

On the Phenomenon of “Political and Economic Disjunction” In Sino-Japanese Relations

中日関係の「政経分離」現象の分析

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The recent Sino-Japanese relationship has often been described as “politically cold, economically hot.” The anti-Japanese demonstrations between April and June in 2005 were expected to add one layer of frost to chill the Sino-Japanese economic relationship. However, this did not happen. In 2006, the newly-elected Prime Minister Shinzo Abe chose Beijing as the destination of his first foreign visit. However, the Japanese FDI in manufacturing had decreased about 30%. Therefore, the phrase “politically warm, economically cool” has been used to conclude the Sino-Japanese relations since then. Why there is often a “political and economic disjunction” syndrome in Sino-Japanese relations? In the political domain, China and Japan have differences and disputes in history, nationalism, territory, social system, and security issues. They have established political or military allies with third parties. In economics, they are very realistic and practical. Japanese businessmen do not give up the market and profits in China because of anti-Japanese demonstrations. Chinese consumers do not stop buying Japanese goods because of Koizumi’s Yasukuni visits. This article is to analyze the unique phenomenon of Sino-Japanese relationship being “political and economic disjunction” based on the related political and economic facts.

Introduction

The recent Sino-Japanese relationship has often been described by many commentators as “politically cold, economically hot” (Feng, 2005; Jin, X. 2005; Jin, R. 2005; Liu, J. 2005; Liu, C. 2006; Zhang, X. 2006), or “a mini-Cold War between the two giants” (Taaffe, 2005). Yet, since the normalization of Sino-Japanese diplomatic relations in 1972, especially after the bilateral peace treaty signed in 1978, the two economies have been deeply attached, except for a short period of time after the Tiananmen Incident in 1989. The anti-Japanese demonstrations between April and June in 2005 were expected to add one layer of frost to chill Sino-Japanese economic relationships. However, this did not happen. In the same year when the anti-Japanese demonstrations happened, Japanese FDI to China experienced not only a “V-Recovery”, but also set a record of \$6.5 billion, with an increase of 19.8% compared with that of 2004. The sum of Sino-Japanese trade reached \$184.5 billion, a 12.7% increase compared to 2004 (Cheng, 2006). In November and December 2005, JETRO (Japan External Trade Organization) did a survey on whether the company was going to expand the business in China among 2,500 Japanese companies, 75.3% of them had a positive answer. Although it was nearly 10% less than Japanese companies with the same answer than the year before, China was still the country that Japan

invested the most in among all Asian countries in 2005 (Xin Hua Wang, March 9, 2006). However, the phenomenon of “politically cold, economically warm” has changed since October 2006 when the newly-elected Prime Minister Shinzo Abe went to Beijing as his first foreign visit since he took the office to show his good will to improve Sino-Japanese relations. Yet, the economic statistics seem to suggest that the Sino-Japanese economic warmth is starting to cool down. It is the third year that as a trade partner, Japan is behind the EU and the US. The Japanese manufacturing direct investment in China also decreased about 30% in 2006. Japanese ODA to China is going to come to an end in 2008. Therefore, the phrase “politically warm, economically cool” has been used to conclude the Sino-Japanese relations since then. Why didn’t the Anti-Japanese Movement chill Sino-Japanese economic relationships? And why didn’t Abe’s China visit warm up Sino-Japanese economic relationships? The answer to these questions can be many faceted. This article explores the issues from various perspectives in terms of how to look at the Sino-Japanese relations, the integration and complementarities of two economies and the maturity of Sino-Japanese economic relations. The article also discusses some important aspects of maintaining and improving this bilateral relationship.

Variables of the Sino-Japanese Relations

China and Japan have had a long relationship as close neighbors in East Asia. However, in most of the history, the relationship between the two countries was not between two equals, either China was much stronger than Japan or Japan was much more powerful than China. In terms of productivity, the relation between China and Japan was one of agriculture-agriculture, and then agriculture-industry. It is coming to an age of industry-industry relationship between China and Japan. As long-term former Chinese Premier Zhou Enlai said to Japanese visitors fifty years ago, if it were forever that this relationship is between the industrial Japan and the agricultural China, there would have been no good Sino-Japanese relations, and that, only when both China and Japan are industrialized, will the two countries co-exist peacefully, and share prosperity (Zhou, 1990). Since three decades ago, China has started moving towards industrialization. It is also the best period of Sino-Japanese relations because for the first time China and Japan can realize the complementarities of their economies in the areas of bilateral trade, direct investment and ODA, and have a win-win relationship.

