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# Mutual Assured Production

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## Why Trade Will Limit Conflict Between China and Japan

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*Richard Katz*

**D**uring the Cold War, the United States and the Soviet Union carefully avoided triggering a nuclear war because of the assumption of “mutual assured destruction”: each knew that any such conflict would mean the obliteration of both countries. Today, even though tensions between China and Japan are rising, an economic version of mutual deterrence is preserving the uneasy status quo between the two sides.

Last fall, as the countries escalated their quarrel over an island chain that Japan has controlled for more than a century, many Chinese citizens boycotted Japanese products and took to the streets in anti-Japanese riots. This commotion, at times encouraged by the Chinese government, led the Japanese government to fear that Beijing might exploit Japan's reliance on China as an export market to squeeze Tokyo into making territorial concessions. Throughout the crisis, Japan has doubted that China would ever try to forcibly seize the islands—barren rocks known in Chinese as the Diaoyu Islands and in Japanese as the Senkaku Islands—if only because

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the United States has made it clear that it would come to Japan's defense. Japanese security experts, however, have suggested that China might try other methods of intimidation, including a prolonged economic boycott.

But these fears have not materialized, for one simple reason: China needs to buy Japanese products as much as Japan needs to sell them. Many of the high-tech products assembled in and exported from China, often on behalf of American and European firms, use advanced Japanese-made parts. China could not boycott Japan, let alone precipitate an actual conflict, without stymieing the export-fueled economic miracle that underpins Communist Party rule.

For the moment, the combination of economic interdependence and Washington's commitment to Japan's defense will likely keep the peace. Still, an accidental clash of armed ships around the islands could lead to an unintended conflict. That is why defense officials from both countries have met with an eye to reducing that particular risk. With no resolution in sight, those who fear an escalation can nonetheless take solace in the fact that China and Japan stand to gain far more from trading than from fighting.

### **THE TIES THAT BIND**

Although China first claimed the Diaoyu/Senkaku Islands in 1971, it never did much to pursue its claim until recently. On the contrary, in the interests of improving economic and political ties, Chinese Premier Zhou Enlai and Japanese Prime Minister Kakuei Tanaka agreed in 1972 to shelve the issue indefinitely. Beijing even stopped Chinese nationalist activists from trying to land on the islands and prevented articles that asserted

China's claim to them from appearing in the Chinese press. In the last few years, however, China has reversed course and started to back up its claims with actions. In 2010, for example, a Chinese fishing boat rammed a Japanese coast guard ship in the waters around the islands. When the coast guard personnel arrested the fishing boat's captain, Beijing declared that Japan had no jurisdiction in "Chinese territory" and cut off supplies to Japan of vital rare-earth minerals until he was released.

It took until July 2012 for the issue to explode. That month, then Japanese Prime Minister Yoshihiko Noda announced that his government intended to buy some of the islets from their private Japanese owner. Noda's aim was to prevent them from being sold to the right-wing governor of Tokyo, who had revealed plans for the islands that would certainly have provoked China. But Beijing told Noda that it would see even the government's purchase as an unacceptable change in the status quo. The Noda administration ignored warnings from both Beijing and the U.S. State Department and deluded itself that China would acquiesce to the purchase.

Then came the riots and the boycotts. For several weeks in August and September, Chinese protesters caused a ruckus, damaging Japanese-made cars, vandalizing stores selling Japanese products, and setting a Panasonic factory on fire. The police vacillated between encouraging and suppressing the riots, and some Chinese state media outlets listed Japanese brands to boycott. By the time the dust settled, Japanese firms operating in China had suffered about \$120 million in property damage, and for a few months thereafter,

sales of Japanese cars fell by approximately 40-50 percent.

The riots have stopped, but the larger conflict shows no signs of fading. China regularly sends armed surveillance boats into the islands' territorial waters, and the Chinese Foreign Ministry now calls the islands a "core interest," a term limited to the most sensitive areas regarding China's sovereignty, such as Taiwan and Tibet. China's Commerce Ministry has hinted at the possibility of a prolonged boycott to get Tokyo to concede that China has legitimate claims to the islands. It warned last September that Noda's purchase of the islands would "inevitably affect and damage . . . Sino-Japanese economic and trade relations."

