

Re-examination of the Economic Interdependence between China and Japan

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Abstract

China and Japan, the world's second and third largest economies. They have established one of the biggest bilateral trade relationships in the world and also is considered as close economic interdependence. However, tensions between these two countries have further escalated in recent years. Why economic interdependence cannot prevent the escalating tensions between China and Japan? This article tries to re-visit the theory of economic interdependence, in order to tackle the puzzle between economic interdependence and conflict in the case of Sino-Japanese relationship. I will demonstrate the key features on the development process of this economic interdependence relationship and show the dynamic change of increasingly obvious flaws in this relationship. In this context, I emphasize the necessity of establishing coordination mechanism between China and Japan, which can ease the anxiety of the two governments for the unfavorable situation brought by the worsening flaws in this economic interdependence. The Sino-Japanese relationship was seriously affected by these two factors: the increasingly obvious flaws on the one hand and the effort of both governments to build the coordination mechanism on the other hand, during the first decade of 21st century. These two factors working together have led to the repeated unstable situation between China and Japan in the 2000s. More importantly, the frustration with the establishment of the coordination mechanism in the case of Sino-Japanese relationship is the most important factor leads to the escalating current tensions.

Keywords: Sino-Japanese Relationship, Economic Interdependence, International Relations

I. Introduction

Economic interdependence among the major powers has continued to reach new heights in the context of the accelerated economic globalization. Scholars have provided numerous studies to prove the important role of economic interdependence in international relations. However, they have still not been able to determine whether

economic interdependence leads to war or peace.

The liberal scholars have argued that closer economic interdependence can reduce the possibility of military conflict. On the contrary, realist scholars believe that economic interdependence exacerbates the possibility of military conflict. In a new theoretical development, Dale Copland(Copland, 2015) [1] proposed a theory that would draw an intermediate route between these contradictory assumptions. He

proposed the Trade Expectations Theory and argued that states' expectation of future trade and investment environment determines whether economic interdependence can lead to peace or war.

This paper re-visits the theory of economic interdependence by searching for a suitable theoretical explanation for the current Sino-Japanese relationship. China and Japan are the world's second and third largest economies and this bilateral relationship evidences considerable economic interdependence. However, tensions between these two countries have further escalated in recent years. The Sino-Japanese relationship is a good case to reconsider the limitations of previous theories and further contribute to the development of the existing theoretical discussion.

Since China and Japan achieved the normalization of diplomatic relations in 1972, the two countries have carried out fruitful cooperation in the economic field. They have established one of the world's biggest bilateral trade relationships. The size of bilateral trade reached a record of US \$34.494 billion in 2011. Until 2014, this bilateral trade was ranked the third-largest in the world (Drysdale, 2015) [2]. The relationship between China and Japan has long been described as economically interdependent. Not only scholars but also the official website of the Ministry of Foreign Affairs of Japan described the economic relationship between China and Japan as closely interdependent (Ministry of Foreign Affairs of Japan [MOFA], 2016) [3].

Meanwhile, the Sino-Japanese relationship has entailed historical problems of the war and colonialism as well as realistic territorial disputes. In the 2000s, even when the economic and trade relationship between China and Japan was developing rapidly, the

political tensions also exacerbated repeatedly in multiple issues, such as the controversy concerning history textbooks, Japanese prime ministers' visit to the Yasukuni Shrine, political speeches by politicians, and drilling oil and gas fields in the disputed area. More seriously, due to the escalating tensions in maritime and security issues, the political opposition between China and Japan has become increasingly serious in recent years. The frequent confrontations of the official vessels in the disputed waters and of the China Air Force and the Japan Air Self-Defense Force [JASDF] on the high seas, amidst the absence of a maritime security liaison mechanism. In 2016, the number of emergency takeoffs of JASDF reached a new record, and more than 70% were considered to be against the China Air Force (JASDF, 2017) [4]. The highly-intensive interception greatly increases the likelihood of incidents. For example the JASDF fighters once launched chaff (interference countermeasure) to the Chinese air fighters on the high seas in 2016 (Ministry of National Defense of the People's Republic of China, 2016) [5].

Thus, China and Japan have the so-called close economic interdependence on the one hand, yet they also have the increasing tensions of the security situation with the possibility of military conflict on the other. Why economic interdependence cannot prevent the escalating tensions between China and Japan? In order to answer this question, this work will demonstrate the dynamic of this relationship, and reconsider the theory of economic interdependence and conflict. By re-examining the economic interdependence between China and Japan, I will argue that the huge amount of profit in the economic interdependence between China and Japan is insufficient to provide positive expectation for

the two governments in this relationship. Two other factors, the increasingly obvious flaws and the changing coordination mechanism, play an extremely important role in affecting governments' expectations in the case of Sino-Japanese relationship. This explanation is proposed as a complement to existing theories, which is helpful for further explaining the policy changes in other major power relations in the context of accelerating globalization.

The argument is supported by personal interviews and secondary sources. I conducted interviews with key people, such as diplomats, current and former government officials, managers of Japanese companies in China, as well as those who have a long-term commitment to nongovernmental cultural exchanges.

In the next section, I will reconsider the previous studies of the relationship between economic interdependence and conflict and propose my hypothesis. In the third section, I will re-examine the economic interdependence between China and Japan, and illustrate the dynamics of this relationship. In particular, I will show that the increasingly obvious flaws of this economic interdependence and the frustration concerning the coordination mechanism. The last section will summarize the main findings.

II. Previous studies and theoretical modifications

When it comes to the concept of economic interdependence, we have to go back to the origin of this concept. Regarding to the changing trends in the 1960's among the industrialized European countries, Richard N. Cooper proposed that there is sensitivity in the relationship between domestic economy

and the international economies. This is the 'economic interdependence' relationship. In the context of economic interdependence, "to give up some of the national autonomy in order to enjoy the benefits by closer international economic relations"(Cooper, 1968) [6] will form mutual restraint between interdependent states and also increase the space for mutual compromise.

