



**China Perspectives**

2013/4 | 2013  
Chinese Visions of Japan

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**Stephen Robert Nagy**

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**Electronic version**

URL: <http://journals.openedition.org/chinaperspectives/6321>  
DOI: 10.4000/chinaperspectives.6321  
ISSN: 1996-4617

**Publisher**

Centre d'étude français sur la Chine contemporaine

**Printed version**

Date of publication: 1 December 2013  
Number of pages: 46-57  
ISSN: 2070-3449

**Electronic reference**

Stephen Robert Nagy, « Territorial Disputes, Trade and Diplomacy: Examining the repercussions of the Sino-Japanese territorial dispute on bilateral trade », *China Perspectives* [Online], 2013/4 | 2013, Online since 01 December 2016, connection on 28 October 2019. URL : <http://journals.openedition.org/chinaperspectives/6321> ; DOI : 10.4000/chinaperspectives.6321

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# Territorial Disputes, Trade and Diplomacy

Examining the repercussions of the Sino-Japanese territorial dispute for bilateral trade

STEPHEN ROBERT NAGY

**ABSTRACT:** This paper will examine the repercussions of the Sino-Japanese territorial dispute for bilateral trade. Using interviews with businesses, scholars, and government officials in Beijing, Hong Kong, and Tokyo, and data gathered from policy papers and businesses, this paper argues that the traditional *seikei bunri* (separation of politics and economics) relationship that existed between Japan and China in the post-World War II period has given way to a more confrontational relationship in which economic pressure can be and has been applied as a means to press Japan on bilateral issues. It argues that understanding the way in which frictions arising from territorial disputes have affected the Sino-Japanese trading relationship may hold implications for the handling of similar disputes across North- and South-East Asia.

**KEYWORDS:** Sino-Japanese relations, territorial disputes, trade, integration.

## Introduction

Territorial disputes in East Asia continue to be a source of tension between countries in the region. In the South China Sea, China, Taiwan, the Philippines, Vietnam, Brunei, and Malaysia argue over the ownership and control of islands that would give them exclusive access to substantial oil and natural gas resources.<sup>(1)</sup> The Liancourt Rocks, also known as Dokdo or Tokto in Korean and as the Takeshima Islands in Japanese, represent another territorial dispute that continues to plague the region. Most significant, though, is the ongoing territorial row over the Senkaku/Diaoyu islands, which are claimed by Japan, Taiwan, and mainland China.

In the autumn of 2010, a Chinese fishing vessel rammed a Japanese Coast Guard vessel in the area surrounding the Senkaku/Diaoyu islands.<sup>(2)</sup> The captain, a Chinese national, was arrested and incarcerated in an Okinawan jail to await trial for his infringement of Japanese territory and for damaging the Japanese Coast Guard vessel.<sup>(3)</sup> The arrest of the fisherman resulted in a public outcry against the Japanese government in China and demands to have the fisherman released and repatriated.<sup>(4)</sup> More significantly, the Chinese response to this incident involved tacit trading sanctions, namely a limit on the export of rare earth materials to Japan and Japanese businesses within China and, according to the Japanese embassy in Beijing (personal communication, 11 November 2011), an informal boycott of Japanese products in China.<sup>(5)</sup> Japanese businesses affected by this embargo, in cooperation with the Japanese government, responded by reducing their dependence on China for rare earth materials through intensifying exploration and mining in other parts of the world (Japanese embassy in Beijing, personal communication, 11 November 2011).<sup>(6)</sup>

Following the return of the detained fisherman to China on 24 September 2010, Sino-Japanese tensions over the disputed islands returned to their pre-clash levels until the nationalist Governor of Tokyo, Shintaro Ishihara, made a proposal to purchase the disputed islands from their private owner in early April 2012, leading to the re-emergence of tension in August 2012, when a group of

Taiwanese and Hong Kong activists landed on the Senkaku/Diaoyu islands.<sup>(7)</sup> This landing was followed by a Tokyo lawmaker also landing on the island and Japanese government negotiations to purchase the remaining islands from their private owner in an effort to prevent Governor Ishihara from purchasing the islands.<sup>(8)</sup>

In China, the Japanese move to nationalise the islands was interpreted by analysts and citizens as an instance of overt coordination between Governor

A word of thanks to my RA Ms Helen Chan, The December 2012 Salzburg Global Seminar on "China in the 21<sup>st</sup> Century", the Global Exchange Office for Research and Education at GAKUSHUIN University (GEORE), the reviewers, and my informants for their valuable help, support and comments for making this article possible.

1. Peter Dutton, "Three Disputes and Three Objectives: China and the South China Sea," *Naval War College Review*, Vol. 64, No. 4, 2011, pp. 42-67, [www.usnwc.edu/getattachment/feb516bf-9d93-4d5c-80dc-d5073ad84d9b/Three-Disputes-and-Three-Objectives—China-and-the](http://www.usnwc.edu/getattachment/feb516bf-9d93-4d5c-80dc-d5073ad84d9b/Three-Disputes-and-Three-Objectives—China-and-the) (accessed on 18 February 2013); Ian James Storey, "Creeping Assertiveness: China, the Philippines and the South China Sea Dispute," *Contemporary Southeast Asia*, Vol. 21, No. 1, 1999, p. 96.
2. AFP, "High-seas collisions trigger Japan-China spat," *Google News*, 7 September 2010, [www.google.com/hostednews/afp/article/ALeqM5gfux6suEvEhsCmNjgxMYAYK68ZIQ](http://www.google.com/hostednews/afp/article/ALeqM5gfux6suEvEhsCmNjgxMYAYK68ZIQ) (accessed on 18 February 2013).
3. Martin Fackler and Ian Johnson, "Arrest in disputed seas riles China and Japan," *The New York Times*, 19 September 2010, [www.nytimes.com/2010/09/20/world/asia/20chinajapan.html](http://www.nytimes.com/2010/09/20/world/asia/20chinajapan.html) (accessed on 18 February 2013).
4. Mure Dickie and Kathrin Hille, "Japan's arrest of captain angers Beijing," *Financial Times*, 8 September 2010, [www.ft.com/cms/s/0/a09e651a-bb04-11d1-9e1d-00144feab49a.html](http://www.ft.com/cms/s/0/a09e651a-bb04-11d1-9e1d-00144feab49a.html) (accessed on 18 February 2013); Mure Dickie and Geoff Dyer, "Japan-China tensions continue despite release," *Financial Times*, 25 September 2010, [www.ft.com/intl/cms/s/0/e9bad4b8-c7b6-11df-8683-00144feab49a.html#axzz2eYNXKCBu](http://www.ft.com/intl/cms/s/0/e9bad4b8-c7b6-11df-8683-00144feab49a.html#axzz2eYNXKCBu) (accessed on 18 February 2013); "9.18 shijian 79 zhounian Zhongguo duochu chuxian fanRi shiwei" (9.18 incident 79th anniversary, anti-Japan protests spread across China), *Lianhe zaobao*, 18 September 2010, [www.zaobao.com/special/hotspot/pages/hotspot100918hh.shtml](http://www.zaobao.com/special/hotspot/pages/hotspot100918hh.shtml) (accessed on 18 February 2013).
5. "9.18 shijian 79 zhounian Zhongguo duochu chuxian fanRi shiwei," *Lianhe zaobao*, *art. cit.*
6. "Companies seek to reduce reliance on Chinese rare earths," *Asahi Shimbun*, 25 September 2012, <http://ajw.asahi.com/article/asia/china/AJ201209250059> (accessed on 8 February 2013).
7. "Japan arrests pro-China activist swimmers in island row," *BBC News*, 15 August 2012, [www.bbc.co.uk/news/world-asia-china-19264633](http://www.bbc.co.uk/news/world-asia-china-19264633).
8. Yoko Wakatsuki, "Japanese prime minister accuses Chinese navy ship of 'dangerous' act," *CNN*, 6 February 2013, [http://edition.cnn.com/2013/02/06/world/asia/china-japan-disputed-islands/index.html?eref=rss\\_mostpopular&utm\\_source=feedburner&utm\\_medium=feed&utm\\_campaign=Feed%3A+rss%2Fenn\\_mostpopular+%2BRSS%3A+Most+Popular%29](http://edition.cnn.com/2013/02/06/world/asia/china-japan-disputed-islands/index.html?eref=rss_mostpopular&utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+rss%2Fenn_mostpopular+%2BRSS%3A+Most+Popular%29) (accessed on 8 February 2013).