However when the Sino-Japanese relationship is one between two powers, it arouses other issues, mainly the security issues. It is the first time in history those two are both powers in East Asia. This creates pressure on both China and Japan, thus the two countries fell into a “security dilemma” (John Herz’s concept, in Feng, 2005). In a security dilemma, there are no authorities such as international force or organization to guide or protect each power on one hand; on the other hand powers do not trust each other or lacking communication between them. When a new power rises, it increases the uncertainty in the international structure. Therefore the powers in this structure have worries and suspicions, and fight for more power in order to feel more secure. In history, this security dilemma happened between Spain and Britain, Britain and France, Britain and Germany, Soviet Union and the U. S., and now it is happening between Japan and China. Since the normalization, the economic

relationship between Japan and China has become more integrated; the political relationship of the two countries is yet stable. Japan worries that China will become a threat to her; China is concerned about the recovery of Japanese militarism. When China increases its military expense or does a nuclear test, Japan considers itself as the target of China’s action. When the Yasukuni visits and history textbook issues occur in Japan, China considers that as signs of Japanese militarism. In order to walk out of this security dilemma, China and Japan should trust each other and work together in the shared ideals and identity. That both China and Japan have become the main players in the regional security community of East Asia is an important step towards a stable Sino-Japanese political relationship.

It is very difficult to separate economic activities from political status when international relations are discussed. The phrases such as “politically cold, economically hot”, “politically warm, economically cool”, “politically cold, economically cool” and “politically warm, economically hot” are only for describing the phenomenon not the essence. In his “the Configuration of East Asia and Sino-Japanese Relationship” J. Liu (2005) did a quantitative and qualitative analysis of the hexagonal relations among China, Japan, the U.S. and Russia. In this system of analysis there are six qualitative aspects and six quantitative divided values. The six qualitative aspects are history, nationalism, territory, social system, security, and economic relationship; the six quantitative divided values are serious problems (-3), big problems (-2), some problems (-1), very close relationship with potential problems (1), not very close but no problems (2), and close or very close relationship (3). Liu’s analysis is presented in the following chart:

	China/Japan	China/US	China/Russia	US/Japan	US/Russia	Japan/Russia
History	-3	1	1	1	1	-1
Nationalism	-1	2	1	1	-1	-1
Territory	-2	2	2	2	2	-3
Social System	-1	-2	1	3	1	1
Security	-1	-3	3	3	-3	-1
Economic Relationship	3	1	1	1	2	2
Bilateral Relations	-5	1	9	11	2	-3

Note: Translated from J. Liu (2005).

The chart above shows that there are more political variables than economic ones determining a bilateral relationship. The quantitative evaluation of six bilateral relations among the four countries (Liu, 2005) shows that the relations between Japan and the U.S. and between China and Russia are much better than those of Sino-Japanese and Russia-America. The relations between Japan and the U.S. and between China and Russia get the positive points for all six categories, whereas the relations between Japan and China and between Japan and Russia get mostly negative points. Among the six factors Liu listed, five of them are political. Thus, no matter how hot that the bilateral economic relations are, the Sino-Japanese relationship is measured as negative points. How should one evaluate Sino-Japanese relations? First, when evaluating a bilateral relationship, one is more likely to get a better

