

Chapter 2 Advancing globalization will transform China into the “market of the world”

[Key Points]

1. China is increasing its role in the world economy, mainly as a production base that takes advantage of its plentiful labor force. China is likely to increase its share of world's imports to the order of 7% by 2010, and become a major market for final consumer goods.
2. China's remarkable economic growth achieved in recent years is the result of its globalization pursued under the reform and open market policy. Since joining the World Trade Organization (WTO), China has opened its domestic market and attracted more foreign investment, leading to further expansion of the Chinese market. Furthermore, China is now poised to expand into the markets of the neighboring Asian nations by concluding free trade agreements (FTAs).
3. Japan and China are at very different stages of development, and they are likely to achieve a win-win situation if they cooperate with each other. China's rapid progress will prove to be favorable to Japan if the two nations can complement each other through trade. To fully realize this complementary relationship Japan and China should bring down existing trade barriers by means of an FTA and other means.

1. Accession to WTO, promotion of FTAs, and globalization of the Chinese economy

Under the reform and open market policy put in place in the late 1970s, China has deepened its ties with the world economy step by step. This trend has accelerated following its accession to the WTO in December 2001. Through such process, China's domestic markets have been basically opened under international rules. Foreign companies have entered retail, financial and other service markets that had so far been protected by all kinds of regulations, and competition with Chinese firms has helped created new demand. The participation by these foreign firms have created jobs, increased income, and expanded the consumer market. On the back of new business areas being opened and rising consumption demand, foreign firms are now focusing more on marketing and sales in the local market than using China an offshore production base. New products targeted at the Chinese market launched by foreign automakers and consumer electronics industries are creating new demand. Furthermore, the Chinese government is working for closer economic

relationships with its neighboring nations, and has aggressively embarked on the conclusion of FTAs as a strategy to access their markets. In the FTA with ASEAN nations in particular, China has advanced the lifting of trade barriers on agricultural products, contributing to the market expansion of agricultural products on both sides. Such rapid progress in globalization has intensified competition, which in turn has led to large-scale corporate restructuring. However, the Chinese economy has gained vitality in this process, which in turn has provided new business opportunities for Japanese firms.

1.1 Accession to the WTO invites foreign capital and leads to greater consumption

The entry into the WTO had been China's fifteen-year-long aspiration. Since its shift to the reform and open-market policy in 1978, China has been pursuing a market economy, globalization, and the creation of a legal framework. Such process, though, has been moving forward little by little and step by step, and domestic markets, notably markets for service, opened to foreign companies were strictly controlled and regulated even in the late 1990s. In the process of WTO accession, however, all domestic markets were basically opened to foreign capital, and the legal system including investment rules was also modified in accordance with international norms. Trade barriers including import duties have been substantially reduced, and many more sectors have become accessible to foreign capital including the retail and financial markets. The accession to the WTO not only has made China open its door to foreign capital but has also enabled Chinese firms to aggressively increase exports to the world market using as a weapon their price competitiveness in labor-intensive industries, and to cooperate with foreign companies investing in China in the form of joint ventures. Thus, the Chinese market is becoming increasingly integrated into the world market.

Under an open market system, competition works to promote efficiency and speed up reform of the legal system. However, it was widely believed that, although over the medium-to-long term China could expect the fruits of the reform and open market policy, for the first two to three years following WTO accession it would see imports grow so fast that many enterprises, principally state-owned firms, would go bankrupt and agriculture would follow a course of decline. Such process would lead to increased unemployment and falling income among farmers, and to a shrinking consumer market; consequently, it would render the Chinese market unattractive to foreign capital. In retrospect, however, people in China have come to realize how the reform and open market policy has improved the economic system and stimulated economic growth. Now most people evaluate the entry into the WTO as "very positive." In fact, after becoming a WTO member, the Chinese economy has remained robust, though somewhat overheated. The speed of reform and market opening has accelerated, and China's market environment has improved thanks to the

progress made toward the establishment of the rule of law.

After the 8.3% growth of 2002, China continued to grow as fast as 9.3% in 2003 and 9.5% in 2004 on a solid growth trend. China's overall foreign trade for 2004 totaled \$1.15 trillion, replacing Japan to become the world's third biggest trading country. Furthermore, in 2004, China received direct foreign investment of an all-time high of \$60.6 billion. In addition to traditional labor-intensive industries, capital- and technology-intensive industries have also been receiving increasing investment, helping to upgrade China's industrial structure.

The entry into the WTO made China open some of its markets that had so far been closed to foreign capital. Great changes are now occurring in such newly opened sectors, as new markets are being developed through competition between foreign and domestic firms.

Let us take a look at the banking sector, for instance. The banking sector was one area where foreign banks were strictly limited to a narrow scope of operations, as they were not allowed to make yuan loans or offer other services; at that time, Chinese banks, most notably the four major state-owned banks, were virtually unexposed to any direct competition with foreign banks. The entry into the WTO, however, has widened to a considerable extent the scope of operations allowed by foreign banks. Now they can make yuan loans, though not in all regions (restrictions relating to regions are being lifted step by step). As a result, Chinese banks have to face severe competition with foreign banks.