Ishihara and the then PM Noda rather than an effort to prevent a provocative figure from gaining control of the disputed islands.<sup>(9)</sup> For many, it was inconceivable that a local leader such as Governor Ishihara could “engage in the purchase of these islands without collusion with the national government” (Interview with Chinese scholar in Beijing, 11 October 2012).

On 11 September 2012, PM Noda announced the purchase of the disputed islands from their private owner, resulting in a fierce backlash from the mainland Chinese government and its citizens,<sup>(10)</sup> including “a string of measures, termed ‘combination punches’, that bore the hallmarks of a well-planned campaign with multi-agency coordination and high-level decision making,”<sup>(11)</sup> as well as a less bellicose reaction by citizens in Hong Kong and Taiwan.<sup>(12)</sup> At the government level, China cut off communications and began a vocal campaign that blamed Tokyo for the dispute because it had “failed to liquidate militarism.”<sup>(13)</sup> At the popular level, there were widespread anti-Japanese riots, boycotting of Japanese products, and vandalism directed against Japanese businesses and Japanese business interests throughout mainland China.<sup>(14)</sup>

This article examines the repercussions of Sino-Japanese territorial friction for bilateral trade. It employs state territorial dispute resolution approaches and interviews with businesses, scholars, and government officials in China, Japan, and Hong Kong. Primary data has been gathered from policy papers and businesses to argue that the traditional *seikei bunri* (separation of politics and economics) relationship that existed between Japan and China in the post-normalisation period has given way to a more confrontational relationship in which economic pressure can be and is applied as a means to press Japan on bilateral issues. This article ponders whether the territorial tensions between Japan and China constitute a watershed moment for the two Asian giants in terms of deepening their economic integration. The author recognises that the territorial dispute is a barometer of the state of bilateral relations between Japan and China and that the territorial issue is connected to domestic politics and socio-economic stability within each state, downstream territorial issues, and broader security issues. This paper takes no position on the sovereignty of these disputed territories; rather, the author is interested in how the territorial dispute is tangentially connected to trade relations.

The first section introduces this paper’s argument and methodological framework with reference to previous research on territorial dispute settlement within the East Asian context. The second section provides a brief account the post-World War II economic relations between Japan and China. It is intentionally brief to allow the paper to focus on the relationship between current and pending territorial disputes and changing trade patterns. The third section discusses an abbreviated list of the effects of the recent trade disputes on Japan-China trade relations. The fourth section then considers some possible mid- and long-term effects of the recent turn in bilateral relations. It is shown that Japanese companies are attempting to hedge their economic bets by partially deleveraging their investments in China while looking for friendlier pastures in the ASEAN states. Lastly, this paper concludes by discussing the implications of the end of *seikei bunri* relations between Japan and China for bilateral and regional relations.

Primary data is drawn from 50 interviews in Hong Kong and Japan with Japanese businesses conducting business in China, using snowball sampling from January 2012 to September 2013. Interviews were conducted using Japanese and English and recorded for transcription. Interviews were also conducted in person and in personal communication with diplomats and scholars in Hong Kong, Beijing, and Tokyo. Informants from various business sectors shared their primary data and views on the relationship

between trade and investment strategies in light of the anti-Japanese riots that took place in fall 2012. Meanwhile, testimony from diplomats experienced in managing bilateral relations between Japan and China offer insights into the complex links between the territorial dispute, domestic politics and wider geopolitical issues. They also offer insights into the shifting approaches to the Senkaku/Diaoyu Islands dispute.

## Approaches to dispute settlement

International relations scholars have spent considerable effort to understand the approaches that states utilise in territorial dispute resolution. Approaches vary from compromise and concession to aggression and war. Nie Hongyi, in his 2009 article “Explaining Chinese Solutions to Territorial Disputes with Neighbour States,” attempted to examine why China took hard-line policies in certain territorial and border disputes while a more concessionary approach in others.<sup>(15)</sup> Employing domestic politics-oriented theories, transition theories, equilibrium theory, and institutional theories to explain China’s approaches to dealing with territorial disputes, Nie demonstrated that “China resolved disputes with states that did not have expansionary territorial designs through negotiations that emphasised mutual understanding and tolerance, and worked towards a mutually beneficial and equitable solution.”<sup>(16)</sup> Nie’s comparative study of border disputes between China and the USSR, China and Vietnam, and China and India in the post-WWII period demonstrated that China’s approach to territorial disputes has grown and adapted hand-in-hand with its growing economic clout.

The above theoretical approach contrasts with that of the editor of *Peace in Northeast Asia: Resolving Japan’s Territorial and Maritime Disputes with China, Korea and the Russian Federation*. Thomas J. Schoenbaum’s *prescriptive approach* to territorial settlement is based on three separate negotiated agreements between Korea-Japan, Japan-China, and Japan-Russia.<sup>(17)</sup> Instead of positing a simplistic dichotomy between strategies for the resolution of territorial disputes characterised by “concession” or “aggression,” Schoenbaum emphasises negotiations among interested parties to balance

- Jonathan Manthorpe, “China’s goading boosts Japan’s right wing,” *Vancouver Sun*, 13 November 2012, [www.vancouversun.com/story\\_print.html?id=7543110&sponsor=](http://www.vancouversun.com/story_print.html?id=7543110&sponsor=); Sina, “Meiti pilu Riben ‘goumai Diaoyu dao’ naoju lailongqumai” (Media reveals the beginning and subsequent development of Japan’s purchase of Diaoyu Islands), 12 September 2013, <http://news.sina.com.cn/c/2012-09-12/033525152702.shtml> (accessed 18 February 2013).
- “Dangerous Waters: China-Japan Relations on the Rocks” *Crisis Group Asia Report*, No. 245, 8 April 2013, p. 10.
- “Zhongguo hanwei Diaoyudao zhuquan youliyouju” (China has every reason and right to defend sovereignty of Diaoyu Island), *The People’s Daily*, 27 September 2012.
- “Pekin no Nihon daishikan ni susennin, toseki mo Chugoku hannichi demo” (Thousands protest and throw rocks at Japanese embassy in Beijing – anti-Japanese demonstrations in China), *Nihon Keizai Shimbun*, 15 September 2012, [www.nikkei.com/article/DGXNASGM14072\\_V10C12A9MM0000/](http://www.nikkei.com/article/DGXNASGM14072_V10C12A9MM0000/); “Diaoyu dao zao guoyouhua Zhongguo zaixian fanRi chao” (Japan’s nationalisation of the Senkaku Islands provoked anti-Japanese protests across China again), *China Press*, 12 September 2012, [www.chinapress.com.my/node/352648](http://www.chinapress.com.my/node/352648) (accessed 18 February 2013).
- “China blames Senkaku dispute on Japan’s failure to end militarism,” *Kyodo News*, 19 November 2012, <http://english.kyodonews.jp/news/2012/11/194761.html>; “Wen zongli Li Mingbo tongpi junguo zhuyi” (Premier Wen Jiabao and Lee Myung-bak blame Japanese militarism together), *Sing Pao*, 20 November 2012, [www.singpao.com/xw/nd/201211/t20121120\\_402889.html](http://www.singpao.com/xw/nd/201211/t20121120_402889.html) (accessed 18 February 2013).
- “Anti-Japan protests in China swell, turn violent,” *Associated Press*, 15 September 2012.
- Hongyi Nie, “Explaining Chinese Solutions to Territorial Disputes with Neighbour States,” *Chinese Journal of International Politics*, Vol. 2, No. 4, 2009, pp. 487–523, <http://cjp.oxfordjournals.org/content/2/4/487.full> (accessed on 18 February 2013).
- Ibid.*, p. 522.
- Thomas J. Schoenbaum (ed), *Peace in Northeast Asia: Resolving Japan’s Territorial and Maritime Disputes with China, Korea and the Russian Federation*, Cheltenham, Edward Elgar, 2008, pp. 1-6.

