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Chinese Economy and the Sino-Japanese Economic Relations

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Yuqing Xing<sup>1</sup>

Keio University Global Research Institute

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Professor, National Graduate Institute for Policy Studies

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<sup>1</sup> Email: [yuqing\\_xing@grips.ac.jp](mailto:yuqing_xing@grips.ac.jp)

## **Abstract**

This paper briefly reviews the current status of Chinese economy. It argues that “new normal” cannot fully explain the dramatic slowdown of the Chinese economy and the sharp fall of China’s exports growth is mainly due to the reorientation of global value chains—relocation of low value added tasks out of China. Persistent depreciation of the yuan and massive capital outflows since last summer challenges the stability of the Chinese economy and may trigger financial crisis. Despite of unstable political relations between China and Japan, the two economies have been closely integrated through bilateral trade and investment. The two countries will benefit more from further economic cooperation, especially when the world faces the headwind of anti-globalization.

## 1. Introduction

After the high growth of three and half decade, the Chinese economy has slowed down dramatically. In 2015, China's gross domestic product (GDP) grew 6.9%, the lowest since 2000. In the first three quarters of 2016, the growth further went down to 6.7%, according to the official statistics released by the National Statistics Bureau of China. Many observers of Chinese economy debate whether the dramatic fall of the economic growth was due to structure problems or business cycle (Yao, 2016). The Chinese government, however, refers the moderate growth as "a new normal"—an era of moderate growth and suggests that the economy would stay on so called "L shape" path for a few years (People's Daily, 2016).

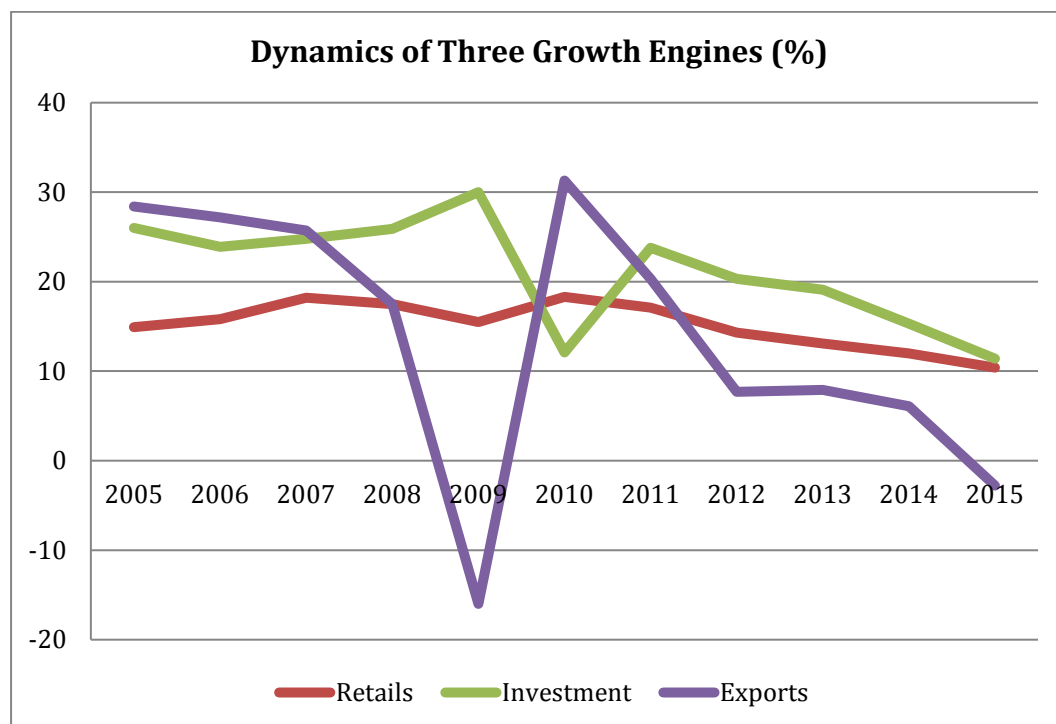
The law of diminishing returns can explain the rationale of the new normal. Following decades of high growth, the Chinese economy has surpassed Japan and turned into the second largest in the world, with more than \$10 trillion GDP. The enormous size of the economy implies that it is natural that the economy started to expand at a moderate pace. Taking the US as an example, its GDP exceeded \$10 trillion mark in 2000. Since then, it has never grown more than 4% annually.

On the other hand, examining dynamic changes of three growth engines: consumption, investment and exports, which had powered the unprecedented rapid growth, indicates that the new normal cannot fully explain the substantial fall of China's economic growth. Actually, there are more unanswered questions. First of all, the growth of fixed capital investment fell off the cliff and dropped sharply to 10% in 2015. During the high growth period, fixed capital investment on average rose more than 20% annually. In the first 11 months of 2016, the growth of fixed capital investment slipped further to 8.3%. Even more alarming is that fixed capital investment of private sectors tumbled to 3.1% from 10% of a year before. Excess production capacities, deteriorated business environment, concerns over the safety of investment and capital outflows all hinder domestic investment, which in turn undermines the growth momentum of the Chinese economy (Zhou, 2016).

Secondly, the engine of exports has lost steam completely. Exports used to be one of critical sources of China's economic growth, in particular after China entered the World

Trade Organization. It is estimated that exports contributed more than one third of China's economic growth from 2001 to 2011 (Xing and Pradhananga, 2013). The growth of exports plunged significantly in recent years from 20.3% in 2011 to -2.8% in 2015 (figure 1). Instead of contributing to the economic growth positively, exports actually dragged the economy down. From January to November of 2016, exports further shrank 7.5% in terms of the US dollar compared with one year earlier. Popular wisdoms blame weakened external demand for the sudden reversal of export growth from more than 20% to negative. It is true that falling prices of oil and primary commodities and sluggish recovery of the world economy dragged down the volume of world merchandise trade as a whole (WTO, 2016). On the other hand, the structure of China's exports is very unique with more than 95% manufacturing products, and largely relies on foreign invested firms and the operation of global value chains (GVC). The reorientation of GVCs--moving low value added tasks such as assembly out of China, because of deteriorating competitiveness of China in conducting labor intensive tasks, has been undercutting China's export capacity. In the next section, I will analyze why the engine of exports lost the growth momentum completely in the context of GVCs.