Edward L. Morse further introduces this theory into the field of international relations. He believes that under the impetus of modernization, economic interdependence will have three impacts. First, the borders between domestic and foreign affairs will dissolve. Second, the distinction between high politics and low politics will be less important. Third, the ability of state leaders to have political control will decrease with the growing interdependence (Morse, 1973) [7]. He also believes that under the wave of modernization, international relations will further accelerate the transformation. Under economic interdependence, the competition among countries will change from a zero-sum game to a win-win game, and the separation of a country's commercial and national security policies will no longer be realistic(Morse, 1976) [8].

Both Cooper and Morse believe that the new changes in the international relations will weaken sovereignty and reduce the possibility of conflict between states. However, after their proposal, the debate over the relationship between economic interdependence and the major power conflicts continues. The debate can be mainly divided into two main camps: the liberal and realist theories.

The existing theories both have their own characteristics and disadvantages in explaining different cases of international relations. In the case of the contemporary

Sino-Japanese relationship, existing theories cannot provide a logical coherent explanation. This section points out the limitations of the existing theories and will modify them. This will become the theoretical basis for the subsequent sections to explain the case of Sino-Japanese relations.

1. Theories of economic interdependence and conflict

As mentioned previously, studies of the relationship between economic interdependence and conflict in international relation theory have been mainly proposed by liberal and realist scholars. In fact, there have been a large number of empirical studies. They all found cases that could support their arguments. However, no single theory can perfectly explain all cases because some cases do not fit certain theoretical explanations.

Liberalists believe that military power is not the most critical factor in international relations. They put forward another concept of power based on the asymmetric dependency between countries. The concept of asymmetric interdependence came from one of the most famous books in liberal understanding of economic interdependence, *Power and Interdependence*, written by Robert Keohane and Joseph Nye in 1977. In this book, Keohane and Nye argue against the idea of realism, which considers military security as a state's most important priority. Instead, they proposed the concept of "Complex Interdependence". Complex Interdependence has three characteristics: multi-channel of linkages between countries, absence of hierarchy among diplomatic issues, and the minor role of the military force (Keohane & Nye, 1977) [9].

All in all, the idea of liberalism can be summarized as this: any state in

interdependence will seek to avoid war and maximize its benefits of close ties from peaceful trading because trade provides benefits while war causes economic loss. Keohane and Nye's idea of asymmetric interdependence showed a gap of power between the more dependent state and the less dependent state. Namely, more dependent states are likely to enjoy peace while less dependent states are tend to be aggressive to make other states concede. At the same time, even less dependent states need to consider the opportunity cost, especially when other states are signaling that they are willing to suffer the higher cost. Therefore, less dependent states will not push too hard in negotiations. With this prediction, liberalists believe that interdependence should lower the risk of war. They explained some cases in the history, such as the 1967-1978 period during the Cold War (Gasirowski & Polachek, 1982) [10] or the First World War (Gartzke & Lupu, 2011 [11]; Gartzke & Lupu, 2012 [12]) to support their hypothesis.

The realist argument is completely opposite to the liberalist one. Realists firmly believe that the international community is an anarchy. Therefore they assert that interdependence will only increase the chances of conflict. Based on this idea, they argue that the country's first priority lies in its own security (Grieco, 1988 [13]; Mearsheimer, 1995 [14]). Realists have highlighted the risk of a state being cut-off from important markets and raw materials, and restructuring of economic relation that may bring huge costs (Waltz, 1979) [15]. Under this premise, they insist that higher interdependence creates higher uncertainty that may push the great powers into war and conflict². According to them, when states realize that they are caught in interdependence, they will seek

opportunities to reduce dependency, even by conflict and war. Realists identified cases in history that can support their hypothesis, for example, the First Opium War between Britain and China.

Both camps have carried out numerous studies of empirical analysis with different cases. These results show that both liberalist and realist theory have their respective strengths in explaining the relationship between economic interdependence and conflict in different cases. However both liberalists and realists have shown their weakness in the interpretation of cases that do not meet their predictions. Liberalists cannot explain that why radical policy changes still happen even when two countries have huge common commercial interests. On the other hand, realists cannot explain that why countries will form economic interdependence and ignore the risk of uncertainty. This is due to the theoretical disadvantage that exists in the interpretation of both liberal and realist predictions, which is that their view of economic interdependence is just a snapshot in time and thus ignores the dynamic changes between the economy and international relations. Neither liberal or realist theory were designed to tackle the case of the Sino-Japanese relationship, but this theoretical disadvantage has led to the inability to explain the situation between China and Japan.

The situation between China and Japan shows that liberal prediction does not apply to the current situation. At least in the 2000s, economic and trade exchanges between China and Japan experienced rapid growth, however tensions between the two countries have not eased. The political tension and the close economy formed a very famous dichotomy, namely, the 'Cold Politics and Hot Economy'³. After a territorial dispute broke out in 2012,

the tense relationship became even worse. The relations between China and Japan plunged into a long and multi-field antagonistic period, which had not happened since their relations had resumed in 1972.

On the other hand, the realist prediction cannot provide a logical coherent explanation for the case between China and Japan either. For example, realist prediction seems to align with the situation during the Cold Politics and Hot Economy period, however, this is completely incompatible with the situation in the 1980s when the two countries enjoyed increasing economic interdependence and also a close political relationship. Realism also cannot explain why China and Japan were willing to take the risk of vulnerability that accompanies deepening dependence in the first place. In their predictions, China should have not given up on its autarkic policies, but nonetheless, it entered the international market in 1979.

2. The trade expectations theory and the reality

Dale Copeland provided a better approach to explain the relationship between economic interdependence and great power conflicts from a dynamic perspective. In contrast to both liberalism and realism predictions, Copeland⁴ argues that economic interdependence actually can lead to either peace or war. In his argument, what really matters to the relationship between interdependence and war is the future expectations of the trade and investment environment between states. Copeland argues that, "*liberals are right to assert that trade and investment flows can raise the opportunity cost of going to war...realists are correct in their claim that commercial ties make states vulnerable to cutoffs...*"⁵. He combined these

two reasonable assumptions of the different theories to argue that states go to war because of falling expectations that will make them pessimistic about their long-term security prospects. Through this logic, Copeland overcome the gap between liberal and realist theory, and links economic factors with national security.

