How Japan's Economic Class Views China and the Future of Asian Regionalism

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Alongside Japan's contentious diplomatic relations with China are vibrant economic relations. While much is heard these days of the political bickering, the opinion of Japan's economic class is less aired. How does Japan's economic class view the implications of relations with China for constructing Asian regionalism? Scores of interviews I conducted with government officials in charge of industry, agriculture and foreign affairs, with national politicians, and with people in business, labor and the academy underscored how divided the economic class is on the key issues regarding China and Asian regionalism. My purpose here is to show the cluster and range of economic voices from Tokyo.

Sino-Japanese competition is profoundly affecting the process of regional economic institution building in East Asia in all core dimensions: the nature of preferential trade ties between Northeast and Southeast Asian nations; the proliferation of overlapping FTA (free trade agreement) networks; and the rekindled debate on the inclusivity and exclusivity of integration processes.

At the core of the matter is whether institution building in East Asia will entice cooperation among Japan and China to maximize economic benefits; or will it trigger competition to hinder the quality of regional integration by pursuing low quality FTAs creating significant transaction costs for the private sector through differing tariff regimes and hefty rules of origin.

Japan and China, therefore, stand at a crossroads. The historical precedent is clear: the regional integration in Europe only took off after former arch-enemies – Germany and France—reached accommodation and shelved their mutual mistrust. In Asia, the answer to the most important question is still up in the air: Will Japan and China reach an understanding, use regional institutions to improve their relations, promote economic cooperation with other Asian nations, and exercise leadership, or will the opportunity be missed?

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Big Questions, Multiple Answers

Three dimensions in particular reveal the complexity of the bilateral relationship in the era of Asian regionalism. First, talks about regional integration and Sino-Japanese relations take place in the broader context of security and global foreign policy concerns. Are Japan and China balancing one another, and regional integration policy becomes one more theater of this bilateral competition? Or, can free trade negotiations be isolated from broader geopolitical concerns, and be used to improve bilateral relations?

Second, both Japan and China have exhibited a very active ASEAN policy of late, initiating and, in the case of China, concluding FTA negotiations. Why does ASEAN figure so prominently in Japanese and Chinese FTA diplomacy? What are the main differences in the Japanese and Chinese approaches?

And third, what are the likely scenarios for Asian regionalism? Will an encompassing regional bloc develop, or will the current wave of bilateral agreements predominate? Will the general approach to institution-building in East Asia be of inclusion or exclusion?

There is no easy answer to these questions, but perhaps more interestingly there is not a *single* answer to them either. Japanese economic elites are profoundly divided on all these key issues.

Friends or Foes?

The “rise of China” with the strengthening of Chinese economic and military capabilities and the protracted economic downturn in Japan led many to predict a fundamental structural shift in the regional distribution of power, with consequent increase of bilateral frictions. It is perhaps not surprising that critical voices of Chinese policy and pessimist views on the future of the bilateral relationship are so predominant in Japan.

For instance, several of my interviewees in political circles and the economic bureaucracy expressed strong reservations about the ability of the Chinese government to comply with its WTO commitments, to crackdown on the rampant piracy problem, and to strengthen the rule of law in the country. Others complained about the unbridled competition for natural resources, particularly regarding the exploitation of disputed gas and oil deposits in the East China Sea. These voices

argued for a more active Japanese policy to develop these resources and to closely monitor Chinese drilling activities. The sources of friction among neighbors are of course manifold, and one in particular stood out during these conversations: the pollution externalities suffered by adjacent nations from the breakneck pace of economic growth in China.

Others proposed that it was time to reconceptualize Sino-Japanese relations to better reflect current conditions. In essence, this meant breaking away from the old mold of Japan as the developed nation helping China overcome the challenges of development. Some expressed the view that if China is already capable of extending economic assistance to boost its regional leadership, it should no longer qualify as recipient of Japanese aid. The recent decision to phase out ODA (overseas development assistance) loans seems to derive from these views.

Some argued that history, security, and global foreign policy concerns were large factors in the recent downturn in bilateral relations. These critics complained about Chinese manipulation of the "history card." In their view, the Chinese government has skillfully tapped the public's anger over Prime Minister Koizumi's visits to Yasukuni Shrine, where the spirits of Japan's war dead are enshrined, and over the Japanese government approval of controversial history textbooks to weaken Japan's standing in the region. Moreover, they perceive such Chinese actions as affecting not only Japan's Asia policy, but in fact harming Japan's global foreign policy. Many believe that the Chinese government acquiesced to massive anti-Japanese riots in the spring of 2005 with the explicit aim of undermining Japan's bid for a permanent seat in the United Nations Security Council.

