How to Access the Fast-Growing Chinese Market

FDI vs. FTA

By C. H. KWAN

Author
C. H. KWAN

CHINA'S emergence as an industrial power has given rise to concerns that Japan's hollowing-out problem and its international competitiveness may worsen. But because economic relations between Japan and China can be characterized as complementary (that is, in areas where Japan is strong China is weak, and vice versa) rather than competitive, economic cooperation can be a win-win game that benefits both sides.

To fully exploit the complementarity between the two countries, Japan should relocate declining industries to China through foreign direct investment (FDI) on the one hand, while promoting new industries at home on the other. The two countries should also pursue a free trade agreement (FTA) that removes trade barriers between them. By allowing Japan's high-tech industries to access the fast-growing Chinese market through trade instead of through FDI, an FTA would help Japan achieve industrial upgrading without hollowing out.

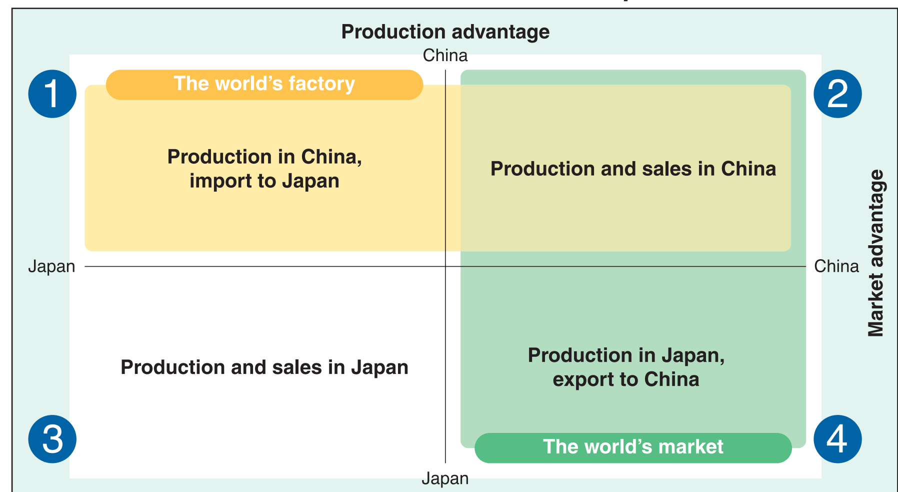
Should Japanese Firms View China as a Production Base or a Market?

When considering China's emergence as a business opportunity, Japanese companies need to ascertain whether market advantages and production advantages lie with China or with Japan. The fact that wage levels in China are much lower than those in Japan does not mean that all products can be manufactured more cheaply there. At present, China does not have its own technology or brands, and has no choice but to rely on cheap labor to compete. In contrast, Japan continues to be very competitive in the production of technology-intensive goods. At the same time, while it is true that income levels in China are rapidly rising, it is still a developing country whose per capita GDP has just reached the $2,000 level, and its consumption structure no doubt greatly differs from that of industrialized nations. Therefore, the answer to the question of whether China is a "production base" or a "market" differs from one industry to another.

According to whether China is a production base or a market, the strategies that Japanese companies could pursue can be classified into the following four cases *(Chart)*. Firstly, in areas where China has the advantage on the production front, but Japan has predominance as a market, it is better to manufacture in China and then import to Japan. Secondly, in areas where China enjoys advantages both as a production base and as a market, Japanese firms should strive to produce locally and sell locally. Thirdly, in areas where China is superior only as a market and Japan is more competitive on the production front, it would be advantageous to produce in Japan and then export to China. Machinery industries, such as automobiles, fall into this category. Finally, when Japan is dominant both in production and consumption, Japanese companies should concentrate on domestic production and domestic sales.

When considering business operations in China, one should also fully recognize the fact that direct investment and trade are substitutes for each other, and Japanese companies can access the Chinese market not only by manufacturing locally but also by producing in Japan and exporting to China. In choosing between direct investment and trade, their respective costs and benefits should be taken into consideration. In the case of direct investment, the influence a firm wields over management matters increases in proportion to the ratio of its investment, but then so does the risk. In contrast, in the case of trade, which is supposed to be a one-time transaction, the risk is small.

