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# Comments on China as a Regional Player

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## About the Author

Edward J. Lincoln joined the Council on Foreign Relations (CFR) as a senior fellow in February 2003. Dr. Lincoln came to the CFR from the Brookings Institution, where he had also been a senior fellow. He had been at Brookings since 1984, leaving temporarily for two and a half years at the beginning of 1994 to serve as special economic adviser to Ambassador Walter Mondale in Tokyo. In that position, he was responsible for providing Ambassador Mondale with analysis and advice on economic development important to the conduct of bilateral affairs. At the CFR, Dr. Lincoln specializes in the Japanese economy, U.S.-Japan economic relations, and broader Asian economic topics. His most recent book, *East Asian Economic Regionalism* (Council on Foreign Relations and the Brookings Institution Press, March 2004) concerns the evolution of regional trade and investment ties, the rise of regional economic institutions (such as the Asia Pacific Economic Cooperation forum), and the implications of these developments for U.S. foreign economic policy. He is currently working on his next book, which will examine the relevance of international economic interdependence for American foreign policy. While at Brookings, Dr. Lincoln published *Artbritic Japan: The Slow Pace of Economic Reform* (2003), concerning the impediments to systemic economic reform in Japan. Earlier publications at Brookings include *Troubled Times: U.S.-Japan Economic Relations in the 1990s* (1999), *Japan's New Global Role* (1993), *Japan's Unequal Trade* (1990), and *Japan: Facing Economic Maturity* (1988). In addition, Dr. Lincoln has published numerous articles and spoken widely on issues related to Japan and U.S.-Japan relations. He also teaches about the Japanese economy at Johns Hopkins University's School of Advanced International Studies. Dr. Lincoln holds a bachelor's degree from Amherst College, a master's in East Asian Studies and a doctorate in economics from Yale University. He currently serves on the board of directors for the *Journal of Japanese Studies*.

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# Comments on China as a Regional Player

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## China in the Region

China ought to be able to produce a relatively high economic growth rate over at least the next decade. There are a number of problems confronting the economy, but one of the great lessons of the past half-century of world economic growth is how much growth can result even when economies have considerable institutional flaws. Economists usually speak about the need to get the “fundamentals” right to produce economic growth, but we should also keep in mind that nations need not get have a perfect set of institutions and rules to generate growth.

As China continues to grow, the rest of the region will see the situation as more of an opportunity than a threat for three important reasons:

1. China is a relatively open economy, with the ratio of imports to GDP now at 30 percent (a percentage that will presumably fall somewhat due to the recent upward revision in GDP figures). Not only is this ratio high, it has risen dramatically over the past two decades. Thus, quite unlike the case with the rise of Japan over the past half-century, neighboring countries have seen a dramatic rise of export opportunities as China has grown and opened up to the outside world. For the ASEAN countries, this sense of opportunity is being enhanced by the emerging ASEAN-China free trade agreement.

2. China is also rather open to inflows of foreign direct investment. This, too, is in great contrast to the history of Japan's rise in the past half century. The annual inflow of foreign direct investment has been running on the order of ten to twelve percent of total fixed capital formation in recent years – a relatively high level (in Japan, by way of contrast, this ratio is only one percent).

Several years ago ASEAN countries were worried about China sucking in investment from developed countries at their expense, but this concern has diminished. Except for Indonesia, inflows of investment to ASEAN are returning. The large population base of ASEAN as a whole makes investment there attractive (with AFTA enhancing the possibilities for ASEAN-wide distribution. Furthermore, firms from developed countries are somewhat wary about putting all their regional production into China, given some doubts about future political and economic scenarios. To the extent that ASEAN countries continue to feel threatened by the diversion of direct investment to China, they can always accelerate their regional consolidation by improving the currently imperfect state of AFTA.

3. While China has a global current-account surplus, it does not have a surplus with the rest of the region. Furthermore, both political and economic forces over the next decade will

probably contain the size of the global surplus. This means that, unlike the United States, there is relatively little concern about being “hollowed out” by China. This reinforces the first point: as long as China’s imports are rising as fast as its exports to the region, these countries can easily see China as an opportunity rather than a threat.

None of these three points necessarily mean that the rest of the region is entirely comfortable with China, but they do mean that the sense of competitive threat that has bubbled up in the United States is largely absent.