A boycott would indeed prove disastrous for Japan's export-dependent economy. From 2002 to 2007, a third of Japan's GDP growth came from an increase in its trade surplus, and another third came from capital investment, much of which was tied to exports. And China stands at the center of this picture. From 1995 to 2011, increased shipments to China accounted for 45 percent of the overall growth in Japanese exports. Since the crisis erupted last July, however, Japan's price-adjusted exports to China have fallen by 20 percent, compared with an 11 percent drop in its global exports (as of March).

Japan's dependence on China helps explain why the new Japanese prime minister, Shinzo Abe, has not followed through on the hawkish positions he touted during last December's election campaign, such as his plan to place personnel and facilities on the Senkakus. Abe knows that his popularity hinges on Japan's economic recovery, and lest he forget it, Japanese businesses have been

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urging him to refrain from any provocations while still seeking a resolution that maintains the country's sovereignty over the islands.

But it is not only Tokyo's behavior that has been tempered by economic interdependence. This year, Chinese censors have blocked the phrase "Boycott Japan" from Weibo, China's equivalent of Twitter. During February's New Year's celebrations, Beijing banned sales of the popular "Tokyo Big Bang" fireworks, which simulate the burning of the Japanese capital. In late March, China even joined Japan and South Korea in long-anticipated talks aimed at forming a trilateral free-trade agreement.

Meanwhile, Chinese provincial governments, hungry for jobs and tax revenue, keep imploring Japanese companies to expand their operations in China. In February, the city of Chongqing hired the Mitsui Group, a Japanese conglomerate, to develop an industrial park aimed at attracting foreign investment. At a March conference of the Japan-China Economic Association in Beijing, China's new vice president, Li Yuanhao, may have insisted that the media not photograph him shaking hands with Japan's top business leaders, but he nevertheless asked those leaders to step up their investments. Even on the national level, China is far more pluralistic than it used to be. The Communist Party-owned *Global Times* published both pro- and anti-boycott op-eds last fall.

Nor do most Chinese consumers seem interested in a boycott. The Japanese products that have lost the most sales during these latest tensions have been the highly visible ones, which are vulnerable to social pressure. Last fall and winter, sales of the popular cosmetics



*Buy local: at an anti-Japanese rally in Chengdu, China, October 2010*

and skin-care products made by the Japanese company Shiseido tumbled, partly because many customers refrained from sending them as holiday gifts. Some stores temporarily displayed Shiseido products less prominently, but very few stopped carrying them altogether.

The worst-hit Japanese products have been cars, since many were vandalized by hooligans during the riots. But sales are recovering. Last fall, Nissan, the Japanese automaker, offered its Chinese customers its new “Promise for Car Security” program, a guarantee of free repairs for vehicles damaged in anti-Japanese riots. That’s one reason why in March, sales at Nissan dealerships finally rose above the previous year’s levels. And as China’s infamous air pollution has worsened, February sales of air purifiers by Panasonic doubled

from the year before, and sales of those made by Daikin quadrupled. Both are Japanese companies.

### **MADE IN CHINA, WITH HELP FROM JAPAN**

Why does China, the world’s largest exporter, so badly need what Japan is selling? Put simply, China’s export-driven economic miracle depends on imports. Around 60-70 percent of the goods China imports from Japan are the machinery and parts needed to make China’s own exports. China cannot cut off this flow, or risk disrupting it through conflict, without crippling its economy. That is why, during the height of the island crisis last fall, the same Chinese customs officials who sometimes delayed shipments of Japanese consumer goods let industrial parts pass through.

For years, Japan has been China's single largest source of imports. A 2012 International Monetary Fund report calculated that for every one percent of growth in China's global exports, its imports from Japan rise by 1.2 percent. Take away those imports, and China's exports collapse.

Consider the iPhone and the iPad. Although Apple hires Taiwan's Foxconn to assemble these products in China, they contain Japanese parts, including Toshiba flash memory drives and Sharp LCD screens. The case of Apple is instructive for two reasons. First, as China has increasingly begun to export high-tech products, it has needed to rely more and more on imported parts. During the middle of the last decade, imported parts accounted for 22 percent of the value of low-technology goods exported from China. For information and communications equipment, however, that number was almost 50 percent. And it is precisely these import-intensive machinery and electronics products that are becoming more important to China's economy, rising from just 22 percent of all Chinese exports in 1992 to 63 percent in 2006 and presumably even more today.

