

The Japan-China Relationship and Its Importance to Australia and the Region

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There have been a number of encouraging developments in the bilateral relationship between China and Japan over the past year. Chinese Premier Wen Jiabao's visit to Tokyo last April for talks with his Japanese counterpart, Shinzo Abe, greatly eased the more immediate difficulties in political relations between these two giant neighbours in Asia. The agenda for economic and other cooperation on which the two Prime Ministers agreed was also a huge step forward in re-establishing a positive tone in the relationship. In December Prime Minister Fukuda's visit to Beijing set a new, positive tone in the relationship despite unresolved territorial and other issues. The expectations for President Hu Jintao's visit to Japan in the northern spring are high.

In this paper I focus on longer term issues in the relationship and order the argument around two questions. Do the encouraging developments in recent times reflect strategic reassessment of bilateral interests on both sides of the relationship? What structural factors define where the relationship might head and how it must impact on East Asian and global affairs? An underlying question is how do the politics of the relationship between Japan and China impact upon the economics of the relationship and how do the economics shape the politics of the relationship?.

It may seem strange that an Australian should presume to comment on affairs between China and Japan, but the message here is that third countries, Australia prominently among them, are now so deeply affected by the relationship between the two big East Asian powers that they have an important strategic interest in assessing where it might head in the longer term.

Background

China's sheer size, even when it was a weak and small economy, established its place as a major political player under the communist government in the post war period.

The commitment to modernisation at the end of the 1970s saw rapid growth of the Chinese economy and its integration into the regional and international economy, so that China is the second largest economy in East Asia, measured in current exchange rate terms, and already the world's third largest trading nation.

This transformation in China's economic status through sustained, rapid economic growth in the reform era, and China's new political circumstance at the end of the Cold War present a challenge to the international economic and political systems and to the major powers as they accommodate, and respond to, China's rise as an economic and political power (Drysdale, 1988). Perhaps nowhere is this challenge more intense, yet less resolved, than in China's large industrial country neighbour, Japan.

True, though it has been growing incredibly rapidly, China is at an early stage of its economic development. Perhaps on some assessments its established power and the trajectory of the growth of its power are over-estimated, although Segal (1999) among others miscalculates in the opposite direction. But there is little reason to believe that China's capacity to 'catch up' economically will diminish greatly over the next two decades, nor that it will not sustain a rate of economic growth — not necessarily consistently but on average — much higher than most of the big industrial countries, including Japan and the United States, and continue to become a steadily more important element in the world economy and the world trade. In the longer term that trend will change because of demographic and other factors, but not over the next two decades.

With ten times the population of Japan, the Chinese economy will overtake the Japanese economy in terms of size, if not sophistication, once China's per capita GDP reaches one tenth of Japanese per capita GDP. With five times the population of the United States, China will overtake the United States once its per capita GDP is one fifth the per capita GDP in America. This is the simple arithmetic. The first goal will probably be achieved in the next decade or so, even if incomes are measured in terms of current exchange rates. What is less widely understood, is that measured in purchasing power parity terms, China is already a bigger economy in aggregate terms than is Japan.

On quite conservative projections, the growth of China's trade will see it emerge as a more and more important market for its East Asian and global partners, including Japan. Last year, China displaced the United States as Japan's largest import supplier. China is already Japan's second largest export market after the United States, only by a smidgen if Hong Kong is included. By 2006, China had displaced Japan as the world's third largest exporter, and is now ranks only after Germany and the United States as a global trader.

Transformation of relative economic power

Measured in purchasing power parity (PPP) terms, even with the recent downward adjustment of Chinese real output released by ADB (ADB, 2007b), Asia's share of global GDP will amount to around 23 per cent in 2020, of which China alone will account for over 14 percentage points.¹ This is more than both North America (21.6 per cent) and the EU (22.4 per cent). And China will hold almost double the share of world output that Japan is projected to hold in that year (see Figure 1).

