

# Current State & Future Prospects for the Japan-China Economic Dependency Relationship

By Shingo Ito



Author Shingo Ito

## Introduction – Unease About Increasing Economic Dependence on China

China is an important trading and investment partner for Japan. According to customs statistics for January–November 2022, China is Japan's largest trading partner, and in terms of outward direct investment balance also, China is the world's third-largest investment destination for Japan (at the end of 2021), after the United States and the United Kingdom. Various surveys indicate that Japanese companies still regard China as one of the most promising destinations for future business expansion. For example, according to a survey conducted by the Japan Bank for International Cooperation (JBIC) between July and September 2022 of Japanese companies with three or more overseas subsidiaries, 37.1% of respondents said that China is a promising business development destination in the medium term (the next three years), ranking second only to India, which ranked first (40.3% response rate).<sup>1</sup> This is because China is highly regarded for its large market size and its potential. In the long term (the next 10 years), China is the second most promising business development destination with a 36.6% response rate, following India (50.6%).<sup>2</sup>

At the same time, however, the current situation is that the high degree of economic dependence on China is now perceived as a risk to Japan more than ever before, against the backdrop of the intensifying US-China conflict, the spread of Covid-19, growing concerns about a Taiwan emergency spurred by the Russian invasion of Ukraine, and uncertainty about the future of the Chinese economy. According to a survey conducted by the Japan External Trade Organization (JETRO) on Japanese companies in China from August to September 2022, only 4.9% and 1.4% of respondents answered that they will “downsize” or “relocate to a third country (region) or withdraw” in the next one to two years, respectively. However, the “business expansion” response rate was the lowest ever at 33.4%.<sup>3</sup> In a September 2022 survey conducted by Nikkei Inc. of presidents (including chairpersons) of major Japanese companies, 31.1% and

64.7% of respondents stated that they were “strongly concerned” and “somewhat concerned” about a “Chinese invasion of Taiwan (Taiwan emergency)”, respectively. The percentage of respondents who answered that they have a business continuity plan (BCP) in preparation for a Taiwan scenario was 14.2%, with 68.0% saying that they are “considering” implementing a BCP. As part of their BCP, some respondents indicated that they are implementing or considering “alternative procurement from outside China” (30.6% of respondents), “relocation of production outside China” (18.4%), and “curtailment of production and development in China” (16.3%).<sup>4</sup>

Thus, Japan is now facing a growing sense of uneasiness about its economic dependence on China which remains a reliable business destination and is being forced to revisit the nature of its economic relationship with China. This report analyzes the current state of mutual economic dependence between Japan and China and examines ways to mitigate the risks posed by excessive economic dependence while ensuring the stability of economic relations between the two countries.

## Increasing Asymmetry in Inter-economic Dependence Between Japan & China

Japan's degree of dependence on trade with China (trade volume as a percentage of GDP, based on customs statistics) has been on an upward trend (*Chart 1*). The pace of increase in Japan's trade dependence on China has slowed since the mid-2010s, when rising production costs in China and the deterioration of Japan-China relations triggered by the “nationalization” of the Senkaku Islands in 2012 led to an awareness of “China plus one”. However, by 2021 both Japan's export and import dependency on China recorded record highs (4.1% and 3.7%, respectively).

For its part, China's dependence on trade with Japan is rapidly declining. Both China's dependence on exports to and imports from Japan peaked in 2004 (4.8%) and then declined rapidly, dropping below Japan's dependence on exports to and imports from China in

1 Research Department, Planning Division, Japan Bank for International Cooperation, “Survey Report on Overseas Business Expansion of Japanese Manufacturing Firms: Results of FY 2022 Foreign Direct Investment Questionnaire (No. 34)”, Dec. 16, 2022, p. 17.

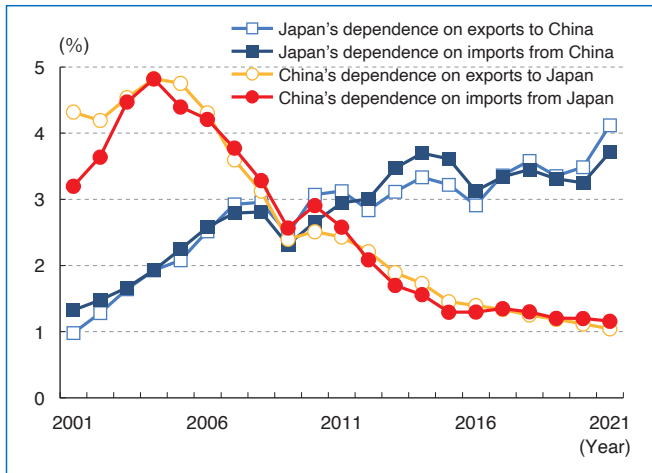
2 Ibid, p. 31.