their national and regional geopolitical needs in a historical and legal context framed by international law. This negotiation-based approach resonates with Kimie Hara's dispute resolution recommendations, although the details of the negotiated settlement differ.<sup>(18)</sup>

Other scholars have conducted their analysis of territorial disputes on the basis of the *sovereignty game framework*, which takes "the ability to exercise sovereignty over a territory and to have that sovereignty recognised, as the basic desire of a state involved in a territorial dispute."<sup>(19)</sup> For O'Shea, Japan and China have adopted more uncompromising positions on the territorial issue at the expense of weakening their bilateral relations.<sup>(20)</sup> China has prevented Japan from exercising complete and comprehensive sovereignty and pressed its own claims, while Japan has been able to limit China's claims on the islands by pressing the status quo. At the same time that they have secured their own and weakened each other's interests, Chinese approaches to the escalated territorial tensions in fall 2012 resulted in mutually unbeneficial economic disruptions.<sup>(21)</sup> On the Japanese side, exports to China plummeted, while at the same time important exports of small machinery parts for manufacturing bases in China also dropped, having a deleterious effect on manufacturing in China.<sup>(22)</sup>

The changing structure of the international system has also been evoked in analyses of how China has dealt with territorial disputes.<sup>(23)</sup> Hyer argued that the different approaches taken by China via territorial disputes that exist within the East and South China Sea could be attributed to the necessity of counterbalancing the USSR during the Cold War. Maintaining the status quo regarding the Sino-Japanese territorial dispute during the Cold War period, Beijing moderated its rigid position on the territorial issue. Beijing made it clear that China "absolutely will not permit" the territorial dispute to "sow discord in the friendly relations between the Chinese and Japanese people."<sup>(24)</sup> According to Hyer's interpretation, because of a change in the perception of Japan's role in China's foreign policy, "Japan's 'wicked tactic' of 'postponing resolution' had become a virtue; flexibility was completely acceptable in the pursuit of entente with a former enemy, Japan, in order to confront a former ally, the USSR, which had become the preeminent threat to China's security."<sup>(25)</sup>

It may be observed that approaches to the handling of Sino-Japanese territorial disputes variously involve appeals to international law, engage in 'sovereignty games', follow single- or multi-track negotiating strategies, or adopt tactical, aggressive or concessionary approaches, depending on the interests and relative strength of the parties to the dispute. The territorial dispute between Japan and China that erupted during the second half of 2012 witnessed a congregation of domestic political agents coming together to push for particular policy responses. On the Japanese side, the effort to block the purchase of the islands by the nationalist Ishihara was driven by Japanese government concerns regarding the negative repercussions for Japan-China relations were the islands to be acquired by Tokyo municipality. On the Chinese side, a forthcoming power transition and the need to demonstrate strong military credentials and distract the populace from growing social inequality were powerful drivers of a strong and uncompromising stance on the disputed territories.

Using the "sovereignty game framework" espoused by O'Shea and Nie's thesis that "China resolved disputes with states that did not have expansionary territorial designs through negotiations that emphasised mutual understanding and tolerance, and worked towards a mutually beneficial and equitable solution,"<sup>(26)</sup> I hypothesise that the territorial dispute between Japan and China has shifted away from a concessionary-based, quiet diplo-

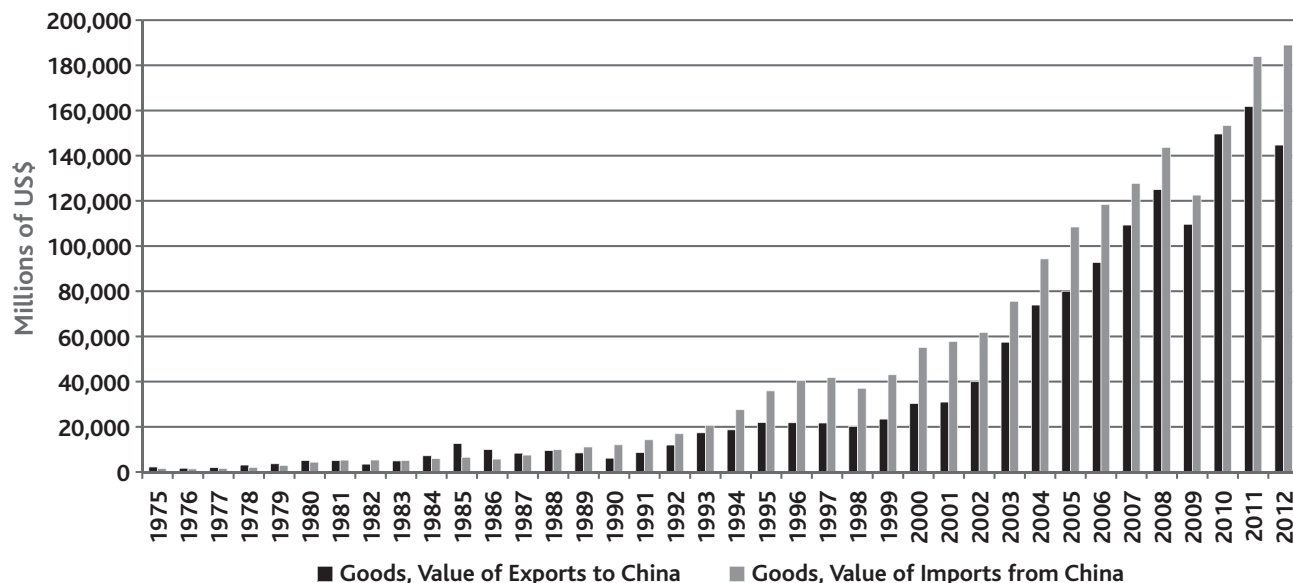
macy approach towards an approach that clearly recognises the reorganisation of the international system and relative economic weakening of key players in that system (Japan and the US). China has taken a more assertive approach to exerting its territorial claims vis-à-vis the Japanese by eschewing its historical pattern of resolving disputes through negotiation and making concessions based on mutually equitable and acceptable terms. In terms of O'Shea's sovereignty game framework, it could be argued that China's recent assertive behaviour regarding the disputed territories demonstrates that it has been able to unbalance Japan's unquestioned sovereignty through repeated incursion into Japanese territory involving both military and non-military vessels.<sup>(27)</sup> More assertive behaviour from China is also indicative of the success of political groups that advocate more aggressive approaches to territorial issues over those that stress the economic risks associated with a decline in bilateral relations. This more unyielding approach to territorial disputes may also be indicative of territorial dispute strategies that may be applied in other territorial disputes within the region and particularly in the South China Sea.

## Background on trade relations

Trade relations between Japan and China have mostly expanded in the post-WWII period. Maruyama breaks down this economic development into four periods: (1) The 1950-60s, in which trade was mostly private sector-oriented but also involved small-scale, selected, pro-Chinese firms; (2) the 1970s, in which intergovernmental trade (encouraged by both governments and facilitated by Japanese Overseas Development Aid) began to flow following the normalisation of Sino-Japanese relations; (3) the 1980s, when there was substantial improvement of bilateral economic cooperation that occurred in concert with Deng Xiaoping's stewardship over China; and (4) the mid-1980s onward, which witnessed the rise of a more equal trade relationship through direct investment and stabilisation of the Chinese economy and political governance.<sup>(28)</sup> This account of the shifting patterns of economic relations between the two states closely follows changes in the structure of the international system and opportunities to engage China as it normalised relations with the US and Japan.