The scale and weight of income growth in Asia, of itself, will have a huge impact on trade in goods and services both globally and within the region. The income growth projected here could not be sustained without continuing to maintain the openness to international trade and private capital flows that has helped to drive successful growth in the past. Increased incomes in the Asian economy will lift the importance of Asian trade in world trade; the Asian share in every country's international trade will grow, on average, commensurately with Asia's growth in world trade share. For some economic partners, such as the Asian economies (including Australia²) themselves, proximity to the region and the complementarity of their economic and trade structures will intensify intra-regional trade and investment ties as Asia experiences deeper integration with global markets.

¹ These projections suggest that China and India will have an impact on the world economy substantially larger than that projected in the World Bank Report *Dancing with Giants*, where more conservative growth rates were assumed at constant prices to initial output shares. The case for using PPP data rather than initial market exchange rate data to project the future structure of world output rests on the likelihood that substantial exchange rate appreciations in rapidly growing economies (such as China) will more accurately reflect their weight in the world economy 15 years hence (Winters, 2006: 5, fn 7).

² Australia is the most Asia-oriented economy defined in the world in terms of its trade share going to, and derived from, Asian economies. In the projections reported here, East Asia includes Australasia.

Figure 1 Projected World Output Shares at Purchasing Power Parity, per cent

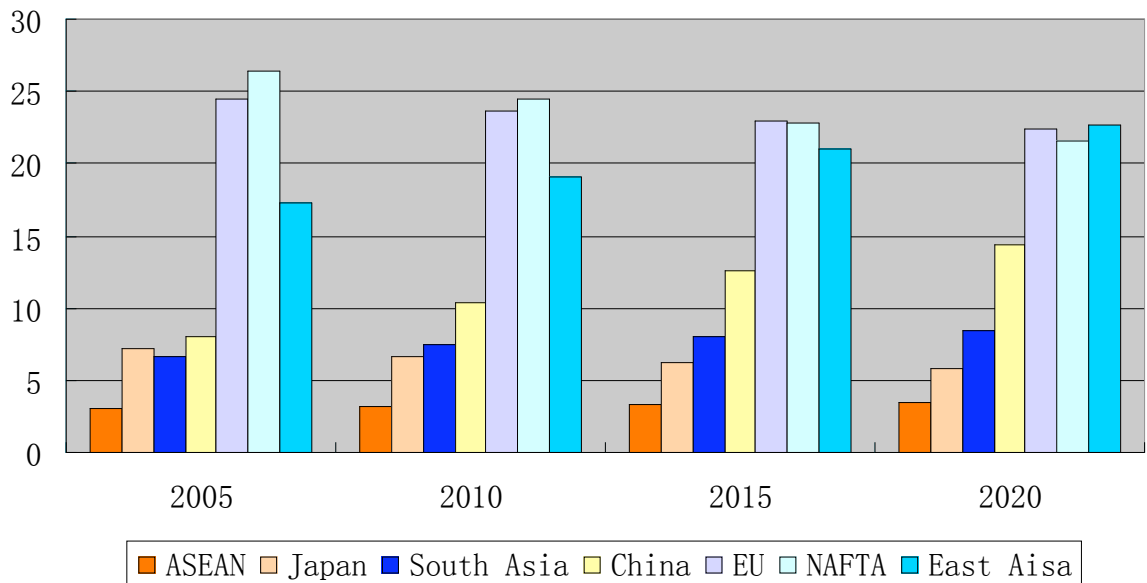
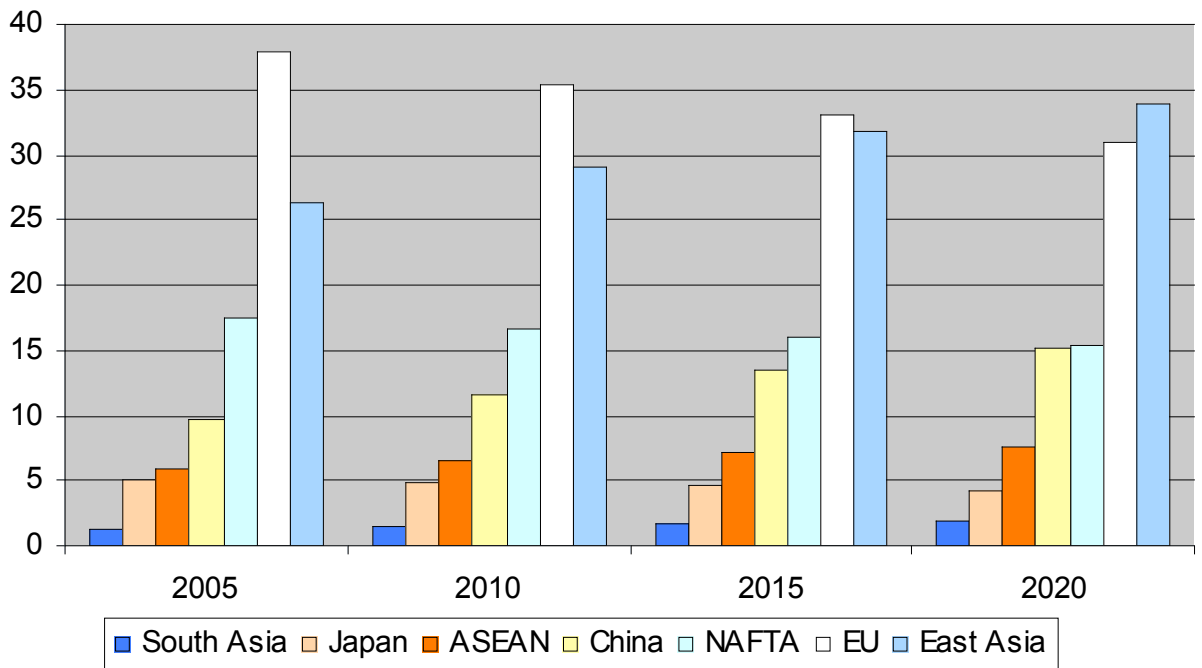