Others, however, take to task this interpretation of adverse geopolitical trends for Japan and to the unlikely prospects of building cooperative Sino-Japanese relations. In their view, talk about Chinese ascent and Japanese descent is overrated, and portraying a zero-sum game is also misleading. Any account that does not factor in the *de facto* economic interdependence between Japan and China is myopic. The extensive web of trade and investment relations ties the economic future of both nations. Regional institutions, therefore, can play a catalytic role in maximizing gains from economic exchange, and help diffuse mistrust in the security arena. These interviewees found Koizumi's annual visits to Yasukuni counterproductive.

The heated debate in Japan on the essential nature of Sino-Japanese relations goes well beyond technocratic concerns over market access negotiations in the new FTA policy. It encompasses much larger questions regarding the regional balance of power and Japanese leadership in regional institution building. Domestic politics is no longer immune. The controversial visits to Yasukuni Shrine and the future of Japan's Asia policy are coming to the fore as the quest for the prime minister's office next fall heats up. The irony of Japanese isolation at the heyday of East Asian integration is increasingly exposed. So far, the path to economic integration in Northeast Asia with China and South Korea has been blocked with strained diplomatic relations, making Southeast Asia the main theater for the Sino-Japanese rivalry.

Courting Southeast Asia

Japan and China have adopted strikingly different approaches in their FTA initiatives towards Southeast Asia. China's FTA initiative was the negotiation of a multilateral agreement with all ASEAN nations. In contrast, Japan decided to move first by signing bilateral agreements with several ASEAN countries, and only later to initiate the negotiation of a broader Japan-ASEAN FTA.

Why have Japan and China adopted such radically different approaches in courting preferential trade partners? Three main arguments were advanced by my interviewees:

1) Structural differences in the nature of economic involvement in the region. The pattern of Japanese and Chinese economic exchange with ASEAN is quite different. Japan has deeper roots in the region with the local operation of numerous subsidiaries of Japanese multinational companies. China, on the other hand, does not have such a direct manufacturing presence in the region with only modest outward investment flows.
2) Dissimilar motivations guide FTA policy. Reflecting the different economic stakes, Japan and China are not pursuing the same objectives in their free trade negotiations. China's motives in FTA diplomacy are primarily political: to boost its credentials as regional leader. For Japan, the primary rationale is economic: to improve the business environment for Japanese

multinationals. Therefore, for China a multilateral FTA is best suited to acquire regional stature, whereas for Japan the negotiation of more comprehensive bilateral FTAs was important to address the concerns of its multinational corporations.

3) International constraints on FTA policy vary. China could more easily begin with a multilateral FTA with ASEAN because it did not have to pass as high a bar as Japan must. While industrialized nations such as Japan are bound to liberalize substantially all trade in their FTAs by article 24 of the WTO charter, an FTA between developing nations can be formed under the softer conditions of the "enabling clause," with limited sectoral coverage and contained adjustment costs.

The modalities of FTA negotiation with ASEAN vary, but Japan and China are driven toward a common goal: to become the regional integration focal point. Frequently, my interviewees noted that Japan and China are racing one another for diplomatic and economic gains.

Examples of competitive dynamics include the Chinese decision to go ahead with the ASEAN FTA after Japan successfully wrapped negotiations with Singapore, and the Japanese government's announcement to negotiate in the future with ASEAN as a bloc following China's bolder initiative. First-mover gains are important not only in terms of diplomatic points scored, but also in terms of trade diversion.

Some of my interviewees reported concern that the China-ASEAN FTA could further promote hollowing-out of the Japanese economy as Japanese companies adjust to the elimination of tariffs in China-ASEAN trade. However, others noted that this concern dwindled when it became known that a ten-year moratorium on liberalization in sectors such as automobiles and electronics radically reduces the impact of the China-ASEAN FTA.

In short, FTA is a strategic game of matching and counter-matching moves. The stakes for both countries are diplomatic (cementing ties with Southeast Asian nations) and economic (avoiding trade discrimination). But it is also a broader quest for defining the parameters of the integration process in East Asia. It is about leadership and standard-setting. There is indeed wide variation in the multiple

FTAs signed by East Asian nations today. An insightful point made by some of my interviewees was that Japan and China were offering different models of regional integration, and that the race is on to see which one disseminates further and faster.

A common perception in Tokyo was that China is prepared to negotiate narrower FTAs affecting mostly tariffs on goods, while offering agricultural concessions through the early harvest program. On the other hand, Japan is interested not only in tariff elimination but rule-setting on issues such as government procurement and intellectual property. However, Japanese resistance to open agricultural markets has stood in the way of smooth negotiations.