Figure 1



Source: China's Statistics Bureau

The sluggish performance of exports and the reorientation of GVCs are partially rooted in the rigid exchange rate regime of China. By any standards, Chinese yuan has been overvalued against the U.S. dollar. The over-valuation has driven multinational enterprises (MNEs), which use China as an export platform, to move their production facilities back to home or relocate to third countries with relatively low production costs. Revitalizing export growth and eventually stimulating the growth of the Chinese economy requires substantial depreciation of the yuan. The inflexibility of China's exchange rate regime and the government excessive concerns over the stability of exchange rates, however, have severely hindered the process of the exchange rate adjustment (Yu, 2016). In 2016, Chinese yuan depreciated against the U.S. dollar about 6.4% while foreign exchange reserve dropped to \$3.05 trillion by the end of November from the level of \$3.33 trillion at the end of 2015 because of constant interventions of the People's Bank of China (PBoC). Now the Chinese government is facing the dilemma of defending the exchange rate or preventing foreign exchange reserves from further depletion. The uncertainty of the yuan's exchange rate poses a potential risk to the stability of the Chinese economy and interferes the independence of China's monetary policy. It may trigger a financial crisis in China, which has been luckily untouched by the Asia financial crisis and the global financial crisis. In section 3, I will discuss the exchange rate dilemma.

Finally, I will briefly review the Sino-Japanese economic relations. Both China and Japan achieved their economic miracles following export-oriented strategy and benefited significantly from unprecedented globalization of the last decades. With the surprising victory of Trump, the two countries will face serious challenges of inward-looking and anti-globalization policy of the Trump administration. Close collaboration between the two countries is essential for sustaining trade liberalization and regional economic integration. Both countries will surely benefit from the cooperation.

## **2. The Reorientation of Global Value Chains and the Fall of China's Exports**

Most of China watchers blame sluggish external demand for disappointing export growth. To a certain extent, weakened demand of the U.S. Japan and the European Union, the major destinations of China's exports, undermined substantially the growth momentum. Examining the structure of China's exports, however, tells a different story. China's exports consist of ordinary and processing exports. Processing exports are

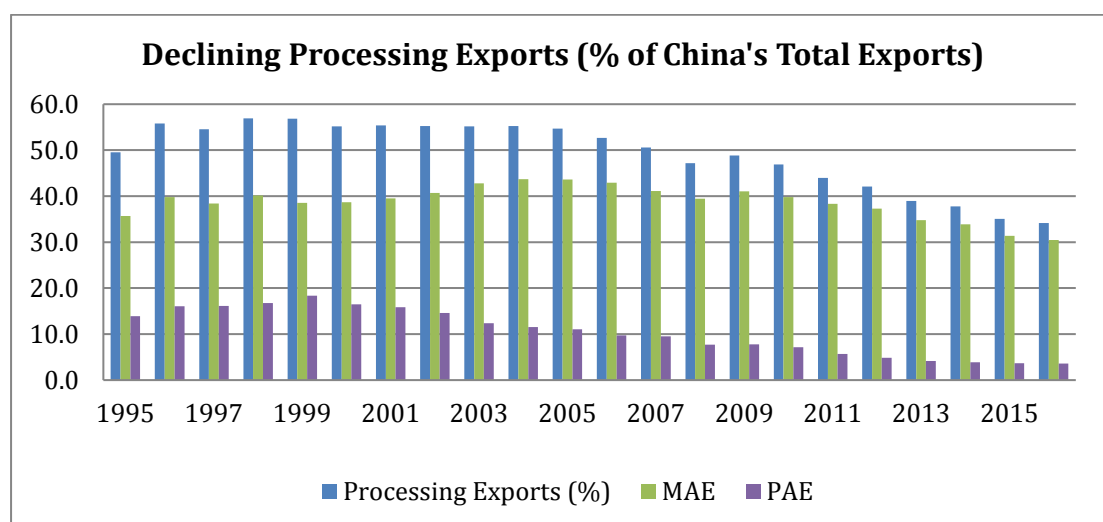
made with imported intermediate inputs and divided into pure assembly exports (PAE) and mixed assembly exports (MAE). All intermediate inputs used to produce PAE are imported. Chinese workers simply assemble imported parts and components into products according to the requirement of foreign suppliers and then export PAE abroad. Low skilled labor services are the only value added to PAE by Chinese workers. 3G iPhones is a typical example of PAE. Of \$179 manufacturing cost per 3G iPhone, Chinese workers added a merely \$6.5, about 3.6% of the total cost (Xing and Detert, 2010). MAE is manufactured with parts and components produced both domestically and abroad. Key components defining the sophistication of MAE, such as central processing units of personal computers, mobile chips of smart phones, lenses of digital cameras, etc., are generally imported. Moreover, most of MAE carries foreign brands and is marketed through the global distribution networks of multinational enterprises.

Decomposing China's exports into ordinary and processing exports shows that, the performance of those two different categories diverged substantially. Despite of the overall negative growth of China's exports, in 2015 ordinary exports rose 1.2%. In contrast, processing exports plunged greatly, specifically PAE fell 10.1% and MAE shrank 7.2%. In the first eleven months of 2016, both PAE and MAE further decreased more than 10%. As a matter of fact, in 2007 PAE started to decline and 2015 is the first year that MAE grew negatively since China embraced processing exports as a driver of export growth. The significant contraction of processing exports dragged down the overall performance of China's exports. The persistent fall of processing exports is very alarming and challenges the recovery of export growth, as processing exports remains more than one third of China's exports (Figure 2).

Processing exports is actually a subset of GVC activities. By engaging in processing exports, Chinese firms have been successfully integrated with GVCs and gained accesses to the global market. Lacking in brand recognition, global distribution networks, and advanced technology, Chinese firms face tremendous difficulties in penetrating international markets, in particular the markets of high-income countries, where consumers prefer branded products and high-tech gadgets. Being a part of GVCs, Chinese firms can easily overcome these obstacles and enter international markets, by leveraging on the advanced technology, brands, and global production networks of GVCs' lead firms (Xing, 2016b).

The rapid expansion of processing exports suggests that, GVCs have actually functioned as an effective vehicle for Chinese firms to sell their low skilled labor services and low value added parts and components to consumers of international markets. Besides the intrinsic comparative advantage in abundant labor endowment, plugging into the value chains of the global manufacturing industry by specializing in processing exports, explains most of China's export boom in the last decades. It is the processing exports that transformed China into the largest high-tech exporter. About eighty percent of China's high-tech exports falls into the category of processing exports. China's leading position in the export of information technology products, such as mobile phones, laptop computers, and digital cameras, was achieved through rapid expansion of processing exports (Xing, 2014).

