

FOCUS



By Carlos Casanova,
Economist for Asia Pacific
Hong Kong

Clash of the Titans: China's rise fuels competition with Japan's interests in Asia

China has undoubtedly modelled itself as the new champion of globalisation. Nowhere is this felt more strongly than in Asia. Since its accession to the World Trade Organization (WTO) in 2001, the country has positioned itself at the core of the world's most important supply chains, rapidly becoming the largest trade partner for many Asian economies. More recently, the intensifying rhetoric surrounding China's Belt and Road initiative¹ – aimed at boosting investments in infrastructure and beyond – has led observers to neglect the role played by another regional powerhouse: Japan. Although China may be king in terms of trade, it is considerably behind Japan in terms of investment. But fears surrounding China's hegemonic dominance in Asia Pacific (APAC) may have been overplayed: Japan remains a key player in this sphere, and will continue to be so for the foreseeable future.

However, a closer look at the evolution of trade and investments reveals that the two countries' are becoming competitors in the region. Japan and China are net commodity importers from Asia. More importantly, they both import significant amounts of mechanical and electronic parts and components, which are processed into higher value-added goods for export, owing to the important role that both countries play in the global electronics supply chains. Not surprisingly, the top three exports to Asia for China and Japan are exactly the same: electrical machinery and equipment, machinery and mechanical appliances, and steel products. Their production structures are therefore becoming increasingly similar. This has led China to refocus its investments, moving away from mineral resources and towards manufacturing. Increases in Chinese investment in the Asia-Pacific region may eventually pose a threat to Japanese corporate interests.

¹ - Formerly known as the "One Belt, One Road" initiative

China remains the King of Trade, despite higher Japanese investments

A lot of attention has centred on the role of Chinese investment into Asia and its potential implications for the continent. China's flagship Belt and Road initiative was conceived to foster economic cooperation and development through infrastructure investments, so as to boost regional interconnectivity - with China at the centre. However, the grand narratives surrounding the initiative have not yet led to the surge in investments touted by its architects. The reality is that a series of domestic considerations have taken precedent over an abstract geopolitical agenda. According to figures released by China's Ministry of Commerce in early 2017, Chinese inbound Foreign Direct Investment (FDI), from the world into China, rose by 7.9% in 2017, reaching USD 135 billion. Meanwhile, Outbound foreign Direct Investment (ODI), from China to the world, declined by 29.4%, amounting to USD 120 billion during the same period. This constitutes the first annual contraction in outbound flows since 2009. Moreover, it implies that China has returned to being a net recipient of FDI, after briefly joining the likes of the United States and Japan in attaining net donor status in 2015.

“China’s share of total global ODI stocks is only 3%, a very low sum relative to its share of global GDP (15%) and global exports (14%)”

The decline in ODI does not come as a surprise, even in the context of the intensifying Chinese Belt and Road rhetoric. Chinese investments abroad intensified tremendously starting from the early 2000s. China's “go-out strategy”, introduced as part of the tenth Five-Year Plan (2001-2005), encouraged ODI projects that helped Chinese companies with their internationalisation - a key part of China's preparations for accession into the WTO. Support for ODI increased in the late 2000s as a means to diversify large foreign exchange reserves and in order to secure access to natural resources. ODI was further liberalised under the twelfth Five-Year Plan (2010-2015), with the State Council easing rules for ODI projects in 2013.

However, all of this came to a halt following twin stock market crashes and the authorities' decision to devalue the yuan by 3% in August 2015, resulting in relatively large external pressures to attract foreign investment in 2016. As a consequence, policies were put in place to reverse single-sided depreciation expectations on the yuan and encourage capital

inflows. Authorities resorted to obstructing ODI deals, particularly in non-core areas, and in some cases, encouraged companies to sell overseas assets and repatriate profits. Not surprisingly, ODI fell in 2016 relative to its peak in 2015, and China became a net recipient again in 2017.

