

Japan And China: A Ruinous Rivalry?

The New 'Great Game' In Asia

By Clay Chandler

Asia's two largest nations are battling it out for the hearts and minds of their regional neighbors. So far Japan is doing a better job of making friends, as it shifts aid and investment toward Southeast Asia. In the long run, though, China's market power will continue to be its strongest asset.

On January 1, 35-year-old Xu Shuaijun climbed into a brightly colored hot-air balloon and charted a course for the world's most dangerous islands. Ascending from Fuzhou, on China's southern coast, he floated for seven hours over the East China Sea towards a chain of uninhabited rock outcroppings called the Senkakus by Japan (which controls them) and the Diaoyus by China (which claims them). Xu, a chef by training, maneuvered his unlikely craft to within 13 miles of the disputed islands before the winds turned against him, battering his balloon and forcing him into the sea.

Xu escaped the crash unhurt. More remarkably, he failed to provoke an international incident. His misadventure was handled with extraordinary civility on all sides. A distress signal from Xu's balloon was picked up by maritime authorities in Taiwan, who alerted the Japanese coast guard, who fished Xu out of the ocean and surrendered him to a Chinese patrol boat. Chinese officers thanked the Japanese coast guard via radio and returned the troublesome cook to his native shore.

The decorum with which Xu's trial balloon was deflated belies the growing rancor of Sino-Japanese relations—and rising concern through-

Clay Chandler is principal of the Barrenrock Group, an independent research firm in Hong Kong. He is a former McKinsey & Co. consultant, and reported from China and Japan for the *Wall Street Journal*, *Washington Post* and *Fortune*.

out the region that Asia's two biggest economies are spoiling for a fight. The long-simmering Senkaku/Diaoyu dispute gained new acrimony in 2013 as Beijing increased the frequency with which Chinese ships pass through waters surrounding the islands, raising the risk of a confrontation with the Japanese coast guard. Those forays come as Beijing advanced expansive new territorial claims in the East and South China Seas. In November, Beijing stirred even greater controversy by announcing a far-reaching air defense identification zone (ADIZ) in the East China Sea

that encompasses territory claimed by China, Japan, South Korea and Taiwan.

Japan is pushing back. Since his election as prime minister in November 2012, Shinzo Abe has taken a tough line with China, advocated a

more assertive military and national security policy for Japan, and pushed for revision of Japan's pacifist constitution. In December, Abe marked the anniversary of the first year of his term by paying a visit to the Yasukuni Shrine, considered a symbol of Japan's militarist past because it honors Japanese war dead, among them 14 Class-A war criminals.

A war of words

The strain in Sino-Japanese relations has resulted in shrill and sometimes silly rhetoric from both sides. Japan's foreign minister has blasted China's new air defense zone as a "one-sided action" that "cannot be allowed." A Chinese government spokesman deplored Abe's Yasukuni visits for "trampling on the feelings of the people of China," while Liu Xiaoming, China's ambassador to Britain, likened the Japanese leader to Voldemort, the dark wizard of Harry Potter fame. "The Yasukuni Shrine," Liu wrote in an article published in *The Daily Telegraph*, "is a kind of horcrux, representing the darkest parts of [Japan's] soul."

For his part, Abe, speaking at a press conference at the World Economic Forum in Davos, argued Japan and China are in a "similar situation" to Britain and Germany in 1914: while the two nations may be trading partners with a mutually beneficial economic relationship, he suggested, that would not necessarily deter them from going to war.

Such bickering discomfits Asia's lesser powers—and with good reason. China and Japan are the world's second and third largest economies respectively. The economic partnership between the two powers is easily the most important in Asia. Bilateral trade between the two nations

The strain in Sino-Japanese relations has resulted in shrill and sometimes silly rhetoric from both sides

reached US\$329 bn last year. The operations of Japanese manufacturers on China's mainland are an indispensable link in the global supply chain which, if halted even temporarily, would have repercussions around the world.

