

ECONOMIC RESEARCH CENTER
DISCUSSION PAPER

No.157

East Asia FTA
&
Trade between Japan and China in Major Industries

by
Koichi Ishikawa

May 2006

ECONOMIC RESEARCH CENTER
SCHOOL OF ECONOMICS
NAGOYA UNIVERSITY

East Asia FTA
&
Trade between Japan and China in Major Industries

By
Koichi Ishikawa

Abstract

East Asia FTA will not be completed without Japan-China FTA. Among the proliferation of FTAs in East Asia Japan-China FTA is a missing link. Though business circle of Japan is positive about Japan-China FTA, Government of Japan has never touched upon FTA with China. One of the reasons for cautiousness may be “China threat” in Japan and fear for devastating effect to agriculture and some manufactures in Japan by intrusion of cheap Chinese products.

China is the biggest trade deficit creating country for Japan. Huge trade deficit is one of the causes for “China threat”. Trade deficit with China, however decreases considering export through Hong Kong to China. In 2004 Japanese trade with China was in balance including trade through Hong Kong. China enjoys dominating status in Japanese imports of labor intensive products such as apparel and toys. China increases exports of machineries such as electrical apparatus and computer which Japan enjoyed strong competitiveness with China. If we look at trade statistics in detail, we find that Japan is still very competitive in higher value added items. For instance, Japan imports finished products and China import key components from Japan. Trade between Japan and China is complementary one and Japan and China needs each other.

Visiting Research Fellow (From October 1, 2005 to March 31, 2006), Economic Research Center, School of Economics, Nagoya University

Professor of Institute of Asia Studies, Asia University

I would like to express many thanks to Professor Hitoshi Hirakawa for his invitation to Economic Research Centre as a Visiting Research Fellow. I also appreciate Mr. Shin Kawai and staffs of the Center for their cooperation and kindness to me.

Import tariff of Japan is already very low except for agricultural products and apparel and that of China is relatively high in spite of tariff reduction committed at their accession to WTO. Many products are, however traded without imposition of tariff due to concession provided to some business such as outward processing trade. Therefore effects of FTA would be more limited than generally considered and Japanese side would be more beneficial. Various problems facing Japanese FDI firms in China in relation to investment environment are expected to be improved in FTA. Some of the Japanese businesses express concern that they would be seriously damaged if other countries competing in business with China conclude FTA with China in advance.

I . FTAs in East Asia

In East Asia FTAs proliferate. FTA signed amounted to 6 and FTAs under negotiation and/or study are more than 60(1). At the turn of century, there was virtually only one FTA in East Asia. Therefore East Asia was called Empty box of FTA (2). East Asia has caught up rapidly with the rest of the world in term of regional integration. East Asia , however lags behind Europe and Americas. The reason is that East Asia lacks FTA which covers entire region. EU expanded its members from 15 countries to 25 in 2004 and Free Trade Area of Americas (FTAA) has been negotiated for more than four years. In East Asia, all of FTAs are bilateral and East Asia FTA (EAFTA) is a concept under consideration.

Currently three “ASEAN plus one” FTAs proceed in parallel in East Asia. ASEAN-China FTA, which started tax reduction in July in 2005, is most advanced most among them. ASEAN-Korea FTA, negotiation of which was commenced in 2004 reached basic agreement in December 2005. Japan-ASEAN FTA is behind other two because Japanese Government placed a priority on bilateral negotiation with individual member of ASEAN rather than total ASEAN. In northeast Asia, China concluded CEPA with Hong Kong and Macao. China and South Korea started governmental study in 2004. Japan-Korea FTA has been negotiated from December 2003, but negotiation is halted now. Between Japan and China, there has been no

-
1. Signed FTAs are AFTA, Japan-Singapore, Japan-Malaysia, China-Hong Kong, China-Macau, South Korea-Singapore
 2. Koichi Ishikawa(2003) “FTA stream in East Asia”, Fukunari Kimura eds.

concrete movement toward FTA up to now.

East Asia FTA, which was agreed at ASEAN plus three summit in 2004 as a mid term target will not be completed without Japan-China FTA. Japan and China totally account for more than 80% of GDP of East Asia, so East Asia FTA without Japan and China FTA is less influential.

China offered a study on Japan-China FTA to Japanese side, but Japanese Government made no official response (1). The reason may be that there persists “China threat” and strong opposition to Japan-China FTA may affect adversely FTA negotiation with other countries. In contrast to cautious stance of Government, business people are positive about Japan-China FTA. Japan-China FTA is, however most desired FTA by Japanese business circle according to various surveys and Japan-China FTA is most effective in term of raising GDP according to the simulation done by Japanese Cabinet Office(2).

II. Industry-by-Industry Analysis and Target Sectors

1. Why is industry-by-industry analysis necessary?

Trade between Japan and China is expanding rapidly both ways, and it continues to be in deficit, although shrinking, for Japan. According to Japanese statistics, Japan's exports to the country amounted to \$73.8 billion and imports \$94.2 billion in 2004, leaving a deficit of \$20.4 billion. With China Japan ran the greatest deficit of any countries of the world. Seen by major commodities or industries, the composition of the bilateral trade is quite variegated—including goods in which Chinese competitiveness is overwhelming, those of which Japan's export is large in volume and continuing to grow, those in which ‘intra-industry trade’ is taking place in both ways between the two countries.

Moreover, as to the mode of trade, it includes “consigned manufacturing” and “re-import” in which materials and components are exported from Japan for processing in China into products to be shipped back to Japan. Not a few goods are listed as

1. Chinese ambassador to Japan proposed feasibility study in his contribution to Nihon Keizai Shimbun dated February 22, 2005
2. Questionnaire survey conducted by JETRO shows that FTA with China was most desirable. Simulation result was reported in Nihon Keizsai Shimbun dated December 31, 2005

exports to Hong Kong in statistics, but actually they are re-exported to China.

While China's domestic markets are said to be highly competitive and local firms are said to have strong competitive advantage, many industries are marked by a division of labor whereby high-performance and high-end products are Japanese-made and popular or low-end products are Chinese-made, and in many cases, Chinese companies depend on imports from Japan for key components.

Under the circumstances, in order to get an accurate picture of bilateral trade and relationship of competition and division of labor between the two countries, it is necessary to examine the relationship of division of labor between the two countries' markets, especially Chinese markets, product by product. It is also warranted to grasp the mode of trade, Japanese firms' moves into China, and Japanese trade with China through Hong Kong. In order to assess the influence of FTA(free trade agreement), should one come into existence, problems Japanese firms in China are facing in trade and investment, such trade barriers as tariff rates, must be clarified.

2. Eight major industries that count large

This report takes up eight selected major industries from the above viewpoint and surveys the actual situation of division of labor between Japan and China and the impact of JAPAN-China FTA could have. The survey attaches importance to findings of canvassing of Japanese and Chinese firms, along with an analysis based on statistics and documented materials.