Figure 1 Projected World Trade Shares by Region, per cent



The projections I have developed here – based on conservative Asian GDP and trade growth rates, and incorporating a contraction of the US current account deficit and the effects of a tax on trade in carbon generating products – lead to an Asian share of world trade of 36 per cent compared with a North American share of 15 per cent in 2020. East

Asia's share of world trade, under these assumptions, is 34 per cent, larger than that of North America and even Western Europe (see Figure 3). China's is close to 15 per cent – more if China's trade is measured to include Hong Kong net of intra-Hong Kong–China trade.

Looking ahead in this way highlights the potential of the China economic relationship for Japan. It also underscores the huge shift in relative economic power that is taking place between Japan and China.

Importance of China to Japan

The growth and opening up of the Chinese economy has been of more importance to Japan, given the role of geography and the underlying structure of resource endowments in the relationship, than to any other country except, perhaps, the United States. The expansion of trade and, more recently, investment has established a new level of economic interdependence between the two countries that has grown well beyond the bilateral arrangement with which it began, into a relationship of regional and global significance. Business between Japan and China is booming and when Japanese business leaders are asked to identify their most prospective markets and investment opportunities, China is usually nominated as number one.

Despite the burden of the history of Japanese imperialism in the interwar and wartime years, and perhaps in part because of it, there remains a significant reservoir of sentiment in Japan that is deeply supportive of China's modernisation ambitions and conscious of the debts in history and culture that the Japanese nation owes to China (Kobayashi, 2006). This has been a significant and positive element in Japan's relationship with China.

Yet although the China–Japan economic relationship is large and full of promise, and there are these ties of sentiment, there is an underlying unease in the relationship between the two countries – an unease which in less cautious moments I have described as bordering on schizophrenia.

Both countries are trying to achieve a more secure position in the post-Cold War world and there is still uncertainty about whether this might set them on a collision

course. Japan's security anxieties, after the collapse of the Soviet Union and with the rapid economic rise of China, encouraged the re-invigoration of US–Japan security arrangements. China is watching American intentions and the new tone in US–Japan security arrangements. The fulcrum of these strategic tensions lies in relations between Beijing and Taipei but there are other and perhaps more fundamental irritants in the relationship as well (Drysdale and Zhang, 2001). Whether the history of strategic rivalry between Japan and China will be renewed hinges, of course, on broader strategic relationships, in which the United States will play a crucial role.

