



# Economic Commentary

Number 2003-03

## Trade Between Japan and China: Dramatic Expansion and Structural Changes

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### *Rapid increase in trade between Japan and China*

Japan's trade with China, both in exports and imports, has been growing overwhelmingly over the past few years (Chart 1)<sup>1</sup>. In 2002 in particular, Japanese exports to China marked their highest growth of the past decade, sustained by strong domestic demand there and also by the effects of China's accession to the World Trade Organization (WTO) at the end of 2001.

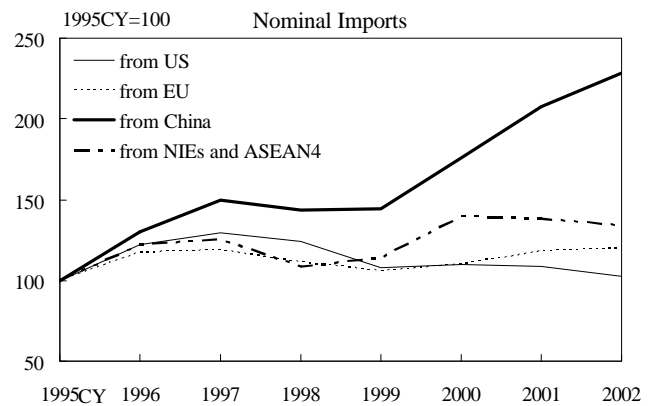
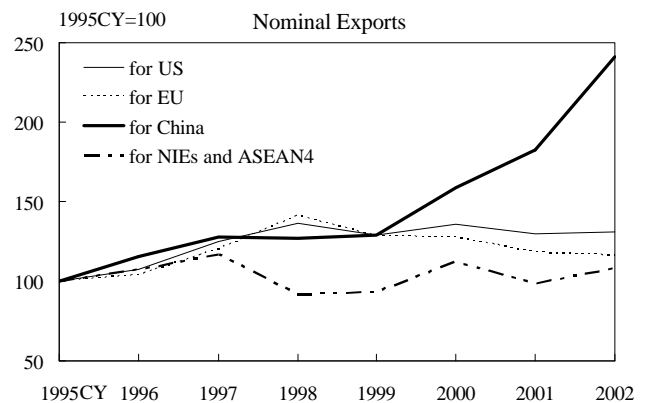
As a result, in terms of changes in trade share by country/region during the past five years (Chart 2), China increased its share from 5 percent to 10 percent in exports and from 12 percent to 18 percent in imports. Particularly, as for imports by country, China is now Japan's largest trading partner, as imports from China exceeded those from the United States in 2002.

This brief report summarizes the developments and background of this dramatic expansion in trade between Japan and China.

### *Why have Japanese exports to China increased so rapidly?*

The dramatic increase in Japanese exports to China in recent years is attributable to the following three factors, with each factor itself having positive effects on the others.

**Chart 1 Japan's Exports and Imports**



**Chart 2 Shares in exports and imports by countries/regions**

	Exports of Japan		Imports of Japan	
	1997	2002	1997	2002
US	28	29	22	17
EU	16	15	13	13
China	5	10	12	18
NIEs+ ASEAN4	35	32	22	23
East Asia	41	42	35	41

Note: Nominal value. East Asia consists of China, NIEs, and ASEAN4 (Thailand, Malaysia, Indonesia, and the Philippines).

Source: Ministry of Finance, "The Summary Report on Trade of Japan."

**(1) Self-sustaining growth in China's economy**

Domestic demand in China has grown rapidly in recent years. Private consumption is expanding, especially in the urban areas along the coast, where the number of people with high levels of income is increasing. There is strong demand for household electronics, mobile phones, and visual devices (televisions with thin liquid crystal displays, digital video players and recorders, and digital cameras), and many Japanese companies have comparative advantages on those products and parts. In addition to these high-tech products, demand for automobiles has been increasing quickly as well. Although the level of demand for automobiles is still low, it is often said that this low level itself promises a future rapid expansion. According to the China Statistical Year Book, even among the wealthiest households—defined as the upper 10 percent of the 400 million of residents in the urban areas—only 1 to 2 percent of them possess automobiles.