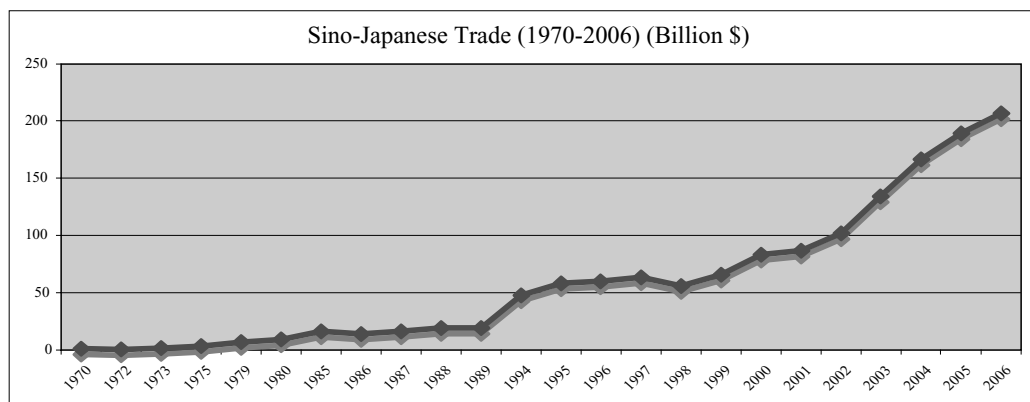
picture and understanding if this bilateral relation is put in an international structure as J. Liu did. China, Japan, the US, and Russia are the major players in the region. The hexagonal relations among them have important affects on any of the six bilateral relations. Second, when an international relationship is concerned, both political and economic factors should be included. However, is the ratio of political and economic factors should be 5:1? Does each qualitative item play an equal importance in a bilateral relation like the chart above shows? How do the six qualitative factors affect each other? The answer to this has its practical meaning to improving the Sino-Japanese relations. Third, if the political factors have more shares in international relations, they are the key to improving Sino-Japanese relations. If both sides deal with the five political issues in a mature and cautious way, it will not only improve Sino-Japanese relations but also improve the positions of both Japan and China in this international structure.

Political and economic factors cannot be separated when a bilateral relationship is examined. But do they affect each other in the way that politically cold is therefore economically cool or that politically warm is therefore economically hot? There is no such correlation between the two from the facts of the last 35 years' Sino-Japanese relationship.

China-Japan Trade (1970-2006)

Years	Billion \$	Years	Billion \$	Years	Billion \$
1970	0.8	1987	16.5	1999	66
1972	1	1988	19	2000	83
1973	2	1989	18.9	2001	87
1975	3.8	1994	47.9	2002	102
1979	6.7	1995	58	2003	134
1980	8.9	1996	60	2004	167
1985	16.4	1997	63	2005	189
1986	13.9	1998	56	2006	207

Source: Embassy of China in Japan (<http://www.china-embassy.or.jp/chn/22623.html>); L. Zhang, 2006; Soeya, 1998; Cheng, 2006; & Huan Qiu Zai Xian, 2007, http://www.chinadaily.com.cn/jjzg/2007-01/19/content_787569.htm



(Based on figures from the above chart).

Sino-Japanese trade started at a non-governmental level in 1952. Between 1952 and 1958, Japanese companies and Chinese government signed four trade contracts. However, the fourth contract signed on March 5, 1958 was not implemented mainly due to the “Nagasaki Flag Incident” when some Japanese in Nagasaki showed disrespect towards the Chinese flag (L. Zhang, 2006). In 35 years between 1972 and 2006, the China-Japan trade kept a continuous growth from \$1 billion to \$207 billion. The development in the recent five years is one and an half times that of the earlier 30 years.

The statistics from Japan and China often do not exactly match mainly because of Hong Kong’s role in this bilateral trade; however, the data from JETRO shows the same developmental tendency as the Chinese data. It also shows the rapid increase in trade volume. There are only two decreases: one is from 1989 to 1990; the other is from 1997 to 1998. They are because of Tiananmen Incident in 1989 and the Asian Financial Crisis in 1997. The affect of the Asian Financial Crisis was more severe than the Tiananmen Incident. There are two periods during the last 35 years when China-Japan trade had a continuous progress; the first one was early 1990s, and the second one was since 2000.

China-Japan Trade (1989-2006)

Year	Thousand \$	%	Year	Thousand \$	%	Year	Thousand \$	%
1989	19,661,650	1.7	1995	57,853,151	25.1	2001	89,195,467	4
1990	18,183,049	-7.5	1996	62,439,843	7.9	2002	101,557,182	13.9
1991	22,808,980	25.4	1997	63,850,728	2.3	2003	132,411,959	30.4
1992	28,901,919	26.2	1998	56,917,450	-10.9	2004	168,047,936	26.9
1993	37,837,809	30.9	1999	66,215,867	16.3	2005	189,387,360	12.7
1994	46,247,620	22.2	2000	85,730,918	29.5	2006	207,360,000	13

Source: 日本貿易振興機構：日中貿易の推移, <http://www.near21.jp/data/trade/japan/ja-chi/main.htm>;

Huan Qiu Zai Xian, 2007, http://www.chinadaily.com.cn/jjzg/2007-01/19/content_787569.htm



(Based on figures from the above chart).