Lofty Belt and Road narratives, hinting at sizeable investments in the region, may (understandably) have also played a role in bolstering the expectations of Asian policymakers. If the size of China's economy and its share of global GDP is anything to go by, the potential could be huge. China's share of total global ODI stocks is only 3% - a very low sum relative to its share of global GDP (15%) and global exports (14%). Additionally, China's net International Investment Position (IIP) is positive (like most Asian economies), thanks to its vast foreign reserves. However, the net contribution of FDI to China's IIP remains negative: equivalent to -15% of its GDP in 2016, compared to almost 20% in the case of Japan (**CHART 3**). This means that China receives more investment than it exports, but a normalisation of conditions should point towards larger outbound flows - at least in theory. Together, these factors help to explain some of the fixation surrounding the potential disruptive role of Chinese investments in the region. While not entirely inaccurate, we believe these factors may have been overblown.

Meanwhile, Japan has continued to grow its investments overseas. ODI flows reached USD 130 billion between January and September 2017, according to figures compiled by the Japan External Trade Organization² (JETRO), and are positioned to outstrip 2016's level of USD 170 billion. This means that Japan surpassed China in the first nine months of the year alone, suggesting that the country is a larger player in this space in Asia.

Currently, Japanese investment is larger than that of China in terms of stocks and flows, both globally and within Asia-Pacific. Japan's ODI stocks in the ten largest economies in Asia, excluding China, reached USD 259 billion in 2016, while Chinese ODI stocks in the same countries only reached USD 58.3 billion (**CHARTS 1 AND 2** - note that the y axis is larger in the case of Singapore in **CHART 1**). This excludes investments to Hong Kong which, representing 60% of China's total ODI flows, act primarily as an intermediary of funds between China and the world. As seductive as the narratives surrounding China's Belt and Road initiative may be, the truth is that more attention should be paid to the impression that Japanese corporations are making on the economic landscape in the region.

CHART 1
Chinese outbound FDI stocks in APAC in USD billions (excluding Japan and Hong Kong)

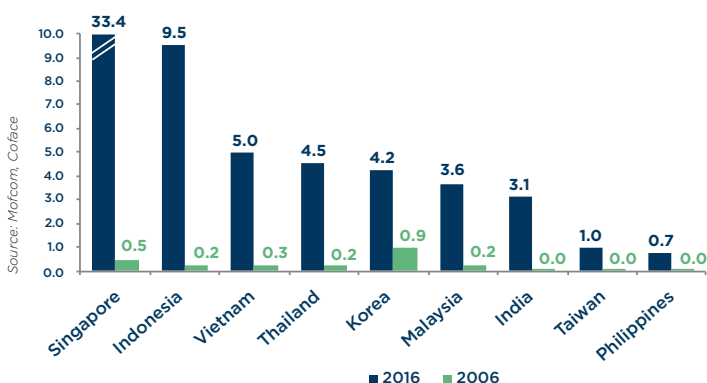
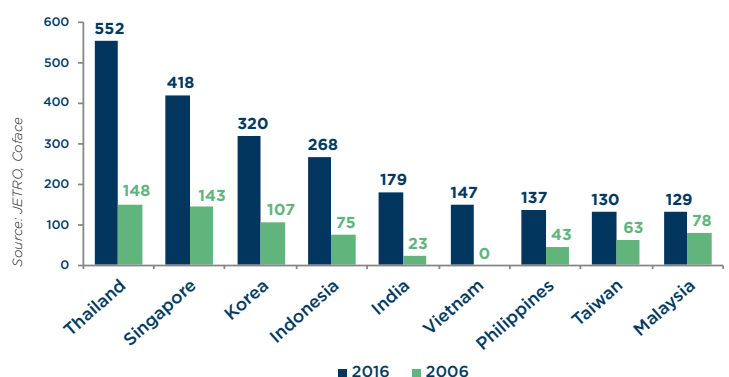