According to the theory, expectations for the trade and investment environment are not based on a certain point of time, but rather on the expectation of future trends that will affect policy changes. Even though trade and investment between two countries are working well in the current circumstances, if a government expects that the current system will lead to unfavorable conditions, then policy changes will be an inevitable choice. Therefore, Copeland successfully avoided looking at just a snapshot of the dynamic changes between economy and international relations. More importantly, Copeland elaborated on the critical effects of sustained economic prosperity to the stability of the regime. When the governments expected long-term economic recession is approaching in their economic interdependence, then having policy change will be a reasonable choice to prevent the occurrence of unfavorable circumstances.

However, Copeland's theory cannot explain why the positive expectation of the trade and investment environment did not prevent the escalating tensions in case of Sino-Japanese relationship. This is because only looking at the trade and investment environment is not enough to draw the whole picture of the economic interdependence in the context of the accelerated globalization process.

Applying Copeland's theory, we can identify extremely positive expectations for

the trade and investment environment between China and Japan at least in the first decade of the 21st century. According to the annual reports of the Japan Bank of International Cooperation [JBIC], China has been the most promising overseas investment market for Japanese companies since the 1990s (JBIC, 2012) [16]. Even after the territorial disputes in September 2012, JBIC's emergency survey showed that China was still the most popular overseas investment destination for Japanese companies (JBIC, 2013) [17]. Likewise, positive expectations expressed in the annual reports of Japan External Trade Organization [JETRO] were also very impressive. In the first decade of the 2000s, the trade between China and Japan maintained rapid growth (JETRO, 2011) [18]. JETRO's reports show very positive expectations for the China-Japan trade situation even in the report published in 2013, when a sudden fall of trade volume happened in the previous year. This report predicted that the China-Japan trade volume would be higher than 2011 and create a new record (JETRO, 2013) [19]. Such optimistic trade expectations can also be found in the annual reports of the Ministry of Commerce of the People's Republic of China [MOFCOM] (MOFCOM, 2004 [20]; MOFCOM, 2006 [21]).

However, the optimistic expectations did not meet the reality. Obviously, Copeland's theory already cannot explain the changing situations since 2000s'. Contrary to the prediction of the trade expectations theory, China and Japan have been caught in a hostile spiral. And such a situation even with worsening tensions since 2012.

There are two reasons for this gap. Firstly, Copeland did not include any cases after the end of the Cold War to demonstrate his theory. After the end of the Cold War, the

acceleration of globalization had further expanded requirements of economic interdependence beyond trade and investment. Secondly, the characteristic of the Sino-Japanese economic interdependence is not as strong as many people have thought. Despite the huge profits from trade and investment, the flaws of this relationship are also becoming more and more prominent.

3. Proposed theoretical modifications

I argue that the increasingly obvious flaws as well as the frustration with the establishment of the coordination mechanism between China and Japan, are the most important factors that affect the future expectations of economic interdependence between governments.

Profit is the driving force for countries to establish the economic interdependence relationship. The gain from profit in the economic interdependence is equivalent to its loss when the economic cut-off occurs. If the gain from profit falls, and then turns into a long recession in the economic interdependence between major powers, the economic prosperity and stability of the regimes will be seriously affected. Therefore, profit emphasizes sustainability. However, there are two factors that have negative impacts on the sustainability of profits in the relationship between China and Japan.

I define flaw as negative trends of the economic interdependence relationship which may cause recession in the future. Although the economic interdependence between China and Japan seems to be very beneficial for both countries, there are actually four flaws in this economic interdependent relationship. Firstly, strategic resources in the trade goods are absent. Secondly, main trade goods are replaceable by third parties. Thirdly,

investment costs in the Chinese market are on the rise. Finally, China's amount of investment in Japan is very small. These flaws in the economic interdependence between the two countries have increasingly become more obvious since the late 90s due to the economic development. At the existence of the flaws does not necessarily cause recession, flaws do not prompt the time or the intensity of a recession's occurrence. However, governments cannot ignore this risk, especially when they have huge profit from economic interdependence. The increasingly obvious flaws continue to amplify the possibility of recession, which promotes negative expectations for the two governments.

Coordination mechanism is a new requirement for economic interdependence in the context of accelerated economic globalization. The purpose of establishing the coordination mechanism is to jointly resist the risks, and further assist each other in order to shorten the recession if it happens. Coordination mechanism includes currency swap agreement, tariffs and trade agreements, regional economic integration and other financial and monetary cooperation. In addition to the flaws in economic interdependence, external factors such as global or regional financial crises can also increase the risk of economic recession. Although the monetary cooperation does not guarantee to overcome this risk, it can greatly ease the fear of recessions for governments. On the other hand, frustration in the establishment of coordination mechanism will exacerbate the trepidation between governments, especially when the economic interdependence itself has obvious flaws. I argue this is the situation between China and Japan.

In the next section, I will demonstrate this argument with concrete data and point out that two governments have failed to both overcome the flaws and deepen the coordination mechanism in this relationship.

III. Economic Interdependence between China and Japan

1. The development of this economic interdependence

The concept of economic interdependence has been widely used to describe the Sino-Japanese relationship in academia. As mentioned previously, even the Japanese government's official statement about this relationship mentions the close economic interdependence. However, scholars have scarcely demonstrated the development process of this economic interdependence relationship.

Although we evaluated this economic interdependence between China and Japan as close, this relationship actually went through a long and complicated process of development.