## Japan and China

The general economic points made above apply to Japan’s relationship with China. Japan’s exports to China have risen quickly, and it has a trade surplus with China (if one includes Hong Kong as part of China). Indeed, an accelerated growth in exports to China (and a shift in the trade balance from negative to positive) in 2002-2003 provided the initial impetus for the economic recovery that Japan has been experiencing. By 2005 or 2006, Japan will probably export more to China than to the United States (and it has imported more from China than the United States since 2002). On investment, there was a slump in flows from the mid-1990s until about 2001, but since then, Japanese investment flows have rebounded, reaching close to \$5 billion in fiscal 2004 (or about twelve percent of total Japanese outward direct investment flow).

Despite these rapidly expanding economic ties, the Japan-China political relationship has become increasingly troubled. The root causes here involve a deep anxiety on the part of some Japanese about the international power implications of China’s rapid growth, along with a bruised ego as Japan loses a sense of self-worth as the informal “leader” of East Asia (a positive self-image considerably inflated beyond the lesser reality of the 1980s and 1990s). The Japanese government, for example, has been humiliated by having to adjust its policy toward the region in response to Chinese policy initiatives. The dramatic turn in Japanese trade policy to pursue an FTA with ASEAN, for example, came only after the Chinese government initiated its negotiations for a China- ASEAN FTA.

The surface manifestation of these deeper causes has been a series of provocations over the past two years by the Japanese government and individually by leading Japanese politicians. These provocations have included Prime Minister Koizumi’s repeated visits to Yasukuni Shrine, and his strong unapologetic statements about his right to go whenever he wants; Foreign Minister Aso’s various nationalistic statements; the Education Ministry’s approval of a new version of a history textbook written by a right-wing group; public exposure of the discovery of a Chinese submarine in Japanese coastal waters; and, most recently, the revelation of the suicide of a compromised Japanese diplomat in Shanghai. These latter two provocations obviously involve Chinese misbehavior as well, but are the sort of rather commonplace actions that the aggrieved nation usually chooses to keep hidden (with the U.S. government, for example, not revealing that it knew when Soviet submarines were in our waters). Most of the Chinese “provocations” have actually been in the form of somewhat excessive negative reactions to these Japanese provocations. As a result, while

one can find blame on both sides for the recent two years of deteriorating relations, the primary cause has been a set of deliberate antagonistic actions by Japanese politicians and in Japanese government policy.

Why now? One obvious reason is that the Chinese government has only recently begun to play a larger role in regional affairs, and the Japanese are reacting to this. In addition, however, Japanese politicians have been keenly aware of the greater emphasis that the Bush administration placed on the U.S.-Japan strategic relationship when it came into office, and the unease or antagonism toward China expressed by a number of senior Bush administration officials. Thus, the Japanese government has felt that a policy of voicing hitherto suppressed negative feelings about China (and South Korea) or expressing openly their attitudes about the “history” issue would not cause any negative reaction from the Bush administration. Until recently, this calculation appears to have been correct.

The deliberately engineered deterioration in Japan-China political relations is a sharp contrast to the rapidly expanding economic relationship. So far, the political tensions do not appear to have affected the decisions of the Japanese business community concerning trade and investment with China. The noisy anti-Japanese protest marches last spring did not appear to have led to any organized activity against Japanese companies or their products. While Japanese managers have often sounded somewhat more cautious about doing business in China than American managers, this caution does not show up in the trade and investment numbers. One can add that the past five to six years have also seen an expansion of the number of Chinese students studying in Japan (now 80,000, though exactly how many of these are legitimate students is questionable), with no reports of any recent decline.

Where is this relationship likely to go? In the short run, it is clearly in the interest of the Japanese business community to put pressure on the politicians. While muted, this process has begun, with Toyota chairman Hiroshi Okuda speaking out in his capacity as head of Keidanren (the association of big business in Japan), admonishing Prime Minister Koizumi to stop visiting Yasukuni Shrine. How effective this pressure will be is uncertain, and there are many business executives who harbor negative or ambiguous personal feelings about China and who might be sympathetic to Koizumi and others. Thus, the domestic dynamics between a business community that has clearly benefited from China and a political community increasingly willing to antagonize China remain complex. Nonetheless, the general thrust of business pressure will be to smooth over bilateral relations.