Turning to business fixed investment, new plants have been built and existing plants have expanded their capacities, in response to the increase in production and exports. Construction investment is also increasing due to huge national projects such as the development of western China, the Olympics in Beijing scheduled in 2008, and the International Exhibition in Shanghai scheduled in 2010.

In sum, this expansion in China's domestic demand is the most fundamental reason for the dramatic increase in Japan's exports for China.

**(2) China's accession to the WTO**

As for the surge of Japan's exports for China in 2002, China's full accession to the WTO in December 2001 has had an especially

significant influence.

As a member of the WTO, the Chinese government has declared a "three-pillar" free trade policy: lowering tariffs, abolishing non-tariff barriers such as mandatory import quotas, and deregulating the entry process (treating foreigners and locals equally). Tariffs began to be reduced in early 2002, in line with the mid-term schedule (Chart 3). In particular, tariffs on automobiles, which had been very high, have been lowered significantly, which, as discussed above, has stimulated domestic demand and brought about signs of "motorization" in China. Under these circumstances, Japanese automobile exports to China surged in 2002 by as much as 75 percent from the previous year.

**Chart 3 Schedule for Tariff Reduction**

	2002 (realised)	Plan from 2003	Abolition of import restrictions
IT-related goods	Computers and integrated circuit: from 12.5% to 0%	Abolishing all tariffs on IT-related goods by 2005	
Capital goods and parts	Semiconductor testing equipment: from 6% to 3%	Semiconductor testing equipment: to 0% by 2003	
	Offset duplicator: from 17.2% to 14.8%	Offset duplicator: to 10% by 2004	
Motor vehicles and related goods	Automobiles: from 70-80% to 43.8-50.7%	Automobiles: Reduction step by step to 25% by 2006 Engines: Reduction step by step to 10-31% by 2006	In 2003: Engines In 2004: Buses and Trucks In 2005: Automobiles and micro-buses
Intermediate goods	Para-Xylene: from 6% to 5%	Para-Xylene: Reduction step by step to 2% by 2005	
Consumer goods	Television sets from 31.7% to 30%	Audio equipment: from 24% to 15% by 2004	In 2002: Component and parts for VTR and digital cameras

Reference: Sososya, "Chugoku shijou Kaiho Program." (Published in Japanese)

**(3) Increase in foreign direct investment in China**

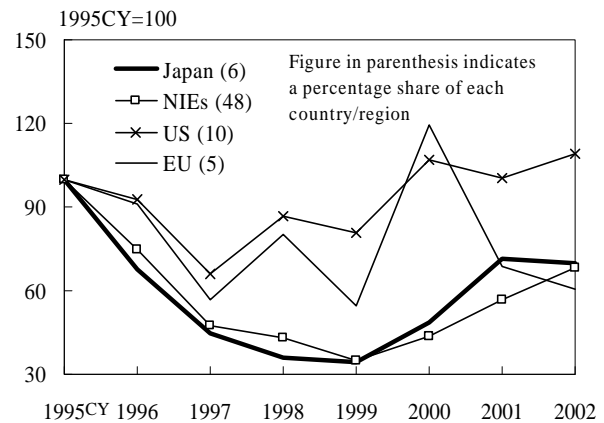
The recent dramatic changes in China's economy cannot be fully explained without focusing on the country's aggressive open-

market policies and the endorsement of foreign direct investment by the Chinese government, a movement related to its accession to the WTO. Looking back at the developments of the past decade, the Chinese government at first did not completely settle its position on open market policies, changing the priorities between protection of domestic industries and the introduction of foreign capital. For instance, the government declared to accelerate its “Policies of reform and opening to the outside world” in 1992, but then it moved to put more weight on the protection of domestic enterprises from 1995.

In addition to these fluctuations in the Chinese government’s basic stance, difficulties remain for foreign enterprises in doing business in China due to the unique business practices there. These difficulties once led Japanese enterprises to tend to shrink or withdraw their investments in China. However, after the amendment of the Constitution at the National People’s Congress in March 1999, a legal foundation to foster the market economy has been established, paving the way for the country’s accession to WTO membership.