Keen competition between Chinese and foreign banks subsequent to China's accession to the WTO is symbolically represented by the "Ericsson Case," a case of a loan shift from a Chinese bank to a foreign bank. Nanjing Ericsson (Nanjing Ericsson Panda Communication), a Chinese joint venture by the foreign mobile-phone operator Ericsson, made an early repayment of 1.99 billion yuan to Bank of Communications, Industrial and Commercial Bank of China, and Bank of China, and received a similar loan from Citibank. Now foreign banks are allowed to handle yuan-based business in more cities. At the end of 2001, such cities included only Shenzhen, Shanghai, Dalian and Tianjin (4 cities), but pursuant to its commitment made upon entry into the WTO, now in more cities China permits foreign banks to handle the yuan. Since December 2004, foreign banks have been allowed to handle the yuan in 16 cities including Beijing according to the committed schedule. The Hong Kong and Shanghai Banking Corporation (HSBC) was the first bank to be granted a permit to operate in the city of Beijing. The upper limit of investment in a domestic bank by a single foreign institutional investor has been raised from 15% to 20%.

In addition to yuan loans, Japanese and other foreign banks now offer new financial services by capitalizing on their expertise, such as purchasing doubtful receivables held by foreign companies against Chinese firms and dealing with derivative transactions. Thus, Chinese financial markets are now provided with new types of services that never existed before, which are helping the markets

to widen.

To prepare for the intensifying competition with foreign banks, at the initiative of the government, China's top four state-owned banks are accelerating bad-debt disposal and corporate governance reform in preparation for the listing of their stock. As a result, their services should improve so that both foreign and Chinese firms can enjoy better services.

In respect to the service sector, the retail market was also opened to foreign capital at a dash by China's accession to the WTO. Japanese, U.S. or European companies are aggressively entering into China with an eye on its huge consumer market. In Beijing, 23% of large-size supermarkets with floor space over 8,000 square meters are now run by foreign operators. Wal-Mart opened its first store in Beijing in July 2003, and Metro is planning to do the same. These two add to Carrefour, which is already operating a few stores in Beijing; the world's top three supermarket chain operators will be present in Beijing to compete with each other. As to convenience stores, ever since Lawson opened its first store in Shanghai in 1996, the number of convenience stores has gradually increased, and today some 7,000 convenience stores of domestic and foreign chains operate across the country. Shanghai leads all other cities with some 3,500 convenience stores (at the end of 2003). Convenience stores were first set up in busy streets and residential areas, but nowadays they are found in diverse places such as subway stations, gasoline stations, and office buildings.

Foreign-related supermarkets and convenience stores are set up to target consumer markets in big cities with huge populations and rising income. They provide services of different types and categories to Chinese consumers who had previously been unable to receive wide-ranging, diverse services because state-owned department stores were almost the only retail service providers. Thus, supermarkets and convenience stores also create new consumer demand to help markets expand.

Communications and airline industries used to be monopolized by state-owned enterprises, but now these industries are actively pushing ahead with consolidation to be more competitive for the day when their markets will also be opened to foreign airlines. In the communications industry, China Telecom Corp., which had monopolistically covered all parts of the country, was divided into southern and northern companies on May 17, 2002 following China's accession to the WTO. The division seeks to break down the existing monopoly of the communications business and prepare the industry for the competition to be imposed by the entry of foreign communications companies. On the other hand, in the airline industry, on October 11, 2002 the nine airlines directly controlled and owned by the Civil Aviation Administration of China (CAAC) were divided into three major groups; Air China group, China Eastern Airlines group, and China Southern Airlines group. The China Southern Airlines group is listed in Hong Kong and New York, the China Eastern Airlines group in Hong Kong, New York and Shanghai, and the remaining Air China group was listed in

Hong Kong and London on December 15, 2004. In 2004, the Chinese government approved the establishment of three new civil airlines in addition to the above three major airline groups. Thus, the airline industry is moving into a new phase of reorganization.

Corporate splits in the communications and airline industries that had so far been under the monopoly of the state are intended to prepare the industries for foreign companies' inroads under the open market policy. Such moves are expected to provide better services to customers through more efficient management. Thus, also in this field, the open market policy will prompt the markets to grow and the quality of service to improve.

In the manufacturing sector, the impact of WTO accession is most apparent in the automobile industry. Before China joined WTO, many simulations were performed as to how it would affect China's automobile industry. While China has a comparative advantage in a labor-intensive industry, it is not competitive in a technology-intensive industry like the automobile industry. At the time, a general prediction was that tariff reductions following WTO accession would flood the Chinese market with imported cars. Things developed, however, in the opposite direction. Partly helped by the remaining import quota system, car imports have not skyrocketed subsequently. Rather, foreign automakers have invested more in China.

Foreign automakers' have joined hands with China's national automakers. A representative case is the tie-up between Toyota Motor Corp. and First Automobile Works in August 2002. This was followed in the next month by an overall tie-up between Dongfeng Motor Co. and Nissan Motor Co. In October, Dongfeng expanded its tie-up with the PSA-Citroen group. One month later in November, a Korea-China joint venture, Beijing Hyundai Motor Co., Ltd., was formally established, which was followed successively by a joint venture between Honda Motor Co. and Dongfeng (August 2003) and between Toyota Motor Corp. and Guangzhou Auto Group Corp. (September 2004) in a chain of increasingly vigorous moves from the industry reorganization.

Why are there so many successive tie-ups between foreign automakers and Chinese firms? For one thing, there still remains a limit on the share of foreign ownership, and, for another, foreign automakers need to tie up with Chinese automakers which have national sales channels in order to get a larger share of the fast-growing Chinese market. In addition to eased restrictions on individual purchases and the rising income level; the rising automobile demand in China can be attributed to the new models that have been successively launched by Japanese, U.S., and European automakers in their efforts to gain a good share in "the market of the world."