The Sino-Japanese face-off forces neighboring states into the classic dilemma of international political theory: "power balancing" versus "bandwagoning." Is it better to lock arms with Japan and other Asian neighbors to keep emerging China in check? Or ally with China, clearly the region's new heavyweight, and trust in Beijing's benevolence? Beijing and Tokyo are actively engaged in trying to influence that decision. The two powers' scramble to win hearts and minds in Asia is a new "Great Game" whose stakes could well be higher than the 19th-century competition between Russia and Britain in central Asia.

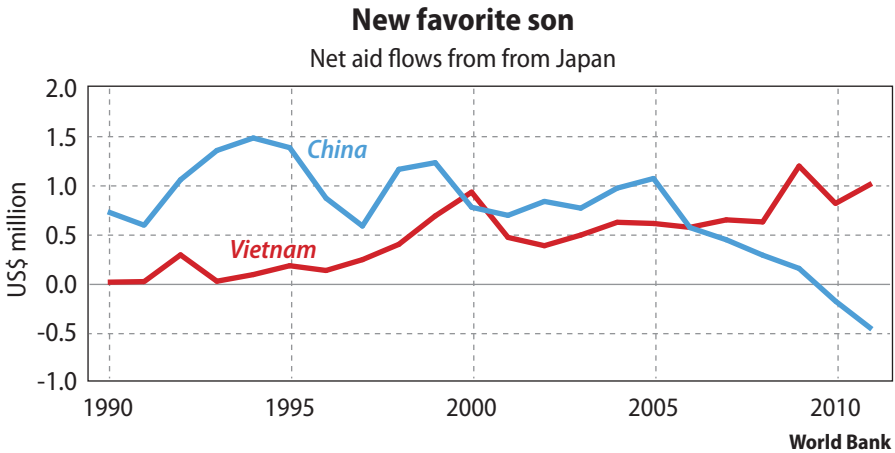
The two powers' scramble to win hearts and minds in Asia is a new "Great Game"

Abe's Yasukuni visit hasn't helped Japan's efforts to win this contest. But, beyond China and South Korea, it may not have done much damage. The early evidence suggests Asian states would far rather "balance" with Japan than "bandwagon" with China. That was the obvious conclusion from the latest Asean summit, held in Tokyo in December, which issued a communiqué praising Japan's efforts in "contributing constructively to peace, stability and development in the region."

The gathering itself was a diplomatic victory for Japan. Usually the 10 Asean nations—Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam—only meet with Japan in conjunction with China and South Korea, a configuration dubbed Asean+3. But the December summit was convened in Tokyo to commemorate the 40th anniversary of Japan's relationship with the group. China and South Korea were not invited. Japan used the occasion to pledge an additional US\$1.65 bn in overseas development assistance and investment loans to Asean countries.

A Japanese charm offensive

The Asean meeting capped a year-long Japanese campaign to strengthen relations in the region. In his first term as prime minister seven years ago, Abe chose China for his inaugural foreign visit. But within weeks of assuming the post a second time, Abe was barnstorming through South-east Asia, making visits in Vietnam, Thailand and Indonesia. In the first year of his second term, Abe visited every Asean country—a first for any



Japanese prime minister—lavishing development assistance and trade initiatives at each stop.

Japan has always taken a pragmatic approach to development assistance, viewing aid in the context of broader economic relations. Traditionally, Japanese aid has favored middle-income Asian neighbors over poorer African countries, and emphasized loans tied to specific development projects over grants for poverty relief. China became the biggest recipient of Japanese aid after normalization of Sino-Japanese relations in 1978. But in recognition of China's rapid economic rise, the two nations agreed to halt Japanese aid in 2008. Thailand and Indonesia also have been big recipients of Japanese aid, but in recent years, aid to those nations has actually contracted as they continue to pay down past loans. Now Japan's key aid targets include Vietnam and Myanmar.