The eight industries selected are electric machinery and electronic appliances, transportation equipment, machine tools, construction machinery, steels, chemicals, textiles and foods. These eight sectors account for 67% of Japan's imports from China (on the basis of HS2 digits, 2003), and 79% of Japan's exports to China; they account for 84.5% of Japan's total accumulated amount of manufacturing investments into China (Table 1). They range from labor-intensive products to technology-intensive and capital-intensive products, and include products in various forms of transaction, such as trade via Hong Kong, processing on commission, and reverse imports. These industries are fields in which intense competition is taking place, Japanese and Chinese firms are joining hands in partnership, or Japanese companies are newly moving into China. Analyzing these eight industries should make it possible to know the relationship of division of labor between the two countries and the impact a free trade agreement would have, should it be signed.

Table 1. Share of Eight Major Industries in Japan-China Trade (2003)

(In %)

	Japan's imports	China's imports
Electric machinery and electronics (HS85)	17.1	31.4
Machinery (HS84)	15.4	22.6
Transportation machinery (HS87)	1.3	5.4
Steels (HS72, 73)	2.3	7.2
Chemicals (HS28, 29, 38, 39)	4.0	10.7
Textiles (HS52, 54, 55, 60, 61, 62)	20.4	3.5
Food (HS 03,07,12,20,21)	6.8	0.2
Total	67.3	81.0

Note: Classifications above do not agree with classification in the analysis of each industry. For example, computers and white home electric appliances included in HS84 Machinery are discussed in the section on electric machinery and electronic appliances.

Source: Trade statistics of the Ministry of Finance, and China's customs statistics.

III. Japan-China Trade in Various Forms

1. Trade through Hong Kong

Trade through Hong Kong is declining in proportion year by year owing to the buildup of port facilities in many parts of the Chinese mainland, yet it still retains importance, with China's imports from Japan through Hong Kong accounting for 23% of China's total imports from Japan in 2003. The proportion of Japan's exports through Hong Kong varies widely from product to product. In machinery, for example, it is high at 35% for electric machinery, but at a low 7% for transportation machinery (Table 2).

The trade statistics is compiled on the basis of a rule to list exports according to destination, and imports according to the country of origin; in Japanese export statistics, exports to China through Hong Kong are treated as those to Hong Kong, making the amount of exports to China smaller than they actually are for products for which the export ratio through Hong Kong is high.

For example, bilateral trade in 2003 was in Japan's deficit of \$18 billion. According to Hong Kong trade statistics, re-export to the Chinese mainland of products from Japan as the country of origin amounted to \$16.9 billion. When this is added to Japan's export to China, Japan's deficit shrinks to \$1.1 billion. On the hand, since China's import from Japan is listed as products from Japan as the country of origin, including those through Hong Kong, it is believed to be closer to Japan's actual export to China. If China's import from Japan is regarded as Japan's export to China, Japan's trade with China in 2003 was in Japan's deficit of \$1.4 billion. It is known that the trade balance in the past five years is pretty close to the balance in which re-export through Hong Kong is added(1).

For industries and products in which the proportion of trade through Hong Kong is high, accurate assessment of the relationship of division of labor and competitive power is impossible without taking trade through Hong Kong in consideration. For products for which imports from China or exports from Japan constitute an overwhelmingly large proportion, the relationship of division of labor or competitive power cannot be missed, even if trade through Hong Kong is not counted. But where intra-industry trade is in an advanced stage in which the two countries sell each other products in the same industry, Japan's deficit turns into surplus when trade through Hong Kong is added as in the case of electric machinery and electronic appliances (HS 85). For the assessment of competitive power, examination of trade through Hong Kong is necessary. For that reasons, this survey sheds light on trade through Hong Kong for industries where the proportion of such trade is high.

1. For detail refer to Koichi Ishikawa (2004) "Rethinking Japan-China trade"
International Trade and Investment Quarterly No.58, August 2005, Institute for
International Trade and Investment

Table 2 Proportion of Re-Export to China through Hong Kong

HS	Products	1999	2000	2001	2002	2003
	Total	35%	32%	29%	26%	23%
16	Prepared foods	7%	22%	58%	60%	65%
29	Organic chemicals	13%	9%	7%	6%	5%
39	Plastics	39%	40%	34%	30%	25%
55	Staples of man-made fiber	14%	10%	9%	7%	7%
72	Steels	32%	24%	19%	18%	16%
84	General machinery	28%	25%	23%	20%	20%
85	Electric machinery	47%	45%	43%	41%	35%
87	Transportation machinery	37%	15%	10%	12%	7%

Note: Ratio of re-export = (Japan as country of origin + re-export from Hong Kong of products bound for China) ÷ China's imports of products from Japan as the country of origin.

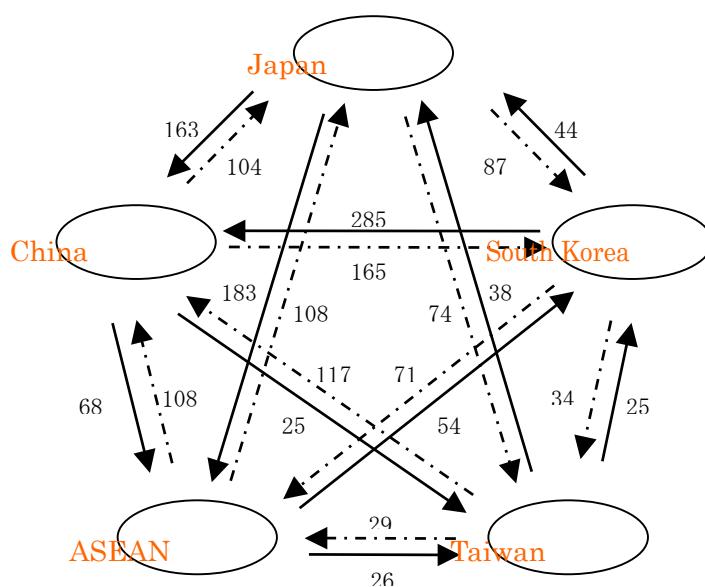
Source: Customs statistics.

2. Japan-China trade as part of East Asian intra-region trade

Next, let's turn to the position of Japan-China trade within East Asia. The region is replete with multilateral, closely-knit trading networks. To take the example of electric machinery, one of the major commodities in intra-regional trade in East Asia, such a close trading network is in existence, showing the progress of de facto economic integration in the region (Figure 1). Here, Japan runs surplus with all the countries and territories, including China, while China runs deficit with all the countries and territories (Table 3). South Korea and Taiwan are in heavy deficit vis-à-vis Japan and in surplus vis-à-vis China. Such a pattern illustrates the importance of Japan as a supplier of capital goods and that of China as a market; it also shows clearly that

Japan's exports to China consist not only of direct sale to that country but also shipment of products assembled using components exported to Southeast Asia, that is indirect export, which constitutes a major percentage of the total. China's importance as an export market for Japan, it may be said, is far larger than is explicit in bilateral trade.

Figure 1 Trading Pattern in East Asia
(Electrical machinery, in 2002, in 100 million dollars)



Note: Based on import statistics.

Source: Trade statistics of each country.

Table 3 Balance with Japan and China in Electrical Machinery Trade
(In 100 million dollars)

	Balance with Japan	Balance with China
South Korea	△43	53
Taiwan	△36	92
ASEAN 5	△75	40

Source: Trade statistics of each country.