1.2 Accessing neighboring countries' markets by means of FTAs

After opening its markets upon joining the WTO, China has been pushing forward a more aggressive globalization strategy. It can be seen in its active efforts to enter into FTAs with

neighboring countries, notably the ASEAN nations. China has so far successfully attracted greater foreign investment through the open market policy adopted following its entry into the WTO. The strategy to promote FTAs with neighboring nations is intended to ensure stable growth of the region through opening Chinese markets and gaining access to growing Asian markets. The adverse effect of the 1997 Asian currency crisis on China's domestic economy was limited, but the crisis made the Chinese government well aware that the sustainable growth of its own economy requires the stable development of the neighboring countries. Such awareness has been prompting China in recent years to earnestly promote financial cooperation in Asia, and has encouraged China to promote regional FTAs.

At the summit meeting held between China and ASEAN nations in November 2001, it was agreed that an FTA would be concluded within the next ten years, and a "framework agreement" was signed at the November 2002 meeting that sets a specific roadmap leading to the FTA. The projected FTA with ASEAN nations clearly shows China's attitude toward not only opening its own markets but also seeking the stable economic growth of the region through economic cooperation with ASEAN.

China has given consideration to ASEAN in three areas. First, China has pledged to advance the liberalization of agriculture (where ASEAN nations have strength) starting in 2004 and to go on reducing import duties down to zero by 2006. Secondly, China has granted a five-year grace period to less developed Cambodia, Laos, Myanmar and Vietnam ("CLMV") until they actually liberalize trade. China has further pledged to unilaterally grant the most favored nation treatment to CLMV, which are not WTO members. Thirdly, China has included the development of the Mekong Basin as part of its economic cooperation with the ASEAN nations. This development project comprises water resources development, water transportation, railway and road construction, and industrial promotion. Cooperation in this project shows China's proactive efforts toward the economic integration of the ASEAN region including improvement of transportation infrastructures.

In recent years, trade between China and ASEAN nations has grown very rapidly, spurred by the progressing division of labor in electronic/electrical industries and other things. The ASEAN side may expect from an FTA with China further growth in the export of agricultural products and eventually of industrial products as well to China's huge markets. On the Chinese side, some Chinese enterprises confronted with fierce competition from foreign companies because of China's entry into the WTO are moving toward investment in foreign countries in their quest for markets. Some of the home electronics/electric companies and motorcycle makers have already established production bases in ASEAN countries, and China's FTA with ASEAN nations will accelerate this process.

Ahead of concluding FTA negotiations with ASEAN, in June 2003, China formally signed a CEPA (Closer Economic Partnership Arrangement) with Hong Kong. The CEPA covers a wider range of items than the FTA, including investment facilitation and service trade.

The CEPA permits a total of 273 items including electronic/electric products, apparel, plastic products, paper products, chemical products, and watches to enter China duty-free. Together, these items account for more than 60% of Hong Kong's overall exports to the Mainland.

As one of the CEPA's features, China has opened to Hong Kong firms service-related markets covering 18 industries ranging from financial and retail industries to distribution and communications industries. For the purpose of the CEPA, a "Hong Kong company" is defined as one incorporated in Hong Kong and has operated for 3 to 5 years. Included in the definition are also Hong Kong subsidiaries of multinational corporations. A Japanese firm not incorporated in Hong Kong may easily become qualified for entry into the aforesaid service markets if it buys a Hong Kong company. Also, a firm established in Mainland China may enjoy CEPA preferential treatment by setting up a base in Hong Kong.

Why has China opened such service markets by means of CEPA? China's decision seems to derive from its intention to vitalize its own service markets, drawing on the know-how that Hong Kong has accumulated over the years as the world's financial center and an international city visited by tourists from the world over. CEPA also enables banks in Mainland China to transfer their international securities operations as well as foreign exchange centers to Hong Kong. Mainland banks are also encouraged to expand their business by means of M&A in Hong Kong. This is intended to open the possibility for Mainland banks in fierce competition with foreign banks to pursue business opportunities in the Hong Kong market and strengthen their competitiveness through the acquisition of financial know-how in Hong Kong. Hong Kong's financial market will grow with the expansion of yuan-denominated offshore operations conducted by Mainland banks, helping Hong Kong to consolidate its position as China's financial center.

Concluding FTAs in Asia will enable China to diversify and expand its trade markets, and consequently secure a more stable export environment. With regional integration gathering pace in Europe and America under the EU (European Union) and NAFTA (North American Free Trade Agreement), respectively, China fears that it will be kept out of these markets. China has been particularly dependent on trade with the U.S. In 2004, the United States recorded a \$161.9 billion deficit in trade with China, which far exceeded the U.S. trade deficit with Japan. The Chinese government is concerned that the trade imbalance between China and the U.S. may lead to trade frictions as was the case with Japan in the 1980s. The diversification of export markets to its fast-growing neighbors through FTAs is required as a measure to lower its dependence on the U.S. and eliminate causes of trade frictions.

2. Toward a win-win relationship between Japan and China

Japanese firms have traditionally used China as a production base, taking advantage of its position as “the factory of the world.” In recent years, however, with the growth of China’s local market, Japanese firms have increased investment that aims at local sales in “the market of the world.” Japanese firms are facing competition with Chinese firms only in the Chinese markets, but also in overseas market. An objective analysis made of China’s real power based on its exports to the U.S. market shows, however, that there is still a clear division of labor between China and Japan. Japanese firms will be able to build a win-win relationship with China by taking advantage of China’s strength while complementing its weakness.