This series of events has clearly showed foreign and domestic enterprises that China has made several irreversible steps toward opening its market. Not only physical infrastructure projects such as road networks and airports, but also institutional infrastructure like legal frameworks have begun to be established. Under these circumstances, foreign direct investment, including those by Japanese enterprises, has rebounded quickly since 2000(Chart4). This increase in foreign direct investment in China, which coincided with technological innovation and an increase in demand for IT-related sectors on a global level, has changed China’s trade structures in two important ways.

**Chart 4 Foreign Direct Investment in China**



Note: Figures of the foreign direct investment in China are on a U.S. dollar basis, contracted in each calendar year.

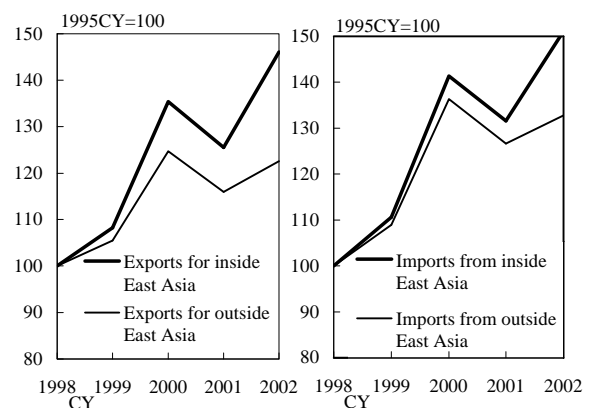
Source: CEIC Data Company.

First, trade among East Asian countries has become active (Chart 5). This expansion of trade within the region is likely to be encouraging the autonomy of the East Asian economies by easing to some extent shocks originating from economic fluctuations in the outside areas, such as the United States and European countries.

**Chart 5 Exports and Imports of East Asian Countries**

(1) Exports of East Asia

(2) Imports of East Asia



Note: These figures consist of the exports or imports of China, NIEs, and ASEAN4 (Thailand, Malaysia, Indonesia, and the Philippines).

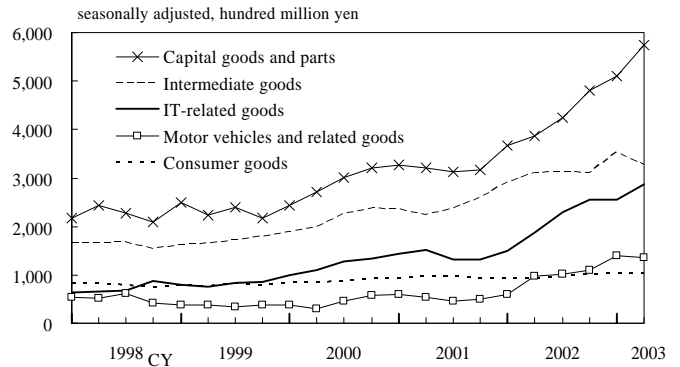
Source: CEIC Data Company.

Second, China’s economy has become highly industrialized. Only until several years ago, China was typically characterized as an economy producing labor-intensive goods

such as apparel or light industrial products. During that period, direct investment by Japanese enterprises, such as transfers of their plants to China, was mainly motivated by the cheap labor costs there. Recently, however, processing and assembly plants have been integrated mainly in the coastal areas, thus playing an important role in the international division of labor for IT-related products such as personal computers. On the supply side, this integration of the production base has encouraged an increase of suppliers providing specialized equipment and parts. On the demand side, it has expanded consumption through the creation of income, as discussed in (1). These effects in turn have attracted more foreign investment, introducing a favorable growth cycle in the region.

Thus, industrial activities in China have been growing rapidly, especially in IT-related sectors as one of the key industries. China is now even called the “factory of the world.” As a result, among the exports of Japan for China in 2002, exports of capital goods and parts and IT-related goods contributed significantly to the overall increase (Chart 6). For example, as for digital visual devices, the demand for which is growing on a world-wide scale, a larger part of the final assembly is conducted in China, which is a new development. However, Japan still has comparative advantages on the development and production of many core parts of those products, such as CCDs (Charge Coupled Devices, i.e., parts of digital cameras), other related electronic parts, and plasma displays. Therefore, exports of these electronic parts and related products from Japan to China are increasing significantly, as China develops itself into the world’s assembly base.