Such are the economic and strategic circumstances which confront Beijing and Tokyo at the beginning of the twenty first century. The challenge will be to develop a political relationship in which these economic and strategic interests can be balanced. The argument I make suggests that the way to successful management of these interests in the relationship lies in the structure of the regional and global arrangements in which they might be embedded over the coming decades.

New pattern in bilateral relations

In short, a new paradox has emerged in relations between China and Japan. While economic relations are booming, political and strategic differences are widening. There were clashes, for example, over the revival of the US-Japan security treaty, over relations across the Straits of Taiwan, over territorial claims in the East China Sea, and over resolution of the problem of the Korean peninsula. None of these issues has itself disturbed the fundamental interests in the relationship, but underneath the surface there is ongoing questioning about where the bilateral relationship might be headed (Drysdale and Zhang, 2001).

The problem lies in the wariness in Tokyo and Beijing each of the other's emerging strategic interests. The nature of these tensions is familiar. Koizumi's stance on visiting Yasukuni shrine earlier put paid to getting the relationship back on track despite signs that the new leadership in Beijing might have wished to, until Abe assumed the prime ministership in Japan.

Both sides now are making every effort to overcome, or avoid through strategic ambiguity, the difficulties of the past and to put new strength into bilateral ties. Some

(Curtis, 2007) now talk of the relationship enjoying something of a honeymoon phase. The question is not whether the honeymoon will end but whether its end ushers in a period of stability and strategic cooperation between Asia's dominant economic power and its fastest growing one, or whether there will be a return to the bickering of the past several years, or worse and how that might affect development of the East Asian economy.

The outcome is crucial to Australian interests in its relationships with both countries as well as East Asian economic cooperation and security affairs.

The economic relationship

While political relations between Japan and China may be problematic, reform, deregulation and growth of the Chinese economy and the complementarity of the Chinese economy with Japan's industrial, financial and technological capability have driven the economic relationship to new heights (Kojima, 2006). Bilateral trade has grown enormously, rising from US\$5 billion in 1978 to US\$211 billion in 2006. Last year two-way trade exceeded a quarter of a billion US dollars, one of the biggest bilateral trade flows in the world. Japanese investment in China has reached US\$58 billion in over 30,000 projects creating more than 10 million Chinese jobs. These aggregate statistics reflect a myriad of bilateral economic activities ranging from large private and official lending to direct investment, joint ventures, technology licensing arrangements and technical cooperation that underpin a huge economic relationship (Armstrong, 2007a). And Japan owes its own economic recovery over the past six years to the Chinese boom, as much as to any other single factor. The successful relocation of uncompetitive Japanese industrial capacity to China is a major element in the continued growth in the competitiveness of the Japanese economy.

In 2006, Japan was China's third biggest export market, after the United States and Hong Kong. Japan's exports to China (including net trade with Hong Kong), at 20 per cent of Japan's total exports, were just under those to the United States, at 22 per cent (ANU, International Economic Data Base). The economic agenda has come to dominate dealings between the two governments, and much progress has been made in improving access to one another's markets, not least because of China's successful accession to the WTO and the reforms and market-opening measures that have

accompanied it. The China–Japan relationship rapidly became embedded in China’s broader links with the Asia Pacific and international economies as China became a central force in the intensification of highly specialized intra-industry and intra-regional trade and an engine of broader East Asian growth.

Growing regional economic interdependence led Japan and China to look to regional forums, such as the Asia Pacific Economic Cooperation (APEC) process, as a means of dealing with economic problems that increasingly extended beyond bilateral boundaries and required regional and multilateral solutions. They sometimes also provided a useful place to hold bilateral meetings and resolve bilateral issues without loss of face. The East Asian economic crisis was another reminder of how closely linked the economies of East Asia and the Pacific have become and led to renewed interest in strengthened regional, beyond bilateral, arrangements and consultations, notably in the formation of the ASEAN + 3 forum.

Sensitivities in the political relationship affect some aspects of Japan’s economic relationship with China more than others (Armstrong, 2007a). 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. 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 compatible with a *cold* political relationship.