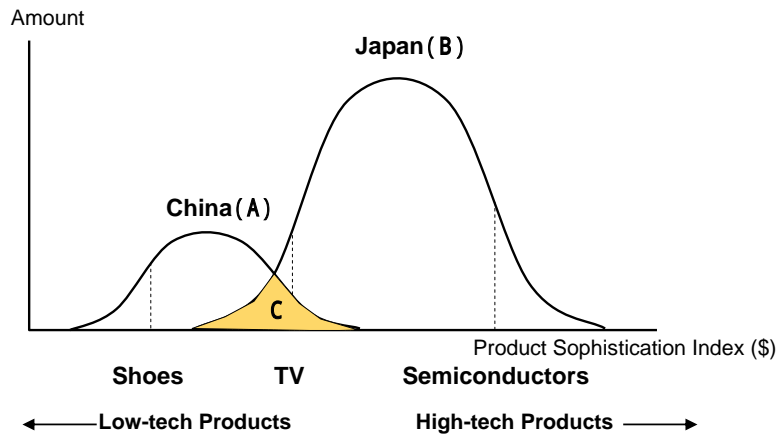
2.1 Complementary relationship between Japan and China

A Japan-China complementary relationship means that Japan is weak in areas where China is strong, while China is weak in areas where Japan is strong. Being the world’s greatest market, let us premise the U.S. market for “the world market” and see how much Japanese and Chinese products compete there. Figure 1 lists Japanese and Chinese products in ascending order of technological sophistication, showing each country’s export structure as a distribution. The size of the distribution is proportionate to the volume of export. The more inclined to the right the distribution is, the more sophisticated the export structure. The bigger the overlapping area of the two mountains is, the more the two nations compete with each other; and the smaller the overlapping area, the more complementary the two nations are.

Until now, Japan has a larger export volume and a more sophisticated structure of exports than China. In recent years, however, China’s distribution has become bigger and bigger and has moved toward the right. Those who chant Chinese threats find a serious competitor in China and are concerned that Japan’s distribution will become hidden behind that of China sooner or later.

Chinese exports, however, are principally labor-intensive products, and do not compete with Japanese products to a high degree. Certainly, the U.S. import statistics indicate that an increasing number of products exported by the two nations are competing in the U.S. market, but on a value basis, it is still only about 20% of total Japanese exports to the United States (calculated by dividing C by B in Fig. 1). Furthermore, for many of the competing products, Japan specializes in high-end items while China specializes in general-purpose ones, and Chinese products depend highly on imported parts (which are not made in China). Taking these factors into consideration, the actual degree of competition should be substantially below the estimated 20 percent. What’s more, Japanese industries that compete with China represent Japan’s declining industries. Thus, there is a clear division of labor between Japan and China in their export markets.

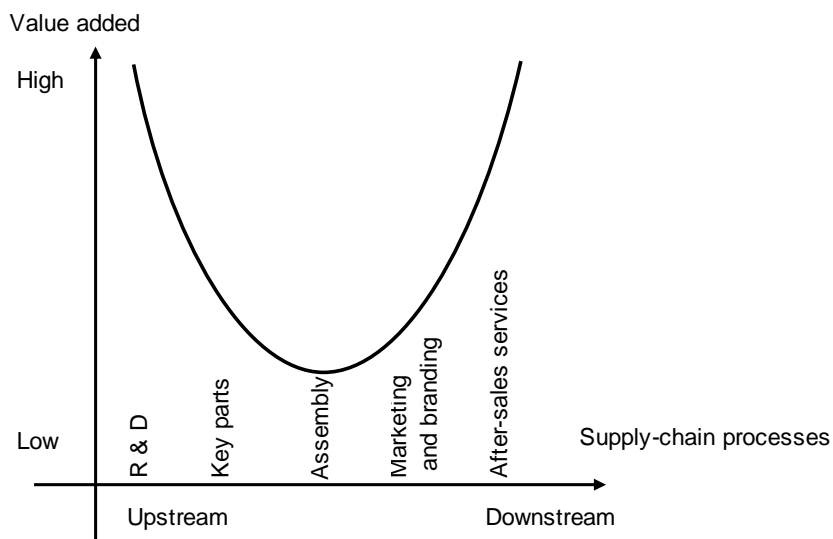
Figure 1. Competition between China and Japan



Prepared by the author.

The complementary relationship between Japan and China can also be verified from the viewpoint of the division of labor between the two nations among different production processes (Fig. 2). Along the product supply chain from R&D through delivery to consumers, China's strength is limited to the low-value added, midstream processes (such as assembling), while Japan and other advanced countries have comparative advantage in the high-value added, upstream processes (R&D and production of core parts) and downstream processes (marketing & sales, branding and after-sales service). In fact, although the U.S. and Japanese markets are flooded with products "made in China," very few Chinese brands are widely recognized there.

Figure 2. The Smiling Curve



Prepared by the author.