Second, China's modernization depends on a host of multinational corporations using China as their workshop. In 2010, foreign companies and joint foreign-Chinese ventures accounted for more than 25 percent of China's entire industrial output, 39 percent of its apparel exports, and 99 percent of its computer exports. And these companies rely on imports from Japan. China cannot single out Japanese products without damaging and alienating the network of multinational companies that are fueling China's march up the value chain and toward higher living standards.

Today, China's cheap but high-quality labor and its fantastic infrastructure make the country an attractive production base. But if nasty international politics get in the way of those advantages, multinational corporations have other places to go. Only \$4 of the value of the 2005 vintage iPod, priced at \$299, came from China, and most of that was assembly work that could have been done elsewhere. Rising wages and worsening pollution have already led some electronics firms to shift their assembly operations to Southeast Asia. China cannot take foreign investment for granted.

Japanese firms know this, which explains why they are not fleeing despite the recent tensions. Japan remains the largest source of foreign investment in China today. According to Masaki Yamazaki of the Japan Center for Economic Research, some Japanese firms are considering a "China plus one" strategy, a way of diversifying their risks and finding another large market to invest in and export from. But, he added, "it's unrealistic to think that all the Japanese companies will rush away from China." As long as multinationals want to assemble products in China, Japanese suppliers need to be there as much as China needs to host them. What is more, China's bulging middle-class market is too big to be ignored by Japanese companies that produce consumer products and are plagued by low growth at home.

Indeed, in a survey conducted by the Japan External Trade Organization last November and December, just after the spate of violence, only six percent of Japanese companies in China said they were going to leave or downsize. Conversely, 52 percent planned on expanding,

and 42 percent indicated that they would keep their operations at the same level while monitoring the situation. In 2012, a year in which global foreign direct investment in China fell by 3.7 percent, Japanese investment rose by 6.0 percent. As one Japanese business consultant told me, “Japanese firms see no early end to the territorial tensions. Some feel that they may just have to accept that, every few years, there will be an outburst of boycotts and even some violence.”

### **PAX ECONOMICA**

As World War I cruelly demonstrated, economic self-interest does not always override nationalist emotions. But it does raise the costs of letting passions dominate foreign policy.

For most of the past three decades, in recognition of those costs, China has sought what its leaders term a “peaceful rise.” In the past few years, however, Beijing has shifted to a far more abrasive posture toward several countries in Asia. Some observers speculate that China’s newfound assertiveness is a response to political dysfunction and the financial crisis in the West, which have led Beijing to doubt the United States’ staying power and overestimate its own strength. Whatever the reasons, the new approach is reportedly disdained as self-defeating by many of China’s business leaders and, according to Kiyoyuki Seguchi, research director at the Canon Institute for Global Studies, even by certain elements of its military.

Mao once observed that “political power grows out of the barrel of a gun.” But in today’s China, it is trade and globalization that pay for that gun. Despite Beijing’s increasingly assertive stance, many Chinese officials recognize

the costs of threatening the country’s economic ties. As an op-ed in *China Daily*, an official Communist Party paper, put it last August, “Blindly boycotting Japanese goods by giving way to sentiments could harm our own industries and exports, and reduce employment.”

Unfortunately, Beijing is not the only capital where politicians are ginning up nationalist fervor. In April, Abe began to show his more hawkish side. That month, some of his cabinet ministers and a record 168 Diet members visited the Yasukuni Shrine, which pays tribute to Japan’s war dead and is controversial because it includes World War II war criminals—such a trip understandably outrages China, South Korea, and others. Then, Abe publicly questioned whether Japan’s actions in China and Korea during World War II and earlier really constituted “aggression” and indicated that he might partially retract Tokyo’s 1995 apology for Japan’s behavior. Some fear that if Abe’s party wins the July elections for the upper house of the Diet, Abe will further unleash his nationalist instincts.

For now, China is sending mixed signals as to whether it will escalate or calm these tensions, something the Japanese interpret as a lack of a policy consensus. Even though some officials in both capitals are looking for ways to save face and step back from the precipice, an unintentional conflict is still possible. But there is at least one reason for hope: although money is said to be the root of all evil, it may also be what ultimately tips the balance of forces within each country back toward those who can prevent war and eventually put the conflicting territorial claims back on the shelf.