Figure 2



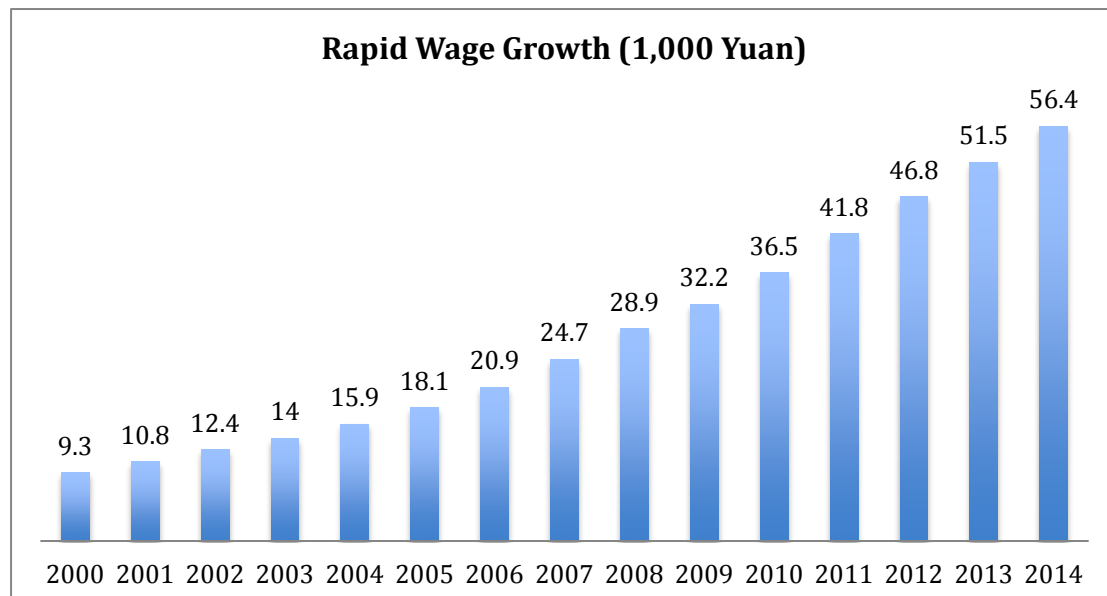
Source: the author's calculation based on the data of China Customs.

Processing exports used to account for more than 50 percent of China's exports before the global financial crisis. At its peak, its share reached as high as 57 percent. The drastic expansion of processing exports powered the double-digit growth of China's exports since China officially joined the WTO in 2001, and eventually transformed China into the No.1 exporting nation in the world. The share of processing exports fell below 50% after the global financial crisis, and since then decreased steadily to 37 percent by 2015 (Figure 2). It cannot be simply explained as a healthy adjustment of the export structure. The increase in ordinary exports failed to offset the contraction of processing exports. The decline of processing exports has been accompanied with

decreasing and even negative growth of overall exports.

The shrinking of processing exports is mainly due to gradual exits of both domestic and foreign firms from processing exports. Wage increases and cumulative appreciation of the yuan against the U.S. dollar have eroded the competitiveness of both domestic and foreign companies assembling exports in China. From 2000 to 2014, the wage of Chinese workers grew more than 13% annually. In 2014, the annual wage averaged 56,400 yuan (about U.S. \$9,300). If wage growth exceeds workers' productivity growth, firms' profits and competitiveness will be undermined. Additionally, in China employers' contributions to all benefits of employees, such as pension, healthcare, and unemployment insurance, are based on wages. Higher wages imply more benefit contribution. The actual production costs rose much more than what the wage increase indicates. Chinese firms engaging in processing exports generally have no pricing power and cannot pass on the increased labor cost to foreign buyers. They have to accept processing fees set by lead firms of value chains, and absorb the increased labor cost either by improving productivity or lowering profit margins. If they fail to cope with the rising labor cost, they will exit processing exports or relocate to third countries, which undercut the export capacity and employment of the Chinese economy.

Figure 3



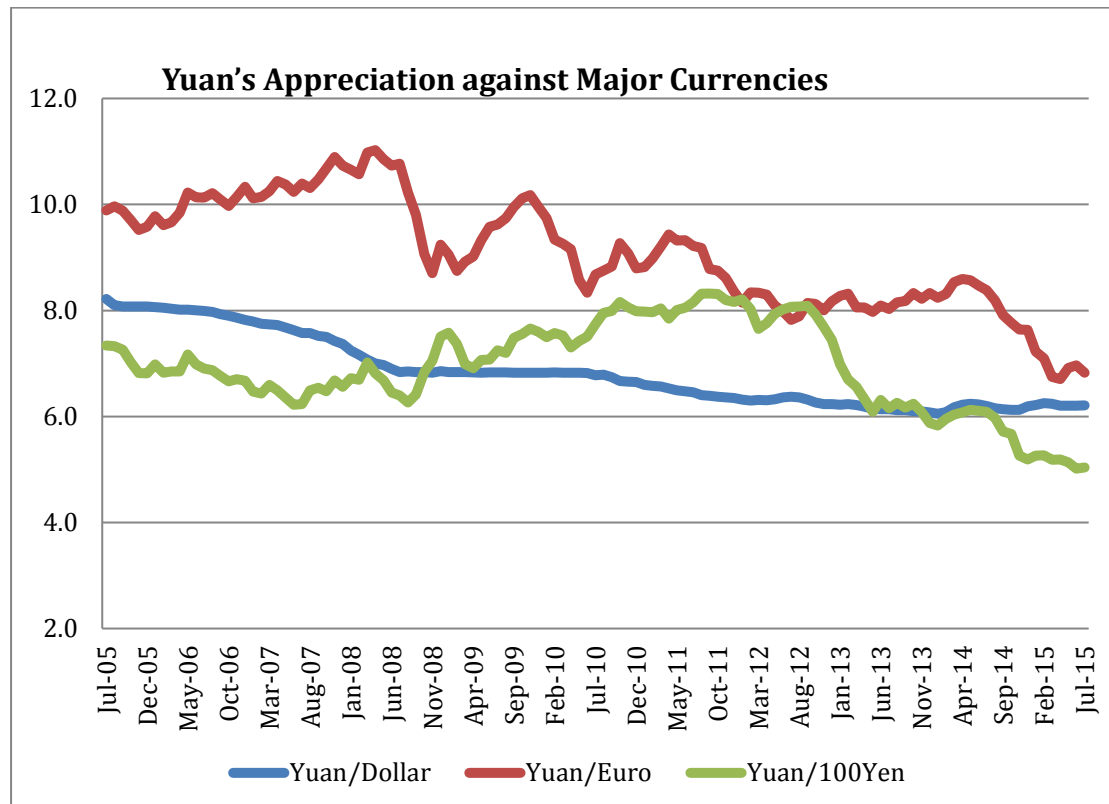
Source: China Statistics Yearbook

Moreover, from July 2005 to July 2015, the yuan appreciated cumulatively against the