If the Japanese government were to continue its antagonistic stance, a longer-term outcome is likely to be a more rapid shift in informal regional “power” away from Japan toward China. At a regional conference in Bangkok in December, for example, the complete lack of sympathy by Southeast Asian participants toward the belligerent stance of Japan toward China was striking.

The best guess one can make about Japan-China relations in the next several years is a “muddle through” outcome. The concern over Koizumi’s shrine visits implies that his successor is unlikely to continue them (even if it is a nationalistic individual like Abe or Aso). Some leading members of the business community will continue to work behind the scene to enable this outcome, as well as applying pressure to tone down nationalistic rhetoric in general. Even the Bush administration appears to have finally recognized that the

deterioration in Japan-China relations (and Japan-Korea relations) is worrisome, with Bush allegedly advising Koizumi privately to behave more responsibly. And Japanese government officials appear to be aware of their own problems in maintaining any sense of regional leadership if they continue to tarnish their reputation in Southeast Asia by being so provocative toward China.

## Regional Integration and China

The above analysis suggests that regional economic integration is likely to be driven increasingly by China rather than Japan. However, it is important to emphasize that any regional integration is likely to proceed slowly. Because of the very wide variation in per capita GDP among the nations in the region, it has proven rather difficult to define a common economic interest (with the minimalist Chiang-Mai Agreement on expanded foreign exchange reserve swap arrangements about the only substantive agreement in the past five years). Policy discussion is also currently hindered by Japan's political problems with both China and South Korea. Furthermore, there remains little agreement on what the "region" includes. Malaysia, for example, has been outraged at the inclusion of Australia, New Zealand, and India at the recent East Asian Summit meeting.

For the moment, therefore, any narrow East Asian economic regionalism that excludes the U.S. government as a participant appears unlikely to proceed very far. However, as long as that possibility exists, it ought to be the objective of the U.S. government to encourage institutions that include the United States, principally APEC. As much as both Japan and ASEAN countries see opportunity rather than threat in economic engagement with China, they remain wary about the power relationships when they sit at a negotiating table on economic issues. Therefore, it ought to be in their interest to have the U.S. government in the room as well. Indeed, it appears to have been this kind of thinking that led the Japanese to press for inclusion of India at the East Asian Summit.

Exactly what the Chinese themselves want is unclear. Back in the early 1990s when Malaysian Prime Minister Mahathir proposed the East Asian Economic Caucus, he clearly had in mind a deliberate snub of the United States and other Western powers. When the Japanese proposed the Asian Monetary Fund in 1997, they, too, were motivated by a desire to snub the United States (at least rhetorically, since the AMF was not really a serious policy proposal). But the Chinese do not appear to harbor such intentions at the present time. Unlike the Japanese, they display a greater recognition of their global economic interests. Chinese export markets are global (and the United States remains the largest single destination by a considerable margin). Both European and American firms are important investors in China. As financial reform proceeds, it will be American and European financial institutions that become larger players in China. Meanwhile, the Chinese appear to enjoy their ability to be a player in WTO negotiations. The regional FTA with ASEAN, therefore, appears to have been more of a political decision (to improve relations with ASEAN countries) than an economic decision to move in a more regional direction.

## China-India

The final question is the future of the economic relationship between India and China, with *Business Week* coining the phrase “Chindia.” However, at the present time, any strong bilateral economic integration between these two populous nations appears unlikely. For example, less than one percent of China’s exports in 2004 were to India.

Furthermore, suppose there were to be greater synergy and activity between these two countries in the future? The economic benefits to the world would be positive (barring creation of an exclusive bilateral FTA). Since both China and India are so large in population terms, the impact of economic adjustments across the globe is more visible than if these two countries were small. But the big adjustments come simply from the growth and increasing integration of these two countries into the global system. The additional adjustment resulting from increasing integration between the two of them is relatively small in comparison.

## Conclusion

The above comments on the role of China in East Asia prompt two further comments related to American policy:

First, it would be a mistake to think that much of East Asia shares American ambivalence about the rise of China. For Southeast Asian countries in particular, China is large, growing, and beneficial. While they may have some wariness about regional power relationships, they will willingly continue their expanding economic engagement. Japan is possibly the only exception.

Second, to the extent that we should be concerned about the direction that East Asian economic integration might take, the appropriate response is to reinvigorate the APEC process. APEC may be a flawed process, but it is the only regional economic arrangement that includes the U.S. government.