The rapid development of China-Japan trade is a major manifestation of the “economically hot”. Here are some issues often used as signs of “politically cold”: history textbooks, Diaoyu island, Yasukuni shrine visit, nuclear test, etc. The chronicle of those incidents is as follows:

- 1973-1975: Taiwan issue such as Roundtable of Japan-Taiwan Relations of Japanese congressmen;
- 1977: Japan and South Korea Joint Exploring the Continental Shelf; Chinese government protested;
- 1982: The first history textbook incident;
- 1985: Prime Minister Nagaso Ne visited Yasukuni shrine;
- 1986: The second history textbook incident;
- 1987: China protested Osaka Supreme Court's decision on Guanghua Dormitory of Chinese students;
- 1989: Japan announced a series of sanction towards China due to the Tiananmen Incident;
- 1995: Japan protested China's nuclear test;
- 1996: Japan protested China's nuclear test; China protested Japanese going to Diaoyu Island;
Prime Minister Hashimoto visited Yasukuni shrine;
- 1997: China protested that seven Japanese landing on Diaoyu Island;
- 1999: Governor of Tokyo prefecture Ishihara declared Nanjing Massacre as a fabrication and
visited Taiwan;
- 2000: A gathering at Osaka International Peace Center announced that Nanjing Massacre was the
biggest rumor of 20th century;
- 2001: The third history textbook incident; Prime Minister Koizumi's first visit to Yasukuni shrine;
- 2002: Prime Minister Koizumi's second visit to Yasukuni shrine;
- 2003: Prime Minister Koizumi's third visit to Yasukuni shrine; the fourth history textbook incident;
China protested Japanese' going to Diaoyu Island; Japan invited Taiwan to World Health
Organization; issue of the Toxic Bomb Japan left in China;
- 2004: Prime Minister Koizumi's fourth visit to Yasukuni shrine; Diaoyu Island Issue; issue of the
Toxic Bomb; Taiwan issue (Li Denghui's visit to Japan);
- 2005: Diaoyu Island issue; Japan protested China's Anti-Japanese propagandas; Taiwan issue
(concerning Japan-America Security Contract); the fifth history textbook incident; China's
anti- Japanese Demo; in the White Paper of Defense Japan concerns Chinese military as a
severe threat; (L. Zhang, 2006); Prime Minister Koizumi's fifth visit to Yasukuni shrine;
- 2006: Prime Minister Koizumi's sixth visit to Yasukuni shrine.

The chronicle of Sino-Japanese relations shows that more than half of the time in last 35 years there had been certain problems in the relations between the two countries. They all fell into the five categories that J. Liu listed such as history, nationalism, territory, social system and security (2005). Among these five political factors there are three important ones: history, territory, and security. They are the main barriers to a healthy bilateral relationship between Japan and China. However, they do not necessarily have a direct affect on Japan-China trade. The two peaks of China-Japan trade in last 35 years have occurred in very different political atmospheres. The first one (in early 1990s) was during a problem zero time when nothing harsh happened between the two countries, but the second one (since the new century) was carried on in a political trough in Sino-Japanese relations. Thus, the chronicle of Sino-Japanese trade and political relations in the last 35 years shows that the economic section did not develop at the same pace as political section, sometimes they even went in the opposite directions. Why when the political gunfire between the two governments sparked here and there, Japanese businessmen

did not stop their speed of marching on the Chinese market? Why when Mr. Abe took steps towards improving the bilateral relationship, many Japanese companies started withdrawing from Chinese bases? To answer these questions, we need go beyond the phenomenon, and look into the essences of this relationship.

Interpretation of the Sino-Japanese Economic Relations

The Japanese and Chinese economies have been more integrated than ever. This is because of: 1) the international integration of the world economy, and 2) the complementarities of Japanese and Chinese economies. The complementarities are seen in the performance of continuous development in bilateral trade as the data above shows, in direct investment, and Japanese ODA to China. However, the maturity of this bilateral economic relationship does not mean the course of development is always towards one direction. Both sides adjust this relationship constantly based on each other's needs, their own role in the world economy, and most importantly for the best interest of their own economy.