U.S. dollar about 32.2% from 8.2yuan/dollar to 6.2yuan/dollar. During the same period, both Japanese yen and euro depreciated against the U.S. dollar. As a result, the compounded effect made the yuan appreciate against the yen and euro even more. The exchange rate of the yuan to euro fell to 6.8yuan/euro from 9.9yuan/euro, implying a 45.6% nominal depreciation of the yuan; the yuan to yen decreased from 7.3yuan/100yen to 5.0yuan/100yen, about 46% nominal appreciation. Processing fees or the prices of China’s processing exports are mainly invoiced in the U.S. dollar, euro or yen. There exists no automatic transmission mechanism to pass on the appreciation to foreign contractors or buyers. Chinese firms have to shoulder all the cost associated with the appreciation of the yuan. Compounded with the wage increase, the appreciation of the yuan further eroded China’s competitiveness as the assembly center of the global manufacturing industry, and has resulted in an exodus of export-oriented foreign investors, which resulted in substantial decrease in China’s processing exports, of which foreign invested firms accounted for more than 70%. The empirical research suggests that wage increases and the appreciation of the yuan are the two major factors undermining the growth of processing exports (Xing, 2016a).

Figure 4



Source: Pacific Exchange Rate Service

In recent years, many Japanese firms, such as Panasonic and Citizen Holding closed

their factories in China and relocated the production facilities either back to Japan or South East Asian countries. China had been the top destination of Japanese direct investment. Now ASEAN has replaced China as the largest host of Japanese direct investment in Asia because of rising production costs associated with the appreciation of the yuan and rising labor costs (Xing, 2016c). The survey of JETRO (2015) shows that, Japanese firms that planned to withdraw from or stop expansion in China cited the wage as one of the most important factors. Foxconn, an exclusive assembler of iPhones, has decided to invest \$50 billion in India for building assembly facilities and investigated the possibility of assembling iPhones in the U.S. As more and more MNEs relocate their production capacities out of China or reduce the scale of outsourcing low value added tasks to Chinese firms, China's processing exports will continue to fall. Hence, it will be very challenging for China's exports to regain the growth momentum unless the yuan could depreciate to the level by which the retreat of foreign investment could stop.

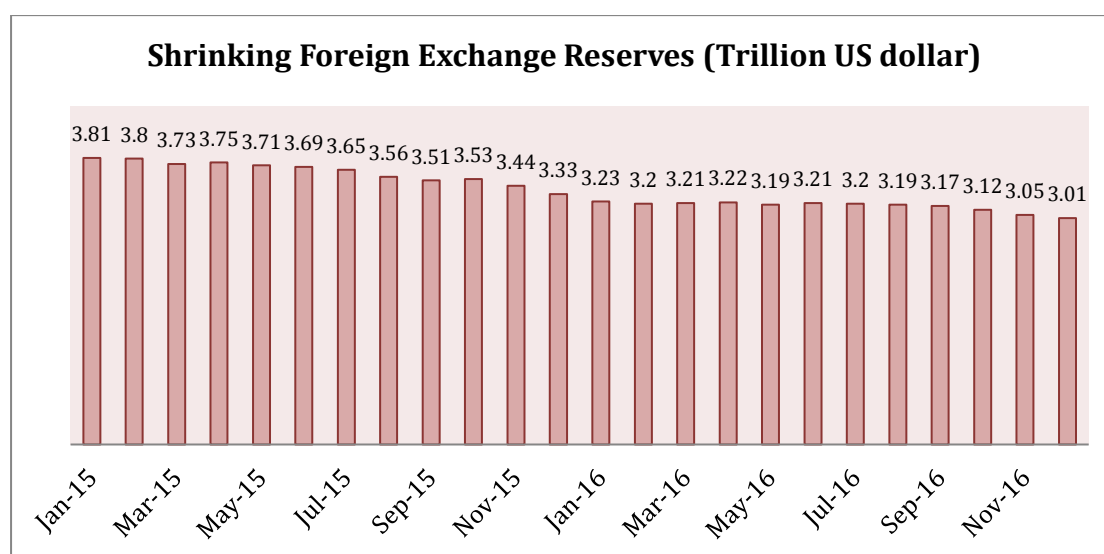
It is true that production capacity and technology of Chinese firms have advanced substantially in the last decades. Their technologic gaps with the firms of developed countries have been cut. The advancement of Chinese firms also contributed to the decline of processing exports. On the other hand, since the overall growth of exports turned to negative from more than 20% over just a few years, it suggests that the progress of Chinese local firms, which produce ordinary exports, is limited and has not been able to offset the vacuum left by the firms which exited the business of processing exports.

### **3. The Depreciation of the Yuan and Capital Outflows**

Since Aug. 2015, the yuan has depreciated more than 10% against the U.S. dollar. The persistent depreciation is positive to revitalize the growth engine of exports, but has created anxiety in China and triggered massive capital outflows, which has become a major financial risk to the stability of the Chinese economy. China's foreign exchange reserves dropped \$69.1 billion in November of 2016. It has been falling since August 2014. Money had been leaving for more than two years. As a result, China's foreign reserves lowered to \$3.05 trillion from its peak of \$3.96 trillion.