CHART 2
Japanese outbound FDI stock in APAC in USD billions (excluding China and Hong Kong)



Japan has played a more prominent role in the region for several reasons. The country started to invest overseas much sooner than China. Japan is a mature economy and has been so for a number of years. Hence, Japan is much more affluent than most of its peers in the region, including China, in terms of per capita purchasing power parity terms. This means that labour costs are much higher than in other countries in the region, while productivity remains low. As a result, a lot of manufacturing found its way into markets where cheap labour was plentiful. At a very early stage, this included places such as China³, greatly aiding in the industrialisation of the country. More recently, a lot of this manufacturing has shifted to countries with lower labour costs in South East Asia. For example, average wages in Vietnam are USD 200 per month, compared to USD 400 in Thailand and USD 800 in China. This has enabled Japanese companies to build momentum, which is why the country still invests more in the region than China does in terms of stocks and flows.

“As seductive as the narratives surrounding China’s Belt and Road initiative may be, the truth is that more attention should be paid to the impression that Japanese corporations are making on the economic landscape in the region.”

The Japanese economy grew very rapidly in the 1980s, but has been experiencing a period of protracted low growth and deflation following the collapse of the asset bubble. As a result, Japanese companies have had to resort to overseas markets for growth and returns on investments. Domestic economic conditions – in particular, negative interest rates – have prompted Japanese companies to seek better returns overseas. Compounded with the fact that Japanese companies are very cash-rich, this may help to explain why Japan remains a more active investor than China.

The frenzy surrounding China’s role as the lender du jour for the emerging world, and in particular Asia-Pacific, can be explained by the magnitude of its trade flows to and from the region. As a norm, trade flows are much larger than ODI flows for both countries. It is in this space where China really eclipses Japan: China’s total bilateral trade (including imports and exports) with the region (excluding Japan) amounted to USD 1.3 trillion in 2016. This was roughly equivalent to one third of China’s total trade with the world. By comparison, Japan’s total bilateral trade with the region (excluding China, its largest trade partner) only amounted to USD 365 billion during the same period (CHART 4).

To put this into context, Japan’s trade with Asia Pacific is equivalent to only 28% of China’s. Moreover, while both countries possess surpluses with the region, China’s is hundreds of billions of US dollars larger than Japan’s. The need to diversify economic relations away from unbalanced trade patterns may have triggered an interest in developing closer investment ties with China.

Increasing competition between both countries

Recent developments point towards increasing competition between both countries in the region, although this has yet to concretely manifest itself. This could pose threats to Japanese corporate interests in Asia Pacific down the line. Both countries initially had distinct approaches to trade and investment in the region, but these have since begun to converge.

CHART 3
Net international investment position (% GDP)

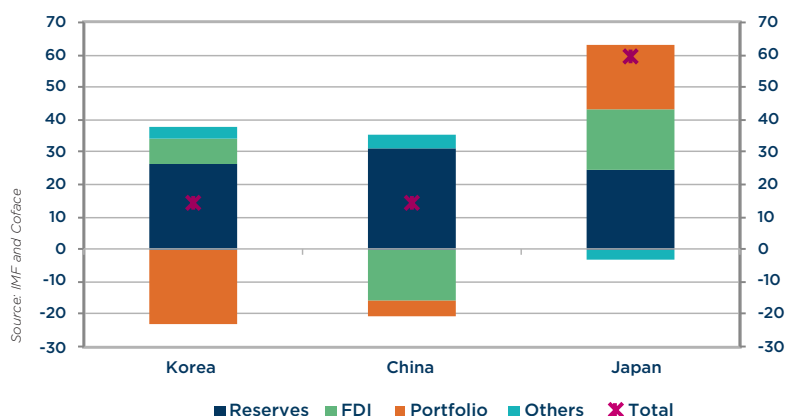
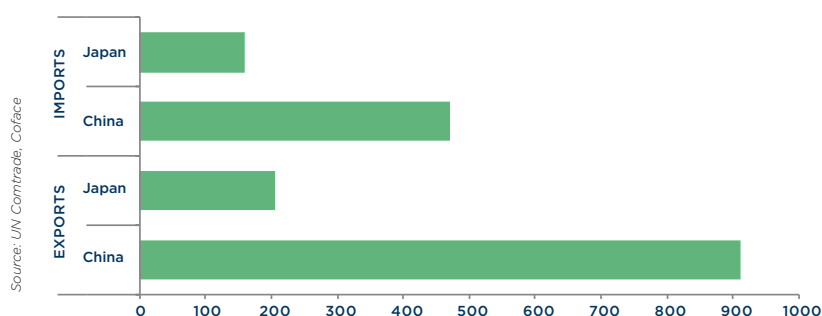