But Japanese business dealings with the Chinese government are another matter. High political relations are important infrastructure for bilateral dealings that involve government, and many do. Few 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 still a top down process, though this is gradually changing. Japan's lack of access to top level policy makers in China hurts the interests of Japanese business.

China's accession to the WTO in December 2001 marked an important turning point in China's integration into the world economy (Drysedale and Song, 2000). The recognition by major industrial countries of the new legal status of trading with China not only provided more security for China in international markets but also for foreign business in Chinese markets. 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.

Some in Japan are pursuing the idea of an Economic Partnership Agreement (EPA) with China. This would supersede and include the idea of a Free Trade Agreement on goods trade. Both sides concede this is a long term goal but its consideration could get them 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

Dynamic strategic context

The strategic context in which Japan and China now have to shape their political relations has changed dramatically since the end of the Cold War. The international environment is more fluid and foreign policy choices are more complex.

The Cold War period was characterised by a stable alliance framework. Within that framework policymakers had a clear vision of national interests and priorities. Strategic friends and enemies were clearly identifiable; policies generally commanded domestic support. In the Cold War period strategic rivalry between the United States and the former Soviet Union divided the world and national security became the

overarching concern. This framework also shaped the international economy. Trade friction among allies, such as between the United States and Japan, or the challenge of the rise of new economic powers, such as Japan and Germany, was subsumed and subdued within the alliance framework.

Despite the ‘war on terror’, this system no longer exists and no similarly stable system has yet replaced it. In the post–Cold War period, friends and enemies are not clearly identifiable. The erosion of American influence and authority complicates the strategic environment vastly. Strategic and economic interests compete for attention. And the rise of new economic powers, like China, is not automatically accommodated within the structure of established security relations.

Nowhere is this seen more clearly than in the evolution of relations between China and Japan over the last decade.

China’s rise is a challenge for such established powers as Japan and the United States, as they contemplate the strategic and military implications of China’s economic potential. This was the genesis of the revival of the US–Japan security treaty. But it is not at all clear that this can be the end-point in the evolving East Asia security architecture, given the growing depth of the economic relationship between Japan and China and China and the other economies in East Asia, though some in America think that it is.

China itself has the challenge of coming to terms with its new status in this system. While it complains about American hegemony and interference, the Chinese leadership clearly understands that the current international system is of enormous benefit to China economically. Moreover, modernisation for some in China is not merely an economic goal, but a political and social goal. A key question for China, therefore, is how to respond to developments (like the renewal of the US–Japan security treaty) in a way that avoids its becoming a primary target in a new alliance structure rather than a full partner in ongoing regional and global political and economic affairs.

There are basically three alternatives we might contemplate in the international political and security system: hegemonic power and order, the re-emergence of power balance, or the construction on a new concord of powers in Asian and Pacific affairs. However much we hanker for it, hegemonic power is in disarray. Any system that relies on power balance alone in the Asia Pacific theatre is likely to see Japan (and for that matter Australia) straddled between its two most important relationships in the region – with China and the United States. And, to be brief, there is no clear focus on constructing an effective and durable concord of powers in our region.

The challenge for China

China has enjoyed some notable successes in managing tough calls in foreign economic diplomacy over the past few years. Examples include the articulation of the response to the East Asia crisis (holding the nominal value of the renminbi to the US dollar and undertaking large scale fiscal expansion). The establishment of ASEAN + 3 was another success. Hardly less so was Zhu Rongji's footwork in the United States when he met with President Clinton's ill judged rebuff on the terms of accession to the WTO in April 1999, and eventual success in accession to the WTO in December, 2001. And the ASEAN + 1 initiative, which saw China assume the lead in regional trade negotiations and political positioning in Southeast Asia, caught Tokyo totally off guard. The capacity for strategic thinking and positioning perhaps comes more naturally from Beijing, than from other East Asian capitals.