Whenever the yuan depreciated against the U.S. dollar, the Chinese policy makers, media and mainstream analysts, blamed unscrupulous speculators and argued vehemently that there was no basis for the long-term depreciation of the yuan. The detailed examination of the evolution of both Chinese and US monetary policies in the last two years, however, unequivocally suggests that the yuan has been facing a pressure of depreciation in the short-run. According to economic theory, interest rate parity determines the equilibrium of exchange rates in the short-run. The divergence of monetary policy between China and the U.S. broke the original interest rate parity. The adjustment of the yuan's exchange rate is required to achieve a new equilibrium.

Figure 5



Source: the People's Bank of China.

In October 2014, the U.S. officially exited quantitative easing, the non-traditional monetary policy adopted by the U.S. Federal Reserve to combat the great recession following the bursting of the housing bubble in 2008. In December 2015, the U.S. Federal Reserve raised the interest rate to 0.25 percent from zero, indicating the beginning of a new cycle of rising interest rates. Again, the U.S. Fed raised the interest rate 0.25 percentage points in Dec. 2016 and the meeting minutes of the Fed suggest that there would be three hikes of interest rates in the coming year. In contrast, China entered a cycle of declining interest rate in November 2014, when the PBoC cut the one-year deposit rate to 2.75 percent from 3.0 percent to support the growth of the Chinese economy. So far, the PBoC has cut interest rates five times and lowered one-year deposit rate to 1.5%. Clearly, the return of the dollar denominated assets has been

rising while that of the yuan has been decreasing, which raises the demand for dollar assets and erodes the demand for yuan assets. Given relative weak economic growth, it is impossible for the PBoC to raise interest rates in foreseeable future. It is the invisible hand that has been driving the depreciation of the yuan. All speculators who expected the yuan to fall are simply smart enough to foresee the trend ahead of the curve.

Purchasing power parity determines the equilibrium of exchange rates in the long run. The purchasing power of a currency has a negative relationship with money supply. China's 4 trillion yuan stimulus implemented by the Chinese government to counterbalance the shock of the global financial crisis and the subsequent credit expansions have greatly bloomed the money supply of the Chinese economy, pushing broad money supply M2 of 2016 to 153 trillion yuan, more than 200% of China's nominal GDP, much higher than that in the U.S. The purchasing power of the yuan has been greatly eroded relative to the U.S. dollar. The buying frenzy of Chinese tourists in Japan and the seemingly unsaturated appetite of Chinese investors for foreign real estate are evidence that the yuan has been overvalued, not only to the dollar, but also to euro and Japanese yen.

In a closed economy, it is possible to maintain a fixed exchange rate regime. For an economy like China, which every year trades about \$4 trillion in goods and services with the rest of the world and has a liberalized current account, it is almost impossible to maintain a very rigid managed floating system, which only allows a narrow band of 2 percent around predetermined midpoint. The PBoC attempted to reform the rigid exchange rate regime. On 11 August 2015 it unexpectedly announced that, the central parity of the yuan' exchange rates should be based on the closing rate of the previous day, in conjunction with the demand and supply. It cut the reference rate by 1.9% on the day. The decision shocked both domestic and foreign markets and triggered massive volatilities. Market players interpreted the new policy as a green light to gradual depreciation of the yuan. Since then, the yuan has entered a path of depreciation. To slow down the pace of the depreciation, the PBoC has repeatedly intervened foreign exchange markets by selling the U.S. dollar at both on-shore and off-shore yuan markets. In Feb, 2016, the PBoC adopted a new rule to determine the daily reference rate with a basket of currencies and the closing rate of the previous day. All these measures failed to stabilize the exchange rate of the yuan. The depreciation expectation

about the yuan has not faded yet but intensified.

Concerned with the depletion of foreign exchange reserves and continuous depreciation of the yuan, the Chinese government introduced capital controls from the beginning of 2017. Overseas investment has been recentralized. All overseas investment projects more than \$5 million should be approved by the State Administration of Foreign Exchanges (SAFE). Even though SAFE keeps \$50,000 annual quota for each individual retail consumer unchanged, purchasing U.S. dollar or any foreign currencies has become difficult and subject to rigorous screening. Chinese residents should fill complicated forms and state clearly why they purchase foreign currencies and when they will use them. False reporting may be subjected to a penalty equivalent to 30% of the transactions and of losing the \$50,000 quota for two years.

In fact, China has entered the trilemma of open macroeconomic policy — independent monetary policy, capital mobility, and a fixed exchange rate cannot be achieved simultaneously and any combination of two policy objectives implies the third is impossible. The trilemma is true, regardless of the size of an economy. As the second largest economy with more than \$10 trillion GDP, China cannot afford to lose the independence of monetary policy. A series of interest rate cuts since September 2014 and a recent cut on the required reserve ratio of commercial banks indicate that monetary policy remains an indispensable tool to stimulate the growth of the Chinese economy. On the other hand, the intervention of the PBoC in foreign exchange markets actually sterilized the monetary expansion induced by the decrease of interest rate.

Continuous interventions not only deplete foreign exchange reserve, more importantly weaken the autonomy of monetary policy. China's foreign exchange reserves have dropped almost \$1 trillion since PBoC started to reform the exchange rate regime in the summer of 2015. Actually, China had managed to maintain a handsome surplus in trade of goods and services. Adding the trade surplus to the top of the reduction in foreign exchange reserves, cumulative capital outflows from Aug. 2015 to Nov. 2016, amounted about \$1.67 trillion. No other country could afford such a huge capital outflow. The ratio of China's foreign exchange reserves to money supply M2 has fallen below 14%, much lower than the safe level 20% recommended by the International Monetary Fund. As the stock of the foreign exchange reserve gradually shrinks, the

ammunition that the PBoC can use to stabilize the exchange rate of the yuan will become less, which may further strengthen the belief that the PBoC would eventually give up its intervention, like all the central banks which attempted to defend fixed exchange rate regime during crisis but eventually ended up with sharp depreciation. It is highly likely that a one-time sharp depreciation of the yuan and continuous capital outflows might trigger financial turmoil and severely undermine the stability of the Chinese economy, which is the major risk of the Chinese economy in the short-term.