CHART 4
Trade with APAC: China vs Japan (USD billions)



The main factor behind this is China’s ability to leap-frog its way up global value chains, which has greatly changed the composition of its imports to and exports from the region, as well as the sectors in which it invests.

Looking at trade on a sector basis (TABLE 1), we see some similarities between both countries. Japan and China are net commodity importers from Asia. More importantly, they both import significant amounts of mechanical and electronic parts and components, which are processed into higher value-added goods for export. Among China and Japan’s top suppliers are countries like Australia, one of the top miners of iron ore globally, as well as Indonesia and Malaysia, important fuel and palm oil producers. Korea, a leading player in semiconductors, is also among the Top 5 import markets for China and Japan. China and Japan are important constituents of global supply chains, especially electronics. Similarities are even more remarkable on the export front, reflecting growing competition in third markets. Not surprisingly, both countries export predominantly manufactured goods. The top three exports to Asia for China and Japan are exactly the same: electrical machinery and equipment, machinery and mechanical appliances, and steel products. Japan continues to have a competitive advantage in vehicles, while China has developed an edge in chemicals.



There are also striking parallels on the investment front, where we again see some convergence between both countries in recent years. Comparing ODI flows between 2006 and 2016 helps shed some light on this aspect (CHARTS 5 – 8): China moved from investing significantly into the extractive (mining) and infrastructure (transport and storage) sectors, to refocusing more on manufacturing, retail, and business services. The mining sector went from fourth place to thirteenth place between 2006 and 2016. Meanwhile, retail and business services have consistently ranked amongst the top sectors for Chinese investment, while manufacturing went from fifth to second place.

Retail and business services also rank among the top recipients of Japanese investment overseas. The country remains a key player in manufacturing, but its focus has clearly shifted. Manufacturing accounted for 69% of total ODI flows in 2006, falling to just 35% in 2016. Instead, a lot of its investment has refocused towards high-value-added services and ICT⁴ sectors, in line with China. In sum, the two countries' production structures are becoming increasingly similar, which has started to translate into a shift in Chinese investments away from mineral resources, and towards sectors where Japan has traditionally played a stronger role, including manufacturing and services.

TABLE 1
China and Japan trade with Asia* by sector (Top-5) - more similar than different

EXPORTS					
CHINA			JAPAN		
COMMODITY	USD Billion	% TOTAL	COMMODITY	USD Billion	% TOTAL
Electrical machinery and equipment	89	25	Electrical machinery and equipment	27	21
Machinery and mechanical appliances	46	13	Machinery and mechanical appliances	22	17
Iron and steel	20	6	Iron and steel	12	9
Organic chemicals	12	3	Organic chemicals	11	9
Plastics	11	3	Plastics	7	6
IMPORTS					
CHINA			JAPAN		
COMMODITY	USD Billion	% TOTAL	COMMODITY	USD Billion	% TOTAL
Electrical machinery and equipment	138	41	Electrical machinery and equipment	20	18
Machinery and mechanical appliances	31	9	Machinery and mechanical appliances	15	14
Iron and steel	23	7	Iron and steel	10	9
Organic chemicals	21	6	Organic chemicals	4	4
Plastics	15	5	Plastics	3	3