China and Japan have had a long history of commercial exchange. However, after the founding of the People's Republic of China, the disruption of official contracts between Japan and the Chinese mainland resulted in a period where trade was cut-off. In 1951, the two countries have gradually started in the form of non-official trade, in order to rebuild their trade relationship. After four civil trade agreements and the semi-official *LT Trade*⁶, China and Japan were making economic preparations for the political recovery of their diplomatic relations. In 1965, Japan became the largest trading partner of the People's Republic of China for the first time (Tanaka, 1991) [22]. The trade volume between China and Japan was not large at that time, which

was only US \$46.97 million. This figure, however, reached US \$110 million in 1972 when China and Japan successfully achieved the normalization of diplomatic relations. That is, the figure increased to more than double, which showed great potential for its future development. This fact provides a strong motivation for both governments to seek higher profit in this relationship.

The development of the Sino-Japanese relationship has further met this demand. The Twelfth National Convention of the Chinese Communist Party was held in September 1978, and decided to implement the 'Reform and Opening-up' policy. This huge potential market finally opened its door to the world. However the lack of advanced technology and capital was the biggest problem China faced in its development. In December 1978, Masayoshi Ohira became the Prime Minister of Japan. Ohira attached great importance to Sino-Japanese relationship, as he repeatedly expressed, and to also deepening the friendship between Japan and China, which was viewed as important for the maintenance of peace in Asia and the world (Song & Tian, 2010) [23]. Therefore, their policy on China became one of the most important diplomatic issues for Japan.

On December 5, 1979, Ohira made an official visit to China. Before his trip, the commercial relationship between Japan and China had undergone rapid development in a short time. The large commercial negotiations represented by Baoshan Iron and Steel Plant in Shanghai had a contract of more than US \$5 billion with a Japanese company for exportation of equipments to China. However, Chinese companies did not have enough strength to withstand such big contracts at that time, which meant that US \$2.7 billion of this contract could not be fulfilled⁷. This made

many Japanese companies worried and doubtful about whether China's reform and opening-up could be sustained or not. In response, the Japanese Prime Minister pledged official development aid [ODA] during his visit. As one of the most important policies for China's economic development, the Japanese ODA became the first foreign loan for the People's Republic of China, which supported the implementation of China's reform and opening-up in the context where China was lacking capital. On the other hand, China's ongoing reform and opening-up also provides a guarantee for sustainable gain of profit in this economic interdependence relationship.

Data of the trade between China and Japan supported the optimistic expectations of both governments. In 1980, the next year in which Japan gave ODA to China, the trade volume reached US \$940.17 million. Until 1985, 6% of Japan's total foreign trade was with China. Japan is the nearest developed country to China, so China-Japan trade itself has a geographical advantage due to low transportation costs.

Furthermore, if we look at the trade category of products during this period between China and Japan, it was highly complementary. China exported raw materials to Japan and imported industrial products and machinery from Japan, which became one of the key characteristics of this relationship. This characteristic of China-Japan trade has existed up until now, which is the most prominent feature compared to China's other trading partners⁸.

Meanwhile, China has decided to adopt a more open policy in several coastal cities during the same period. China welcomed and gave preferential treatment to the investment of Japanese entrepreneurs. Furthermore, the Chinese government agreed to cooperate with

Japanese companies in the development of coal, oil, and non-ferrous and rare metals in south-west and north-west China (People's Daily, 1984) [24]. The support from both governments gave Japanese companies and the financial community confidence to invest in China. In fact, the number of Japanese investment projects in China increased by 109.7% and the actual amount of capital increased by 136% in 1988, which is the same year that Japanese Prime Minister Noboru Takeshita visited China and signed the *Agreement on the Encouragement and Reciprocal Protection of Investments* between the two countries. By the end of 1991, a total of 1995 Japanese companies invested in China with contracts totaling US \$4.124 billion⁹.

From the performance of trade and investment between China and Japan during this period, we can confirm the appearance of economic interdependence or, at the very least, they had begun to enter an economic interdependence relationship. The rapid growth of profit in the early stages of this relationship provided a positive expectation of the future, which made the two governments more inclined to maintain the existing policies.

One of the very best examples to show this impact of the economic interdependence was the governments' behavior was when western countries launched economic sanctions against China in 1989. In June 1989, the United States and major European countries began to impose sanctions on China. However, the profit gains in the economic interdependence between China and Japan was rapidly growing in this period, and therefore, Japan did not want to join the ranks of sanctions against China. Japanese Prime Minister Sōsuke Uno said on June 6 that if China was isolated by sanctions, as a

neighboring country Japan would also feel anxiety¹⁰. On June 13, the Japanese Foreign Ministry made a statement on the Japanese ODA to China, and said that the aid it committed to China's development was separate from the humanitarian issues. On August 29, while attending the international conference on Cambodian issues, Japanese Foreign Minister Taro Nakayama met with the Chinese Vice Minister of Foreign Affairs Liu Shuqing in Liu's hotel room. Nakayama said to Liu, "*I hope the Chinese government understands that Japan-China relations are different from the relations with other western countries.*"¹¹ Liu also invited Nakayama to visit China immediately. In addition, when Deng Xiaoping met with the delegation of the Japan-China Friendship Parliamentary Union on September 19, he said, "*China noticed Japan's attitude towards China in the G7 meeting was different to other countries*" (Tian, 1997) [25]. The Japanese government was quite reluctant to impose sanctions on China, although eventually joined other countries in doing this, but it did not last for long. The economic interdependence between China and Japan indeed greatly affected the governments' behavior in how they dealt with relations with the other country.