Integration

International economic integration occurred after the World War II when the permanent peace became more people's wish and the world economy developed a tendency of interdependence, and all nations shared the common loss and gain of the modern science and technology. Thus the core of the international politics is not merely a problem of security. It focuses on more pressing problems such as natural resources, environmental and ecological equilibrium, food and labor shortage, capital and technology balance, market distribution, etc. To solve these problems, humanity needs cooperation. The world is moving towards the trend of international economic integration. Trade, FDI, ODA and other transnational economic activities are all part of this trend.

International economic integration, being the highest level of existing international economic relations and cooperation, is the essential factor for world progress. Its inevitability lies in the development of productivity and international division of labor; and its universality lies in the globalization of economy and the development of international cooperation. Generally speaking, each of the main regions in the world has been involved in the progress of integration, but their degrees are quite different qualitatively and quantitatively. In theory, due to the various standards of productivity and social economic systems, the international economic integration can be divided into three categories: 1) Cooperation and coordination among the countries of the same productive level and the same social system, for example, the North-North relations and the South-South relations such as the European Economic Community, the Council for Mutual Economic Assistance and various regional integrated organizations established by the developing countries. 2) Intercourse and division of capital, technology and labor among the countries of the different productive levels and different social systems, for example, the North-South relations such as numerous bilateral economic exchanges. The key is to acknowledge both political independence and economic interdependence. 3) Coexistence and

competition among the countries of the same productive level and different social systems. Politically, this is about peace and security, and is still under the shadow of the Cold War. Otherwise, it should be as similar as the first category. The three types of international integration are mainly for the purpose of cognizance. In reality, they overlap and are mixed. In terms of resources, labor, market, and their accessibility, regional integration is the most practical and relatively profitable format. When it comes to practice, the regional economic integration focuses on national interests and mutual benefits. (author's Master thesis, 1988)

The relationship between the Japanese and Chinese economies used to belong to the second category; it started moving towards the third category in recent years, thus peace and security became more of a problem. However, international economic integration is fundamentally an economic activity, the political factors should have less and less influence on the process of the integration of the two economies. The integration of the Sino-Japanese economies is processed during transaction of trade, FDI, and Japan's ODA to China. Due to the complementarities of the two economies, the process of the integration has gone on broadly and profoundly. The maturity of Sino-Japanese economic integration can be shown in some of the numbers. Japan has been the top trader of China for 11 years until 2003. Through 2004 and 2006, the China-Japan trade has been still moving towards a positive direction, and was increased to \$207 billion in 2006. More than 70 Japanese companies from the 500 world fortunes set up their branches in China. Up to the August 2006, there have been 36,000 Japanese investments in China with the capital of \$56 billion realized. Japan has been either the second or third foreign investor of China (Cheng, 2006). The provision of a massive amount of Japanese ODA to China has facilitated the development of the Chinese economy and thus has also contributed to improving the living standards of many ordinary Chinese people. It also helps to improve the environment of Japanese FDI.

Complementarities

Japan and China are two important countries in the East Asia. Japan is the world's second strongest economy and the number one overseas creditor world-wide. Japan's GDP is about four times the GDP of China. Japan owns the most advanced technologies in many areas such as electronics and automobile manufacturing. Its annual capital export is more than any other country. Whereas China, despite the recent two decades of fast development, the average GDP per person is only one-fortieth that of Japan (Zhang, 2001). What Japan has the most is what China needs the most – technology and capital. On the other hand, China has what Japan needs the most – cheap labor and a huge market. Because of the basic characteristics of the complementarities, the Japanese and Chinese economic relations have had a steady development over the last 35 years especially since 1990s. The two economies are more integrated and dependent than ever. FDI, Trade, and ODA are three main areas of the Sino-Japanese economic relations. FDI occupies a large portion of trade, and ODA creates a good environment and atmosphere for establishing more FDI. And that more FDI accompanies are the impetus to more trade. The three areas are not only connected horizontally, but also vertically. They are moving towards the higher-level complementarities of product innovation, technology advancement, and the balance of economic