18. Kimie Hara, *Cold War Frontiers in the Asia-Pacific: Divided Territories in the San Francisco System*, London, Routledge, 2007.
19. Paul O'Shea, "Playing the Sovereignty Game: Understanding Japan's Territorial Disputes," PhD dissertation, University of Sheffield, 2012, p. 21.
20. *Ibid.*, p. 22.
21. Ansuya Harjani, "Japan economy to contract as China dispute bites: JPMorgan," *CNBC*, 8 October 2012, [www.cnbc.com/id/49325503/japan\\_Economy\\_to\\_Contract\\_as\\_China\\_Dispute\\_Bites\\_JPMorgan](http://www.cnbc.com/id/49325503/japan_Economy_to_Contract_as_China_Dispute_Bites_JPMorgan) (accessed on 18 February 2013).
22. Allison Jackson, "Island dispute disrupts Sino-Japanese trade," *Financialist*, 30 January 2013, [www.thefinancialist.com/territorial-dispute-disrupts-sino-japanese-trade/](http://www.thefinancialist.com/territorial-dispute-disrupts-sino-japanese-trade/).
23. Eric Hyer, "The South China Sea Disputes: Implications of China's Earlier Territorial Settlements," *Pacific Affairs*, Vol. 68, No. 1, 1995, pp. 34-54.
24. "An Chih-yuan refuted Japanese representative's absurd statement about Tiaoou Island," *Peking Review*, Vol. 15, No. 11, 17 March 1972, p. 11.
25. Eric Hyer, "The South China Sea Disputes," *art. cit.*, p. 44.
26. Paul O'Shea, "Playing the Sovereignty Game," *art. cit.*; Hongyi Nie, "Explaining Chinese Solutions to Territorial Disputes with Neighbour States," *art. cit.*, p. 522.
27. Yuka Hayashi and Brian Spegele, "China Irks Japan with patrol-ship incursion," *Wall Street Journal*, 14 September 2012, <http://online.wsj.com/article/SB10000872396390444023704577650371657448542.html> (accessed on 18 February 2013).
28. Maruyama Nobuo, "Nihon keizai kankei" (Sino-Japanese economic relations), in Okabe Tatsumi (ed), *Chugoku o meguru kokusai kankyo* (The international environment concerning China), Tokyo, Iwanami Shoten, 2001, pp. 79-112, quoted in Xianfen Xu, "The Study of Sino-Japanese Relations in Japan and China, 1990-2005," *Modern Asian Studies Review*, Vol. 12, 2007, p. 87.

Graph 1 – Overall trade between China and Japan



Source: Data from the International Monetary Fund, Direction of Trade Statistics, 2013, <http://elibrary-data.imf.org/FindDataReports.aspx?d=33061&e=170921> (accessed on 19 February 2013).

Hattori and Kojima discuss economic relations between Japan and China in terms of economic cooperation and Chinese prosperity.<sup>(29)</sup> Identifying three phases in post-normalisation Sino-Japanese economic relations, Hattori and Kojima see the 1970s period as characterised by the promotion of mutual economic dependence based on increased trade. They describe the 1980s as a period typified by large volumes of Japanese foreign direct investments (FDI) and monetary loans that contributed to building Chinese infrastructure and the expansive production network that exists in China today. In the 1990s, the overwhelming focus on FDI was succeeded by a combination of trade, investment, and official overseas development aid (ODA) in an effort to consolidate past gains and establish deeper economic integration.<sup>(30)</sup>

JETRO, Japan's trade office overseas, asserts that Japan's Outward FDI to China (Balance of Payments basis, net and flow) increased from US\$1.86 billion in 1997 to US\$12.65 billion in 2011.<sup>(31)</sup> In terms of Japan's Inward FDI from China (Balance of Payments basis, net and flow), there was an increase from US\$22 million in 1997 to US\$109 million in 2011. As of December 2012, the total trade between Japan and China was US\$333.7 billion.<sup>(32)</sup> The drop in trade between the two countries from 2008 to 2009 can be attributed to the global financial crisis, in which not just Sino-Japanese trade was affected but also global trade in general.<sup>(33)</sup> The decrease in trade in 2012 between Japan and China cannot be attributed to a financial crisis. On the contrary, the drop in 2012 can be attributed to the territorial disputes between Japan and China and the Chinese consumer boycott of Japanese brands.<sup>(34)</sup>

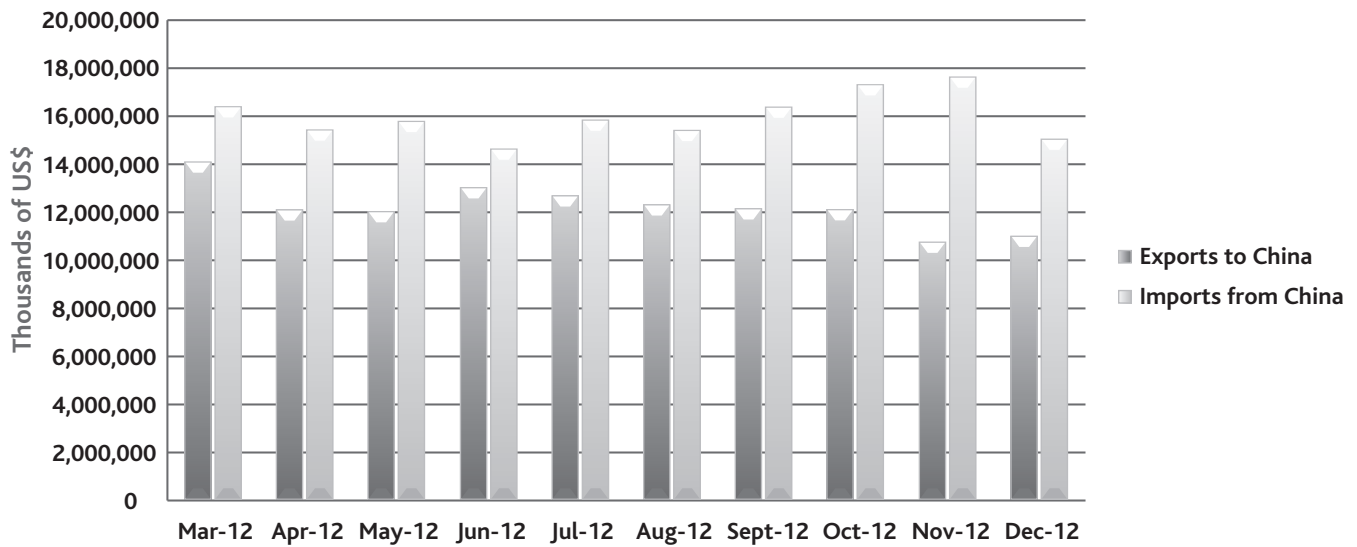
Despite these two blips, post-normalisation trade between Japan and China has grown consistently (see Graph 1). Today, China and Japan are each other's largest trading partners in the region, with China being home to extensive Japanese production networks.<sup>(35)</sup>

### Immediate trade effects of territorial disputes

Territorial tensions have affected trade relations between Japan and China in at least five ways. First, there were immediate import/export effects as-

sociated with Chinese abstention (voluntary and government-encouraged) from buying Japanese brands. JETRO's month-by-month and year-by-year data on import/export trade relations demonstrates significant impact on the sales of Japanese brands in China as the dispute intensified in the fall of 2012. Second, Japanese companies located in China that were victims of anti-Japanese vandalism of their businesses had to temporarily shut down to avoid further damage and accrued the cost of repairing their business as the violence dissipated. Third, some Japanese companies in China temporarily closed their businesses to wait out anti-Japanese sentiments and protect their interests. Fourth, there was a decrease in travel between Japan and China affecting businesses associated with the tourism industry. Fifth, Japanese businesses investing in China have deliberately slowed down and are "exercising caution regarding future investments in China as the Sino-Japanese relations normalise."<sup>(36)</sup>