2.2 Expanding China's housing and automobile markets by leveraging Japanese firms' strength

For Japanese firms to leverage the growth and globalization of Chinese markets as good business opportunities, the key to success will be how to make the most of the complementarity between Japan and China. The progress made in China's reform and open market policy has provided Japanese firms with greater access to business opportunities in Chinese markets. In China, Japanese firms should enjoy business opportunities in high growth sectors such as housing, automobile and distribution as well as labor-intensive industries that leverage the plentiful labor force, and, further, Japanese firms' high-level technologies and experience acquired in the environment-related sector. Japan is inevitably apt to focus on China's strengths because of its rapid growth, but the complementarity between the two nations leads us precisely to the conclusion that Japan should be more confident of its strength and that the two nations should leverage each other's advantages.

In China, the housing and real estate markets are expected to grow in the future. In 1998, the government's housing allocation system was abolished, and now people can freely buy a house put up for sale in the market instead of renting it from the state as they once did. This change, together with high economic growth and household income growth, has boosted housing demand. Some Japanese homebuilders have started moving into China's lucrative housing market. Now that foreign banks have been granted a wider scope of operations in the financial market, their activities in housing loans and other related operations have become a focus of attention.

Another market receiving attention is the automobile market. On the back of increasing household income and construction of expressways, motorization is moving at a fast pace. As a result of joining the WTO, import duties on finished cars will be reduced to 25% by 2006 and the quantitative import restriction will be lifted. After a period of hyper-growth, automobile demand is in a correction phase at this moment, and, with major automakers of the world all rushing into China, the Chinese car market may face oversupply in the future. Japanese firms should therefore be cautious. One way to reduce risk would be to produce cars (particularly higher-end ones) in Japan for export to China,

Furthermore, China's accession to the WTO has made it possible for foreign firms as well to enter the distribution and service markets. With restrictions related to the share of ownership, quantities and regions being lifted, more foreign companies will invest in China's and help build a more efficient distribution system. After-sales service and related operations have also become more easily accessible to foreign firms. This deregulation will also enable Japanese firms to find business opportunities in various high-value added service markets that are derived from automobile production such as auto loans, distribution and sales, auto insurance and after-sales

service.

Housing, automobile and distribution markets are areas where Japanese firms have so far been successful to a certain extent. The application of their experience may prove to be an effective strategy. As the Chinese economy continues to grow, other sectors also provide growing markets for Japanese firms to develop business activities by capitalizing on their accumulated know-how.

While growing into an increasingly attractive, major consumer market, China is also attractive as a production base for labor-intensive products given that its average wage level is still one-thirtieth that of Japan. If we look at supply and demand in China's labor market, and the vast amount of redundant labor force sitting idle in rural areas, we foresee little upward pressure on wages for some time to come despite the industrial sector's increasing demand for workers. Thus, labor-intensive products will continue to be competitive for the time being. It is important for Japanese firms to accurately grasp China's consumer market as well as its strength as a production base for outsourcing.

However, if China is to be considered as a production base for the future, improvement of its technological capabilities will have to be addressed. Although termed "the factory of the world," China has neither world-class technologies of its own nor adequate capabilities to develop such technologies. If China fails to narrow the technology gap with advanced countries, Chinese firms will have difficulty competing not only in overseas market but also in their own markets opened upon joining the WTO. China needs to introduce technologies from abroad to enhance its economic efficiency and upgrade its industrial structure. Reflecting the wide gaps still existing between Japan and China due to their different stages of development, a technology that is obsolete in Japan may turn out to be useful in China. This would mean that China provides a promising market for technology trade.

On the other hand, China is afflicted with serious environmental problems just as Japan was decades ago. China's environmental problems comprise not only of domestic problems but also some problems that spread beyond its border to adversely affect Japan such as acid rain. In view of such problems, Japan's official development assistance (ODA) to China is now more inclined to environmental issues than to traditional infrastructural investment. For Japanese firms, an environment-related market is precisely where they can make the most of their accumulated experience and technologies.

3. "The factory of the world" versus "the market of the world"

Since China joined the WTO, Japan's mass media have changed their way of looking at China. They now view China not just as "the factory of the world," but also as "the market of the world." Japanese firms' focus on business with China is also shifting from using China as an

export-oriented production base to targeting its market. We should not forget, however, that for accessing the Chinese market we also have the alternative of producing in Japan products exportable to China. Particularly in the area where products manufactured in Japan are competitive in the international market, such products essentially do not have to be produced in China. The shifting of production of such high-value-added products to China in order to overcome trade barriers would lead to a hollowing-out of Japan's industry.

3.1 "Local production for local sales" is not the only business model applicable to China

If you take China's emergence as a business opportunity, you should determine on which side, Japan or China, holds the advantage in market and in production. China surely offers wages much lower than in Japan, but this does not mean that all products can be made at a lower cost in China. Rather, the reality is that China has to depend on cheap labor for competitiveness because it has no brand or technology of its own, while Japan is still very competitive worldwide in technology-intensive products. Although its income level is rapidly rising, China is still a developing country with a per-capita gross domestic product (GDP) of around 1,000 dollars and a consumption structure very different from that of an advanced nation. Thus, the answer to the question of whether China is a "factory" or a "market" varies depending on the sector.

A Japanese firm may choose between one of the following four "business models" based on whether it is cheaper to produce in China or in Japan and whether the market lies in China or Japan. First, for a given product where China has the advantage in production and Japan in market, it is preferable to produce it in China and bring it into Japan for sale. Secondly, where China has the advantage in both production and market, the Japanese firm should seek to both produce and sell in China. Thirdly, where China has the advantage only in market and Japan in production, it is preferable to produce in Japan for export to China. This case applies to the machinery industry including the automobile industry. Lastly, where Japan has the advantage in both production and market, the Japanese firm should dedicate itself to domestic production and marketing.