**Chart 6 Japanese Exports to China**



Note: The latest figures for 2003 are those for the second quarter.  
Source: Ministry of Finance, “The Summary Report on Trade of Japan.”

***How is progress in the international division of labor related to the recent increase in imports of Japan?***

China’s trade statistics are also useful to investigate how the changes in China’s industrial structure, coupled with progress in the international division of labor, have affected China’s trade structure. Comparing the trade structure in 1995 with that in 2002 (Chart 7), the most remarkable change is that the share of machinery and equipment to total exports increased from 22 percent to 39 percent, and exceeded that of textile products.

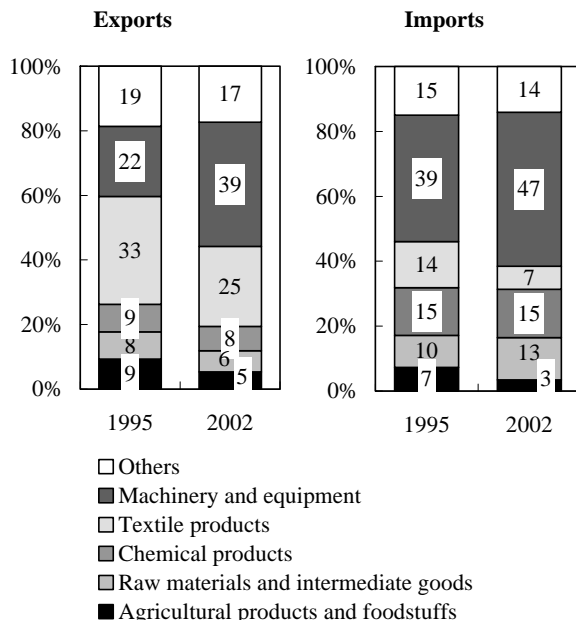
Increase and change of composition in Japan’s imports from China are very closely related to the changes in China’s trade structure mentioned above. First, as for Japan’s imports from China by goods (Chart 8), imports of IT-related goods have been on a clear uptrend since around 2000, and the pace of the increase has even accelerated in 2002. This is largely because many manufacturing firms, including those producing personal computers (PCs) in Japan and also in other East Asian countries such as those in NIEs, have transferred their plants to China. As for Japan’s imports of office machinery (including PCs) by region (Chart 9), the share of China has been increasing rapidly since 2002.

Second, Japan's imports of capital goods and parts from China are also on a relatively clear uptrend. An interesting fact is that trade in capital goods and parts, as well as in IT-related goods, is accelerating in both exports and imports (Chart 6, 8). The increase of these highly processed goods in both exports and imports implies that trade between Japan and China is not simple vertical trade, but reflects an aspect of the developing international division of labor.

Third, Japan's imports of consumer goods from China have stopped increasing for the past two years, after they had surged around 2000, mainly in imports of textile products.

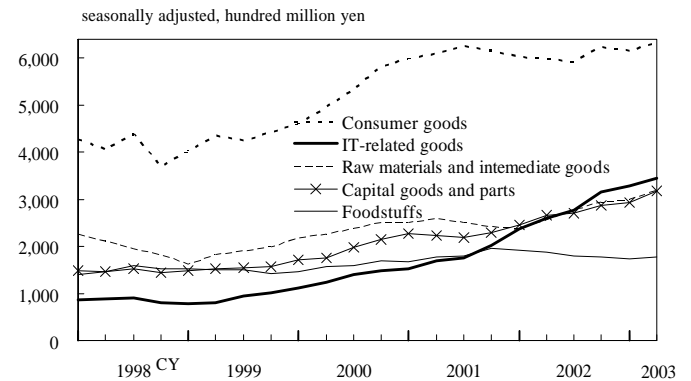
All three of these facts about Japan's imports from China are consistent with the rapid increase of machinery and equipment in terms of the share in China's exports.

