenues for the restructuring of their

economies. They also involved each country in a dynamic process of economic restructuring in the Asia Pacific region.

With growing Japanese FDI in China, enormous differences in Japanese and Chinese perceptions emerged, leading to bilateral friction at the micro level. These differences in perception have their roots in different life-styles, values, patterns of decision-making, business interests and government policies, not to mention different political and economic systems (Peng 1994; Chen 1992). In the face of such differences, the earlier perception that China and Japan shared a cultural affinity began to appear questionable.

It may be that China's economic reform will provide a chance for these perceptual differences to converge. Life-styles in China and Japan may come to resemble each other as China catches up economically. A similar economic convergence is occurring between Japan and the United States, between the Asian newly industrialised economies (NIEs) and Japan, and between China's coastal cities and the Asian NIEs. While China's cheap labour is attractive to many Japanese investors, rapidly rising Chinese incomes, at least in the coastal areas, are appealing to Japanese firms seeking to access the Chinese market. The experience of intensive interaction at a personal level allows for the understanding and even acceptance of values, patterns of decision-making and business norms and practices which are essential to business success (*Jiji Press*, 22 October 1996). This is particularly the case in successful China-Japan joint ventures, where considerable adjustments and accommodation in values and managerial styles are occurring daily (Kobayashi 1994, pp. 2-9). Failure to learn from each other and to cooperate condemned some business ventures to ruin (Sonoda 1994, pp. 8-11). As China continues its marketisation drive, its economic system has come to resemble Japan's. A convergence of political systems between the two countries may yet develop in the future.

All these convergences, if indeed they occur, will take time, while friction arising from bilateral differences in FDI requires immediate resolution. As China is still in the midst of an institutional transition towards a fully market-based economy, the rules and institutional framework used to facilitate adjustment of different interests involving FDI will affect the deepening of bilateral economic interdependence between China and Japan. In this respect, facilitation by Japan of China's acceptance of a multilateral rules-based framework should deepen China's integration into the world economy and ensure relatively smooth adjustments to different interests and fair resolution of friction arising from intensifying bilateral FDI activities. Such assistance by Japan could include Japanese pressure for national treatment for Japanese investors in China, enhancement of China's understanding of international business practices through academic and business exchanges, promotion of China's involvement in regional economic forums such as APEC, and Japanese efforts to bring China into the GATT/WTO.

Conclusion

China's market-oriented reform and internationalisation have contributed to the transformation of China–Japan economic relations. Japan's relative importance as China's trading partner and the pattern of bilateral trade between them have changed remarkably. Decentralised market forces, rather than a central planning mechanism, have played an increasingly important role in the expansion of their economic relations. Economic friction, however, has also arisen from the deepening of bilateral trade and investment ties between China and Japan and raised a number of challenges.

The first challenge came as a result of the reduced importance of the LTTA agreement in bilateral trade. Although the agreement still exists, it covers a far smaller proportion of bilateral trade in the 1990s than in the late 1970s. This is a direct result of China's decentralisation of its foreign trade authorities, leaving

market forces to determine the pattern of trade between China and Japan. While bilateral economic relations driven mainly by market forces have contributed to a trade pattern that conforms with the comparative advantage of each country, this has made the management of such relations more difficult when bilateral trade was centrally planned and controlled.

Management of bilateral economic relations between China and Japan has also had to take into account the altered nature of the political dimension of their relationship. International politics have become increasingly delinked from bilateral economic relations, reflecting the fact that both countries have concentrated on the development of such relations. As China and Japan rely closely on one another economically, economic changes in one country exert a greater impact on each other than ever before, thus opening the door to domestic industrial adjustment politics in their economic relationship.

In addition, the management of their bilateral economic relationship has increasingly been defined by China's market-oriented reform and internationalisation. This point was clearly demonstrated in bilateral friction arising from Japanese FDI in China, calling for the introduction of international rules-based institutions to govern FDI in China. More generally, the effort to bring China into the GATT/WTO will provide the relationship with an international rules-based framework to ensure that China and Japan successfully resolve the differences that exist in their bilateral economic relationship.

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Notes

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- 1 I owe this point to Mr Isayama Kenji, Deputy Chief of MITI's Police Bureau (March 1995).
- 2 All figures in this paper, unless otherwise indicated, are based directly on UN Trade Data from the International Economic Databank, Australian National University.
- 3 See *Japan Economic Journal*, 1 October 1988, p. 3; *NEWS*, 3 November 1988; interview with JETRO research officer, March 1995.
- 4 These figures derive from UN Trade Data, International Economic Databank, Australian National University.
- 5 *The Daily Yomiuri*, 4 April 1995, p. 7; interview with MITI official, April 1995; *Top 7*, June 1995.