Another point of importance when considering business with China is to recognize that direct investment and trade are substitutes for each other and that there exist many intermediate forms between the two. Direct investment will make it easier for a locally established foreign firm to push through its majority shareholder's management policy in proportion to the percentage of its ownership, but at a proportionately higher risk. On the contrary, one-time transaction-based trade involves a much smaller risk. Consequently, whether you treat China as a factory or as a market, you are not necessarily required to have a 100%-owned factory of your own. If a Japanese firm wants to utilize China as its production base, it may have various alternatives to choose from: (i) buy the required products directly from a Chinese firm, (ii) enter into a contract to have a Chinese

firm produce the required products for marketing under your own brand, (iii) establish a joint venture with a Chinese firm for the production of the required products, or (iv) establish a 100%-owned subsidiary. Even without any investment, you may have your policy properly adhered to by a subcontractor so long as you have a firm control of the key portions of the supply chain (marketing in the case of UNIQLO). Also, when a Japanese firm targets the Chinese market, it can choose between exporting from Japan and producing in China.

In reality, however, high import duties on some products force Japanese firms into local production to gain access to the Chinese market. The conclusion of an FTA between Japan and China will make it easier for Japan's industries that are still competitive including the automobile industry to produce their products in Japan for export to China, thereby creating high-value-added jobs within Japan. Thus, the conclusion of an FTA between Japan and China will be one effective way for Japan to make the most of China's vitality.

3.2 Japan-China FTA is recommended

Actually, there are increasingly active developments regarding FTAs in the East Asian region involving Japan and China. As stated earlier in section 1, China is using WTO accession and promotion of FTAs as leverages to press ahead with its policy of globalization, market opening and expansion into the markets of the neighboring countries. Inspired by China's strategy, Japan has come to recognize the need to open its markets and promote domestic reform through global and regional free trade initiatives.

In line with what is taught in textbooks concerning international economics, an FTA will produce a positive "trade creation effect" and a negative "trade diversion effect." The former means that regional trade will grow as a result of the elimination of intra-regional trade barriers, and the latter that as a result of trade barrier elimination only within the region, low-cost imports from outside the region are replaced by high-cost intra-regional imports. Countries in a complementary relationship are likely to enjoy the trade creation effect in excess of the trade diversion effect more than those in a competitive relationship, and, therefore, are believed to benefit much from the conclusion of an FTA. Generally speaking, a stronger complementary relationship exists between two countries at stages of development far apart, while, conversely, two countries at closer stages of development are in a stronger competitive relationship with each other. Among Asian nations, Japan and NIES countries have a complementary relationship with China, while ASEAN nations have a competitive relationship with China. The complementary relationship between Japan and China is particularly strong, and, consequently, the two nations should benefit much from the conclusion of an FTA.

In view of such bilateral complementary relationship, an FTA between Japan and China will

ensure that technology-intensive products featuring Japan's strength will be able to increase their share in the Chinese market while labor-intensive products supported by China's strength will do so in the Japanese market. Such possibility indicates that Japan's labor-intensive industries such as the textile industry will be opposed to the FTA, while in China the FTA will meet similar opposition from uncompetitive technology-intensive industries. A Japan-China FTA is the most desirable policy from an economic viewpoint in terms of the benefits derived from the division of labor. An FTA, however, will be politically a highly difficult measure to implement because the above-mentioned industries on both sides will raise objections even if agricultural products are excluded.

Japan and China are both big countries whose combined GDP accounts for 80% of East Asia's overall GDP. If Japan and China take the lead in entering into an FTA, other Asian nations will proactively participate in it so as not to miss the train, and regional integration will accelerate at a dash.

Certainly a Japan-China FTA will come across obstacles from the opposition in certain national industries in both countries, as well as in the issues of historical perception and mutual distrust deriving from it. In Europe, however, France and Germany, two nations which fought two world wars against each other in the first half of the 20th century, are now overcoming their past history precisely through economic integration. What is required of Japan and China involves such change in the way of thinking and political leadership.

4. Chinese market as a market for final products - 2010 scenarios

China's presence in the world economy is becoming increasingly strong as it became the world's third biggest trading nation in 2004, passing Japan in total trade value. In addition, Japan's economy is now influenced by developments in the Chinese market as expressed in the phrase "special procurement by China." Certainly, at present, China should be viewed in the world economy as basically a "production base" that leverages its plentiful labor force, still far from being a "market" of end-products. From a medium-term perspective, however, the Chinese market is likely to grow into the "market of the world." Let us look ahead as to how the Chinese market will have changed by 2010 under three scenarios - "standard," "optimistic" and "pessimistic."¹

Table. Final market in the 2010 China as tentatively calculated

	China's share in the world's total imports (%)	Japan's exports to China (vs. U.S.) (%)	Aggregate sales of Japanese firms in the Chinese market (vs. U.S.) (%)	Total final demand from Japanese firms in the Chinese market (vs. U.S.) (%)
2003	5.3	70.7	42.0	23.9
Standard scenario (growth assumed at 8.05%)	7.2	95.8	56.9	32.3
Optimistic scenario (growth assumed at 12%)	9.2	119.7	71.1	40.4
Pessimistic scenario (growth assumed at 4%)	5.5	75.7	44.9	25.5

Note: Chinese market includes Hong Kong; however, China's share in the world's total imports is calculated based on China's imports only.