But China also faces a handicap in reading correctly the intentions of its major partners, including Japan. The handicap is partly a product of the political system through which the Chinese leadership rose to power and a political culture in which foreign policymaking is a highly centralised process. Difficulty in reading Japanese intentions, of course, also lies in part with the ambiguities of language that Japan has used in describing the invasion of China or the coverage of US–Japan security arrangements — ambiguities which reinforce Chinese suspicions of Japan. Indeed, language is a more fundamental problem in the relationship – as China speaks forcefully and directly in expressing its views and aspirations while Japan speaks with a muffled voice. But Chinese leaders are inclined to view all voices in Japan as having official sanction, without regard for the role of a free media in a pluralistic

political system, a tendency which confuses management of bilateral relations with Japan and other industrial democracies.

China's reform has made its society more open and pluralistic, though fundamental change in the political system, while on the agenda of political ideas, is yet to be tackled directly. Differences of view are making themselves heard, even on foreign policy issues. The internet is a potent instrument of public expression in this area. On China–United States relations, China's accession to the WTO, relations with Taiwan, the dispute over the Diaoyu or Senkaku islands, Japan's compensation for wartime comfort women or labourers — there is a stronger public voice over which government scrutiny and guidance has rather less control. An open society in China would not necessarily make management of the relationship with Japan less troublesome – though managing the process of public participation in policymaking is still a difficult task for China's leadership to handle.

Japanese dilemmas

Japan's dilemmas in dealing with China relate to two major risks associated with China's economic rise upon which most that is positive in the relationship hangs.

The first risk is that the strains of rapid growth might tear apart political and social systems and expose Japan to a neighbour that is unpredictable and a major source of regional political instability — in the form of a flood of refugees and a power vacuum in the region similar to that which occurred in the first half of the twentieth century. The potential for systemic failure in China is evident in the vulnerability in the relationship between the political system and private wealth through corruption, of state-owned enterprises and banking system to collapse, in a rising gap between urban and rural populations and between coastal and inland provinces, and from the pressures for change in the political system as the private economy becomes more prominent. It is a race against time for China's leaders to reform state-owned enterprises, the banking and financial systems and the social security network for the unemployed and the retired, to make government more transparent and accountable, and develop a political system that is in tune with economic change. This is why Chinese political reform is so important. Japan's interest is to help China succeed in this task and avoid the risk of system collapse.

The second risk is that success in development could lead to a stronger but also more assertive China. This could re-ignite the deep strategic rivalry between the two countries of the last hundred years. Japan's modernisation was, in significant measure, at China's expense — the defeat of China in Korea and Northeast China a hundred years ago, invasion through to the end of the Second World War, colonisation of Taiwan — and the costs to China of Japan's aggression in the pursuit of modernisation are deeply ingrained in Chinese memory. That is why it is so difficult for China to accept Japan as a normal political power and so difficult for Japan to accept China as an equal power. That is also why the establishment of some kind of concord in political and security affairs in Asia and the Pacific is so important.

China's rise paradoxically also challenges Japan's relations with the United States. A harbinger of this problem emerged in Japanese fears about the implications of President Clinton's visiting China in 1998 without stopping over in Japan. In modern times, Japan has always sought to ally itself with the strongest global power — Great Britain before 1923, and the United States after 1945. This alliance strategy has helped Japan play the role of the East Asian power. Only from the late 1920s to the mid 1940s, when Great Britain was declining and America was yet to come to terms with its status as a great power, did Japan seek to dominate East Asia exclusive of other powers. The disaster of defeat reinforced in Japanese thinking after the war the importance of alliance with global powers. It will clearly take China a while before it reaches great power status equal to that of the United States. But before this eventuates, there will have to be a fundamental adjustment in Japanese political and strategic relations with America. Misjudging and mishandling this adjustment could be very costly and destabilizing to Japan, the East Asian region and the world.

Japan's China policy treads a fine line between preventing China from collapsing and preventing it from growing too strong and assertive.

Japan has moved to strengthen security ties with the United States. The trilateral security arrangements with Australia are an element, however they are described, in the same strategy. But what is the next step?