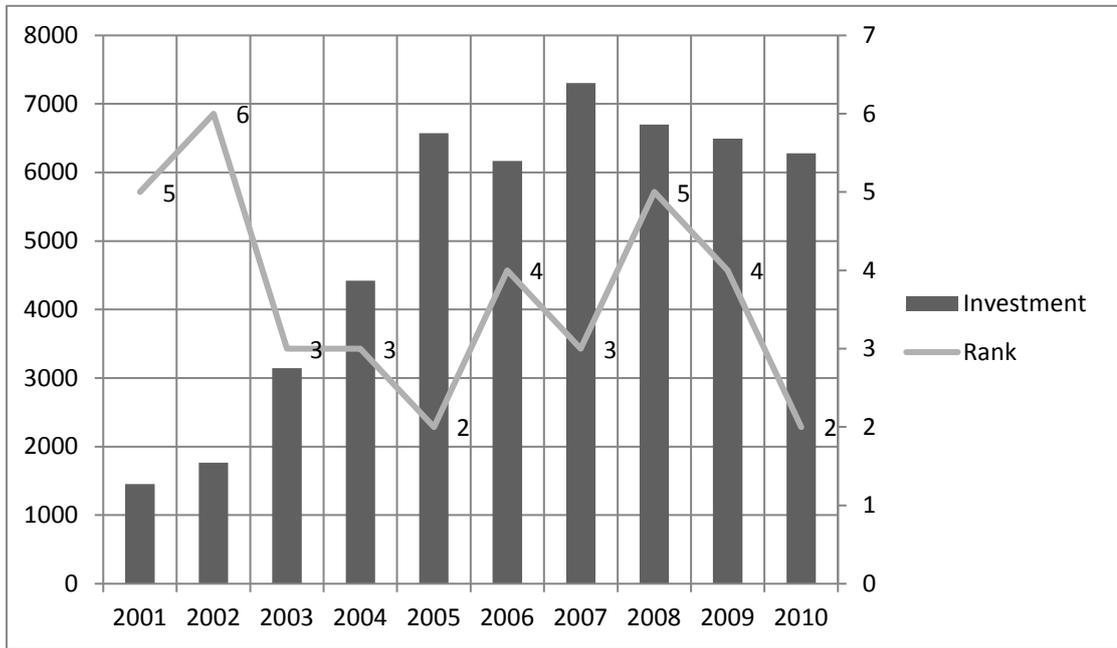
With the further development of economic interdependence between China and

Japan, the huge trade volume between China and Japan became another characteristic of this relationship. Throughout the 1990s, the trade between China and Japan grew from US \$12.92 billion in 1990 to US \$81.37 billion in 2000. From 1992 to 2003, Japan has always been China's largest trading partner (MOFCOM, 2004) [26]. In 2002, China overtook the United States as the largest import country for Japan. In 2007, China became Japan's largest trading partner. In 2009, China surpassed the United States as the largest export country for Japan as well, which truly became the largest trading nation with Japan in the world (JETRO, 2010[27]; JETRO, 2006 [28]). Sino-Japanese trade reached the highest record in history of US \$34.494 billion in 2011. The trade volume between China and Japan increased by more than 360 times in 30 years.

On the other hand, Japan's investment in China was also growing rapidly in this period. After a period of rapid growth in the first half of the 1990s, Japan's investment in China was very briefly affected by the Asian financial crisis. After entering the 21st century however, Japan's investment in China recovered. From 2001 to 2010, China was among the top six of Japan's foreign investment destination countries (Graph 1).

Graph 1. Japan's investment in China and ranking in Japan's foreign investment 2001-2010

Unit: US \$million



Source: JETOR.

As mentioned previously, Japanese companies had very high expectations for the Chinese market because China has always been the most favored destination country of Japanese investment in the last decade. In a 2010 survey, 87.8% of the Japanese enterprises invested in China valued the future growth of the Chinese market (JETRO, 2011) [29].

Not only is the Chinese market very attractive for Japanese companies, but Japanese companies have also provided help to China in two aspects. On the one hand, Japanese companies invest and build factories in China, which is providing a large number of jobs. Take the Toyota Motor Corporation as an example. Up to 2015, the Toyota Motor Corporation invested in 10 factories in mainland China and hired more than 40,000 employees (Toyota Motor Corporation, 2016) [30]. According to MOFA data, until the end of 2012, a total of 23,094 Japanese companies

have invested in China, which was the largest number compared to the other countries investing in China (MOFA, 2016) [31]. On the other hand, Japanese companies that invest and build factories in China also have stimulated China's foreign exports. Take manufacturing as an example. After 2000, Japanese companies' investment in China appeared more in the transport machinery, motor and machinery industries. Japanese investment in transport machinery in 2002 was only US \$194 million, but by 2004 it had soared to US \$1.617 billion. That is, the structure of China's exports to Japan had undergone tremendous changes too. In the early 1990s, the export goods from China to Japan were mainly food, raw materials and clothing. However, in 2005, machinery exported to Japan alone reached more than \$44 billion, accounting for 40.8% of China's total exports to Japan (JETRO, 2006) [32].

However, into the 2000s, the Sino-Japanese relationship has caught in the

Cold Politics and Hot Economy situation. Despite the interdependence between China and Japan, positive expectations seem to have played a positive role only in the early stages of this relationship. On the one hand, in the development process of the economic interdependence relationship between China and Japan, four flaws of this relationship have become increasingly evident. On the other hand, as economic globalization has entered a new stage, the economic interdependence has become multi-facet. I will continue to demonstrate this change in order to uncover the reason for the escalating tensions between China and Japan.

2. Flaws of this economic interdependence

There are four flaws in both the trade and investment aspects of this relationship, which are: (1) the absence of strategic resources in the trade goods between China and Japan, (2) the main trade goods between China and Japan are replaceable by third parties, (3) investment costs in the Chinese market are on the rise, and (4) China's amount of investment in Japan is very small.

These flaws did not emerge in recent years, but rather have existed since the beginning of this economic interdependence relationship. With the continuous development of this relationship, these flaws are also getting more and more obvious. Fixing these flaws, however, would be almost impossible in a short period of time. The profit from the economic interdependence continues to reach new heights, however, the increasingly obvious flaws have highlighted the possibility of recession.

The first flaw is that the trade of goods between China and Japan have an absence of strategic resources.

Strategic resources place emphasis on scarcity and non-renewability compared to other kinds of resources, for example, oil and minerals (Gao & Zhao, 2012) [33]. Japan itself has a lack of natural oil and mineral resources, so it is highly dependent on their import. If these strategic resources are cut-off, then the Japanese economy would suffer a heavy blow. For example, Japan's GDP growth in 1973 was 8.0%, but experienced negative growth due to the first oil crisis in 1974 (Institute of Japan Study of Chinese Academy of Social Sciences, 2008) [34]. In order to rid the negative impact from the oil crisis, Japan even had to follow the requirements placed upon it by Arab countries and thus re-adjusted its policy on Israel (Li, 2003) [35].

