Overcoming Japan's China Syndrome

By Chi Hung Kwan

Photo: Kyodo News

With China's import tariffs coming down after WTO entry, Japanese companies have better access to the fast-growing Chinese market through FDI and exporting from their headquarters

Introduction

More and more people in Japan have come to perceive the rise of China as a threat, prompted by the sharp contrast between the growth performances of the two countries in recent years. It should, however, be noted that the economic relations between Japan and China can be characterized as complementary rather than competitive, reflecting the prevailing gap in the level of development. Both sides can benefit by promoting a division of labor according to comparative advantage, with China specializing in labor-intensive products and Japan specializing in high-tech products.

Although Japan has lagged behind the United States and Europe in penetrating the Chinese market through foreign direct investment (FDI), it has benefited from importing cheap products from China. With China's import tariffs coming down after World Trade Organization (WTO) entry, Japanese companies now also have better access to the fast-growing Chinese market not only through FDI but also through exporting from their headquarters.

Do not Confuse "Made in China" with "Made by China"

Recently, Japanese imports of manufactured goods from China have surged and the reputation of Chinese products has improved substantially, giving rise to concern that China will soon replace Japan as the "factory of the world." An objective evaluation of China's industrial strength, however, suggests that there is still a long way to go before it will become a truly advanced industrial country on a par with Japan.

First of all, the high proportion of labor-intensive products in China's exports means that its trade structure is typical of a Newly Industrializing Economy (NIE). This is different from that of developed countries, where the major export items, such as machinery, are technology-intensive. Although China is increasing its share of the global market for manufactured goods, including some information technology products that are classified as high-tech, Chinese exports are still highly concentrated in lower-end products. In the case of televisions, for instance, Japan specializes in high-definition and other higher-end models, while China produces standard models whose unit values are much lower.

Reflecting China's emphasis on processing trade, goods "made in China" contain large numbers of foreign components, some of which are made in Japan. According to official Chinese statistics, increasing exports by $1 million requires importing intermediate goods and components worth over half a million dollars, which do not form part of China's gross domestic product (GDP). Moreover, the proportion of this imported content is higher for high-tech than for low-tech products. A

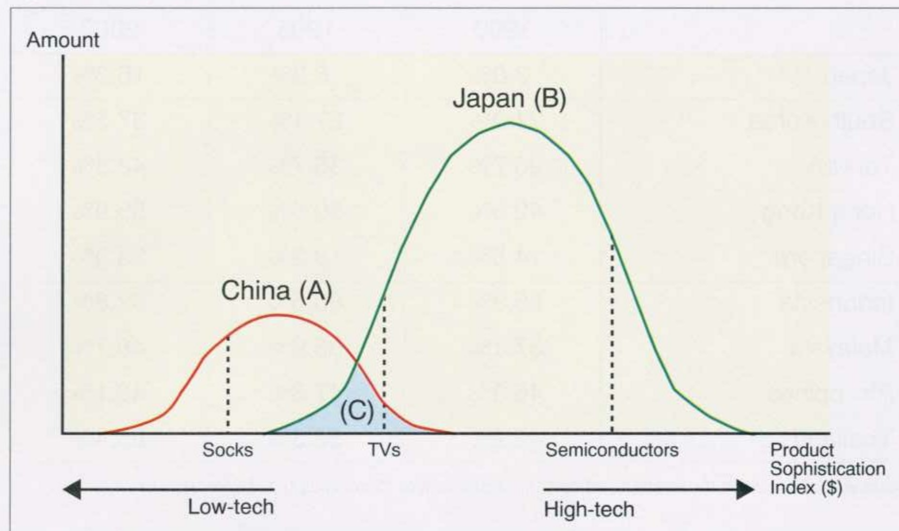
computer labeled "made in China" is likely to contain a large portion of imported contents including an Intel CPU, Microsoft Windows operating system, and a liquid crystal display made in Japan or South Korea.

In addition, approximately half of China's exports are produced by subsidiaries of foreign companies, to which dividends, interest charges, royalties and other fees must be paid. Even among Chinese companies with no capital relations with foreign companies, the majority of their exports are processed under original equipment manufacturing (OEM) contracts and sold with foreign brand names. Thus only a very small percentage of the added value of products labeled "made in China" is actually "made by China." The latter corresponds to the concept of China's gross national product (GNP), and excludes import charges on intermediate goods and investment income paid to foreign countries.

China is so heavily dependent on foreign partners that it has yet to develop its own cutting-edge technology and internationally recognized brand names. On the top of this, Chinese companies are inferior to their foreign counterparts in virtually every aspect, be it capital, human resources, or business management. As a result, China has no option but to look to cheap labor for its export competitiveness. Indeed, the majority of China's contribution to the added value of its exports lies with the cost of labor, and the very low wages in China averaging about $100 a month imply that this contribution must be very small.