Source: UN Comtrade and Coface

*Including India, Indonesia, Korea, Malaysia, Philippines, Thailand and Vietnam

CHART 5:
Japan ODI by sector (2016)

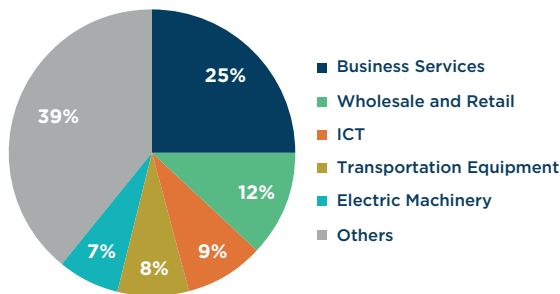


CHART 6:
Japan ODI by sector (2006)

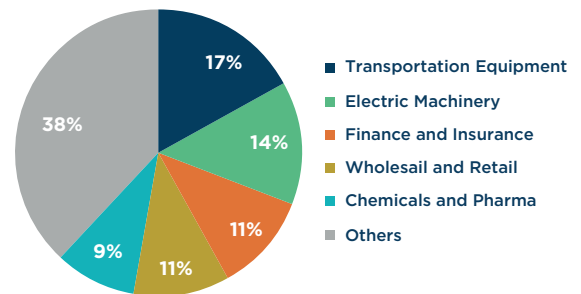


CHART 7:
China ODI by sector (2016)

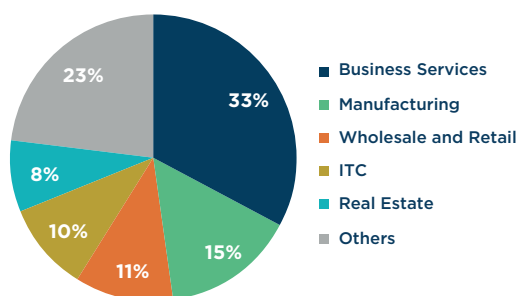
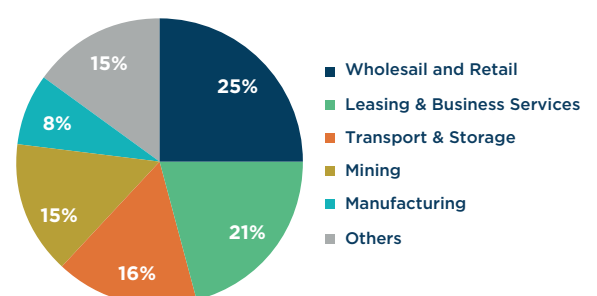


CHART 8:
China ODI by sector (2006)



Source: JETRO, MOFCOM and Coface

DISCLAIMER

The present document reflects the opinion of Coface Country Risk and Economic Studies Department, as of the date hereof and according to the information available at this date; it may be modified at any moment without notice. Information, analysis, and opinions contained herein have been elaborated from numerous sources believed to be reliable and serious; however, Coface does not guarantee in any manner whatsoever that the data contained herein are true, accurate and complete. Information, analysis, and opinions are provided for information purpose only and as a complement to material or information which shall be collected otherwise by the user. Coface does not have any procurement obligation but only obligation of means and shall incur no liability whatsoever for losses arising from the use of or reliance on the information, analysis and opinion herein provided. This document together with analysis and opinions furnished are the valuable intellectual property of Coface; you may download some of the data for internal use only, provided that you mention Coface as author and you do not modify or alter such data. You may not use, extract or reproduce the data in whole or in part, for making any public statement or for any other commercial purpose without our prior written consent. You are invited to refer to the legal notice provided on Coface web site.

COFACE SA

1, place Costes et Bellonte
92270 Bois-Colombes
France

www.coface.com

coface
FOR TRADE