III. Relationship of Division of Labor between Japan and China

1. Complementary relationship between Japan and China

When examined industry-by-industry, Japan-China trade is grouped into three categories: products in which Japan maintains highly strong competitiveness (where balance is surplus, or, tautologically speaking, Japan's trade specialization coefficient in trade with China is near 1); products in which China maintains highly strong competitiveness (Japan's balance in trade with China is deficit, or Japan's trade specialization coefficient in trade with China is close to minus 1); products in which both export and import (intra-industry trade) are taking place between Japan and China (where the trade specialization coefficient is near 0). Automobiles, steel sheets and construction machinery represent items in which Japan possesses strong competitiveness, while apparels and footwear and toys (the two items which are not covered in this survey) are typical products in which China has strong competitive power. Intra-industry trade is taking place for such products as electrical machinery and plastics.

Japan is strong in components and materials, especially those based on a high level of technology, such as steel sheets for automobiles. For textiles as a whole, China has a preeminent competitive edge, but so far as man-made fibers are concerned, Japan sells more to China than it buys from China, enjoying particularly strong competitive power in high-function textiles. China is strong in labor-intensive products, goods processed from natural materials such as foods and wood products, general purpose goods and low-priced goods. Among products in which intra-industry trade is taking place, to take the example of plastics, Japan exports resins, and imports household goods and plastic products for package use. Despite the existence of a broad area of competition, Japan-China trade as a whole is characterized by relationship of division of labor which is basically complementary—with Japan possessing competitiveness in products of high value added and high technological level, such as high-grade materials, high-function components, and with China competitive in products of lower value added and technological level, such as general purpose merchandize and low-end products. A similar relationship of division of labor presumably exists on the Chinese domestic market as well.

2. Real forms of versatile trade

The forms of trade between Japan and China are diverse. Export through Hong Kong, to take the example of audio-visual equipment components, occupied a large proportion, as much as 83%, in 2003. Much trade is done by exporting raw materials and components from Japan, to be processed or assembled into finished products in China for shipment in their entirety to third country markets or to Japan. Such a form of trade is called consignment processing trade in China. In this form of trade, import of raw materials and components is permitted without import duty on condition that products from them be exported entirely.

The institutional support for such trade on the part of Japan is what is called “Article 8 of Temporary Tariff Measures Law” which is widely used in textile trade. Also, much of trade is accounted for by supply of components and materials for use by Japanese manufacturers operating in China. Such trade looks certain to grow in the future along with the start of full-fledged production by Japanese automakers in China.

Trade between Japan and China is being carried out in such versatile forms, with, moreover, a lot of transactions being done between Japanese firms, some within the same firms. The amount of trade by Japanese firms cannot be grasped statistically, but it is assumed to account for a fairly large percentage of Japan-China trade, in view of the fact that 51% of China’s exports is being accounted for by foreign companies (in 2003).

IV. Salient Points of Industry-by-Industry Analysis

What follows is a survey of the current state of the division of labor between Japan and China, as well as possible impacts of a bilateral free trade agreement.

1. Electric and electronic appliances

In trade statistics, electrical and electronic appliances denote: “electric appliance and their components, recording machines, sound playback equipment, appliances for recording and playback of television images and sound and their components and accessories”(HS85), “computers and related components”, “office machinery components,” “air conditioners,” “washing machines,” and “liquid crystal device”

(HS9013), which are included in “nuclear reactors, boilers, machinery and components” (HS84).

Electric machinery and electronics products constitute the largest category of items in Japan-China trade, accounting for 30% of Japan’s exports to China and vice versa. They, moreover, are growing year after year. The trade specialization coefficient of electric machinery and electronics products is minus 0.10 on the Japanese statistics, but when recalculated by replacing imports into China with exports from Japan, the coefficient stands at 0.11, indicating Japan’s maintenance of competitiveness. The reason for this is the high level of trade through Hong Kong; the re-export ratio from Hong Kong of Japan’s total exports to China stands at 35% for electric machinery and electronics products (HS84) and 20% for machinery (HS84). Although the re-export ratio is on a decline, it is still important in electric machinery and electronics of which production is concentrated in Southern China with close connection with Hong Kong. For some products like components of office machinery, the ratio exceeds 60%.

By product, five items—integrated circuits, semiconductor devices, liquid crystal components, office machinery components and audio-visual equipment components—account for 59% of Japan’s total exports in the category, while in imports, computers and related products account for 29%. According to the trade specialization coefficient, Japan’s competitiveness is quite strong in integrated circuits, semiconductor devices, and liquid crystal devices, while China maintains competitiveness in washing machines, air conditioners, computers and related products (Table 4). Intra-industry trade is being carried out for office machinery components and audio-visual equipment components. For those items traded in intra-industry trade, components for industrial and non-general purpose components are concentrated on the Japanese side, while household appliance and assembly components are concentrated on the Chinese side, in a relationship of division of labor. In trade of electric machinery and electronic products, there exists a relationship of division of labor between the two countries, with Japan exporting capital-intensive and technology-intensive products, and China exporting labor-intensive products.

Japan’s import duties on electric and electronic appliances are zero, including the HS84 categories. On the other hand, China lowered its import duties on IT-related products from 2003 to zero in January 2005 under the Information Technology Agreement, but duties on other items remain high—15-30% on televisions, 10-23.3% on air conditioners, 9-30% on refrigerators, and 5-30% on washing machines as of 2004. Digital copiers used to be classified as computer peripherals, with zero import duties,

but from January 2004, they were raised to 14%, the same as those on optical-type copiers.

Since tariff is zero both in Japan and China on most electronic goods and IT products, direct impact of the lifting of the import duties is none or quite limited. Cost arising from importing materials used for electric machinery and electronic appliances, such as chemical products and metals, will be lower to users from the elimination or lowering of import duties by China, contributing to cost reduction. China's tariff reduction or abolition on household electric appliances and copying machines on which the country retains high import duties will contribute to reduction of export costs for Japan, but the impact will be limited because Japanese companies are already manufacturing in China. But if demand for high quality and high price products produced in Japan grows owing to an elevation of income level in China, exports from Japan can be expected to increase, but since these products are being assembled in China, the effect will also be limited. Rather, a more prevalent view in industry holds that the effect of exchange rate fluctuations will be larger than that of FTA.

If an FTA is signed by China with a third country (South Korea in particular) ahead of one with Japan, there is the possibility that Japanese companies would be put on a disadvantage in the Japanese market. As Japanese companies face various problems in business environment, such as copied products, opaqueness and changes in investment legislation, a comprehensive FTA would resolve these problems and improve business environment.