As such, the common assumption that Chinese goods are competitive because the country's wage levels are low holds true only for labor-intensive products, and does not necessarily apply to industry as a whole. Instead, China's low wages should be interpreted as a reflection of the fact that its labor productivity is poor. It is when China's wage levels approach those of Japan, reflecting a rise in productivity, that China will really become a formidable competitor for Japan.

Figure 1 Competition between China and Japan



Complementarity between Japan and China

The recent economic relations between Japan and China can be explained in terms of Figure 1. The horizontal axis represents the level of sophistication of export items, and the vertical axis represents the amount of exports corresponding to export items at different levels of sophistication. A country's exports can then be represented by a distribution among products at different levels of sophistication ranging from low-tech products to high-tech products. Based on the assumption that high-value-added products are likely to be exported from high-income countries, while low-value-added products are likely to be exported from low-income countries, the product sophistication index for each product can be calculated as the weighted average of the per capita GDP of its exporters. The distribution for Japan's exports is expected to be larger than that of China, reflecting its larger volume. It should also be located more to the right, reflecting the fact that high-tech products make up a larger portion of Japan's total exports. The size of the part of the two distributions that overlap one another (C in Figure 1), as a proportion of each country's total exports (A for China and B for Japan), serves as an indicator of the degree of competition between the two countries. The greater the area of overlap between the two distributions as a percentage of Japanese exports (that is, C/B), the more China is a competitor of Japan. Conversely, the smaller the overlap, the more likely that China has an export structure complementary to that of Japan. For China, the degree of competition with Japan is given by C/A. (Figure 1)

There is no question that the size of exports from Japan is bigger than that from China, and that Japan's export structure is more advanced than that of China. However, there has been rising concern in Japan that the distribution representing China is expanding rapidly and moving fast to the right. In contrast, the Japanese distribution has been static and the prospect for restarting the engine of growth has remained dim. Against this background, many people in Japan have come to believe that China has already become a strong competitor for Japan, and that in the near future Japan will be eclipsed by China. Japan's China syndrome is merely an expression of this fear.

Although the total amount of exports from China has been increasing, labor-intensive products still feature largely in the export structure and the level of competition with Japan today is not necessarily high. It is clear that the export structures of China and Japan

Table 1 Asian Countries' Competition with China in the U.S. Market

	1990	1995	2000
Japan	3.0%	8.3%	16.3%
South Korea	24.0%	27.1%	37.5%
Taiwan	26.7%	38.7%	48.5%
Hong Kong	42.5%	50.5%	55.9%
Singapore	14.8%	19.2%	35.8%
Indonesia	85.3%	85.5%	82.8%
Malaysia	37.1%	38.9%	48.7%
Philippines	46.3%	47.8%	46.1%
Thailand	42.2%	56.3%	65.4%

Source: Calculated by the author based on U.S. Department of Commerce, *U.S. Import History*

are complementary to, rather than competing with, each other – just as the big difference in their levels of economic development as well as their export volumes would lead one to expect. Based on the framework laid down in Figure 1, we use U.S. imports from individual countries with detailed breakdown by product (covering 10,000 manufactured goods according to the Harmonized System Commodity Classification) as proxies for their global exports to confirm this point. Our estimates show that China and Japan competed for only about 16.3% of their exports to the United States in value terms in 2000, although the percentage has been growing over time (from 3.0% in 1990 and 8.3% in 1995.)

These results show merely the extent to which products exported from Japan and China overlap, and two additional factors have to be considered to evaluate more accurately the degree of competition between the two countries. First of all, even though certain products are classified in the same category, in many cases Japan specializes in products for an upscale market and China specializes in low-priced products. TVs are a typical case in point, and the price tags for high-definition TVs exported by Japan are many times higher than those for the standard TVs made in China. Also, as noted above, Chinese exports include many more imported parts and components than Japanese exports.

Thus, the degree of actual competition between Japan and China is likely to be even lower than what the result of the calculations would indicate. In addition, the competition between Japan and China exists only in relatively low value-added products, in which Japan no longer enjoys any comparative advantage.

For the sake of comparison, we also calculate the level of competition with China for major Asian economies. Our estimates show that the Association of South-East Asian Nations (ASEAN) countries, whose income levels are still low, tend to compete more with China than Japan and the Asian NIEs, which are at a more advanced stage of economic development. (Table 1)

The Rise of China as a Business Opportunity for Japan

The potential complementarity between China and Japan, however, has not been fully exploited. Many Japanese companies view the expansion of China's production capacity as a threat, while at the same time finding little attractiveness in the Chinese market. As suggested by the GDP identity, income, and thus the size of the market, should grow at the same pace as output. Moreover, due to the high degree of complementarity between the two countries, Japan should enjoy advantages in penetrating the Chinese market. Market information may be biased as companies making money in China prefer to remain mute while those incurring losses are crying out in a loud voice, causing increased pessimism. If in fact market expansion is lagging behind production in China, it may reflect the following three factors.