3 Japan External Trade Organization, Overseas Research Department, “FY 2022 Survey of Japanese Companies Operating Overseas in Asia and Oceania: Continued Performance Recovery in ASEAN and Southwest Asia, Stagnation in China due to Zero COVID Policy”, Dec. 15, 2022, p. 15.

4 “Results of a Survey of 100 Presidents”, *Nikkei Business Daily*, Oct. 7, 2022.

CHART 1

## Degree of mutual trade dependency between Japan & China



Note: Trade dependence is as % of GDP. Japan's exports to China are based on the value of imports from China Customs Statistics, while China's exports to Japan are based on the value of imports from Japan Customs Statistics (to mitigate distortions caused by the fact that export statistics are based on destination and import statistics are based on origin).

Source: CEIC Data

the 2010s. In 2021, China's dependence on exports to and imports from Japan fell to 1.0% and 1.2%, respectively. Thus, China-Japan trade dependency is in a situation increasingly characterized by asymmetry.

In terms of GDP creation, Japan is also highly dependent on Chinese final demand. The added value induced in Japan by China's domestic final demand is 3.1% of Japan's GDP (Table 1), which is larger than its dependence on the US (3.0%). Meanwhile, China's added value induced by Japan's domestic final demand is only 1.1% of China's GDP. Also, in terms of the share of value-added from partner country sources in its own exports and imports, Japan is more dependent than China. This implies that Japan is more vulnerable than China in the event of a disruption in the supply chain between the two countries.

### Dependence on China for Major Trade Items & Specific Critical Commodities

By commodity, Japan is also more vulnerable than China. Japan's five largest imports from China on an HS 6-digit basis are laptop computers (weighing 10 kg or less, HS847130), cellular phones (HS851712), other textile products for fabric weaving (HS630790), switching and routing equipment (HS851762), and photoelectric semiconductor devices and light emitting diodes (HS854140), all of which account for very high shares of Japan's total imports of these products from China (Table 2). Meanwhile, from China's perspective,

TABLE 1

## Japan-China interdependence in value-added trade (2018)

Japan's value-added induced by China's domestic final demand as a share of Japan's GDP	3.1%
China's value-added induced by Japan's domestic final demand as a share of China's GDP	1.1%
Share of Value-added from Chinese Sources in Japan's Exports	2.8%
Share of Value-added from Japanese Sources in China's Exports	1.5%
Share of Value-added from Chinese Sources in Japan's Imports	19.9%
Share of Value-added from Japanese Sources in China's Imports	8.1%

Source: OECD, Inter-Country Input-Output (ICIO) Tables, 2021 edition.

its dependence on Japan as an export market for these products remains low.

In terms of Japan's five major export items to China on an HS 6-digit basis, Japan's dependence on the Chinese market is high, with the exception of passenger cars (cylinder capacity over 1,500 cc and under 3,000 cc; HS 870323) (Table 3). China's dependence on imports from Japan is also high for these products, but in the case of memory (HS854232), alternatives are not entirely ineffective. With respect to automotive gearboxes and their components (HS870840) and hybrid vehicles (HS870340), certain alternatives would be possible if other powertrains were selected.

Some of the products designated by the Japanese government as "specified critical commodities" under the Law for the Promotion of Economic Security also include items that are highly dependent on imports from China. For example, the share of imports from China in Japan's total imports of storage batteries reached 57.2% in January-November 2022. As for "critical minerals", imports from China account for a high 58.5%<sup>5</sup> of Japan's total rare earth imports as of 2020, and the procurement of rare earths from China could adversely affect the supply capacity of permanent magnets, which are also designated as "specific critical commodities". China also accounts for 84% and 28% of Japan's imports of phosphorus and urea, which are important raw materials for fertilizers.<sup>6</sup>

By industry, the dependence on Chinese domestic final demand is high in computer, electronic, and optical equipment; chemical raw materials and products; electrical equipment; water transportation; machinery and equipment; and basic metals (Table 4). Although there are signs that China's standing as the "workshop of the world" is waning, the foundation of China's manufacturing industry remains robust, and the industries that supply intermediate goods and capital goods to China are highly dependent on it.

<sup>5</sup> JOGMEC, "Mineral Resources Material Flow 2021 7. Rare Earth Elements (REE)", 2022, p. 7.