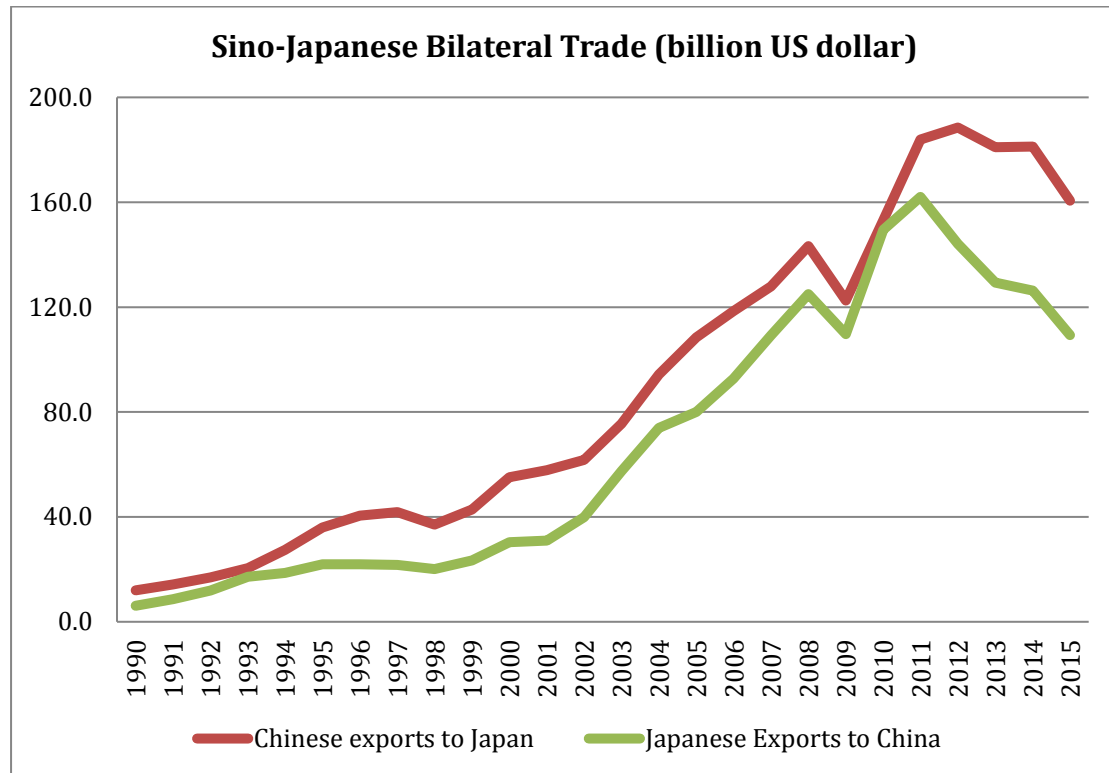
Chinese firms and households have accumulated enormous wealth after the high growth of last decades. They desire to diversify their asset portfolios and pursue investment opportunities abroad. The 4 trillion yuan stimulus led to overcapacity in manufacturing industry. For instance, China's total production capacity of steel in 2012 was 470 million tons, much higher than aggregated demand of 320 million tons; total production capacity of electrolytic aluminum of the country was 11 million tons, far exceeding the national demand of 7.2 million tons (Zhu, 2016). Facing with the overcapacity challenge, many Chinese manufacturing firms had looked for opportunities to expand abroad through mergers and acquisition or green field direct investment. In 2016, China's overseas investment totaled \$221 billion, more than doubled that in 2015. The overseas investment activities also facilitated capital outflows. That is why the Chinese government has re-centralized the approval of overseas investment from the beginning of 2017 to curb the tide of capital outflows.

#### **4. The Sino-Japanese Relations**

There is no doubt that a stable and prosperous Chinese economy benefits the growth of Japanese economy, which remains dependent on external demand, in particular as its population is aging and declining. In spite of political uncertainty, the economies of China and Japan have been closely integrated together through bilateral trade and capital flows, which has enhanced significantly the inter-dependence of the two countries. In 1990, the scale of Sino-Japan bilateral trade was relatively small and amounted \$18.1 billion. It rose drastically in the last two decades and in 2011 reached a record high of \$345.9 billion, more than 19 times of that in 1990. China's transition from a closed to an open economy and the unprecedented high growth of last three decades, has nurtured a new market with 1.4 billion population and more than \$8,000 GDP per capita, which has provided enormous growth potential to Japanese exporting

firms. Japanese firms have seen their exports to China rising exponentially. In 1990, Japan exported \$6.1 billion goods to China, about 2.1% of its total exports. By 2011, the annual volume surged more than 25 times and reached \$162 billion, accounted for 19.7% of Japanese exports to the world (Figure 6). As a result, Japan's exports to China in 2004 exceeded that to the U.S. for the first time. Since then, China has turned into the largest market of Japanese exports.

Figure 6



Source: Japan External Trade Organization

As a high-income country with more than 125 million population, Japan has been an indispensable market of Chinese exports. In 1990, China's export to Japan valued at \$12 billion. It continues to expand the market share in Japan. By 2012, the annual volume reached a record high of \$188.5 billion, about 9.2% of China's total exports to the world. Moreover, during the period of 1990 to 2015, China run trade surplus against Japan every year. The trade surplus increased substantially from \$5.9 billion to \$51.3 billion per year, contributing significantly to China's foreign exchange reserves.

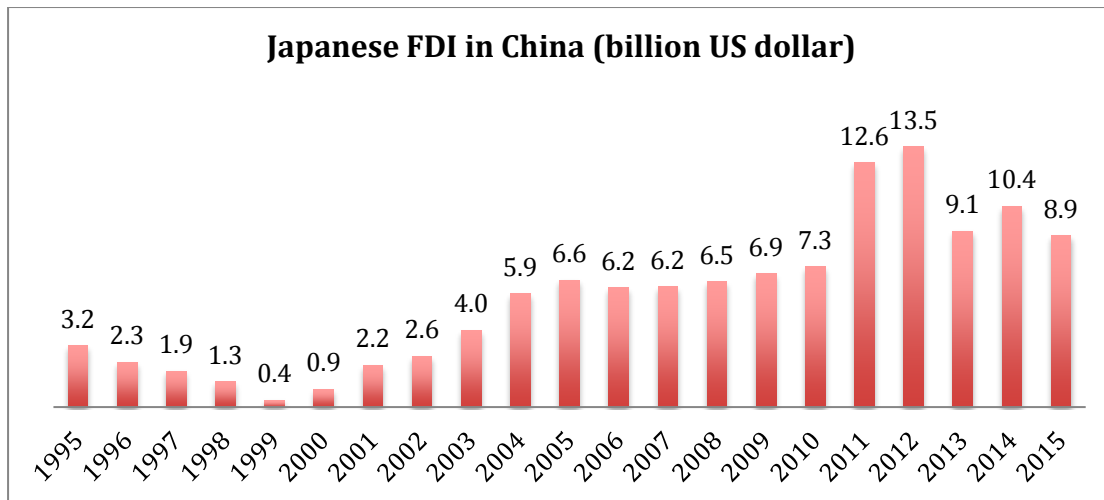
It is worthy to mention that more than half of China's exports to Japan belongs to processing exports, which has functioned as a vehicle for made-in-China products to enter the Japanese market. In 1993, processing exports accounted for 43% of China's