The multilateral framework

As the two largest economies in East Asia and the second and third largest in the world (measured in terms of real purchasing power), what Japan and China do has significant impact on regional and world affairs. In the East Asian crisis, China's foreign exchange rate and macroeconomic policy choices were critical to neighbouring economies. The initiative of China and Japan, together with Korea, in setting up ASEAN + 3 potentially changed the whole architecture of regional cooperation in East Asia. Japan's economic malaise was a substantial problem, and its recovery is now a substantial benefit, for the regional and world economy. China's and Japan's economic prospects are central to the prospects of all the Asia Pacific economies and they are a central element in the fortunes of the global economic system (Imai, 2004).

The regional and global impact of the China–Japan relationship, like that of China's relations with the United States and other countries, recommends its management within regional and global frameworks and institutions, such as APEC, the Asian Regional Forum (ARF), ASEAN + 3, the East Asian Summit process, or perhaps an ongoing and extended version of the six party talks framework on a regional level, and the WTO or the United Nations, on a global level, where problems can be dealt with consistently with multilateral interests and tension in bilateral relations diffused. That is why a deal with China on United Nations reform and Japanese permanent participation in the Security Council could be so productive.

The APEC framework and its core agenda of open regionalism (of which Japan was a leading architect) has been important to successful management of the evolving economic and political relationships between China and the other major powers in Asia and the Pacific as well as to harmonious relations between the smaller economies and major players in the region, including Japan and the United States.

China's (and East Asia's) best choice remains the global choice and a regional framework which is structured to deliver on global objectives. That is why closure on China's accession to the WTO was so important.

The limitation of exclusive, discriminatory arrangements in East Asia is important to China's ability, for example, to manage the development of its relationships within East Asia, of course with Taiwan, but also with Korea, Japan, ASEAN and the Indochinese economies. Asymmetry in China's relations with its neighbours has the potential to bedevil them unless they are part of an open trade and economic system globally. China's involvement in any tight arrangement exclusively linked to East Asian economies, including Japan, presents economic and political difficulties because of both the perception and the reality of asymmetry between China and its partners in the region. China is already a big economy and a big power and will have more comfortable relationships with other major powers and with smaller economies and polities, the more open these relations are. That does not mean that an East Asian framework (the ASEAN + 3 and the East Asian Summit process) will not be important to these broader relationships. Indeed, an East Asian framework can greatly strengthen both China's and Japan's dealings with North America and Europe, providing leverage on trans-Pacific issues and in global forums of value to both countries and their partners in East Asia.

APEC has been of particular value to China in the pursuit and projection of its interests in the global system. The East Asian processes need to complement rather than compete with these trans-regional arrangements.

In search of common ground

Japan and China have much common ground in regional and international economic affairs. But there are also other areas in which shared interests could grow.

An area of central interest is energy security including its regional and global environmental dimensions. The next twenty years is likely to see the most rapid growth ever in the global economy, largely centred on China and India. That will make the establishment of an effective international regime for greenhouse emissions more urgent, even than is recognized by the global warning pessimists, and heightens Chinese and Japanese interests in cooperation in putting in place a post Kyoto regime that takes account of both developed and developing country needs.

Another area of shared interests and political cooperation is in seeking stability on the Korean peninsula and the approach to opening North Korea's isolated economy and society. But if Japan is to resume a leadership role on this issue, there will need to be some impressive domestic political acrobatics brought into play. And there are shared interests in making security arrangements more transparent in Northeast Asia the extension of security dialogues and military exchanges including among the United States, Japan and China.

The triangular relationship between Japan, the United States and Australia has the objective of strengthening security arrangements in the face of China's rising power. But it also carries the danger of psychologically and politically isolating China. In the context of trying to construct a concord of powers in Asia and the Pacific, it might be sensible for Japan to build overlapping triangular regional political and security dialogues (say between Japan, China and Australia) that intersect effectively with its relationships with America. Such overlapping security dialogues and arrangements at least have the potential to ameliorate the entrenchment of instability in power relations in East Asia. That is why the high level security dialogues that are just now being launched between Australia and China have such potential.

Shared economic interests between China and Japan have the potential to grow stronger. China broke new ground in joining the ASEAN + 3 consultations on developments in the East Asian economy, persuaded of a need for more sub-regional coordination of trade, financial, monetary and exchange rate policies in the aftermath of the East Asian crisis. The need to accommodate China, and also to limit it, is evident in Japan's ill-judged push for control over the agenda on regional currency arrangements – yet this too is an area of potential future cooperation. These agendas are at once intensely sub-regional but can also be carried forward in the trans-regional APEC process with North America.