Source: Compiled from MOF, *Foreign Trade Statistics*; METI, *Quarterly Survey of Overseas Subsidiaries*; WTO, *International Trade Statistics*; CEIC Database; and IMF, *World Economic Outlook*.

4.1 Standard scenario (probability 70%): China will grow into a major market accounting for 7% of the world's total imports

WTO statistics² show that the aggregate value of products imported by China in 2003 from the world amounted to \$413.1 billion, or 5.3% of the world's total imports. Its imports then were already greater than Japan's imports of \$382.9 billion (4.9%). In 1999, China's share in the world's imports was only 2.9%, a little more than half of Japan's share (5.4%). Now, China is Japan's second largest export destination after the U.S. Japan's 2003 exports to China and Hong Kong accounted for 18.5% of Japan's total exports. In 1999, Japan's exports to China and Hong Kong were only 33.6% of Japan's exports to the North American market comprised of the United States and Canada, but the ratio shot up to 70.7% in 2003 narrowing the difference. Despite China's increasing presence in world trade, its influence as a final market is not very strong at this moment.

Actually, the end-product "market" that China (including Hong Kong) currently provides to Japanese firms is not more than one-fourth the size of the North American market. Such situation can be expressed in terms of "total sales" consisting of Japan's exports to the destination country and of Japan's production made therein, or in terms of "total final demand" consisting of sales made in the destination country out of Japan's exports thereto and of sales made in the destination country out of Japan's production therein. Here, "total sales" and "total final demand" are calculated using MOF's "Foreign Trade Statistics" and METI's "Quarterly Survey of Overseas Subsidiaries."³ In 2003, Japan's gross sales to/in the U.S. amounted to \$310.6 billion, while its gross sales to/in China (including Hong Kong) were not more than \$130.5 billion. On a final

demand basis, the former had from Japan final demand amounting to \$295.2 billion and the latter \$70.6 billion, meaning that the Chinese market was not more than 23.9% of the North American market. The results reflect the fact that for Japanese firms the U.S. market is precisely the market of final consumption, while China is characterized more as an export-oriented production base.

The situation becomes different, however, if we take a medium- to long-term viewpoint. Over the next ten-year term, China's domestic market is likely to grow into a market attractive to Japanese firms. The reason is that China's entire economy will have greater purchasing power in keeping with its economic growth, and, consequently, the ratio of imported foreign products to be purchased within the Chinese market as well as the sales of locally produced items by foreign firms will become higher. As mentioned in section 1, the implementation of a market economy, globalization and the rule of law in accordance with its commitment upon joining the WTO not only increases China's imports from abroad but also encourages foreign firms to establish their production and marketing bases in China. For foreign firms, China's fulfillment of its commitment to the WTO means that they will be able to increase their export volume more easily, that they will be exposed to less institutional risks when entering China, and that they will be able to establish and operate a production or marketing base in China more easily.

If "total sales" and "total final demand" in the Chinese market (Hong Kong included) grow at an annual rate of 8.05% following the average trend recorded between 1999 and 2003, the Chinese market will grow to be 56.9% and 32.3% of the North American market in 2010 in total sales and total final demand, respectively. If Japan's total exports to the Chinese market (China + Hong Kong) grow at a similar rate, Japan's exports to China in 2010 will grow to be 95.8% of its exports to the North American market (U.S. + Canada), and will slightly surpass its exports to the latter market in 2011. At such time, China's share in the world's total imports will have risen from 5.3% in 2003 to 7.2% in 2010, leaving Japan's share of 4.1% far behind and reaching closer to half the share of the U.S. (15.9%). Then, in reality and in name, China will show its presence as "the market of the world."

4.2 Optimistic scenario (probability 20%): technological advancement will increase income and expand the consumer market

China's growth as a final market as so far mentioned and tentatively calculated should be viewed, so to speak, as a "standard scenario." That is, the scenario assumes that changes due to occur in the future in China's consumption structure and economic system or direct foreign investment will move ahead in step with its economic growth. However, if productivity increases in the private sector or consumers' growing purchasing power accelerates the market economy as committed to upon joining the WTO, or moreover, if the conclusion of FTAs further prompts

foreign trade to be liberalized, China will have more-than-assumed foreign products introduced including locally produced and sold products of foreign origin.

Such ongoing change of China into a final market can be seen in the Quarterly Survey of Overseas Subsidiaries. In the case of China, the ratio of local sales to local production is certainly lower than the ratio of 91.8% (2003) reached in the North American market. Yet the ratio is rapidly growing: local sales by Japanese firms' local subsidiaries in the Chinese area including Hong Kong have grown by an average annual rate of 30.7% since 2000, which is higher than the growth rate of such Japanese firms' sales (23.9%), pushing up the ratio of their local sales from 35.8% to 42.4%. As a result, Japanese firms now highly evaluate the potential of the Chinese market as a final market. In a questionnaire survey to Japanese firms⁴ and published by the Japan Bank for International Cooperation in November 2004, China ranked first as "a promising country for business development over the medium term." Top-named reasons are "potential of local market" (83.3%), "low-cost labor" (66.1%) and "base of supply to assemblers" (28.6%). "Potential of local market" also ranked first at 82.3% in the 2003 survey. The survey confirms that such expectation is not of a temporary nature.