Table 4 Trends of Specialization Coefficient in Japanese Trade with China
(14 major items in electric machinery and electronics equipment, based on statistics of importing country)

HS	Items	1999	2000	2001	2002	2003
	Total of electric machinery and electronics	0.17	0.13	0.07	0.07	0.11
8415	Air conditioner	0.26	0.08	-0.34	-0.58	-0.47
8418	Refrigerator	0.12	-0.32	-0.46	-0.21	-0.15
8450	Washing machine	-0.59	-0.69	-0.90	-0.92	-0.96
8471	Computer & related components	-0.13	-0.47	-0.62	-0.76	-0.77
8473	Office machinery components	0.03	-0.18	-0.08	-0.03	-0.00
8504	Transformer	-0.42	-0.49	-0.45	-0.45	-0.37

8525	Radio transmission equipment	0.81	0.80	0.45	0.46	0.46
8528	Television	-0.51	-0.82	-0.92	-0.95	-0.91
8529	Audio-visual equipment component	0.39	0.19	-0.17	-0.04	0.17
8532	Condenser	0.80	0.72	0.69	0.77	0.78
8541	Semiconductor device	0.76	0.74	0.74	0.80	0.78
8542	Integrated circuit	0.84	0.81	0.84	0.86	0.88
8544	Insulated cable	-0.48	-0.47	-0.51	-0.50	-0.53
9013	Liquid crystal device	-0.02	0.43	0.59	0.62	0.64

Note: Trade specialization coefficient is calculated: (Japan's export to China - Japan's import from China) ÷ (Japan's export China + Japan's import from China) .

The closer to 1 it is, the stronger Japan's competitiveness; the close to -1, the weaker, the Japanese competitiveness; if it is around zero, intra-industry trade is taking place.

Sources: Japanese Finance Ministry statistics, China's customs statistics.

2. Transportation machinery

As a target of analysis, the automobile, the most important item among transportation machinery and facing many business barriers, has been selected.

Along with the electric machinery and electronics equipment, the automobile is one of Japan's major export commodities. The weight transportation machinery carries in Japan-China trade is far smaller than that of electric machinery and electronics. It accounts for 5.8% of China's import from Japan, and a mere 1.3% in Japan's import from China. The low percentage is ascribable to China's protection of its auto industry by means of high import duties, a still relatively short history of Japanese auto industry's investment in China, and China's auto industry still remaining in a pre-export phase. Japanese automakers' advances into China, however, make it certain that auto parts export to China will grow in the future.

Japan's export of transportation machinery (HS87) to China amounted to \$4 billion (in 2003), and import from China came to \$1.02 billion, leaving a heavy surplus in Japan's favor. Exports comprise of automobiles and parts, while imports comprise of bicycles and accessories. So far as automobiles are concerned, bilateral trade is one-sided from Japan to China, leaving a surplus of \$3 billion for Japan. As for motorcycles, China runs a surplus, with Japan's imports increasing, if still lower than

bicycles. In other words, Japan's competitiveness is strong with regard to automobiles, while China is strong in bicycles and motorcycles, indicating the relationship of division labor between the two countries in the sector of transportation machinery. (Table 5) The re-export ratio through Hong Kong is relatively low at 7%. Japanese investment in the transportation machinery sector in China surged 4.4 times in 2003 over the previous year, testifying the expanding China business by the automobile and auto parts industries.

China today is the world's fourth largest producer and third largest market of automobiles. Since the country's auto ownership is still a low 18.3 units per population of 1,000, or only one thirtieth of the Japan level, both production and sales of automobiles are bound to grow in the future, eventually turning the country into a major producer and market of automobiles, second only to the United States. Despite such a scale of the industry, China's auto industry is crowded with as many as 115 manufacturers, preventing it from achieving profits from a large size of the market. Another disadvantage is the underdevelopment of the parts industry, keeping production cost high and technology level low, resulting in weak international competitiveness. A majority of car makers are in partnership with foreign concerns, drawing on foreign makers' models. The relationships between Chinese and foreign makers are complex.

China's import duties on cars which averaged 50-60% at the time of its accession to the WTO are set to be lowered in stages to 25% in July, 2006. Duties on buses and trucks were cut to 25% from January, 2005. The import quota system is scheduled to be lifted entirely in January, 2005, following a 15% expansion each year from the base of 2000. It is also set that other restrictions, such as limit on models, limit on the amount of investment to be approved, or restrictions regarding domestic contents, are either abolished or eased. Despite the series of these market opening and liberalization measures accompanying the WTO membership, problems still remain: the tariff rates are still high, and import procedures to be followed after the abolition of the import quota system remain unannounced, for example. Other problems drawing complaint with regard to investment and auto-related services include: restrictions on the equity ratio, restrictions on the number of joint ventures, restrictions on production models, restrictions on the location of after-sale service stations, protection of intellectual property rights, and other matters in business environment.

Table 5 Trade Specialization Coefficient with China in Transportation Machinery

HS	Items	1999	2000	2001	2002	2003
87	Transportation machinery	0.36	0.40	0.40	0.54	0.60
8701	Tractor	1.00	1.00	1.00	0.99	0.99
8702	Public transport passenger vehicle(capacity for 10 or more persons)	1.00	1.00	1.00	1.00	1.00
8703	Passenger cars	1.00	1.00	1.00	1.00	1.00
8704	Trucks	1.00	0.98	1.00	1.00	1.00
8705	Special purpose vehicles	1.00	1.00	1.00	1.00	1.00
8706	Chassis with a motor	1.00	1.00	1.00	1.00	1.00
8707	Body	1.00	-0.08	0.90	0.51	-0.28
8708	Parts and accessories(limited to those for vehicles 8701-8705)	0.52	0.59	0.64	0.58	0.70
8709	Self-driven working trucks	0.95	0.75	0.89	0.38	0.18
8711	Motorcycles	-0.05	0.06	-0.64	-0.98	-0.97
8712	Bicycles	-0.99	-0.99	-1.00	-1.00	-1.00
8713	Vehicles for disabled persons or hospitals	-1.00	-0.99	-1.00	-1.00	-0.99
8714	Parts and accessories (limited to those for vehicles 8711-8713)	-0.21	-0.17	-0.24	-0.13	-0.13
8715	Buggies and parts	-0.98	-0.97	-0.98	-0.96	-0.95
8716	Trailers, semi-trailers, other vehicles and parts	-0.95	-0.94	-0.82	-0.92	-0.93

The automobile trade is dominated by Japan's almost one-sided exports to China, both in assembled vehicles and parts. Since automakers are sticking to a principle of producing in the market where the products are sold, they are moving to step up local production in China, prompting parts manufacturers to accompany them for local production. Even if an FTA is concluded, it is unlikely that Japanese automakers will switch local production to shipment from Japan. Yet there remains the possibility that for items which cannot count on mass production, exports from Japan will increase. Exports from Japan to China will feel no impact from an FTA because of the zero tariff rate. Imports from China to Japan should depend on strategies of automakers and

parts manufacturers. A comprehensive FTA could work to improve China's business environment. As for China's FTA with ASEAN, it is considered to have only a limited impact because each maker has production bases both in China and ASEAN. For products without benefits of mass production, a division of labor may develop.

3. Machine tools

Machine tools—machines to make machines—include a wide range of devices from lathes, drilling machines, milling machines, grinding machines, gear machines to machining centers. In this analysis are covered metal working (cutting, HS8457-8461), metal molding (forging, press; HS8562-8563), molding box for metal forging, and die (HS8580).

Machinery (HS84) , including machine tools, is the second most important item of trade after electric machinery and electronics equipment. Metal processing machinery (included in HS84) amounted to \$1,535.7 million, or 18% of Japan's total machinery exports to China. But Japan's import was only \$79 million, or 0.7%. As a source of China's imports of machine tools, Japan is competing with Taiwan for the top position. Japan is the top supplier to China of machining centers (HS8457), drilling machines/boring machines/milling machines (HS8460), and planning machines/shaping machines (HS8461).