<sup>6</sup> FY 2018 – FY 2020 average (Cabinet Secretariat, "Expert Council on Economic Security Legislation, Supply Chain Resilience Study Meeting No. 1 (10/18) Materials (Toward Designation as Specific Critical Goods)", November 2022, p. 6). FY 2018 – FY 2020 average (Cabinet Secretariat, "Expert Council on Economic Security Legislation, Study Meeting on Supply Chain Resilience, First Session (Oct. 18) Materials (Toward Designation of Specific Critical Goods)", November 2022, p. 6).

TABLE 2

**Japan's dependency on China for major import products to China (2020) (Unit: %)**

Rank	HS	Product name	Share of Japan's imports from China in total imports of the item	Share of China's exports to Japan in total exports of the item	China's share of global exports of the item	Share of the item in Japan's total imports from China
1	847130	Portable automatic data processing machines (weight 10 kg or less)	99.3	7.6	74.5	6.52
2	851712	Cellular telephones	83.0	6.5	58.9	6.48
3	630790	Weaving fibers and other fiber products	89.5	7.4	79.8	2.90
4	851762	Switching and routing devices	48.1	5.2	36.1	2.00
5	854140	Photovoltaic semiconductor devices and light-emitting diodes (LEDs)	67.2	7.9	42.7	1.25

Note: Both exports and imports are FOB basis.

Source: Created by CEPII BACI.

TABLE 3

**Japan's dependency on China for major export products to China (2020) (Unit: %)**

Rank	HS	Product name	Share of Japan's exports to China in total exports of the item	Share of China's imports from Japan in total imports of the item	China's share of world imports of the item	Share of the item in Japan's total exports to China
1	854232	Integrated circuits (memory devices)	36.4	11.2	27.8	3.61
2	870840	Automobile parts (gearboxes and parts thereof)	30.6	40.0	17.5	3.13
3	870340	Other vehicles (hybrid vehicles)	23.9	60.0	13.4	3.05
4	870323	Passenger cars and other motor vehicles (cylinder capacity over 1,500 cc and under 3,000 cc)	9.6	14.9	12.8	3.02
5	848620	Equipment for manufacturing semiconductor devices or integrated circuits	33.2	27.0	30.7	2.88

Note: Both exports and imports are FOB basis.

Source: Created by CEPII BACI.

## Reconciling the Stability of Economic Relations with China with Avoidance of Excessive Dependence

### (1) Reinforcing "Strategic Autonomy"

Judging from the difference in economic size and potential growth rates between China and Japan, the asymmetry in the mutual economic dependence between the two countries is likely to intensify as long as the Chinese economy does not suffer a prolonged downturn. A state of outstanding dependence on a particular country needs to be addressed from the perspective of risk management, regardless of which country is the counterpart. It is imperative to ensure resilience to shocks from natural disasters, infectious diseases, etc. and, although not desired, economic malaise and spillover of political frictions into the economy. This is the reinforcement of this so-called "strategic autonomy". In enhancing strategic autonomy, the following points should be kept in mind.

First, given the structure of Japan's economic dependence on China described above, large-scale and short-term "decoupling" will inevitably have a profound economic impact on Japan. For example, if 80% of imports from China to Japan, including components, were to be cut off for two months, an estimated 53 trillion-yen worth of production (equivalent to about 10% of Japan's GDP) would be lost.<sup>7</sup>

TABLE 4

## Added value induced by domestic final demand in the US & China as a share of GDP of major Japanese industries (2018) (Unit: %)

Rank	Industry	China	US
1	Computer, electronic and optical equipment	13.6	10.8
2	Chemical raw materials & products	11.3	6.6
3	Electrical equipment	10.9	9.4
4	Water transportation	10.5	5.4
5	Machinery and equipment	10.4	9.3
6	Basic metals	10.2	9.0
7	Rubber & plastic products	7.0	6.2
8	Textiles and textile products, leather, footwear	6.9	4.4
9	Other non-metallic mineral products	6.7	4.6
10	Automobiles and trailers	6.6	18.1
All Industries		3.1	3.0

Note: Ranked in order of share of added value induced by domestic final demand in China.  
Source: OECD, Inter-Country Input-Output (ICIO) Tables, 2021 edition.

Additionally, OWLS Consulting Group estimates that if 80 major products, including home appliances and cars, were to stop imports from China and switch to domestic production or procurement from other regions, costs would increase by 13.7 trillion yen per year. This

is due to the cost of withdrawing from China as a production base, the increased manufacturing costs due to the transfer of production, increased SG&A expenses due to the dispersion of production bases, and the cost of revising designs and dealing with quality control. While 13.7 trillion yen is equivalent to 70% of the total net income of the manufacturing industries listed on the TSE Prime<sup>8</sup>, this cost estimate is based on the assumption that there will be no change in manufacturing for the Chinese domestic market and exports from Japan and other countries to China, and the actual economic impact on Japan could be much more significant than this.