Furthermore, China's growth in production serves as a source in prompting its market to grow into a final market. As of the moment, China is engaged in labor-intensive industries while gradually advancing technologically through relying more on the market mechanism, implementing the rule of law, as well as introducing foreign capital. However, Chinese firms are acquiring foreign technologies through joint ventures with foreign firms, human resources movements, and learning. In addition, they have accumulated capital thanks to the economic development. In actuality, China is now very competitive in such technology- or capital-intensive industries as office and information processing equipment, and the electric/electronic equipment manufacturing industries. If Chinese firms maintain their present momentum and are able to establish core technologies or brands of their own, such activities will contribute to improving their profitability as well as their employees' wages and will lead to market expansion through consumption growth. Consequently, the acceleration of technological progress will change Chinese people's consumption structure and greatly enhance China's attractiveness as a market.

If China's economy continues growing until the 2008 Beijing Olympics or further until the 2010 Shanghai Expo, while its technological progress accelerates in keeping with the pace of economic growth, the level of domestic consumption will rise and enable final consumption to grow. If China successfully controls its macroeconomy, keeping somewhat overheated investment from turning into excessive production capacity, the Chinese market may even grow more than assumed. What is more, the realization of FTAs, the progress in the market economy and the implementation of the rule of law in fulfillment of China's commitment upon entry into the WTO

will expand the sphere in which foreign firms can perform activities. As a result, foreign firms' products will penetrate China's domestic markets, making China a more important customer. Furthermore, the possibility of consumer demand shifting to higher-quality foreign products will enable foreign firms to garner more markets, while forcing Chinese firms to improve their technology more rapidly through competition.

If China's imports or final demand continues at an annual rate of 12%, China's imports will account for 9.2% of the world's imports in 2010, a share more than double that of Japan. Japanese exports to China (including Hong Kong) will catch up with Japanese exports to North America by 2008, and to reach 1.2 times of the latter by 2010. When viewed as a market for Japanese firms, the Chinese market will grow to be 71.1% of the North American market in terms of sales, and 40.4% in terms of total demand, a magnitude not negligible in any way.

4.3 Pessimistic scenario (probability 10%): consumer market will remain sluggish due to the collapse of the bubble

However, if China fails in the macro-control of its economy, causing local governments' overheated investment to result in excessive production capacity and the economic bubble to collapse, economic growth will be restrained, in which case domestic consumption will also remain sluggish and the Chinese economy will grow at a slower pace than assumed. Furthermore, regarding economic growth overly dependent on foreign firms, many people are not satisfied that foreign firms only take advantage of China's plentiful, cheap labor force and do not contribute to China's technological progress; further, vested interest groups, such as executives of state-owned firms that are losing profits due to the wide spreading of foreign products as well as losing discretionary management power as the rule of law comes to be established, will go against further reform. If these views and opinions come to gain certain political power, foreign firms will have greater difficulty entering the Chinese market. It will likely cause a delay in the introduction of foreign capital and technologies, as well as cause the overheated economy to cool down suddenly.

Furthermore, if China delays in establishing core technologies or brands of its own, the level of national consumption will not rise in a manner consistent with the economic growth. At this moment, Chinese firms are not highly evaluated in Japanese markets or other foreign markets. Haier Group that entered the Japanese market in 2002 is still having an uphill battle establishing its brand. When Lenovo Group announced the purchase of IBM's personal computer business in December 2004, IBM PC users voiced concerns because they feared after-sales service might not be adequately maintained, expert human resources might leave the PC division, or the level of R&D would drop; particularly because Lenovo was a totally unknown company in the world. If Chinese firms continue to depend upon price competitiveness to expand market shares in foreign

markets, it will likely prevent the level of domestic consumption from rising.

If the Chinese economy proceeds along this scenario, and if imports and final demand grow at an annual rate of 4%, China's imports will account for 5.5% of the world's imports in 2010, a share more or less similar to the current level. For Japan, in 2010, exports to China (including Hong Kong) will amount to only 75.7% of the exports to the North American market. In terms of sales, the Chinese market will represent 44.9% of sales achieved by Japanese firms in the North American market, and, in terms of total demand, China will represent 25.5% in respect to the North American market, not substantially changing from the 2003 level.

¹ The "standard scenario" assumes that in Japan, China, Hong Kong, the United States, Canada and the world, imports and Japanese firms' local production and sales will increase at the same rate as the rate of the average real economic growth recorded between 1999 and 2003. That is, each country's actual data in 2003 multiplied by (1+each country's average economic growth rate) will give the estimate value for 2004, and the 2004 estimate value multiplied by (1+each country's average economic growth rate) will give the estimate value for 2005. Estimate values for subsequent years are calculated in the same manner. The average rates of economic growth used herein are 8.05% for China, 3.54% for Hong Kong, 2.75% for the United States, 3.61% for Canada, 0.70% for Japan and 3.54% for the entire world. The "optimistic scenario" is calculated using the same growth rates as used in the "standard scenario" except for China, for which 12% is used. The "pessimistic scenario" also uses the rates for the "standard scenario" except for China, for which 4% is used (source: CEIC Database; and IMF, *World Economic Outlook*).

² WTO, International Trade Statistics.

³ In *Quarterly Survey of Overseas Subsidiaries*, data on China include Hong Kong, and data on the North America include Canada.

⁴ JBIC Institute (JBICI), *Survey Report of overseas business operations by Japanese manufacturing companies*, November 2004.