29. Hattori Kenji, "Nicchu keizai koryu no hanmitsuka: Chokiteki antei o motomete" (The growing intimacy of Sino-Japanese economic exchange: Towards long-term stability), in Kojima Tomoyuki (ed), *Ajia jidai no Nicchu kankei* (Sino-Japanese relations in the Asian era), Tokyo, Saimaru Shuppankai, 1995; Kojima Sueo, "Kokko seijokago no Nicchu keizai" (Sino-Japanese economics since diplomatic normalisation), *Chogoku kenkyu geppo*, Vol. 654, 2002, pp. 26-37.
30. Hidemi Kimura and Yasuyuki Todo, "Is Foreign Aid a Vanguard of Foreign Direct Investment? A Gravity-Equation Approach," *World Development*, Vol. 38, No. 4, 2010, pp. 482-497.
31. Japan External Trade Organization (JETRO), "Japanese Trade and Investment Statistics," [www.jetro.go.jp/en/reports/statistics/](http://www.jetro.go.jp/en/reports/statistics/) (accessed on 18 February 2013).
32. *Ibid.*
33. Warwick J. McKibbin and Andrew Stoeckel, "The Potential Impact of the Global Financial Crisis on World Trade," Policy Research Working Paper 5134, The World Bank Poverty Reduction and Economic Management Network International Trade Department & Development Research Group Trade and Integration Team, November 2009, <http://elibrary.worldbank.org/docservers/download/5134.pdf?expires=1361349744&id=id&accname=guest&checksum=6A7652F30F3CAEB94524486AE9A432C4> (accessed on 20 February 2013).
34. James Parker, "The Dangers of a China-Japan Trade War," *Diplomat*, 18 September 2012, <http://thediplomat.com/pacific-money/2012/09/18/the-dangers-of-a-china-japan-trade-war/> (accessed on 20 February 2013).
35. Shujiro Urata, "The Creation of Regional Production Networks in Asia Pacific: The Case of Japanese Multinational Corporations," in Juan J. Palacios (ed), *Multinational Corporations and the Emerging Network Economy in Asia and the Pacific*, London, Routledge, 2007, pp. 114-138.
36. Quote from Carlos Ghosn, CEO of Renault Nissan. See "Nissan cautious on investment in China," *ChinaScope Financial*, 16 January 2013, [www.chinascopefinancial.com/en/news/post/21697.html](http://www.chinascopefinancial.com/en/news/post/21697.html) (accessed on 20 February 2013).

**Graph 2 – Japan’s international trade in goods with China (Month-by-month Change in Export/Import Trade)**

Source: JETRO, "Japanese Trade and Investment Statistics," [www.jetro.go.jp/en/reports/statistics/](http://www.jetro.go.jp/en/reports/statistics/) (accessed on 18 February 2013).

In terms of import/export relations, the territorial disputes between China and Japan have affected short-term trade relations between the two countries. For example, at the height of the anti-Japanese movements, the sales volume of Japanese-made cars in China dropped 2% year-on-year.<sup>(37)</sup> Sales of cars produced by Germany, US, South Korea, and France went up 25%, 19%, 12%, and 4% year-on-year, respectively.<sup>(38)</sup> In response, Japanese car manufacturers have already implemented strategies to restore their brand images in China by selling models tailored to the Chinese market and offering discounts or programs such as free repair of cars damaged during anti-Japanese protests in an effort to avoid another nationalistic backlash against their products.<sup>(39)</sup>

This reduction in trade with Japan, whether officially sanctioned or spontaneous, seems to have a precedent in China's dealings with other countries that do not follow Chinese wishes. In a study employing the "gravity model" of exports to China from 159 partner countries between 1991 and 2008 to test the extent to which bilateral tensions affect trade with autocratic China, it was found that countries that deviated from the political imperatives of Beijing, in this case meeting with the Dalai Lama at high political levels, were subject to punitive economic measures. They caused trade to decrease between 8.1% and 16.9%, depending on which measure was being used.<sup>(40)</sup> Other recent examples of the use of punitive economic tactics related to political disagreements include China stopping the import of Philippines' bananas; disruption of travel by Chinese tourists to the Philippines,<sup>(41)</sup> France,<sup>(42)</sup> and Norway; and stopping the import of Norwegian Salmon and removing Norway from the list of countries allowed visa-free visits to Beijing after the Nobel Peace Prize was awarded to Liu Xiaobo.<sup>(43)</sup>

Mirroring the Japanese automobile industry's decline in car sales in China throughout the elevated tensions associated with the territorial disputes, JETRO's month-by-month and year-by-year comparative data on changes in value of exports and imports by area and country (see graphs 1 and 2) show that trade between the two countries increased year-by-year up until 2011. Graph 2 shows a decrease in exports to China beginning in August at the start of the recent territorial disputes, followed by a continuing month-by-month drop as tensions between China and Japan increased.

Anti-Japanese vandalism occurred in the fashion and technology industries: UNIQLO shut down 42 stores in China, AEON shut down 30 of 35 stores, Nissan Motor stopped manufacturing in two factories, and Canon, Sony, Panasonic, and Hitachi all temporarily closed factories.<sup>(44)</sup> Although they were only temporary shut downs, the business leaders in each of these