Japan-China trade of machine tools (those included in HS84) was in Japan's surplus of \$1,456 million, with Japan holding overwhelming competitiveness in most products with a specialization coefficient larger than 0.9 (Table 6). In the background of Japanese strength is rising demand for Japanese numerically controlled machine tools and Chinese products being absorbed by domestic demand. China's exports are relatively plenty, with the trade specialization coefficient running at relatively small at 0.68, in metal mold/plastic molding machines (HS8480). In this area, Japan's exports peaked out in 2002 and have since been on a decline, while exports from China are on a rise, owing to the transfer of manufacturing bases to China for low-end products. The production of these products in China takes the form of module-type production, in which key components put into a unit are exported to China and assembled there for re-import into Japan.

The mainstay of Chinese demand for machine tools is metal processing machines (cutting machines). Domestic supply cannot keep up with domestic demand, leaving the country heavily dependent on imports from Taiwan, Japan and Germany.

Since China is lagging behind in numerical control of machine tools, only about 10% of those built domestically are the NC-type. The forte of Chinese-made machine tools is their competitive prices and quick repairing service, an advantage Chinese companies established when foreign companies were still handicapped under the policy to restrict their marketing bases. In contrast, it is still difficult for Chinese manufacturers to produce high-precision products, and their dependence on imports is high for key components. Export of low- and mid-priced products to Southeast Asia has been rising in recent years, but they still depend on technologies from advanced industrial countries for the controlling apparatus. The Chinese government is attempting to enhance the quality and technology for machine tools, through mergers and acquisitions as one way to obtain technology. The acquisition of the Japanese machine tool maker Ikegai by Shanghai Electric Group is one example.

Japanese machine tool makers are starting to consider China as a place to base their production, marketing and development activity, and, therefore, move to bolster functions in such fields in that country.

Table 6 Specialization Coefficient for Machine Tools in Trade with China

HS	Items	1999	2000	2001	2002	2003
8456	Machines that process by removing materials with the use of laser and other photon beams, ultrasound wave, electrodischarge, electrochemical method, electronic beam, ion beam or plasma arc.	0.30	0.36	0.69	0.82	0.85
8457	Machining centers for metal processing, unit construction machine (limited to single station types), and multi-station transfer machine	1.00	1.00	0.94	1.00	1.00
8458	Lathes (limited to those for metal cutting)	0.95	0.99	0.99	0.99	1.00
8459	Boring machines for metal, drilling machines, milling machines, screw-cutting machines and tapping machine, threading and tapping machines	0.93	0.97	0.96	0.98	0.99
8460	Grinding machines, honing machines, lapping machines, grinding machines and	0.94	0.96	0.96	0.96	0.96

	other finishing processing machines					
8461	Planing machines, shaping machines, standing cutting machines ,sotting machines broaching machines, gear cutters, gear grinding machines, gear finishing machines、cutting off machines, lathes 、 cutting machines and other processing machines	0.84	0.93	0.91	0.88	0.89
8462	Forging machines, hammers, die-stamping machines, folding machines, straightening machines, flat machines, shearing machines, punching machines, knotting machines	0.99	0.99	0.99	0.97	0.98
8463	Other machine tools	0.97	0.96	0.93	0.98	0.97
8480	Molding boxes for metal forging, molding bases, patterns and metal for forging, dies for metallic carbide, glass, mineral materials, rubber or plastic molding (exclusive those for metallic ingot)	0.89	0.88	0.85	0.81	0.68

In Japan-China trade of machine tools, Japan's competitive power is overwhelming. In metal molds, imports from China are increasing sharply, because Japanese manufacturers have shifted their bases of production of low-end products to China where module production is conducted for re-import into Japan. The Chinese market is shared by domestic products that cater to demand for low-end products and foreign products (or products made by foreign companies in China) for high-end demand. Japanese products, however, are facing competition with Taiwanese and German products. Japanese machine tool makers are moving to collaborate with their Chinese counterparts to establish marketing channels to Chinese users.

The tariff rate on machine tools is zero in Japan, and 9-12% in China. Under the circumstances, an FTA will benefit exports from Japan. Chinese import duties are set lower on NC machine tools than on non-NC machine tools, reflecting China's willingness to introduce NC technology in which it is lagging. In the future, pricing will become an important factor even for mid- and high-price models, with the prospects

that advantages could be gained as to prices if Japan move ahead with an FTA preempting other countries.

4. Construction machinery

Construction machinery is diverse in the product range—from bulldozers, oil hydraulic shovels, road rollers, pile drivers, tunnel diggers, and cranes to dump trucks. Here, cranes (HS8426), bulldozers, shovels, road rollers (HS8429), excavators, pile drivers (HS8430), all construction machinery included in HS84, are selected for analysis.

Bulldozers, shovels and road rollers (HS8429) account for 70% of the world's total trade of construction machinery, Japan is the world's largest exporter (accounting for 20.6% in 2003), while China ranks 11th. In imports, the U.S. is the largest importer, followed by China (accounting for 8. 5%). Japan is ranked 33rd. In machinery trade between Japan and China, construction machinery accounts for 7.5% of China's total imports, and a negligible 0.03% in Japan's total imports. In Japan's construction machinery exports, China as the third largest market accounted for 12.0%, while in China's imports of construction machinery, Japan accounted for 58.2%, as the largest source of imports.

Japan's exports (China's imports in trade statistics) amounted to \$1,128 million (in 2003), with imports a mere \$3.32 million, manifesting Japan's overwhelming competitiveness (Table 7). Japan's exports shot up 5.3 times in 2003 over the preceding year. The largest export item was hydraulic shovels, which accounted for 85% of the entire construction machinery exports. In Japanese trade statistics, exports to Hong Kong amounted to \$620 million (in 2003), showing a gap of \$470 million with China's imports from Japan. When Japan's exports to China and to Hong Kong are put together, the value and as well volume roughly equal to China's imports from Japan, indicating that exports to Hong Kong are re-exported to China. The machinery re-exported from Hong Kong are considered, in view of the unit import price and on the basis of canvassing of companies, to be used machines. Exports to China of construction machinery surged in 2003, but slowed down in 2004, especially sharply after May of that year thanks to the macro-economic control the authorities put into practice.

In China's construction machinery market, there is a clear division: wheel loaders that numbered 68,000 units in 2003 were dominated by Chinese domestic companies, centering on state-owned firms, while hydraulic shovels that totaled 30,000

units were sold mostly by foreign companies from Japan and South Korea. Ninety percent of hydraulic shovels are made by foreign companies, such as Komatsu, Hitachi Construction Machinery, and Kobelco Construction Machinery from Japan, Daewoo Heavy Industries and Hyundai Heavy Industries from South Korea, Caterpillar, Volvo, Liebherr and Atlas from Europe and the U.S. Korean companies have a combined market share of 40% on the strength of price competitiveness, 20% or so less expensive than Japanese companies' products which account for 30-35%. Although the market has been shrinking since May of 2004, the decline is considered temporarily. China's construction machinery market is of a size one third of Japan's, and it is expected to continue to grow. Three major Japanese firms moved into China in 1994, and have been building up production and marketing footholds and opening new ones after 2000.

