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### Analysis

## Politics and the Japan-China Economic Relationship

Shiro Armstrong \*

Japan and China are two giant neighbours in Asia with a booming economic relationship despite a backdrop of simmering tension arising from unresolved political issues.

All bilateral relationships have good times and bad, and many are complicated but the inability of Japan and China to come to terms with outstanding issues in their past and to develop a higher level of trust, has consequences for the welfare of both countries and the region more broadly. A sticking point in the Sino-Japan bilateral relationship is the issue of history.

The current political leadership on both sides clearly understand the importance of the relationship for their economies and security. Getting the relationship with East Asia (read China) sorted out was an issue in the contest for succession after Koizumi's prime ministership. Shinzo Abe's first visit abroad after becoming Prime Minister was to China. There had been no bilateral leadership meetings in the previous six years. Abe was determined to deal with the damage that the visits of his predecessor, Koizumi, to Yasukuni shrine had done to the relationship. In recent months, China is playing its part in getting things back on course, remaining remarkably silent on the increasingly awkward 'comfort women' issue being played out in Japan, which was re-kindled in the US Congress.

Koizumi's six visits to the Yasukuni shrine confronted Abe with a hard policy choice on his taking over of the Prime Ministership. The visit to Beijing tactically neutralised the issue. But there remains strategic ambiguity about how Abe will handle Yasukuni down the track.

There has been equally strategic play from China in managing the Yasukuni problem. Premier Wen's visit to Japan is timed for April 11, right in the middle of the spring reitaisai, one of the shrine's two most important religious ceremonies in spring and autumn. Abe has also been invited to visit China in October this year, again during an important time for Yasukuni. To carry these engagements forward smoothly, Abe will have to avoid an August 15 visit, the anniversary of the end of the war, unlike Koizumi himself in the last year of his leadership. The timing of these events reduce the chances of Abe's visiting the shrine at all or, at worst, make it easier for Abe to visit the shrine at a less public and sensitive time. Both governments are dancing carefully and very strategically around the Yasukuni issue.

Sensitivities in the political relationship affect some aspects of Japan's economic relationship with China more than others. High political relations are important infrastructure for any bilateral dealings. Many large Japanese companies believe they are global brands and so can de-link to a large extent their business in China from their country of national origin. The boycotts, such as those that occurred in 2005, do not significantly affect their sales or investment decisions. Indeed, Japanese business surveys on the investment and business environment in China suggest that a hot economic relationship is thought by business to be roughly compatible with a cold political relationship. Chinese regulations limiting foreign auto company

### Paper of the Month

The paper of the month for March is **An Inquiry Into the Competitiveness of Emerging Philippine Cities** by Raymund E. Magdaluyo et. al.

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ownership to 50 per cent mean, for instance, that all Japanese auto makers are joint ventures with domestic companies, and this reduces negative Japanese sentiment when the political going is tough.

But Japanese business dealings with the Chinese government are another matter. Few in Japan feel that Japan's bid for the most prestigious fast rail contract, the fastest train within the fast rail project between Beijing and Shanghai, was not affected by the political distance with the Chinese government. Japan will still produce high speed trains for the Beijing-Shanghai rail link but France won the prime contract.

China's policy-making is a top down process. Even though this might be gradually changing, with more policy input from a broader spectrum within the bureaucracy and other centres of influence, Japan's lack of access to top level policy makers in China hurts the interests of Japanese business. From a Chinese perspective, the lack of an organised, direct and systematic Japanese voice is missing. The investment climate in China is very important for both countries. The lack of a framework within which to settle differences and to gauge clear policy direction and intention impedes investment flows. The lack of policy transparency in China is cited as one of the biggest impediments to Japanese firms doing business in China. High-level policy dialogue would help alleviate this and create a better investment climate in China.

China's accession to the WTO in December 2001 marked an important turning point in China's integration into the world economy. The recognition by major industrial countries of the new legal status

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of trading with China not only provided more security for China in international markets but also for foreign business in Chinese markets. China front-loaded most of its tariff reductions before accession but the very rapid growth of trade subsequent to WTO entry is testament to the impact of accession on accompanying domestic institutional reform that vastly facilitated trade growth. Japan now competes with other industrial countries in a much more open Chinese market so it can ill-afford to carry political baggage into this economic contest.

Japan is now pursuing the idea of an Economic Partnership Agreement (EPA) with China, which would supersede and include a Free Trade Agreement of goods trade. Both sides concede this is a long term goal but its consideration is likely to get both countries talking and moving in the same direction. It is important that investment would be covered under an EPA. Japanese foreign direct investment in China has helped Japanese firms stay competitive globally, and has helped lift China towards the international technology frontier through Japanese technology transfer.

The nature of Japanese investment in China is changing. Previously most investment in China was aimed at building assembly plants to export to third country markets. The growing domestic market in China has made domestic sales a primary target for Japanese companies. Most of the high value added activities (design, advertising and research) are still undertaken in Japan. These developments and many others, in the area of energy cooperation, financial development and international policy cooperation, as well as the fact that China is already Japan's largest export market, give added priority in Japan to the economic relationship with China and provide a powerful rationale for containing the bilateral political sensitivities that might be-devil delivering its large potential.

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