37. "Japanese car sales fall in 2012 amid island spat," *Bloomberg Businessweek*, 7 January 2013, [www.businessweek.com/ap/2013-01-07/japanese-car-sales-fall-in-2012-amid-island-spat](http://www.businessweek.com/ap/2013-01-07/japanese-car-sales-fall-in-2012-amid-island-spat) (accessed on 20 February 2013). Japanese automakers suffered plunging sales in China in September and cut manufacturing by up to half in China in October after the violent anti-Japanese protests in which Japanese-brand cars and even their owners were targeted. Toyota announced on 9 October that its sales to dealerships in China dropped 49% in September from the same month a year previously, while Honda said that its sales had fallen 40% and Nissan said that sales were down 35%. Mazda said in early October that its sales had fallen 35% in September. See Keith Bradsher, "In China protests, Japanese car sales suffer," *The New York Times*, 9 October 2012, [www.nytimes.com/2012/10/10/business/global/japanese-car-sales-plummet-in-china.html](http://www.nytimes.com/2012/10/10/business/global/japanese-car-sales-plummet-in-china.html) (accessed on 19 February 2013).
38. "Sino-Japan Trade Affected by Disputed Islands Turmoil," *ChinaScope Financial*, 14 September 2012, [www.chinascopefinancial.com/en/news/post/16701.html](http://www.chinascopefinancial.com/en/news/post/16701.html) (accessed on 19 February 2013).
39. He Wei, "Japanese Car Sales 'Back on Track' as Customers Return," *China Daily*, 27 November 2012, [www.chinadaily.com.cn/china/2012-11/27/content\\_15960797.htm](http://www.chinadaily.com.cn/china/2012-11/27/content_15960797.htm) (accessed on 20 February 2013); Yajun Zhang, Colum Murphy, and Yoshio Takahashi, "Japan's auto makers expect a recovery in China," *Wall Street Journal*, 7 January 2013, <http://online.wsj.com/article/SB10001424127887323482504578227212570585692.html> (accessed on 20 February 2013).
40. Andreas Fuchs and Nils-Hendrik Klann, "Paying a Visit: The 'Dalai Lama Effect' on International Trade," Center for European Governance and Economic Development Research Paper, No. 113, 2010.
41. Brooks B. Robinson, *Asia-Pacific Economic Update 2012*, Vol. 3, Honolulu, U.S. Pacific Command, September 2012, p. 23, [www.pacom.mil/documents/pdf/2012-APEU-Vol\\_3\\_091612\\_.pdf](http://www.pacom.mil/documents/pdf/2012-APEU-Vol_3_091612_.pdf) (accessed on 17 June 2013); Takungpao, "Chukou zoujiang, Feilubin xiangjiaoshang xiexin xiang Zhongguo qiuzhu" (Export suddenly decrease, Philippines banana dealers write letters to China to seek help), 26 October 2012, [www.takungpao.com.hk/finance/content/2012-10/26/content\\_1293478.htm](http://www.takungpao.com.hk/finance/content/2012-10/26/content_1293478.htm) (accessed on 17 June 2013).
42. Ian Traynor, "China cancels EU summit over Dalai Lama visit," *Guardian*, 27 November 2008, [www.guardian.co.uk/world/2008/nov/27/china-dalai-lama-nicholas-sarkozy](http://www.guardian.co.uk/world/2008/nov/27/china-dalai-lama-nicholas-sarkozy) (accessed on 17 June 2013).
43. Jamil Anderlini and Clare MacCarthy, "China snubs Norway in visa reforms," *Financial Times*, 6 December 2012, [www.ft.com/intl/cms/s/0/7aa84f82-3f6a-11e2-b0ce-00144feabdc0.html#axzz2WSd3Zizi](http://www.ft.com/intl/cms/s/0/7aa84f82-3f6a-11e2-b0ce-00144feabdc0.html#axzz2WSd3Zizi) (accessed on 17 June 2013); "Nuojiang ban Liu Xiao Bo, Zhong jin Nuowei guiyu" (Nobel Prize was conferred to Liu Xiaobo, China prohibits imports of Norwegian salmon), *Apple Daily*, 6 October 2011, [www.appledaily.com.tw/appledaily/article/international/20111006/33719120/](http://www.appledaily.com.tw/appledaily/article/international/20111006/33719120/) (accessed on 18 June 2013).
44. "Uniqlo, Aeon Shut China Stores as Island Spat Escalates," *Bloomberg News*, 18 September 2012, [www.bloomberg.com/news/2012-09-17/china-japan-dispute-over-islands-risks-340-billion-trade.html](http://www.bloomberg.com/news/2012-09-17/china-japan-dispute-over-islands-risks-340-billion-trade.html) (accessed on 19 February 2013).

sectors continue to express reservations about bolstering investment in China until relations normalise or stabilise.<sup>(45)</sup>

In the wake of the recent riots, there is little chance that we will be able to change [China's] structure through dialogue and international public opinion. As such there is a national risk associated with doing business in China and we should consider the possibility of relocating. (Japanese executive accountant, interview, February 2013)

The recent riots are one of many reasons, including rising labour costs, corruption, and environmental issues, for retreating from the Chinese market. The market in China does not work like Japan (or other countries) and we are becoming more and more hesitant about further investment. (Former Japanese Company President, Linen Industry, interview, May 2013)

Businesses in sectors other than manufacturing, such as retail<sup>(46)</sup> and tourism,<sup>(47)</sup> were also affected by territorial friction. Significant drops in tourism from and to China/Japan are a case in point. Following the anti-Japanese riots that took place in cities in China in the fall of 2012, Japanese tourists cancelled their travel plans out of fear of violence,<sup>(48)</sup> and Chinese tourists to Japan cancelled their travel plans to Japan, resulting in a significant impact on tourist-related industries in both countries.<sup>(49)</sup>

We have seen a decrease in the number of people travelling from China to Japan and from Japan to China since the incident started in September 2012. In addition to socioeconomic effects of the tensions, we have seen effects on cultural exchanges. (Local government official in Ibaraki Prefecture, interview, February 2013)

The territorial tensions between Japan and China have had a major immediate impact on trade relations between East Asia's two largest trading partners, although the examples discussed above merely serve to illustrate a situation characterised by enormous complexity and variety.

### Discussion: Mid- and long-term forecast

The impact of the territorial dispute on trade relations needs to be put into historical perspective. Examining the relations between China and Japan since the end of WWII and their interest in the disputed territories, it is clear that China showed little or no interest in the islands until their official reversion to Japan and the discovery of energy resources.<sup>(50)</sup> Even with the discovery of resources, conversations between Chinese and Japanese leaders at the time came to an understanding that the territorial dispute would not deter economic relations.

When a reporter asked about ownership of the Senkaku islands, the audience became tense, but Deng replied that the Chinese and the Japanese held different views, used different names for the islands, and should put the issue aside so that later generations, who would be wiser than those present, could solve the problem.<sup>(51)</sup>

In this sense, Japan's *seikei bunri* approach to relations with China remained the hallmark of their bilateral relations and mutually benefitted the two countries. The Japanese could continue to expand their manufacturing base into

China, taking advantage of the unlimited supply of cheap labour and materials. On the Chinese side, putting the dispute under the table and concentrating on economic development, the construction of infrastructure, and the expansion of trade was prioritised over territorial disputes.

As Hyer, Nie, and others demonstrated in their studies cited above, China has sought advantages and has taken a more aggressive stance vis-à-vis other states in territorial disputes when that state is perceived to be in a weaker or disadvantageous situation. Based on this evidence and considering the timing, the recent more aggressive approach by the Chinese vis-à-vis the Senkaku/Diaoyu islands can be related to the perceived weakness of Japan and the US Security Alliance in light of the 2008 financial crisis, the prolonged stagnation of the Japanese economy, the political instability in Japan resulting from frequent leadership changes, the need of the Communist regime to demonstrate its strength through a refusal to compromise over the "core" issue of territorial integrity, and the rapid growth of the Chinese economy.<sup>(52)</sup> Critically, domestic instability within China and growing internal discontent associated with corruption, growing social inequality, and environmental degradation have also emboldened China in its handling of territorial disputes such as the one with Japan, and they provide us with some insight into the future direction of trade and economic relations in the region.

In addition to the immediate effects of both spontaneous and government-encouraged abstention from purchasing Japanese brands,<sup>(53)</sup> trade was disrupted by physical damage to Japanese-owned companies manufacturing or providing services in China,<sup>(54)</sup> and confidence in China as an attractive destination for Japanese Foreign Direct Investment (FDI) has been undermined at best and shattered at worst.<sup>(55)</sup>

As a result of the recent anti-Japanese riots, there has been a reduction in the willingness to develop stores in China. (Japanese National Project Developer, interview, February 2013)

