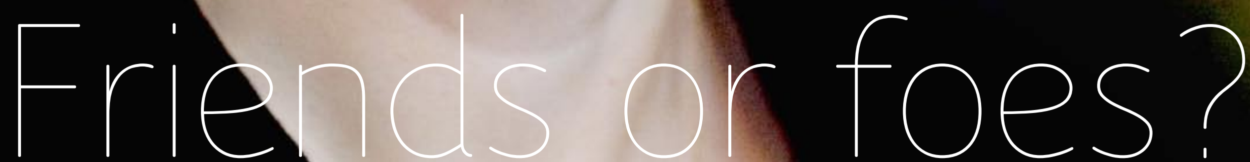

Friends or foes?

*Julian Ryall talks to economist **Naomi Fink** about Japan and China's economic ties*

Photos **ROB GILHOOLY**

Naomi Fink is the Japan strategist of the global markets unit at the Bank of Tokyo-Mitsubishi UFJ. Originally from Los Angeles, 35-year-old Fink graduated from the University of St Andrews in Scotland and has a special interest in the economic relationship between Japan and China.

How would you describe the economic relationship between Japan and China at present?
I would characterise it as one of increasing interdependence. Trade has been growing, both in terms of imports and exports. After a period of exponential growth, there is now a total of ¥1 trillion in trade between Japan and mainland China. Investment might be lagging slightly, especially portfolio investment, but that is largely due to Chinese capital controls.

Investment and trade are the two greatest areas of rising interdependence, while political interdependence lags behind. That said, Sino-Japanese relations have visibly improved over the last 10 years. The challenge will be to continue improving bilateral relations (and refrain from economic protectionism), even as they are periodically tested by tensions such as those over the Senkaku islands.

How has the relationship changed in the last five years?
Ballooning volumes of bilateral trade are the most obvious change. Beyond purely bilateral trade, both countries' intra-regional trade volumes are rising; and they compete in third markets. For example, with the emergence of China's steel industry, both economies compete for iron ore and coal, which has driven the prices for these commodities sharply higher.

But trade with the United States has decreased as a share of total trade, which means that Japan and China's relationship as both partners and competitors is more important than before the financial crisis.

Where does the United States fit in today?
United States demand in the post-war period has remained a constant source of overseas income for Japan, even after the bubble burst in the early 1990s. Now, not only has the US's status as a source of constant demand been thrown into doubt, but there is also another large player in the game, already a large investor and exporter but with the potential to become a much larger consumer and importer.

So while there is a lot of potential in Chinese growth, it would be a mistake to simply substitute China for the US: firstly, because China, a large emerging market economy, is much more volatile than the US; and secondly, because China, like Japan, is still a net saver rather than a large importing consumer. China has yet to increase domestic consumption as a share of gross domestic product, thus allowing the country more stable growth.

Can Japan benefit from a more powerful China?
Yes, through both trade and investment. As China grows, the demand for Japanese exports should grow, which will obviously benefit Japan. But Japan is actually more dependent on investment income than net exports now for growth. Direct investment by Japanese firms active in China has boomed and has much potential.

Still, this means that Japanese firms will have to adapt to new competitive standards abroad, such as rising wages among Chinese factory workers. Additionally, Japan has room to accept more inward investment. Deflation-beset Japan could benefit from the reflationary impact of Chinese inward investment on local asset prices.

What has been the reaction – in both countries – to China becoming the world's second-largest economy?
When a nation commits to maintaining large current account surpluses, the highest ranking its economy will ever be able to reach is number two, since as a net saver you export to an economy that consumes more than you. If the plan is to remain a net saver, why should Japan be dismayed at having another vast economy to export to?

Is China going to become the world's largest economy?
International Monetary Fund estimates of GDP on a purchasing power-adjusted basis point to China catching up with the US by the middle of this decade. The Economist Intelligence Unit estimated at a recent conference that China's GDP would exceed that of the US by 2020. But this also means that China will have to move from an exporting nation to a net consuming nation, which implies drastic changes in its economy first.

Should the West – specifically Europe – be worried?
Europe as a region is a net exporter, so the rise in Chinese consumption is an opportunity, even if China remains a trade competitor in some areas, such as textiles or shoes, which in the past have been areas of bilateral trade tension. On the investment side, Europe has seen its share of challenges recently: markets have reacted violently to the Greek crisis, for example.

And this underscores that, even though Europe is an external surplus holder there are many countries – such as Spain, Greece and Britain – that are dependent on foreign investment. The Chinese government remains one of the world's largest, thus most influential, investors – which is important for European capital markets too. Chinese officials' recent expressions of confidence in European bonds arguably helped to dampen panic over capital flight.

Might we finally see "decoupling"?
It is natural that emerging markets should grow more quickly than developed economies. Still, a complete divorce of growth in emerging economies from demand in developed economies is unlikely. Certainly there are divergences – the overall number of mergers and acquisitions has peaked in the US but is still rising in Asia, for example. That said, the Group of Seven is still by far the largest contributor to global trade. China, in this context is still dependent on the G7, and will be for a while.

What are the biggest potential pitfalls, on both sides?
Protectionism from either side which, in most situations, invites inflation. China is already trying to keep consumer price rises under control, but will struggle as long as it manages its currency tightly against the falling dollar. Japan, of course, is in deflation; but simply forcing the price of imports up through trade or investment barriers is not the answer – this could erode the margins that Japan's most competitive multinational firms have striven to preserve.

What does Japan need to do?
Given sluggish growth in the US, and volatility in Chinese demand, the Japanese services sector – which provides 70% of Japanese jobs – might not remain subsidised by exports. Japan might need to recognise that, as a large and mature economy, its current struggle to extract domestic recovery from a less reliable recovery in exports might not prove as fruitful as in the past. This is because its past reliance on exports for growth might have been over-dependent upon debt-fuelled US consumption, and thus anomalous.

The services sector might become more productive, and hence investment-worthy, by upgrading technology – while more efficiently allocating labour as well as capital. ⓔ