In Vietnam, Japan committed more than US\$1.5 bn in new development assistance last year, and is now Vietnam's largest foreign aid donor. In Hanoi, the Japan International Cooperation Agency together with Japanese construction firms are building a second terminal for Noi Bai International Airport and erecting a huge, five-gated cable bridge across the Red River. Elsewhere, loans from Tokyo are paying for highways, ports and power plants. And Japan has overtaken South Korea and Taiwan as the largest source of foreign direct investment in Vietnam (US\$3.3 bn in 2013, a four-fold increase in just three years). Japanese companies including Canon, Panasonic, Sumitomo Heavy Industries and Yamaha Motors line the highway leading into Hanoi. In February, the city of Ho Chi Minh broke ground on construction of a new technology park specifically designed to accommodate Japanese firms.

In Myanmar, where fear of overdependence on China played a key role

in decision of military leaders to embrace economic and political reform, Japan has agreed to write off more than US\$2 bn in old debt and offered US\$1.5 bn in new loans. Japan is helping Myanmar to build roads, bridges and power grids to connect Yangon to the rest of the country; construct an industrial zone in the port of Thilawa; and build a modern postal system. When he visited Myanmar in May, Abe brought with him a delegation of more than 50 Japanese business executives.

An assist from bumbling Beijing

In his bid for Asian allies, Abe has been aided by Beijing. In November, when Hurricane Haiyan ravaged the Philippines, Japan rushed forth with assistance, proffering more than US\$50m for disaster relief and reconstruction and deploying more than 1,000 Self-Defense Force members to help with rescue and recovery. China chipped in a derisory US\$200,000. The figure was later increased to US\$1.6m, but only after China was ridiculed in the Philippine press.

It doesn't help that China, which has territorial disputes with Brunei, Indonesia, Japan, Malaysia, the Philippines, South Korea, Taiwan and Vietnam, insists it will only discuss territorial issues on a bilateral basis where it can apply greater pressure on individual nations rather than in multilateral settings where other nations might ally against it. When the Philippines sought last year to take its case to a United Nations tribunal, Beijing dispatched ships to harass Filipino fishing boats. Many in Asia see these tactics as bullying. Philippine president Benigno Aquino, who has been among Asia's sharpest critics of China's territorial ambitions, argued in a February interview with *The New York Times* that the West's failure to confront China was similar to the appeasement of Adolph Hitler in the 1930s.

In recent months Beijing has softened its tone noticeably. A recent *Wall Street Journal* analysis credited China for taking a more "button-down tack" in its efforts to vilify Japan. Instead of allowing protesters to pelt Japan's embassy in Beijing with eggs and plastic bottles, the *Journal* suggested, China's envoys, adorned in "tailored suits" and "speaking fluent English," have learned the value of "public diplomacy." The article noted that China's ambassador to Washington allowed himself to be photo-

After Hurricane Haiyan ravaged the Philippines, China initially chipped in just US\$200,000 of disaster relief, later increased to US\$1.6m after its contribution was ridiculed in the Philippine press

graphed with his wife at the Super Bowl and appeared on the Charlie Rose show to state China's case against Japan. So far, however, these moves seem to have gained little traction in Asia.

Not much help from the US

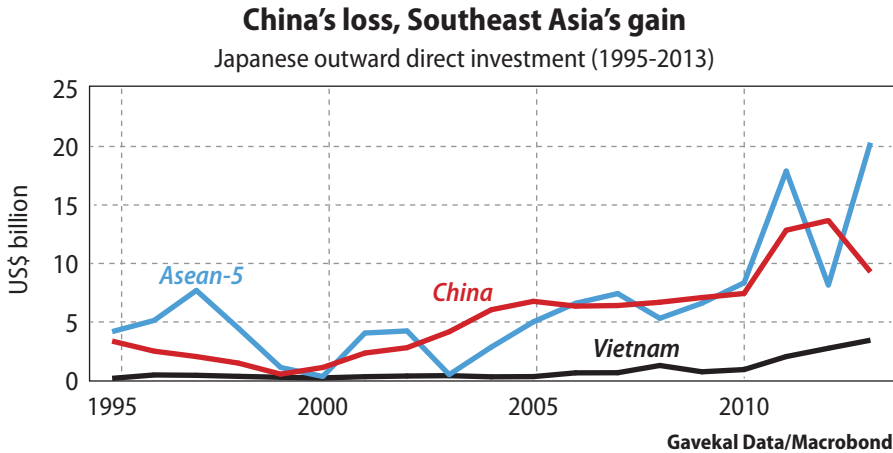
One nation that has remained unmoved by Abe's efforts to cultivate allies in Asia is South Korea. Seoul has its own territorial disputes with Tokyo and, like China, harbors deep resentment over Japan's unwillingness to confront its militarist past. Seoul objects to China's new air defense zones. But it has echoed Beijing's harsh criticisms of Abe's Yasukuni visits, and president Park Geun-hye is the only Asian leader other than Xi Jinping who has steadfastly refused to meet with Abe. For now, Abe seems willing to live with South Korean hostility; he has made little effort to cultivate Park, and may be betting that eventually South Korea will feel isolated and come around.