Which of these two formulas of regional integration is better? This is indeed a pressing question, but one for which we do not have yet the vantage point to be able to provide sound answers. On the one hand, Japan has only one FTA in effect in Southeast Asia with Singapore, has inked one with Malaysia, has reached basic agreements with the Philippines and Thailand, and negotiations with ASEAN as a whole have moved slowly. On the other hand, China's FTA with ASEAN will only enter into force in 2010 for ASEAN-6, and 2015 for the rest of ASEAN. Consequently, the impact of Japan's and China's FTAs with Southeast Asian countries on regional trade and investment patterns remains unknown at this point.

But one major implication of Japan's and China's FTA overtures in Southeast Asia is already plainly visible. What we are witnessing so far is the proliferation of hub-and-spoke regionalism with Japan and China developing separate FTA networks and a large number of bilateral FTAs crisscrossing East Asia. The costs of such approach to regionalism are manifold, including the emergence of a "noodle bowl" with unwieldy rules of origin. FTA quality could also be a casualty to this competition given the growing calls in Japan to emphasize speed and negotiate on occasion narrower FTAs.

The Future of Asian Regionalism

Can East Asia overcome such a fragmented pattern of regional integration and develop into a more cohesive regional entity? While many of my interviewees believed in the benefits of pursuing the larger dream of an East Asian bloc, there was near-unanimous consensus on the impossibility of achieving such a goal in the

near future. The only chance for a comprehensive regional bloc to emerge depends on the willingness of Japan and China to engage each other in free trade negotiations. While many in the business community expressed positive views for such negotiations in order to reap the benefits of an investment protection treaty or hedge against changes in Chinese economic policy, they were not actively lobbying for FTA talks because politicians were unlikely to be receptive under the current climate of strained bilateral relations. Furthermore, there was no sense of urgency in negotiating with China, since most of my interviewees seemed to believe that China must first demonstrate its ability to implement WTO commitments.

Moreover, last December in Kuala Lumpur during the East Asian Summit, Japan and China went on record regarding their clashing views on the future structure of East Asian integration. The old debate on inclusive versus exclusive regionalism is at center stage. China is endorsing a more limited membership with ASEAN + 3 (China, Japan, Korea) as the core group in an East Asian regional entity. Japan, on the other hand, is proposing a more extensive membership in the so-called ASEAN + 3 + 3 formula (with Australia, New Zealand and India as additional members). The desire to dilute Chinese influence in a future East Asian FTA is a large consideration behind Japan's proposal. This is no doubt a major rift between Japan and China regarding the identity of a future regional bloc. However, this disagreement over the larger architecture of an East Asian regional bloc is in fact moot until Japan and China are ready to entertain FTA talks with one another. No broader regional integration project can gain traction without this bilateral understanding.

Towards a New Consensus

There is indeed a plurality of voices in Tokyo regarding the nature of Sino-Japanese relations, growing institutional links with Southeast Asian nations, and the prospects for ambitious regional integration projects. The "hawks" consistently emphasized Sino-Japanese competition for markets and standard-setting, the negative externalities of explosive Chinese growth, ineffective Chinese compliance with international commitments (e.g. intellectual property), and the inevitable progression of the hub-and-spoke scheme of regional integration. In contrast, the

"doves" focused on the progress China has made in opening up to the world economy, on the possibility of maximizing joint gains by engaging China in the region, and on the viability of a future Asian economic bloc.

While there is diversity of opinion among Japanese elites on the issue of China and regional integration, the most powerful message emanating from my interviews is that there is a new consensus emerging which redefines the parameters of Sino-Japanese relations. The separation of economics and politics has been an old dictum among Japanese elites regarding ties with China: Economic exchange could prosper regardless of the vicissitudes of diplomatic relations. This is no longer the case in the world of regional integration. The prospect of negotiating preferentially on many more issues than just tariff reduction renders this division of economics and politics artificial and therefore unsustainable.

Examples of this linkage between politics and economics abound: the reticence of the Japanese business sector to lobby for an FTA given the very negative views about China in domestic political circles; the inability of both governments to move forward with official free trade negotiations in a climate of bilateral hostility and recrimination; and the widely held view in Japan that deep integration with a Communist nation is out of the question. Japan's expectations of China's integration go well beyond WTO compliance to the consolidation of rule of law and a shift towards political opening. Politics, therefore, is in the driver seat of the regional integration process. Pending is creative leadership on both sides for the construction of a robust and integrated economic regional architecture.