**Chart 7 Changes of Composition in China's Exports and Imports**



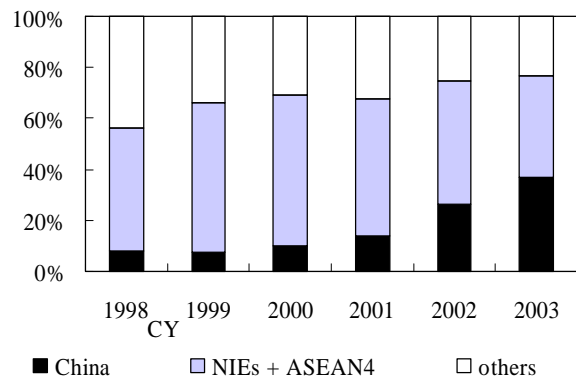
Note: Figures for others contain metal products and transportation equipment.  
 Source: CEIC Data Company.

**Chart 8 Imports from China into Japan**



Note: The latest figures for 2003 are those for the second quarter.  
 Source: Ministry of Finance, "The Summary Report on Trade of Japan."

**Chart 9 Japan's Imports of Office Machinery by Region**



Note: Figures for 2003 are those for the first half of the year.  
 Source: Ministry of Finance, "The Summary Report on Trade of Japan."

**Future prospects**

Although China's economy and trade between Japan and China seem to have been expanding smoothly as discussed above, there still exist some tasks to be settled.

China is still on the way to the establishment of a market economy. As by-products of its rapid economic growth, inequality in income distribution has widened between the urban coastal areas and the inland agricultural areas, and even between the rich and the poor in those urban areas. The non-performing loans problem of the state commercial banks is also a persisting risk factor. Moreover, according to many Japanese enterprises doing business in

China, the local legal systems have not yet effectively operated with respect to the protection of intellectual property. Excessive formalities in the administrative processes and risks in collection of loans and advances are also pointed out as difficulties in doing business in China.

In addition, the severe acute respiratory syndrome (SARS) epidemic broke out in China this spring. Since April, when the epidemic became clear, impediments to business activities there have been reported by Japanese enterprises. Those include slowed business negotiations, delays in installation of local production lines due to suspension of engineers' business trips there, and a decline in local consumption. Judged from figures in the second quarter of 2003, the SARS problem has not had a significant influence on trade between Japan and China. Moreover, the epidemic itself is coming to an end. Nevertheless, possibilities still exist that the increase in trade between these two countries will slow somewhat for the time being, given the temporary delay in business negotiations mentioned above. In addition, some Japanese enterprises have come to recognize the risks of concentrating their plants exclusively in China, taking into consideration the failure by the Chinese government to contain SARS at an earlier stage, and concerns over future recurrence of the outbreak. However, there seem to be few actual cases in which Japanese enterprises have reconsidered their basic strategies on business in China because of the SARS problem, since they still maintain the mid-term prospects that China's economy will be further developed into the market economy and continue to grow rapidly.

As for Japan, "de-industrialization," which may occur as a result of the transfers of plants to China, and its impacts on domestic regional economy and employment, remain important issues. However, recently there are fewer arguments than before that consider China as a threat to Japan's economic growth; more Japanese enterprises now have a positive view on China. They feel that it is a huge potential

market and thus offers great opportunities for their business.

There is of course no guarantee that China's economy and the trade between Japan and China will continue to expand in a straightforward manner. However, it is obvious and undeniable by any trade theory that progress in the international division of labor between Japan and China benefits both countries. Hence, the direction toward further expansion in trade, already strengthened once, is not likely to be easily reversed. What is essential for Japan's economy, then, is to enjoy its economic benefits as much as possible. For this very reason, it is becoming increasingly necessary to implement structural reforms in Japan so that resources will be smoothly reallocated.

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Note1: Figures of Japan's exports for China in this report are based on Japanese trade statistics. They cover only direct exports to China and do not contain those via Hong Kong. According to Hong Kong's trade statistics, the amount of Japan's exports to China via Hong Kong in 2002 is estimated to be approximately one third of those directly exported to China. Taking this into consideration, the balance of trade between Japan and China in 2002 turns out to be a deficit of only about 8 billion U.S. dollars, which is calculated by Japan's imports from China in Japan's trade statistics minus Japan's exports to China in China's trade statistics, the latter of which is equivalent to China's imports from Japan. This is smaller than a deficit of about US\$22 billion, which is obtained from Japan's trade statistics. In recent years, however, it is the direct exports that have been increasing; the share of exports via Hong Kong has been gradually decreasing.

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