exports to Japan. As more and more Japanese MNEs relocated their assembly capacities into China or outsourced low value added tasks to Chinese firms, the share of processing exports in China's exports to Japan surged to 59% by 2005. Due to rising labor cost and the appreciation of the yuan, Chinese firms have gradually lost the competitiveness in low value added task—assembly. Therefore, the share of processing exports declined slightly in recent years, but remained as high as 51% in 2013 (Xing, 2016b).

The growth momentum of the Sino-Japan bilateral trade seems to discontinue in recent years. Japanese imports from China decreased to US\$160 billion in 2015, about 15% lower than in 2012. Meanwhile, Japanese exports to China also decreased substantially and dropped to \$109 billion in 2015, about one third lower than its peak \$162 billion in 2011 (figure 6). There are a few factors contributing to the contraction of the bilateral trade. First, the Japanese government's nationalization of Diaoyu/Senkaku islands triggered anti-Japanese demonstrations in China, which severely undermined the bilateral diplomatic relations, deteriorated the business environment, and enhanced the risk of Japanese firms doing business in China. Secondly, many Japanese affiliated firms in China had used China as an export platform. They imported intermediate inputs from Japan, and then used those imports to manufacture exports for Japanese markets. The activities of these firms contributed to the increase of the bilateral trade. Due to rising costs of labor and land in China, many Japanese firms have relocated their production facilities either back to Japan or third countries, resulting in the decrease of the bilateral trade (Xing, 2016c). Finally, the double-digit growth of the Chinese economy has ended. The Chinese economy has slowed down substantially since 2012 and weakened its demand for Japanese products.

Figure 7





Source: Japan External Trade Organization.

Foreign direct investment is another channel of integrating Chinese and Japanese economies. Japan is one of the largest capital-exporting countries. It holds about 335 trillion Yen overseas assets, the largest in the world. Excluding Hong Kong, Japan has been the largest FDI sources of China. In 1995, Japanese MNEs invested \$3.2 billion directly. The annual inflows surged to \$13.5 billion in 2012, making China the No.1 host of Japanese FDI in Asia (figure 7). According to JETRO, the stock of Japanese FDI in China totaled US\$104 billion by the end of 2014, much larger than that from the United States, or any European country.

Before 2005, most of Japanese firms mainly utilized China as an export platform. Japanese affiliated manufacturers exported most of their products to overseas markets. The shares of exports were particularly high in the sectors of electrical machinery and transportation equipment. In 1996, Japanese affiliated manufacturers of electrical machinery exported 78% of their products abroad while in transportation equipment overseas sales accounted for 84%. As Chinese economy grows and the income of Chinese households increases, Japanese affiliated firms have gradually raised their sales in Chinese local market and switched the focus from overseas to the domestic market. The share of overseas markets decreased steadily while local sales rose rapidly. By 2005, the share of exports of Japanese affiliated manufacturers as a whole decreased to 55%, and further fell to 31% in 2015. The transition of Japanese affiliates' operation in transportation equipment is the most dramatic. In 2015, they exported only 6% of

their products to overseas markets while sold the rest to Chinese consumers. Because of the sustained high growth, China has emerged as the largest automobile market in the world with an annual sale of more than 20 million units. Automobiles are embraced as a standard and necessary item of Chinese middle class families. The strong growth of China's automobile market fueled the shift of Japanese affiliates from export oriented to domestic market oriented. The successful transition of Japanese affiliates' operation strategy shows how foreign firms, which entered China for manufacturing exports at the early stage of China's development, could benefit both in the short and long run. In the short-run, they could take the advantage of cheap labor while in the long-run benefit from growing domestic market, as the income of Chinese households rises and their affordability and preferences of high-quality and big ticket items increase.

Chinese firms have accumulated massive capital after the high growth of more than three decades. They have started their overseas expansion by investing abroad directly. Investment flows between the two countries are no longer a one-way phenomenon. More and more Chinese companies have been searching investment opportunities and acquired Japanese companies. China's investment in Japan is purely driven by the hunger for strategic assets and intellectual properties, such as advanced technology, globally recognized brands and international distributional networks. Chinese M&A deals in Japan exceeded \$1.0 billion in 2015, up 34% over the previous year. Compared with U.S. and other industries, the scale of Chinese M&A in Japan remains relatively small. However, a few highly profiled deals concluded by Chinese companies imply an upward trend of Chinese investment in Japan (table 1).

Table 1 Chinese Firms' M&A in Japan

Year	Buyer	Target Company	Deal Size
2009	Sunning Appliance	Laox	800 million Yen for 27.36% shares
2010	Shangdong Ruyi	Renow	4 billion Yen for 41% stake
2010	BYD	Ogihara	Unknown
2011	Haier	Sanyo Electric	10 billion
2016	Lenova	NEC Lenovo Holding	\$195 million
2016	Midea	Toshiba Home Appliances	53.7 billion Yen

Source: various media reports.

In 2016, Midea, one of leading Chinese home appliance makers, acquired 80% stake of Toshiba Lifestyle Products & Service Corporation with 53.7 billion yen. Toshiba's technology and brand are the prime target of the deal. Through this deal, Midea has obtained the right to use "Toshiba" brand worldwide in white goods for forty years (Midea, 2016). Another Chinese home appliance maker Haier made a similar deal in 2011 by acquiring Sanyo Electronic with 10 Billion Japanese yen from Panasonic. The manufacturing facilities and distributors of Sanyo in South East Asia were transferred to Haier, thus significantly expanded Haier's distribution networks and visibility in the region. Sanyo's energy efficient refrigerator technology and the corresponding brand 'Aqua' were also transferred to Haier, which can use "Aqua" brand to market refrigerators both in Japan and overseas. Facing with stiff competition of Korea and Chinese electronic makers, Japanese electronic companies have gradually withdrawn from home appliance industry. Chinese companies' M&A of Japanese electronic companies are win-win deals. On the one hand, Chinese companies receive technologies and brands, which could strengthen their competitiveness and facilitate the global expansion. On the other hand, Japanese sellers can use the cash payment provided by Chinese buyers to improve balance sheets and restructure business operations. Another significant deal is China's PC giant Lenovo bought 44% stake of NEC in Lenovo-NEC joint venture for \$195 million. The deal will further strengthen Lenovo's leading position in Japanese PC market and support the growth of Lenova's core business.