After the oil crisis, Japan has always been very concerned about its import strategic resource channels. Four of Japan's first six ODA projects in China were related to energy transport constructions. In 1978, China and Japan signed the China-Japan long-term trade agreement, which required China to export a total of US \$10 billion worth of crude oil and coal to Japan over the next eight years (Lin, 1990) [36]. The agreement was last renewed in 2001, where China's exports to Japan would still just be crude oil and coal in this agreement (MOFCOM, 2002) [37].

On the other hand, since 2003, China's annual oil consumption surpassed Japan (BP, 2008) [38]. As China's energy demand grew, it was no longer feasible for China to continue exporting oil to Japan. Therefore, the China-Japan long-term trade agreement was ended in 2005. Not only that, but the energy competition between China and Japan was also surfaced in this period. Especially during Russian Far East Oil Pipeline project, the competition between China and Japan has created a discord in the relations between the

two countries. Therefore, the lack of strategic resources in the trade goods between China and Japan is one of the flaws that cannot be easily offset.

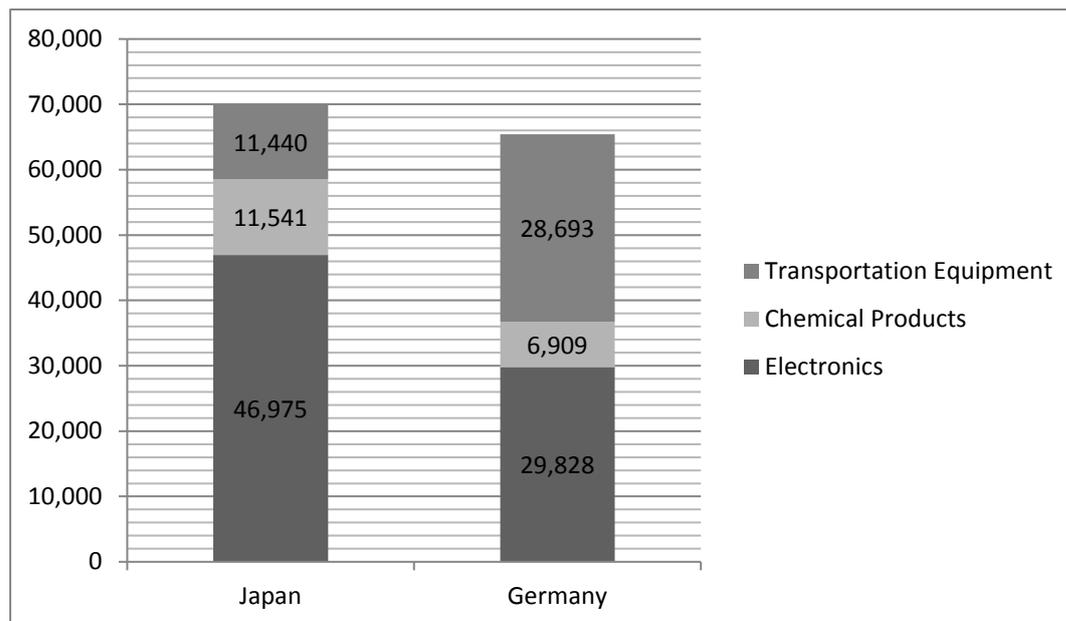
The second flaw is that the main trade goods between China and Japan are replaceable by third parties.

In recent years, the proportion of electronic products in China's exports to Japan continues to increase, but low-value-added goods, especially the proportion of textiles and daily necessities, is still large. With the rising labor cost in China and the investment of Japanese companies in other developing countries, the competitiveness of low-value-added commodities made in China will decline. Even in extreme cases, when Japan lost import channels from China, there are still other countries, such as Vietnam and Bangladesh, that could easily replace China after a period of time.

While Japan's exports to China are mainly high-value-added products, but with China's reform and opening-up, the channels for China to access the international market are also increasing. For instance, in 2016, the top three largest categories of goods Japan exported to China were electronics, chemical products and transportation equipment. It is also the top three categories of German exports to China. The trade volume between Germany and China was only about 60% of Sino-Japanese trade in 2016, but the trade volume of the top three categories of goods that Germany exported to China has already become quite close to Japan's exports (Graph 2). While in 2005, these three categories of German goods exported to China was only one-tenth of the volume exported in 2016 (MOFCOM, 2006) [39].

Graph 2. Top three categories of trade goods that Japan and Germany exported to China in 2016

Unit: US \$million



Source: Trade Report 2016 from MOFCOM.

Such changes are the inevitable result of China's economic development. On the one hand, China needs to upgrade its industries. Sooner or later, China will not be one of the largest producers in the low value-added commodities market. Nowadays, some Chinese enterprises already have the ability to produce some high-value-added commodities. On the other hand, China has more and more trading partners compare to the early stage of its reform and opening-up. Japan is no longer the only choice for China. Not only Germany, but South Korea, the United States and other countries are competing with Japan to win the Chinese market. Therefore, in the foreseeable future, this flaw in the Sino-Japanese economic interdependence will not be solved, but rather it will be further exacerbated.

The third flaw of this economic interdependence is also related to the economic development in China. The difficulties facing Japanese companies, especially for manufacturing companies to have large-scale investments in the Chinese market, have been greatly increasing.

Even though China has always been one of the most valued overseas markets for Japanese companies, when I interviewed key people from Japanese enterprises, I got a slightly contradictory answer. That is, the best opportunity for Japanese companies to invest in China has already passed (Anonymous, personal communication, 2015 & 2016) [40].