***Chart** Models of "China business" for Japanese firms*



Source : Data compiled by author

Good Direct Investment vs. Bad Direct Investment

While there are firms in Japan that are making use of China's vitality, there are still concerns that increased investment in China will lead to a hollowing-out of industry at home. In essence, if the market mechanism is functioning properly, the overseas expansion of companies should encourage the efficient allocation of resources. If a hollowing-out still occurs despite this, it should be attributed to the high cost structure brought about by excessive regulations at home, and to trade barriers in trading partners.

Japan's FDI can be broadly categorized into two types – investment that places priority on production costs and exports, and investment that aims to avoid trade barriers and trade friction. The latter is more likely to lead to a hollowing-out of industry. Direct investment that places priority on production costs and exports aims to reduce costs by securing advantageous production factors overseas and improving export competitiveness. For example, many Japanese firms have set up production bases in China to exploit its cheap labor and mainly export what is produced there to Japan and other countries rather than selling locally. Such investment improves the efficiency of resource allocation and both the investing country and the host country have much to gain. In contrast, direct investment that aims to avoid trade barriers and trade friction is made in situations where there is no choice but to produce locally because exports from Japan are blocked by import restrictions. The resulting division of labor distorts resource allocation because it runs counter to the comparative advantages of both the investor and the host.

A typical example of the type of direct investment that aims to avoid trade barriers and trade friction is that made by Japanese automakers in China. There is no doubt that China's auto market will see rapid expansion. However, local production is not the only way to access the Chinese market – it is also possible to export automobiles from Japan. Although China's import tariff on automobiles was to be greatly reduced upon its entry into the World Trade Organization, it still remains at the high level of 25%, and exporting automobiles to China from Japan could lead to trade friction. In order to circumvent high import tariffs and avoid trade friction, Japanese automakers are expanding their investment in China even though they can produce better and cheaper cars at home.

In terms of the aforementioned business models, automakers would benefit by manufacturing in Japan and exporting to China to take advantage of the complementary relationship between the two countries. However, because of the existence of trade barriers, this has been replaced with local production and local sales in China. If Japanese automakers could manufacture one million cars a year in Japan and export them to China, it would mean that many employment opportunities, in the form of high-wage "good jobs," could be created in an area in which Japan excels. However, if the same one million vehicles are produced in China, even if some parts are still manufactured in Japan, fewer jobs would be created and the opportunity cost would be very large.

In this way, direct investment that places priority on production costs and exports is "good direct investment" that boosts the efficient allocation of resources, while direct investment that aims to avoid trade barriers or friction is "bad direct investment" that leads to a decline in production efficiency and, in the end, a hollowing-out of domestic industry. Unfortunately, however, public opinions regarding the hollowing-out of industry in Japan are arguing for exactly the opposite. In other words, when old factories for industries in which Japan no longer has a comparative advantage are relocated to China, much is made of the matter and it is portrayed as a serious hollowing-out problem because employees lose their jobs. In contrast, when firms in areas such as automobile manufacturing, where Japan still has a comparative advantage, build factories in China, their moves are praised as efforts to open up a new market and so there is no opposition at home. This misunderstanding of the nature of direct investment is leading on the one hand to the protection of declining industries through measures such as import restrictions, while delaying the advancement of industry on the other.

FTA with China – Most Effective Solution to Japan's Hollowing-out Problem

Japan should pursue a free-trade agreement with China to encourage more "good direct investment" and prevent "bad direct investment." If import tariffs are eliminated, trade between the two countries will increase further and Japan's key industries such as automobiles, especially, will no longer have to take the risk of producing in China. In this way, an FTA with China is the most effective way for Japan to prevent a hollowing-out of its industry. JS

Chi Hung Kwan is Senior Fellow, Nomura Institute of Capital Markets Research. He has a Ph. D. in economics, University of Tokyo.