45. Stuart Grudgings, "Hedging China risks, Japan firms turn to booming Southeast Asia," *Reuters*, 5 November 2012, [www.reuters.com/article/2012/11/05/japan-southeastasiaidUSL1E8LV1BW20121105](http://www.reuters.com/article/2012/11/05/japan-southeastasiaidUSL1E8LV1BW20121105) (accessed on 19 February 2013).
46. For example, "Shiseido Co., Japan's largest cosmetics maker, says several hundred shops out of its 5,000-plus network of outlets in China have suspended sales. Chinese sales account for more than 10% of total revenue at the Tokyo-based company." See Takashi Nakamichi, "Japan trade suffers amid China dispute: Exports to Beijing fall from previous year," *Wall Street Journal*, 22 October 2012, <http://online.wsj.com/article/SB10001424052970204425904578071362990981442.html> (accessed on 16 October 2013).
47. "The number of tourist visas issued to Chinese visitors fell 15% from 129,900 in July to 109,700 in August – when the Senkaku dispute began to worsen – according to the foreign ministry." See Michiyo Nakamoto, "Chinese tourists give Japan wide berth," *Financial Times*, 5 October 2012, [www.ft.com/intl/cms/s/0/07b397c4-0d48-11e2-97a1-00144feabdc0.html#axzz2L2c8aT8b](http://www.ft.com/intl/cms/s/0/07b397c4-0d48-11e2-97a1-00144feabdc0.html#axzz2L2c8aT8b) (accessed on 19 February 2013).
48. Karon Snowdon, "China loses favour with Japanese tourists," *Australia Network News*, 5 February 2013, [www.abc.net.au/news/2013-02-05/an-china-loses-favour-with-japanese-tourists/4501832](http://www.abc.net.au/news/2013-02-05/an-china-loses-favour-with-japanese-tourists/4501832) (accessed on 19 February 2013).
49. Michiyo Nakamoto, "Chinese tourists give Japan wide berth," *art. cit.*
50. Yoritumi Watanabe, "China's interest in Senkaku is recent," *Financial Times*, 6 November 2012, [www.ft.com/intl/cms/s/0/be7812b8-2450-11e2-b38c-00144feabdc0.html#axzz2Kx9AF E9K](http://www.ft.com/intl/cms/s/0/be7812b8-2450-11e2-b38c-00144feabdc0.html#axzz2Kx9AF E9K) (accessed on 19 February 2013).
51. Ezra F. Vogel, *Deng Xiaoping and the Transformation of China*, Cambridge, MA, Belknap Press of Harvard University Press, 2011, p. 304.
52. Comments to this effect were a part of the discussions at the Salzburg Global Seminar "China in the 21st Century: What Kind of World Power?" held 4-9 December 2012, in which 50 experts on China and regional issues (including the author) came together to discuss China in the twenty-first century. See Kathrin Bachleitner, *Salzburg Global Seminar Session Report 501: China in the 21st Century: What Kind of World Power?* Salzburg Global Seminar, Austria, 4-9 December 2012, pp. 12-14.
53. James Parker, "The Dangers of a China-Japan Trade War," *art. cit.*
54. Takashi Nakamichi, "Japan trade suffers amid China dispute," *art. cit.*
55. Allison Jackson, "Island dispute disrupts Sino-Japanese trade," *art. cit.*

Last year, I visited China three times to expand our business. However, following the anti-Japanese movement, I felt that it would be difficult to continue this expansion. There are more and more risks associated with business investment in China, including the growing gap between the rich and the poor, the communist regime, an immaturity of the national character, and now anti-Japanese movements. (Japanese IT Company President, interview, February 2013)

The Japanese government has also lost confidence that overseas development aid is an effective and useful tool in fostering better relations with China.

Although we have been giving ODA for many years, it appears that it has not generated good will when we consider the anti-Japanese sentiment taking place in the mainland today. (Japanese consular official in Hong Kong, interview, October 2012)

The financial risks of investment in China have been seen by Japanese business leaders with operations in Hong Kong to be worrisome enough to begin to look to ASEAN countries as a source of political stability, economic opportunity, and a relationship based on longstanding post-WWII, ODA-based exchanges with Japan that have helped develop the region economically. Several Japanese observers echoed these sentiments in the following way:

The ASEAN states represent a 600 million-strong market that has relatively stable political institutions, young and cheap labour sources, and a longstanding relationship based on cultural, educational, and economic exchanges supported by ODA, JIAC, and other Japanese institutions. Most importantly, though, it is a part of the world that “likes” us. (Japanese diplomat in Hong Kong, interview, September 2012)

Over time, business confidence has been greatly affected by the great magnitude of the risk in China. There is not a bright future for revival of investment in China. What we are seeing is that small businesses cannot afford the risk in China, and they are shifting their investment from a “China plus one” pattern to an “ASEAN-only” one. (Japanese bank executive, interview, February 2013)

The anti-Japanese riots are another example of the risk of doing business in China. This risk has been known for some time and our company has made adjustments. There is definitely a rise in anti-Japanese sentiment, but in addition to this, the increasing cost of labour and doing business has made ASEAN states such as the Philippines, Indonesia, Vietnam, and Myanmar attractive business destinations, and as a result we are building manufacturing centres there. (Manager, Sales and Marketing, Japanese Manufacturing Company, interview, May 2013)

Local Japanese business leaders conducting business in China have to varying degrees previously stressed their uncertainty about the attractiveness of the Chinese market because of intellectual property rights (IPR) issues; however, the recent riots have intensified that concern:

The cost of doing business in China keeps rising. It's too big of a market not to be a part of, but the recent anti-Japanese riots and growing nationalism are compelling us to look to “friendlier” markets like those in Southeast Asia. (Hong Kong-based Japanese electronics maker, interview, October 2012)

In addition to changes in the regional economic structure in which increasing labour costs are a disincentive to further investment in manufacturing in China, the voices of local business leaders on the recent trade disputes reflect concerns about the short-, mid-, and long-term impact of growing tension between East Asia's largest trading partners. Anti-Japanese riots have eroded the confidence of Japanese businesses in China, and they have begun increase their investment in ASEAN countries as a way to hedge against the risks attached to investment in mainland China. In this sense, China's more assertive grassroots and government stance on the islands may have unpredicted domestic repercussions in both countries.

In the short term, Japanese businesses will continue to be at a distinct disadvantage as Chinese consumers, both voluntarily and under encouragement from the Chinese government, abstain from purchasing Japanese brands. This may be sustainable in the short term in China; however, there are important caveats that need to be mentioned. Japanese exports to China do not just include Japanese brand-name goods such as electronics, cosmetics, and other items used in everyday life. At a deeper level, Japan also exports key materials, parts, and machines used in Chinese industries, and thus abstention from the purchase of Japanese goods may affect Chinese industries as well.<sup>(56)</sup> From this point of view, the symbiotic relationship between the two economies based on a hierarchal, flying geese model may give Japan leverage in the midterm to stay engaged in the Chinese economy.<sup>(57)</sup> As long as China remains dependent on Japanese technology, small machinery parts, and investment, further escalation on the Chinese side over these disputed territories could significantly harm its economic interests. That being said, China could seek to by-pass its dependency on Japanese technology and related materials by establishing its own domestic supply.

This advantage on Japan's part is not guaranteed and could expire sooner than later, and as a result, we may continue to see a shift from a China-centred production network to a less centralised production network or ASEAN-centred network. PM Abe's January visits to ASEAN countries are already illustrative of a more proactive diplomacy aimed at building reliable partners in the region based on shared interests.<sup>(58)</sup> During his visit to Jakarta, PM Abe outlined his five principle-based approach to diplomacy with the ASEAN states: (1) expand and enshrine universal values such as freedom, democracy, and basic human rights; (2) protect the seas, which should be open, free, and controlled by laws and rules; (3) prosper together by promoting economic networks for enhanced trade; (4) promote investment and exchanges of goods and people; and (5) protect and nurture Asia's diverse cultures and traditions.<sup>(59)</sup> Principles (3) and (4) stand out as strong

56. Yang Xing and Zhu Ni, “Zhong-Ri zhengduan buli Zhongguo jingji fusu” (How hard will the China-Japan islands dispute hit the Chinese economy?), *Jingji guancha wang* (Economic observer), [www.eeo.com.cn/2012/1127/236626.shtml](http://www.eeo.com.cn/2012/1127/236626.shtml) (accessed on 18 February 2012).

57. Kaname Akamatsu, “A Historical Pattern of Economic Growth in Developing Countries,” *Journal of Developing Economies*, Vol. 1, No. 1, 1962, pp. 3-25.

58. Weng Kin Kwan, “Abe's trip highlights importance of Asean,” *Straits Times*, 21 January 2013, [www.stasiareport.com/the-big-story/asia-report/japan/story/abes-trip-highlights-importance-asean-20130121](http://www.stasiareport.com/the-big-story/asia-report/japan/story/abes-trip-highlights-importance-asean-20130121) (accessed on 19 February 2013).