Japanese multinational companies have long-term plans for investing in China. In one

of my interviews, a China regional manager of a major Japanese car company said that the time for Japanese automobile manufacturers to invest large-scale in the Chinese market has happened already (Anonymous, personal communication, 2016) [41]. China's labor costs have recently risen at a rate of 20-25% per year (Zhang & Li, 2015) [42]. Hence, Japanese companies will seek other overseas investment destinations in order to control operating costs. Therefore, maintaining steady low growth has become the main goal, especially for the Japanese manufacturing industry in China.

The fourth flaw is the proportion of investment between China and Japan is very uneven as China's amount of investment into Japan is very small.

Needless to mention the importance of Japanese companies to invest in China, but despite the share of Japan's investment in China declining in recent years, it is still one of the most important overseas investors for China. In contrast, China's investment in Japan can be described as insignificant. According to the information published by JETRO in 2016, China's earliest recorded investment in Japan was 1988, when the total investment in Japan amounted to US \$2 million. This amount of investment has not changed significantly even into the 21st century (Table 1). In general, China's investment in Japan is far less than the US investment in Japan, and even less than South Korea or Taiwan's investment in Japan.

Table 1. China’s direct investment in Japan after 2000

Unit: US \$million

Year Region	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	...	2015
China	0	2	1	-2	-9	11	12	15	37	-137	314	...	554
Taiwan	296	164	-24	80	74	-26	110	36	66	57	21	...	606
Korea	48	38	63	-101	251	31	108	221	279	255	274	...	823
US	-1052	3492	2451	-641	1407	308	105	13270	11792	1831	2961	...	5194

Source: JETRO.

If we look at the total overseas investment from China, we will get better picture of the situation. For example, in 2015 China's overseas investment hit a record high of US \$145.67 billion, accounting for 9.9% of the global investment share. This makes China the world's second largest investor after the United States. However, China's investment in Japan only accounted for 0.3% of China's total overseas investment in 2015. According to the China Statistical Yearbook 2016, China's FDI stock in Japan was US \$0.30 billion in 2015, but China's FDI stock in the US had already reached US \$4.08 billion the same year

To account for this situation, it is important to consider Japan’s aging and low birth rate problems, as well as the high cost of investment in Japan (about 7 times that of the US), and the law restricting foreign investment in Japan (Zhao & Li, 2008 [43]; Gao, 2012 [44]). Chinese companies are also conservative when it comes to investing to Japan, so this situation cannot be changed in the short term.

Thus, these four flaws in the economic interdependence between China and Japan are almost impossible to solve in the foreseeable future. With the rapid growth of profit in this economic interdependence relationship, these flaws are becoming more obvious. The higher the

profit also means the higher the trepidation of the loss of profit. Especially when the increasingly obvious flaws continue to amplify the possibility of recession.

From this, we can clearly see that these flaws will keep on playing a negative role in the future of this economic interdependence relationship. Therefore, these flaws are one of the most important factors that lead to negative expectations in the Sino-Japanese relationship. This negative expectation will thus lead both countries into the hostile spiral.

On the other hand, after the end of the Cold War, the original Planned Economy countries have changed into Market Economy, and trade liberalization and investment liberalization have greatly accelerated the process of globalization (Higher Education Press, 2010) [45]. Even with the rapid growth of the world market, and the internet and computer revolution, the impact of the global economic crisis has also been growing. More and more countries have been affected by the economic crisis and its associated huge economic losses. Apart from economic interdependence itself, there are other reasons that could cause an economic crisis between major powers. Simply cutting off trade or capturing the raw material market are no longer the main

reasons for the economic crisis among major powers after the Cold War.

Therefore, the economic interdependence relationship also has a new requirement for maintaining sustainable profit. Simply measuring the growth in trade and investment cannot provide a comprehensive picture of economic interdependence. Take France and Germany as an example. These two are major powers in Europe, which also have had a long history of both exchange and war. They have not only maintained long-term peace, but also achieved close economic interdependence with far less tensions compared with the Sino-Japanese relationship. France and Germany have the coordination mechanism in many aspects, and eventually achieved regional economic and monetary integration. This reflects another important factor in the economic interdependence, which is the coordination mechanism for the two countries to jointly prevent risks. Serving as an example for both China and Japan, if the two countries can find a way to develop the economic interdependence in building the coordination mechanism, then tensions should be eased.

3. Frustration with the establishment of the coordination mechanism

In fact, the Chinese and Japanese governments have realized the importance of building the coordination mechanism since the late 90s. However, their efforts have not been successful.

In 1997, the Asian financial turmoil swept across Asia. The exchange rate plummeted in many Asian countries and their economies plunged into recession. The crisis made Asian countries fully aware of the importance of building the coordination mechanism, for

example strengthening financial cooperation, in order to resist the recession together.

In May 2000, the finance ministers from ASEAN countries and the People's Republic of China, Japan, and South Korea met in Chiang Mai, Thailand. The ASEAN+3 finance ministers reached agreement on the Chiang Mai Initiative, which would establish a regional currency exchange network. In March 2002, China and Japan for the first time signed a swap agreement for US \$3 billion. In 2007, the People's Bank of China renewed this currency swap agreement with the Bank of Japan. It was an important beginning of the financial cooperation between China and Japan.

Also in 2002, the leaders at the Leadership Summit of China, Japan and South Korea for the first time put forward the idea of the China-Japan-ROK Free Trade Agreement [FTA]. If this is achieved, then a huge market of more than 1.5 billion people and 20% of the world's GDP will take an extremely important step towards building coordination mechanism.

However, the progress of the FTA has not been as smooth as expected. The three countries conducted a feasibility study into the FTA, and had FTA negotiations up until 2012. In contrast to another regional free trade agreement that occurred in almost the same period (Trans-Pacific Partnership [TPP]), the process was significantly faster than the FTA.

The TPP was a US-led free trade agreement, but intended to exclude China from the agreement. The United States hoped to dominate East Asia's trade and investment with Japan, and constrain the growing power of China (Yomiuri Online, 2014) [46]. Although it might seem that the FTA and TPP are not opposing options, the amount of effort the Japanese government put into each of

these agreements would be in fact extremely sensitive for the Chinese government. In October 2010, the Japanese government began to prepare for the negotiations of the TPP and signed it in February 2016. After that, the agreement was quickly passed by Congress and Japan became the first ratified country on 20 January 2017. However, the FTA stagnated and has failed to make any progress so far.