Second, the heavy use of the national security exception will contribute to the tokenization of existing international trade rules. This is in fact the state of affairs in which the policy of “setting up anti-foreign sanctions, anti-interference in internal affairs, and anti ‘extraterritorial application of jurisdiction’” was set forth in the activity report of the 20th Party Congress held in October 2022. In addition, the “holistic view of national security” that the Chinese government is advocating is geared toward consolidating control over an extremely large number of areas by linking them to national security. We cannot rule out the fear that the scope of the national security exception will expand due to the exchange of sanctions and retaliation.

In light of these points, it is important to establish a “small yard-high fence” type export and technology management system and to formulate supply chain resilience measures. In addition, when formulating and implementing industrial policies to strengthen supply chains, it will be essential not only for Japan itself to give due consideration to consistency with existing international trade rules, but also to exhort its allies and partners to do the same. At the Central Economic Working Conference held in December 2022, the CCP declared its policy of “actively pursuing membership in high-standard trade agreements such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the Digital Economy Partnership Agreement (DEPA)”. There is much speculation as to whether China will be able to firmly implement the high level of international rules required by the CPTPP. With such contentions in mind, we should seek information on the status of implementation of the World Trade Organization (WTO) rules on which the CPTPP is premised and on the consistency of the CPTPP rules with China’s current policies and systems, and, after confirming these adequately, leave open the possibility of requesting China to regularize its trade and industrial policies through the negotiations on the CPTPP.

At the same time, it is necessary to continue to nudge the US, EU, and other countries to join the CPTPP, although it will be a tall order. This is because expanding the scope of the CPTPP rules will

encourage Japan to diversify its trade and investment, which will in turn contribute to enhancing its supply chain resilience and strategic autonomy. It will also presumably be necessary for the government to further stimulate the formation of a favorable environment for the diversification of Japanese trade and investment by promoting the execution of trade agreements, while stepping up support for capacity building and improvement of the investment environment in Southeast Asia, India, and other regions.

## (2) Reinforcing “Strategic Indispensability”

In addition to bolstering strategic autonomy, it is also important to enhance “strategic indispensability” in order to revitalize one’s own economy and bring about conditions that make it less susceptible to economic coercion. To this end, it is of vital importance to work unceasingly to strengthen the economic, financial, and fiscal foundations of the country, as confirmed in the National Security Strategy. It is indisputable that more resources than ever need to be invested in R&D and human resource development. Also, with regard to the issue of government debt sustainability – which is becoming a growing concern in terms of international market confidence – a roadmap for fiscal consolidation needs to be presented as soon as possible. This is because of the increased risk of government debt divergence due to higher nominal interest rates and lower potential growth rates.<sup>9</sup> Further protection of intellectual property rights is also needed.

To attain strategic indispensability, highly competitive products must command a reasonable share of the Chinese market. Stability in relations with China is also an important prerequisite for this. In stabilizing relations with China, it will be more important than ever to promote mutual understanding and manage risk through top-level diplomacy, as the centralization of power in China becomes even stronger. It is also important for the stability of Japan-China relations to firmly promote cooperation on common issues. It is fervently hoped that Japan and China will cooperate on climate change, disaster preparedness and mitigation, population aging, and other issues, as well as on third-country economic cooperation. **JS**

Shingo Ito is a senior economist of the Institute for International Economic Research. His primary areas of research are the Chinese economy, the Taiwanese economy, and Cross-Strait economic relations.

7 “If Zero China, 53 Trillion Yen of Domestic Production Disappears: The Cost of China’s Separation”, *Nihon Keizai Shimbun*, electronic edition, Oct. 18, 2022. The original paper is Hiroyasu Inoue and Yasuyuki Todo, “Propagation of Overseas Economic Shocks through Global Supply Chains: Firm-level evidence”, RIETI Discussion Paper Series, 22-E-062, July 2022.

8 “If Zero China, 53 Trillion Yen of Domestic Production Disappears: The Cost of China’s Separation”, *Nihon Keizai Shimbun*, electronic edition, Oct. 18, 2022, and OWLS Consulting Group, “Estimated cost increase in Japan in the case of establishing a de-China supply chain (published Oct. 18, 2022 in *Nihon Keizai Shimbun*)”.

9 Kazumasa Iwata, “Outlook 2023: How to Weigh the Weak Yen, High Prices, and the US-China Competition for Technological Supremacy?” Japan Center for Economic Research, Jan. 11, 2023.