China's tariff on hydraulic shovels, Japan's mainstay export items, was lowered to 8% in January of 2004 from 14% at the time of its WTO entry. During the same period, tariffs on other products were similarly cut to 5-8% from 10% or so. The import quota system and the import bidding system were abolished either in January of 2002 or January of 2004. As for used construction machinery, a quality inspection system was put into effect from 2003, resulting in import restriction as of the autumn of 2004.

Japan's import duties on construction machinery are zero, whereas China's stand at 5-8%, leaving the possibility of expansion of exports and addition of new items from Japan (trade creation effect). For major construction machinery manufacturers of Japan, local production in China and export from Japan are at 5 to 1 or 10 to 1 ratios. This means that improvement in business environment in China, with regard to non-tariff barriers and investment climate, by means of a comprehensive FTA, could benefit Japanese construction machinery makers in a significant way.

Japanese construction machinery makers are turning their eyes to FTAs between China and the ASEAN. Unlike the case of automobiles, their bases of production in ASEAN countries have only a short history, and those in China are said to be better established. Therefore, if China and the ASEAN are linked by FTAs, they can expect to export from China to the ASEAN. Such a prospect has led some makers to strengthen production bases in China.

Table 7 Trade Specialization Coefficient of Construction Machinery with China

HS	Items	1999	2000	2001	2002	2003
8426	Construction	1.00	0.97	0.94	0.98	0.99

8429	machinery					
8430						

5. Steel products

Steel (HS72) and steel products (HS73) are analyzed. Steel accounts for 6% of China's total imports, and for a same percentage of China's imports from Japan. On the other hand, steel accounts for 1 % of both Japan's total imports and those from China. The percentage of steel products in Japan's and China's total imports, and that in the two countries' imports from each other, is 1%. For Japan, China is the second largest market of steel and steel products; as a source of Japan's imports, China is the second largest for steel and the largest for steel products. China's share in both exports and imports of steel and steel products is on the rise. Steel exports from Japan are particularly important for the both countries.

In bilateral steel trade, Japan is in heavy surplus, but it is fairly balanced in steel products. Japan's competitiveness is strong in steel, while intra-industry trade is being carried out for steel products (Table 8). Top five items in Japan's exports of steel—galvanized steel sheet, cold-rolled steel sheet, hot-rolled steel sheet and others—account for 85% of the total. In imports from China, on the other hand, ferroalloy and pig iron account for 86%. Japan's exports mostly consist of steel sheets which China cannot mass-produce, while most of imports are products with a low level of processing not too different from being raw materials. Among steel products, exports from Japan consist of seamless pipes, screws, and special products, while imports contain household sundries and structures which are classified as “other steel products.”

The re-export ratio through Hong Kong has declined to 16% for steel and 5% for steel products, attesting to the diminishing importance of the re-export.

In China, steel makers of varying sizes are scattered in provinces across the nation. Shanghai Baosteel Group Corp. and Anshan Iron & Steel Group Corp. are the only two steel companies with an annual output over 10 million tons. The two companies have a share of only 14% of the market between them, in contrast with the Japanese market where the top four makers account for 75%. High value-added production has only recently started, with the streamlining of the production system and improvement of quality of steel products yet to be advanced. Japanese investment

in the steel industry in China that started with tinplate and galvanization is expanding recently in joint ventures by major companies to produce high-quality steel sheets to meet demand from automakers that have started assemblage in China. Japanese-affiliated steel companies focus their business on the down-stream stage, such as cold-rolled sheets and tinplate. Despite their deployment of world-standard facilities, major Chinese steel makers still lag largely behind their Japanese competitors in their overall capacity that involves operating technology and response to environmental regulations.

While Japan levies no import duties on steel and steel products, with minor exceptions, China is in the process of reducing its tariffs averaging 8.82% on 114 items of steel and steel products under 8-digit classification at the time of the WTO accession by 3.1 points through 2005. The tariff on cold-rolled coils with less than 0.3 millimeter thickness for tin plate was raised from 4% to 6% in 2002, and then cut to 5% in 2003, which still is at the same level with rates on high-valued added products. The Japanese steel industry is seeking a further reduction.

Other trade barriers cited include the steel import quota, the temporary regulations concerning imported products management, safeguard measures, and anti-dumping rules.

In contrast to the zero tariff rate on steel products in Japan, China levies import duties on products including those under two-digit classification. So an FTA will work to be advantageous for Japan. The Japanese steel industry, however, is giving a high mark to China's tariff reduction keeping promise under the WTO accession conditions. Also, thanks to brisk export, Japanese steel makers are not deeply worried about the current tariff rate as a barrier.

The Japanese steel industry supports an early conclusion of economic partnership agreements with Asian countries, because China, as a country which is most important as Japan's steel market, with a relatively high tariff and huge productive power, has signed an FTA with the ASEAN. At the same time, steel companies are concerned that the steel industry, which is a key industry for each country, might be treated as a sensitive sector in negotiations for FTAs with East Asian countries.

Table 8 Trade Specialization Coefficient of Steel-related Items

HS	Items	1999	2000	2001	2002	2003
----	-------	------	------	------	------	------

72	Steel	0.73	0.67	0.78	0.80	0.75
73	Steel products	0.01	-0.14	-0.10	0.05	-0.03

6. Chemicals and chemical products

Chemicals and chemical products are classified into HS28-HS39; in this survey, plastics (HS39) and organic chemicals (HS29) are taken up.

Plastics and organic chemicals combined account for 9.5% of Japan's exports to China and 4.1% of imports from China (in 2003). China is Japan's largest, and expanding, export market of plastics and organic chemicals. In imports, China is the largest source of plastics for Japan and its share is expanding; in organic chemicals imports, the country is the fourth largest source, but its share remains unchanged. The combined share of plastics and organic chemicals in China's total exports is not high, at 3.9%, but their share of total imports accounts for 9%. For China, Japan is the third largest export market and second largest source of import of plastics; Japan is the third largest market for organic chemicals, and second largest source of imports.

Trade of chemicals between Japan and China is in heavy surplus for Japan both in plastics and organic chemicals. Except import of organic chemicals, Japan's export and import of the two categories of products are expanding sharply. Exports from Japan center on plastics for a wide variety of purposes—[those for IT equipment and automobiles, while imports from China are mostly plastic products for packaging and household use. There exists a relationship of division of labor, with Japan exporting high valued added products, and China exporting low-value added products (Table 9).

The ratio of re-export through Hong Kong has been declining, to 5% or so, for organic chemicals, but it still is high for plastics, at 25% (in 2003). The actual value of plastic exports to China is larger than the export value on the Japanese trade statistics.

In contrast with European and U.S. firms, which are engaged in upstream production, like styrene, Japanese companies are mainly in downstream production, such as resins. Products that are increasing recently are high-value added products, called functional plastics, for supply to Japanese electric machinery and electronic appliance makers and automobile makers. Since specifics of functional resins are decided through consultations of chemical companies and user companies, European and American firms tend to use products of European and American chemical

companies, while Japanese firms tend to turn to Japanese chemical makers. While Chinese chemical companies have an advantage in costs and delivery time, Japanese companies have competitive edge in quality and services and there is little feeling of threat from Chinese companies.