Frustration has also occurred with regards to the monetary and financial cooperation. China and Japan reached a groundbreaking consensus on this issue in November 2011 when the Japanese Prime Minister Yoshihiko Noda visited China. It was proposed that the two governments would form a consensus on promotion of a direct exchange between the Chinese RMB and Japanese Yen without passing a third currency (that is, the US dollar). The Japanese government also decided to buy Chinese bonds in this meeting. However, after 2011, this plan has not been implemented. Instead, the Japanese Finance Minister Matsushita Tadahiro, who actively promoted the financial cooperation between China and Japan at the time, suddenly committed suicide on the same day that Japanese government announced the nationalization of Senkaku/Diaoyu Islands (Sept. 10, 2012). Following this, the Chinese and Japanese governments have not made any progress in financial cooperation. Not only that, the bilateral currency swap agreement between China and Japan expired in 2013. Since then, China and Japan have been without any bilateral currency swap agreement.

China and Japan suffered a huge setback on their efforts of building the coordination mechanism. This approach intended to greatly ease the fear of recessions for governments, but it did not succeed. Actually, both the Chinese and

Japanese governments realized the flaws within their relationship and tried to find the solution. During the first decade of 21st century, the Sino-Japanese relationship was seriously affected by these two factors: the increasingly obvious flaws on the one hand and the effort of both governments to build the coordination mechanism on the other hand. These two factors working together have led to the repeated unstable situation between China and Japan in the 2000s. Also, due to the exacerbating flaws and the frustration with the establishment of the coordination mechanism around 2012, negative expectations have completely become mainstream in this relationship. This can explain the reason behind the escalating tensions between China and Japan.

IV. Conclusion

This paper has reviewed arguments of different theories concerning the relationship between economic interdependence and conflict. No matter liberalism, realism or Copeland's trade expectations theory, all have shown the important impact of economic factors in international relations and policy changes. Among the aforementioned theories, Copeland's trade expectations theory can better grasp the dynamics of international relations, and give a logically coherent interpretation to explain the reasons behind policy changes (for both peace and conflict) in a long period of time.

However, if we look deeper into the case of the Sino-Japanese relationship, we will see that the trade expectations theory still cannot explain the situation between China and Japan since the late 90s, especially for the escalating tensions in recent years. This is not only because of the

particularity of the economic interdependence relationship between China and Japan, but also the theoretical disadvantage of the trade expectations theory. In the context of accelerated economic globalization, coordination mechanism became a new requirement for maintain sustainable profit of the economic interdependence.

In the third section of this paper, I highlighted four flaws in the economic interdependence relationship between China and Japan. This was done to demonstrate the development of this relationship, as well as to emphasize the importance influence of flaws in the economic interdependence. When economic interdependence has obvious flaws, the importance of building the coordination mechanism is even more pronounced.

The flaws and the coordination mechanism are the most critical factors that affect governments' expectations. Especially in the case of Sino-Japanese relationship, which flaws are almost impossible to solve in the foreseeable future, the establishment of the coordination mechanism is the decisive choice for both China and Japan in order to maintain the sustainability of profit for this economic interdependence. However, after a period of different efforts, China and Japan have not succeeded in this approach. For this reason, negative expectations between these two countries led to the current situation of escalating tensions.

I used the case of the Sino-Japanese relationship, which is one of the most important relations between big powers, to demonstrate the argument of the link between economic interdependence and conflict. I also tried to answer the question of the escalating tensions using one argument for different periods of this

relationship. I found that using the dynamic perspective which Copeland proposed in the trade expectations theory and re-examining the economic interdependence can provide a logically consistent explanation to this case.

However, this paper cannot answer the question of what was the starting point for this spiral of conflict. Which side, whether China or Japan, was the first to be aware of the flaws of this economic interdependence? Whether it was China or Japan, would either change their behavior and trigger the spiral of conflict?

Therefore, the exact cause and exact time that lead both countries into the hostile spiral is vague. This paper, from only a macro point of view, examined the economic interdependence and the dynamic of escalating tensions between China and Japan. As this paper focused on the contemporary relations, most diplomatic files are not yet available to the public. I hope that the case of the Sino-Japanese relationship can propose an explanation of the link between economic interdependence and the relations of the major powers. Future studies can go beyond the Sino-Japanese relationship, and use this idea to verify the relations of other big powers. Of course, the relationship between China and Japan itself is very complex, involving many actors, even other great powers like the United States, Russia, and so on. Even though I believe that the commercial factor plays the most important in this relationship, the influence of other factors still cannot be denied. Due to the limitations of the paper, these questions cannot be answered, so this is left to future research to pursue.

Footnote*

- ¹ Graduate School of International Development, Nagoya university.
- ² Mearsheimer [14].
- ³ There is no strict definition for the concept of ‘Cold Politics and Hot Economy’, but rather it is more like a widely held assumption within academia. Jin Xide firstly used this concept in 1997, in the magazine *China Campus (Zhongguo daxuesheng)*, No. 9, p. 32. After that, this concept has been widely used in Sino-Japanese relations academia to describe the situation in the first decade of the 2000s.
- ⁴ Copeland [1].
- ⁵ Copeland [1].
- ⁶ LT Trade refers to the semi-official trade basis on the ‘*Sino-Japanese comprehensive long-term trade memo*’ between the People’s Republic of China and Japan since 1962. The two countries used government-guaranteed funds for trade even though they did not have formal diplomatic relations. This has been referred to as the ‘LT Trade’ whose name derives from the Chinese representative Liao (‘L’) Chengzhi and the Japanese representative Tatsunosuke Takazaki(‘T’).
- ⁷ Tanaka [22].
- ⁸ Drysdale [2].
- ⁹ Song & Tian [23.]
- ¹⁰ Tanaka [22].
- ¹¹ Tanaka [22].

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