First, foreign affiliates hold a large share of production as well as corporate earnings in China, so that the country's GNP is far below its GDP. The dividends paid by these foreign affiliates do not become income for the Chinese people, and may actually be transferred overseas. This makes China more attractive as a production base for exports than as a market. Among the foreign companies in China, if U.S. firms and European firms are making money while Japanese firms are not, then the latter should reexamine their corporate strategies.

Second, at the macro level aggregating the household, corporate and government sectors, China has a high rate of savings, so that expenditures are far lower than income. The difference does not translate into demand for goods, but rather is used by the monetary authorities to build up foreign exchange reserves. In this case, Japan should persuade China's monetary authorities to invest a larger proportion of its foreign exchange reserves in yen assets. Unfortunately, the lion's share of this "China money" is flowing to the United States instead of to Japan.

Third, China's terms of trade have been deteriorating as rising exports drive down export prices, so that the same amount of exports can be exchanged for less and less imports. This fall in purchasing power has been reflected in the yuan's sharp depreciation over time, and the slow growth in GDP in dollar terms. Under these circumstances, Japan should benefit by importing cheap products and components from China, which would allow lower prices for consumers while cutting costs at Japanese companies.

Thus even if the Chinese market is not growing as fast as production, there are various ways that Japanese compa-

nies can take advantage of China's growing economy. While importing goods produced in China through OEM and other schemes is going relatively well, Japanese investment in China has stayed at a very low level.

On the other hand, the U.S. and European countries view the emergence of China as a business opportunity, rather than as a threat, and success stories of their companies in China are on the rise. Indeed they now lead the list of the top ten foreign companies in China, which does not include a single Japanese company. Among automakers, for example, Germany's Volkswagen has a market share of 50%, while the mobile phone market has been dominated by Motorola of the United States, Nokia of Finland and Ericsson of Sweden. Even in China's electronics sector, Japanese companies are losing share as many Chinese firms emerge. Thus Japan should worry more about being left out of the fast-growing Chinese market, rather than about the hollowing out of its industry as more and more Japanese companies move to China.

Exports Versus Investment as a Means to Access the Chinese Market

One way for Japan to compromise between the concerns of hollowing out and losing the Chinese market is to put more emphasis on exporting to, than on producing in, China. Indeed, the sharp cut in tariffs following China's WTO accession should favor the former over the latter, particularly in areas where Japan enjoys comparative advantage while China does not.

One example is the automobile industry. Until now, the Chinese government has encouraged foreign automakers to produce in China by allowing auto sales in the domestic market on the one hand, while imposing high tariffs on auto imports on the other. Under this "swapping market for technology" strategy, foreign automakers would hit a wall of high tariffs when they tried to export to China, but the very same wall would protect them if their production were inside China. But things are changing. Following its entry to the WTO, China will abolish import quotas and lower import tariffs on finished cars from 80-100% to 25% by mid-2006. As a result, it may become cheaper to export finished cars to China rather than producing them there.

Photo: AP/WWP

Chinese people look at Nokia's mobile phones; China's mobile phone market has been dominated by U.S. and European companies

Should Japanese automakers opt for exports as a way to increase their presence in the Chinese market, they will be able to shift their investment in China away from production facilities and into the reinforcement of sales networks, aftercare services and the establishment of research and development facilities for improving auto designs to better fit local tastes. Meanwhile, expanding production at home to satisfy the rising demand in China would reduce the pace of the hollowing out of Japanese industry.

Moreover, the Chinese auto industry faces so many handicaps that cheap labor in China does not necessarily translate into low production costs. Most automakers there are so small that they are unable to benefit from the economies of scale. Their productivity and research and development (R&D) capability also remain low and the quality of their products is far below global standards. As a consequence, the costs of local auto production are often higher than international prices for cars of equivalent quality. Utilizing their technology and financial resources, Japanese automakers may be able to overcome some of the drawbacks to producing in China. But it is doubtful whether they can compete with imported cars produced by their foreign rivals when China's import tariffs on auto imports come down to 25%.

The majority view among Japanese automakers is that they should produce close to the market so as to improve their brand image and meet the needs of consumers. But consumers rarely do their shopping by visiting car factories, and their needs can be served better by expanding local R&D facilities and aftercare services. Indeed, European automakers that are expanding their share of the Japanese market do not produce in Japan.

Also, for expensive goods like cars, other things being equal, Chinese consumers would certainly prefer a "made-in-Japan" to a "made-in-China" label. Above all, if Japanese automakers try to increase their production in China, they should also be prepared for the risk of overcapacity problems, which they may face in the near future as a result of too many foreign automakers rushing into the Chinese market. Instead of jumping on the bandwagon and building new plants in China, Japanese carmakers should consider the alternative option of exporting from their headquarters. JJTI

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