Conclusion

The relationship between Japan and China is a relationship that has expanded enormously in the last two decades, significantly because of deeper and broader economic ties. It is a relationship the politics of which have also become considerably more complex. While the relationship has grown in importance and

complexity, it has also had some striking ups and downs. Assessment of its future is invariably conditioned by its present. Few identified much positive in the relationship immediately after Tianamen. When Japan was first to lift sanctions against China, many exaggerated Japan's willingness to compromise with China. Others hailed a new era after Emperor Akihito's visit to China. But relations took a sharp turn for the worse when the United States dispatched aircraft carriers from their Japanese base in 1997 to deter China's manoeuvres around Taiwan at the height of the Taiwan Straits crisis. When the relationship suffered a six year period of doldrums under Prime Minister Koizumi, many exaggerated the impact on economic ties.

How can one assess the interaction between the politics and the economics of the relationship?

One way is to measure potential trade, given the fundamental economic characteristics of the economy such as the size of their GDP, their structure and their location in the international economy. This can be done econometrically and fairly precisely and used as a benchmark whereby to assess whether the politics significantly or unusually affects the achievement of trade potential (Armstrong, 2007c). When we do we find that Chinese exports to Japan are about 60 per cent of potential, up from 49 per cent two decades earlier, whereas China's exports to the world are around 59 per cent of their potential, and to other East Asia around 64 per cent. Japanese exports to China are around 56 per cent, up from 50 per cent two decades earlier whereas Japan's exports to world are around 51 per cent of potential, to US, 61 per cent, and to ASEAN 64 per cent.

In short, the bilateral economic relationship is little disturbed by the vagaries of bilateral political relations and, rather, overwhelmingly determined within the framework of global economic commitments and arrangements in the international markets in which both countries are deeply embedded.

Another way of measuring the impact of politics on trade and trade on politics is to analyze the relationship between political events (negative and positive) and variations in trade flows (Armstrong, 2007d). These relationships can run either way,

but the most powerful association in the Japan–China relationship is for trade growth to have a positive impact of political relations.

Japan's China policy has been subject to a variety of domestic pressures, although bureaucrats and top political leaders kept the field for their own until quite recently. China's Japan policy has become subject to wider influence with economic reform and the opening up of the Chinese economy.

I have emphasized the way in which these structural changes have influenced the strategic interests in the economic relationship between China and Japan. More decentralized economic decision making in China has permanently changed the character of bilateral economic relations. Barring significant external shocks, or internal shocks in China, these trends are inexorably transforming the strategic interests that both countries will come to have in the relationship and how it might serve both their regional and global objectives. A key element in this will be America's re-definition of its role in the world and its ability to accommodate the rise of Chinese economic and political power, and the way in which Japan works with both America and China in this context.

Is an Economic Partnership Agreement between Japan and China a prospect over the next decade or two? The answer might well be 'yes', but this would be a positive outcome only if such an agreement were a centerpiece in both countries' commitments to global openness.

Is it possible over that same period that China and Japan might become partners in a significant security arrangement? Again, improbable though it may seem, the answer might well be 'yes' but such an arrangement is only likely to enhance regional stability if it encompasses the interests of other regional powers, including America.

These may appear optimistic suggestions. They are not ideas that have been evident in thinking about the relationship over the past several years. My analysis is neither optimistic nor pessimistic about the future of relations between Japan and China. But it does reflect a hard-headed look at how the depth of the economic relationship seems

likely to constrain its politics in the future. This will have important impacts on Australia and on regional and global systems.

This year is the thirtieth anniversary of the Long Term Trade Agreement of 1978 that launched the opening of modern economic relations between Japan and China. It is an agreement that is entirely irrelevant to the conduct of the economic relationship today. So the time is ripe for change and a new agreement between the two countries appropriate to meeting the national interests of each of them and those of their regional neighbours and the major global players in a world that has changed vastly over the last three decades and will change even more over the next three.

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