Japanese tariff rates on chemical goods have been lowered in stages in accordance to CHTA—Chemicals Harmonization Tariff Agreement—since 1995. According to the APEC, the average tariff rate for chemicals and photo materials was 2.5% in 2003. Since general preference rates are applied, most products are imported duty free, with the effective tariff rates running at a negligible 0.03% on plastics and 0.18% on organic chemicals.

Meanwhile, China pledged at the time of its accession to the WTO to gradually lower import duties on chemical goods to the CHTA level by 2008. The reduction is phased—to 11.6% in 2004, and to 6.5% in 2008, from 15.4% at the time of the WTO entry. The tariff rates on major resin products are scheduled to go down to the level of industrialized countries. However, specific duties, which translate into a high ad valorem rate, are levied on photo sensitizers. China's effective tariff rate on chemical imports from Japan was 9.02% on plastics and 4.63% on organic chemicals in 2004.

Table 9 Trade Specialization Coefficient of Chemical Products with China

HS	Items	1999	2000	2001	2002	2003
29	Organic chemicals	0.58	0.63	0.60	0.65	0.67
39	Plastics	0.29	0.28	0.22	0.25	0.26
3904	Polyvinyl chloride and other halide olefin polymers (limited to primary goods)	0.99	0.99	0.99	0.99	0.99
3907	Polyester and other polyester, epoxi resin and polycarbonates, alkyd resin, polyester and other polyesters (limited to primary goods)	0.86	0.88	0.86	0.90	0.94
3923	Plastic products for transportation and package and plastic stoppers, lids and caps and similar products	— 0.50	— 0.51	— 0.57	— 0.62	— 0.60
3924	Plastic tableware, kitchen utensils and other household goods and cosmetics	— 0.87	— 0.91	— 0.96	— 0.99	— 0.99

Anti-dumping measures have been invoked one after another against chemicals imports in China. Such a move is considered to reflect a policy to protect domestic makers which are engaged in production with antiquated facilities and to facilitate investment in China by foreign makers. Government-private sector consultations are being held between Japan and China to address problems of the two countries' chemical industries, including anti-dumping issues.

In contrast with Japanese effective tariff rates which are nearly 0%, China is to retain relatively high rates, including 6.5% on major resins in 2008, meaning an advantage on the Japanese side in case an FTA is concluded. The advantage will be maximum if production takes place in Japan for export to China. For Japanese companies engaged in production in China, cost of procurement of materials from Japan will decline. Lower costs of material procurement from Japan could work to increase imports of raw materials from Japan and process them in China for re-export to Japan in labor-intensive industries.

7. Textiles

Textile products range widely from silk and silk clothes in category HS50 to materials for spinning and weaving falling into category HS63. In this survey, man-made fibers (HS54, 55) and clothing and accessories (HS61, 62, 63) are main targets of analysis.

Textiles account for 5.6% of Japan's exports to China and 23.7% of imports from China, and 18% of China's exports to Japan and 4.6% of imports from Japan. They are important items in China's exports and Japan's imports. For Japanese textile trade, China ranks top both in exports and imports, accounting for 41% of Japanese textile exports and as much as 71% of Japanese textile imports. Japan is China's largest export market of textiles, and second largest source of imports, closely behind Taiwan. The two countries are important trading partners of each other in textiles.

Japan's textile exports to China amounted to \$\$3,195 million in 2003 and imports from China reached \$18 billion, leaving Japan in heavy deficit. Japan's exports to China mainly consist of textile materials such as filament of man-made fibers, cotton, knitwear and crocheted knit, while imports are dominated by garments and their accessories. The percentage of clothing and accessories (HS61, HS62) in China's exports to Japan is 20.4%. In trade with China, Japanese products are strongly competitive in materials, while China's maintain competitiveness in garments. A

relationship of division of labor exists between the two countries (Table 10). However, the amount of Japan's exports to China is dwarfed by China's exports to Japan, the latter being several times as large as the former. The ratio of textile trade through Hong Kong is high in filaments of manmade textiles, but no big difference is noted in the trade specialization coefficient due to a small value of imports. In textiles, trade making use of the system stipulated for under Article 8 of the Temporary Tariff Measures Law is important. Under the system, raw materials are exported for processing abroad and re-imported into Japan within a year, which are exempted from tariff equivalent to that on raw materials. It is widely used for re-import from China.

China produces 25% of the world's total output of chemical fibers, and 30% of the world population are said to be wearing Chinese-made apparels. The textile industry in China is called a "10% industry," meaning that it accounts for about 10% of the country's entire industrial production, number of enterprises and employment. Exports that now account for 20% of the total production of textiles are expected to increase further in the future thanks to the abolition of the MFA quotas in January, 2005. China's apparel market is three-tiered—the top tier (high-end market) with Italian products, the second tier (middle market) with Japanese, Hong Kong and Taiwanese products, and the third tier (low-end market) with Chinese products. Japanese textile manufacturers started their moves to China in the latter part of the 1970s and reached a peak in 1995, declining thereafter. They moved up somewhat after 2002.

In Japan, as a result of the revision of the Tariff Temporary Measures Law in 2001, many items of garments became targets of the preferential tariffs aimed at poorer developing countries. Since China does not belong to such a group of countries, preferential tariffs are not applied to a bulk of its garments. As for textiles such as filaments, specific preferential tariff rates (reduced from the WTO rates) are set for each item. For imports making use of the Article 8 system, the tariff rate on the portion equivalent to raw materials is set to be zero. China's tariff rates range from 3% to 19%, which is fairly high. According to promises made at the time of the WTO entry, tariff rates on textiles are set to be reduced to 5% for raw materials, to 10% for fabrics, and to 12-15% for apparels.

Japan applies WTO agreement rates of about 10% to garments. China levies 5-19% tariff rates, considerably high even after the reduction in the wake of the WTO entry. For this reason, the both countries will benefit from an FTA, but the benefit will be larger on exports from a country of lower tariff rates. For example, tariffs of 9.6% or

13.5% are levied on men's overcoat and car coat (furred) in Japan, and 19.4% in China. For Japanese textile industry which is promoting exports, the FTA will be a tail wind. Many industry people said that an FTA was unlikely to work to increase exports from China to Japan, and rather make Japan's exports to China easier.