Abe has worked assiduously to strengthen ties with India, potentially its strongest ally as regional counterweight to China. In Delhi in January, the Japanese leader was welcomed as the chief foreign guest at India's Republic Day. New Delhi signaled solidarity with Japan on the ADIZ question even though China's new policy does not affect India. The two countries also agreed to hold regular bilateral consultations on national security issues. Notably, Tokyo gave a green light to sell India amphibious aircraft, the first time Japan's postwar government has agreed to export equipment with potential military use.

Of course, the strongest counterweight to China is the US; but the Obama administration, despite bold talk of a "pivot" to Asia, has paid relatively little attention to the region. The US joined with Japan and South Korea in criticizing China for its ADIZ, describing the action as provocative, although it has advised American commercial airlines to comply with the new policy to minimize risk of a confrontation. Obama is expected to visit Japan, Malaysia and the Philippines in April in an attempt to make up for canceling a trip to Asia last year. If anything, the absence of a forceful US presence aggravates Asian insecurities about China, encouraging Asean members to close ranks behind Japan.

Stay in China, but hedge your bets

In the meantime Japanese manufacturers have stepped up their efforts to diversify investments away from China to Asia's other economies, partly to hedge political risk and partly to avoid rapidly rising labor costs in China. Japanese direct investment in Asean began to outstrip its FDI in China



in 2006, after Yasukuni visits by Abe's predecessor, Junichiro Koizumi, triggered a wave of anti-Japanese riots throughout the Chinese mainland. After a hiccup in 2012 because of massive flooding in Thailand, Japanese investment in the main Southeast Asian economies surged to US\$23 bn in 2013, while investment in China plummeted to US\$9 bn, down from US\$13.5 bn in 2012.

Even so, Japanese and Western manufacturers will find it difficult to kick the China habit completely. That is because putting factories in China has overwhelming virtues, greatest among them being proximity to Chinese consumers. Despite all the recent troubles, China remains a bigger export market for Japan than Asean. Asean members have pledged to join in an integrated economic zone by 2015, creating a US\$2 trn market with more than 600m consumers. It is an enticing prospect. In practice, however, Asean will remain a fragmented market of different cultures and rules.

India, with 1.2 bn people, offers the promise of a market as large as China's. But India's growth has sputtered badly in recent years, and with its many different cultures, language, religions and caste traditions, India is in many ways an even more fragmented market than Asean. Finally, China's infrastructure gives it a big competitive advantage over Asian neighbors. Japan's efforts to build highways, ports and bridges in Asean will help close the gap, but will take many years to completion. And the increased cost of Chinese labor is partially offset by gains in the productivity of Chinese workers. In economies like Vietnam, Myanmar and India, workers are cheaper but tend to be far less educated than their counterparts in China.

China's advantages aren't set in stone. But reshaping other markets to offset them will take time. The uncomfortable truth is that Japanese firms

will have to learn to live with China, despite the risks. For the immediate future, they remain, like the hapless balloonist Xu, aloft in a region of turbulence at the mercy of the elements.