59. Ministry of Foreign Affairs of Japan, “The Bounty of the Open Seas: Five New Principles for Japanese Diplomacy – The Address by H.E. Mr. Shinzo Abe, Prime Minister of Japan,” 18 January 2013, [www.mofa.go.jp/announce/pm/abe/abe\\_0118e.html](http://www.mofa.go.jp/announce/pm/abe/abe_0118e.html) (accessed on 19 February 2013).



commitments to expanding trade and investment in the region with countries that share similar values.

This commitment to ASEAN partners was further exemplified in the cementing of stronger bilateral ties through trade and the supply of technology. For example, PM Abe signed an agreement to supply coast guard vessels to the Philippines,<sup>(60)</sup> offered ODA that included a special allotment of \$500 million to fund three Vietnamese development projects in trade, investment, and infrastructure,<sup>(61)</sup> and made a commitment to economic cooperation with Thailand, including joining Bangkok and Myanmar in developing the Dawei deep-sea port.<sup>(62)</sup>

PM Abe's pivot to South-East Asia and strong adherence to employing international norms, in particular universal values such as freedom, democracy, and basic human rights, and protecting the seas, which should be open, free, and controlled by laws and rules, are indicative of Japan's interest in consolidating the present international system. The emphasis on prospering together by promoting economic networks for enhanced trade and the investment and exchange of goods and people are equally important. These diplomatic pillars for interacting with ASEAN states are meant to reinforce and consolidate current trade and economic relations in the region, as well as establishing relationships that are based on shared adherence to international norms. In this sense, rather than being a revisionist or expansionist power in the region that aims to challenge the current international system and regional framework, Japan is bolstering its position in the region by investing in the status quo and in existing mechanisms for territorial dispute resolution.

With waning investor confidence in China and the overt shift of the Japanese government to ASEAN, trade with China will not necessarily decrease in volume, but there will certainly be a transformation in the nature of Japanese investment. When asked about the future of Japanese business in China, many informants stressed the changing nature of the economic relationship from one based on China as a manufacturing centre to China as a source of consumers.

China represents the largest and closest consumer market for our products. We must stay engaged despite the current difficulties. We sell excellent products that the Chinese consumer wants or will want. (Electronic appliance manufacturer, interview May 2013)

The Japanese government and Japanese businesses undoubtedly recognise that the Chinese market will continue to be a crucial one with which to engage. That being said, the more assertive stance that the Chinese government has taken with regard to the Senkaku/Diaoyu islands and the punitive measures it has taken on Japanese businesses inside and outside of China have compelled Japanese companies, to quote one informant, "to shift their investment from a 'China plus one' pattern to an 'ASEAN-only' one," or some variation of that investment strategy in which Japanese businesses are not so susceptible to the "risks associated with business investment in China, including the growing gap between the rich and the poor, the communist regime, an immaturity of the national character, and now anti-Japanese movements."

## Conclusion

Returning to Nie's assertions that "China resolved disputes with states that did not have expansionary territorial designs through negotiations

that emphasised mutual understanding and tolerance, and worked towards a mutually beneficial and equitable solution,"<sup>(63)</sup> the shift in trade between Japan and China in the wake of the fall 2012 territorial disputes represents a turning point in their traditional *seikei bunri* relationship.

Similarly, the application of O'Shea's sovereignty game framework has also shown us that China's traditional approach to post-WWII territorial dispute settlement has become more enterprising, in that China has been able to leverage its economic relationship with Japan to negatively affect the latter's trading position while at the same time undermining its unquestioned sovereignty through repeated incursions into disputed territory. It must also be said that the more assertive approach is not merely a result of a shift in policy towards Japan; rather we should understand the shift in approach on territorial issues by China as the outcome of domestic political tensions and divisions within China.

These tools of analysis demonstrate that the territorial dispute did have an effect on trade relations between Japan and China and that the traditional understanding between them that economics should be prioritised over political issues has collapsed in the short term and perhaps shifted in the mid and long term. This conclusion seems to be bolstered by the voices of Japanese business leaders conducting business in China and their growing concerns over the risks associated with this. The shift of the Japanese government and Japanese businesses' interests towards ASEAN states, and the growing investment and commitment to cooperate with ASEAN partners further buttress the argument that trade relations based on the separation of politics and economics is no longer viable. Inclusion of Japan in the Trans-Pacific Partnership (TPP) would provide further evidence that Japan is decreasing its economic dependence on China while strengthening and broadening its economic engagement with other regions of the world by joining a trade agreement that stresses the protection of intellectual property rights (IPR) and "cross-cutting issues like competition, capacity-building, e-commerce, financial services, investment, environment, government procurement, intellectual property, investment, labour, technical barriers to trade (TBT) and trade remedies."<sup>(64)</sup>

Several caveats need to be included in this analysis. First, China, Japan, and South Korea are currently engaged in negotiations over a trilateral free trade agreement. If this agreement does come to fruition, it would deepen the economic integration between the three neighbours and make the kind of economic sanctions and disruptions seen at the height of the territorial disputes more problematic in their application. The same could be said for the Regional Comprehensive Economic Partnership (RCEP) that is currently being negotiated between ASEAN countries and their FTA partners, China, Japan, South Korea, India, Australia, and New Zealand. The clear assumption

60. Jean M. Cordero, "Philippines, Japan boost strategic partnership," *Asia Pacific Defense Forum – Features*, 1 January 2013, [http://apdforum.com/en\\_GB/article/miap/articles/online/features/2013/01/30/philippines-japan-partner](http://apdforum.com/en_GB/article/miap/articles/online/features/2013/01/30/philippines-japan-partner) (accessed on 19 February 2013).

61. American Chamber of Commerce in Vietnam, "Japan's Prime Minister Abe Visits ASEAN," 16-19 January 2013, [www.amchamvietnam.com/9033/japans-prime-minister-abe-visits-asean/](http://www.amchamvietnam.com/9033/japans-prime-minister-abe-visits-asean/) (accessed on 19 February 2013).

62. "Japan, Thailand ties get boost: PM Abe visits, reaffirms Dawei port investment," *Bangkok Post*, 17 January 2013, [www.bangkokpost.com/news/local/331347/japan-thailand-ties-get-boost](http://www.bangkokpost.com/news/local/331347/japan-thailand-ties-get-boost) (accessed on 19 February 2013).

63. Hongyi Nie, "Explaining Chinese Solutions to Territorial Disputes with Neighbour States," *art. cit.*, p. 522.

64. Amitendu Palit, "The Trans-Pacific Strategic Economic Partnership (TPP): Implications for the Asia-Pacific," Keynote Address for the 3<sup>rd</sup> Annual Conference of the International Association for Asia-Pacific Studies (IAAPS), 23-24 November 2012, The Chinese University of Hong Kong, p. 40.

in both of these cases is that all partners abide by the agreement's rules and do not apply economic sanctions and disruptions to settle political disputes.

Lastly, it must be stressed that the recent retreat of official and private Japanese business interests from engagement with China can be attributed to a number of factors, including increasing production costs, corruption, and an associated decline in China's profitability as a manufacturing base relative to certain alternatives (for example in South-East Asia). In this context, political disagreements and the sudden increase in anti-Japanese sentiment following the 2012 nationalisation of the Senkaku/Diaoyu Islands, with the attendant vandalism of Japanese property and decline in consumption of Japanese products, have not been without consequences. These events put both Japanese businesses and government on notice: new think-

ing would be required to secure access to future consumers while simultaneously hedging against risks associated with upsurges of nationalistic, anti-Japanese sentiment.

■ **Stephen Robert Nagy is Assistant Professor at the Department of Japanese Studies at The Chinese University of Hong Kong and affiliated with the following institutions: International Affairs Research Centre, CUHK, the Global Institute of Asian Regional Integration, Waseda University and the Japanese Immigration Policy Institute. Room 412, Leung Kau Kui Building, Department of Japanese Studies, The Chinese University of Hong Kong, Sha Tin, New Territories, Hong Kong (nagystephen@cuhk.edu.hk).**