Table 10 Trade Specialization Coefficient of Major Textile Products with China

HS	Items	1999	2000	2001	2002	2003
54	Filament fibers of manmade fiber	0.95	0.96	0.94	0.86	0.84
55	Staple fibers of manmade	0.69	0.73	0.75	0.77	0.73
52	Raw cotton	0.19	0.31	0.36	0.39	0.44
60	Knitted goods and crocheted goods	0.91	0.91	0.90	0.90	0.92
59	Impregnated, coated, covered or laminated textile fabrics; textile articles of a kind suitable for industrial use	0.68	0.69	0.66	0.66	0.69
50	Raw silk	-0.74	-0.43	-0.38	-0.36	-0.33
62	Apparels and their accessories (excluding knitted and crocheted goods)	-0.99	-0.99	-0.99	-0.99	-0.99
61	Apparels and their accessories	-0.99	-0.99	-0.99	-0.99	-0.99
63	Textiles for spinning and weaving and other products; sets, used apparel ,used spun and weaved goods and scraps	-0.99	-0.98	-0.98	-0.97	-0.98
57	Carpets and floor spreads of spinning and weaving textiles	-0.95	-0.98	-0.98	-0.96	-0.94

8. Foods

Foods in narrow terms are those in Category V in the HS classification (foods and beverages). The objects of the statistical analysis here range from Category I to IV (HS01 to 24) in the HS—Category I that includes meat and fish meat, Category II that includes vegetables and flours and Category III that includes oils and fats—, but the analysis focuses on foods in Category IV.

Foods account for 9.7% of China's exports to Japan, which is China's largest export market of foods, accounting for 29% of China's total food exports (in 2003).

Meanwhile, foods in China's imports from Japan account for only 0.3%. Food exports from Japan in 2003 amounted to \$240 million, and Japan's food imports from China amounted to \$5,970 million, leaving a lopsided balance with a deficit of \$5,730 million for Japan. In terms of the trade specialization coefficients, China's competitive power is overwhelming for most products, except for flours, oils and fats and other prepared foods in which Chinese competitiveness is somewhat weaker than in other products (Table 11).

The largest category of major imports from China is prepared foods, such as meat and fish and shellfish (HS16), which amounted to \$1.7 billion (in 2003), or 2.2% of Japan's total imports from China. As a category of Chinese imports, they ranked 10th, followed by prepared foods of vegetables and fruits (HS20) that amounted to \$800 million (1.2%), ranked 19th. In Japan's exports to China, fish and shell fish (0.16%) ranked 37th and other prepared foods (0.1%) ranked 46th.

China's food industry is growing rapidly, with its output having topped RMB 1 trillion in 2002. It accounts for 9.1% of China's industrial production (in 2003). Its high growth in recent years owes itself to rising investment by foreign companies, including those from Hong Kong and Taiwan. Foreign companies' share of food production reached 25.3% in 2003. Foreign companies have advantages over Chinese companies in such areas as the size of operation, production technology, product development power and market development. They are engaged in global competition on the Chinese food market. Along with the expansion of middle- and high-income group in Chinese population, demand for high-level processed foods, such as dairy goods, confectionery and frozen foods, is rising. At the national level, the share of processed foods in the total food consumption is running at 30%, far below the 80-90% level in industrialized countries, leaving a sizable room for further market development.

Investments in China by Japanese food companies have been rising sharply since 2002. While they concentrated in fresh vegetables, frozen vegetables, frozen processed products of fishery and diary foods and cooked dishes, and beer in the mid-1990s, recent investments are increasing in such areas as confectionery, beverages, seasonings, premixes like frying flours, and restaurants. Japanese food companies are forming partnership with Chinese, Taiwanese and Japanese firms. Good examples are the collaboration of Sanyo Foods and KANGSHICHUAN and that between Kikkoman and TONGYI both tie-ups with Taiwanese firms that have produced synergic effects.

In Japan-China food trade, imports from China overwhelm exports to China.

Under the division of labor that has emerged between the two countries, Japanese companies that have transferred their operation to China produce low-value added products in China for re-import into Japan, while keeping production of high value-added products in Japan.

Foods are not covered by the preferential tariff system in Japan, but many food products, including prepared foods of meat and fish, which are the mainstay of foods imports from China, are covered by the special preferential tariffs. The special preferential tariff items do not include imports from China. For some products, there is no preferential tariff system. Tariff rates are generally higher in Japan, but Japanese rates are high on some agricultural and fishery products. The rate on beef, for example, is 38.5% in Japan, compared to 12% in China. Tariffs are also higher in Japan on citrus fruits. Also, import of many products from China is banned under the quarantine regulations, and the quarantine procedures against residual farm chemicals constitute an import barrier against Chinese products, the Chinese side says. Because of tariff rates higher in Japan on some products and the effect of the quarantine system, the likely impact of an FTA varies from product to product. But the agreement is certain to work in Japan's favor on high quality foods, but the impact will be limited as a whole, given the small quantity of Japanese exports of food to China.

Table 11 Trade Specialization Coefficient of Major Foods with China (HS2 two-digit)

HS		1999	2000	2001	2002	2003
2	Meat and meat scraps for eating	-0.99	-0.99	-0.99	-1.00	-1.00
3	Fish, crustaceans, mollusks, and preparations of other aquatic invertebrates	-0.69	-0.79	-0.83	-0.85	-0.83
7	Edible vegetables and certain roots and tubers	-1.00	-1.00	-1.00	-1.00	-1.00
16	Preparations of meat, of fish or of crustaceans, molluscs other aquatic invertebrates	-0.99	-1.00	-1.00	-1.00	-1.00
19	Cereals, flours, prepared products of milk of starch and	-0.95	-0.94	-0.93	-0.91	-0.95

	baked goods					
20	Vegetables, fruits, nuts and prepared foods of parts of other plants	-0.99	-1.00	-1.00	-1.00	-1.00
21	Other prepared products	0.09	0.09	-0.04	-0.16	-0.30

V. Impact of FTA

Japan's import duties on industrial goods are already very low, with effective rates running close to zero on the strength of preferences, except for apparels and others. China, on the other hand, is engaged in phased reduction of import duties in accordance with its promise with the WTO, but they are still relatively high. Thus, Japan-China will benefit Japan's export, creating and enlarging fresh trade. Yet, the expected benefits will vary from industry to industry, and will be limited as a whole. One reason for such prospects is that many commodities are already being imported into China without paying import duties in the form of consigned processing trade.

It may also be pointed out that for items in which relationship of division of labor is already established, major changes are unlikely to take place in trade thanks to FTA. For example, in sectors in which Japanese companies have already moved their bases of production to China, such as apparels and sundry goods for daily life, and, therefore, there are few exports from Japan, or for labor-intensive goods, there is little likelihood that export from Japan to China will increase even if China's import duties are eliminated under a free trade agreement.

It is certain, of course, that if Japan is the sole country having an FTA with China, that would put Japanese exports at a relative advantage vis-a-vis those from competing countries of Europe, the U.S. or South Korea; it would also be an encouraging development for industries and products attempting to promote exports. Also, for Japanese companies in China importing components and materials from Japan, a cost reduction effect can be expected. On the contrary, if China concludes an FTA with Japan's competitor countries before it does with Japan, Japanese products would certainly be put at a competitive disadvantage.

As for benefits other than import duties, improvement in business environment

can be expected under a comprehensive and broad FTA called an Economic Partnership Agreement (EPA). An EPA covers trade in goods, trade in services, investment rules, IPR protection, trade facilitation such as technical barrier to trade, sanitary and phytosanitary measures, Competition policy dispute settlement and bilateral cooperation. If an FTA works to achieve improvements in investment-related legislation and customs administration which are still lacking in transparency, or problems related to copied products which Japanese companies in China are facing, those companies would benefit greatly.