The acquisitions of Midea and Haier target three properties: brands, technologies and distribution networks of Japanese firms. Lenovo's deal focuses on the well-established domestic distribution channel and the PC lab of NEC. There are some Chinese companies primarily concentrate on technologies of targeted Japanese firms. BYD, China's leading electric car maker, took over a factory from Ogihara Corp., a major Japanese metal die manufacturer, to produce high-precision metal dies for its Chinese factories. Higher-precision dies can improve the quality of auto bodies and other products. The acquisition would help BYD narrow the technical gap with Japanese and Western rivals.

Rising Chinese tourists to Japan represents another shining aspect of the economic integration between the countries. The third arrow of the Abenomics emphasizes the development of tourism industry to offset the shrinking Japanese domestic demand caused by ageing and declining population. In 2016, foreign visitors to Japan surged to 24.04 million, exceeding the 20 million target set by the Japanese government for 2020. 6.37 million Chinese tourists, more than a quarter of the total foreign visitors, visited Japan. It is first time that the number of Chinese tourists exceeded 6 million mark. It is estimated that the Chinese tourists spent 1.48 trillion yen about 40% of foreign visitors spending in Japan. On average, Chinese tourists spend more much than their peers from high-income countries (Japan Times, 2017). The influx of Chinese tourists and their extraordinary preferences to "made in Japan" products boosted the revenues of Japanese retail industry and hotels.

It is worthy to mention that, immediately after the Japanese government's nationalization of Diaoyu/Senkaku islands, many Chinese tour groups cancelled their planned trips to protest the nationalization and the number of Chinese tourists to Japan plunged sharply. In 2013, about 1.3 million Chinese visited Japan, about 10% less compared with the previous year. It seems that the negative impact of the territorial dispute on Chinese tourists to Japan has gone completely. Most of Chinese have rationally insulated their personal decisions from the diplomatic disputes of the two countries. On the contrary, Japanese tourists have been deeply affected by the violent anti-Japanese demonstrations erupted in China because of the nationalization of Diaoyu/Senkaku islands. Their perception about the risk of traveling in China has not

been changed much. According to the statistics of China National Tourisms Administration, the number of Japanese tourists to China dropped steadily every year after 2012. In 2015, Japanese tourist to China decreased to 2.49 million, more than one million less than in 2012. During the period, the total number of outbound Japanese tourists actually rose, implying that Japanese tourist have turned to be less favorable to visiting China. Compared with Chinese tourists, Japanese tourists are much more risk-averse and cautious. It remains an open question when the number of Japanese tourist could resume to the level before the nationalization of Diaoyu/Senkaku islands.

The economic integration between China and Japan through trade, investment and tourists, has been simply driven by the invisible hand. China and Japan have not started to negotiate a bilateral free trade agreement (FTA) yet. Except that both countries belong to the WTO, which entitles them to have the status of the most favor nations, there is no any other institutional arrangement to prompt the bilateral trade of the Sino-Japan. Even worse, political tensions and concerns of national security occasionally damage the progress of FTA negotiations where both China and Japan are involved, such as China, Japan and Korea FTA and Regional Comprehensive Economic Partnership (RCEP), which include 10 ASEAN countries plus China, Japan, Korea, Australia, New Zealand and India.

Japan had given the Trans-pacific Partnership (TPP) top priority in the agenda of regional cooperation. Unfortunately, on the day one at the Oval Office, President Trump officially signed an executive order to withdraw the TPP. Without the participation of the US, the largest economy in the world, the TPP would deteriorate to a minor FTA and “meaningless”, and be no different with many other trade deals in so called “FTA spaghetti bowl”. Trump’s rejection of TPP does not means that the Trump administration intends to weaken Japan-U.S. alliance and single Japan out for fixing the huge trade deficit of the U.S. It is just a beginning of a series of anti-globalization policies, which will be adopted by the Trump administration. China and Japan are one of the largest beneficiaries of the unprecedented globalization of last decades. The economic structures of both economies suggest that they remain highly dependent on exports. It is at the best interests of the two countries, at least in terms of economic welfare, that the countries could cooperate together and jointly defend and lead trade liberalization and economic integration in Asia-Pacific region. Geopolitical concerns

and territorial disputes often hurdle close economic cooperation between the two countries. If the leaders of the two countries could rationally isolate economic matters with national security issues to a certain degree, both countries will surely benefit from further the close economic cooperation. Any forms of regional economic cooperation require active and positive participation of both countries. If China and Japan cannot worker together, both countries will lose and there will be no Asia century.

## **5. Concluding Remarks**

Consumption, investment and exports had supported the rapid growth of the Chinese economy. Now the pillar of exports collapsed completely as its growth turned to negative. Rebalancing Chinese economy from export-oriented to consumption oriented has been called repeatedly by both scholars and policy makers. However, it is easy said than done. The rebalancing requires drastic changes of the economic structure, which cannot be completed in the short-run. As more and more MNEs continues to relocate their production capacities back to home or third countries, Chinese exports will continue to fall unless its currency depreciates sharply.

Chinese yuan has depreciated against the US dollar more than 10% since the summer of 2015. As the U.S. continues to raise interest rates, it is expected that the yuan will depreciate further. The persistent depreciation has caused anxiety in China and triggered massive capital outflows. China may face a financial crisis if it cannot manage the consequence of yuan's excess depreciation and rapid depletion of foreign exchange reserves.

Both China and Japan achieved their economic miracles by adopting export-oriented strategy. These two countries have benefited considerably from the unprecedented trade liberalization and globalization. With the Trump administration, the progress of trade liberalization and globalization is highly likely to be interrupted, or even reversed. The two countries should work together and jointly take the leadership to promote regional economic integration and defend the global trading system. Both countries and the whole Asia pacific region will benefit from the close cooperation of the two countries.

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