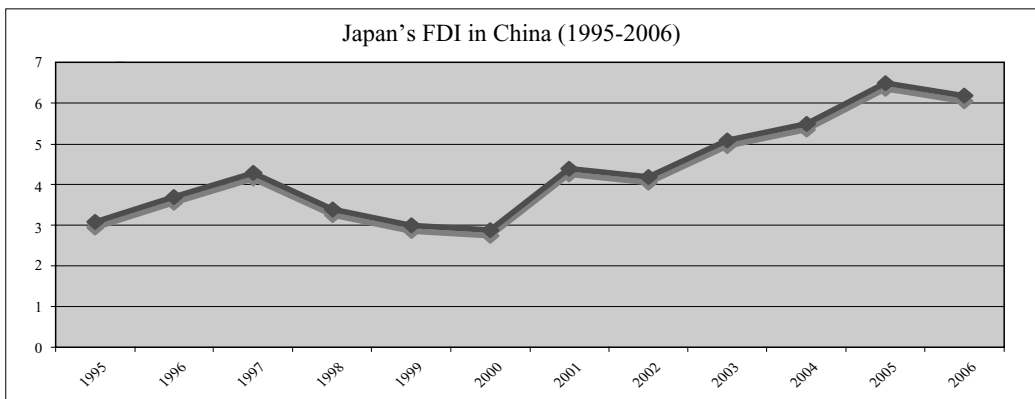
development. FDI plays the most important role to Sino-Japanese bilateral economic integration. The characteristics of Japanese FDI in China can be summarized as the quantitative or qualitative aspects in terms of numbers of FDI, the total capital of the investment especially the actual capital realized, the areas of the investment, the locations of FDI, etc. Manufacturing is the main area of Japanese FDI in China, and its quality is enhanced along with its quantity increase. Japanese investors used to focus more on the east coast regions, but are moving to inland to cope with the development strategy of China. The average amount of capital of Japanese FDI used to be small compared with European or American FDI, but recent years this has changed due to the big automobile companies' participation.

Japanese companies started investing in China in the 1980s on a small scale. It was in the first Japanese investment upsurge between 1990 and 1995 that the capital amount went up from 50.7 billion JPY in 1990 to 421.8 billion JPY in 1995 (Xing, 2004). Between 1995 and 2006 as the chart shows below, Japanese FDI in China had ups and downs. However, since the beginning of the new century, the tendency of Japanese FDI in China has been on continuous uprising.

Japan's FDI in China (1995-2006)

Year	Billion \$	Year	Billion \$	Year	Billion \$
1995	3.1	1999	3.0	2003	5.1
1996	3.7	2000	2.9	2004	5.5
1997	4.3	2001	4.4	2005	6.5
1998	3.4	2002	4.2	2006	6.2

Source: Hao (2006); and Ministry of Commerce of China (2007).



Source: Based on figures from the above chart.

What is the incentive for Japan in moving its manufacturing production base to China? China had cheap labor long before Japanese companies moved there. Xing (2004) refers to other scholars' comments on this issue: political openness and state ownership in China, large regional market and potential market size, good infrastructure, preferential policies, the organization of export processing operations of foreign MNEs in China, low labor cost, geographic proximity, and political stability as primary factors attracting FDI inflows to China. However, Xing's research focuses more on the

exchange rate that has an impact on FDI inflows through the wealth effect channel and the relative production cost channel. Devaluation in the value of FDI hosting country's currency stimulates inflows of foreign direct investment and conversely an appreciation leads to a reduction in FDI inflows. Thus, Japan makes more direct investment as the JPY appreciates and RMB depreciates, and reduces its foreign investment as the JPY depreciates and RMB appreciates. In fact, the determining factors of FDI lie mainly in the economic situations of the two countries in addition to the societal environment of the FDI hosting country. Xing (2004) points out that the main goal of Japanese FDI in China is to use China as the production base for Japan's domestic and international markets, therefore most Japanese FDI in China are export-oriented. They hire cheap Chinese labor to produce low-price goods for Japanese consumers and various parts for Japanese companies. Export-oriented Japanese FDI means reverse-import for Japan. It is advantageous to Japan to keep a positive balance while promoting bilateral trade. The benefits China gets from Japanese FDI also have many aspects. First, it helps to reduce the pressure of unemployment, as Japanese FDI hires thousands of Chinese laborers and technicians. Meanwhile, it helps Chinese companies to join the global production chain and enhance the quality of their products. Second, it increases China's import and export volume and connects the two economies in terms of production process and the technologies involved, and the network of sales and market, thus helps Chinese companies to upgrade their technologies and the values of import and export.

Mr. Koizumi has visited Yasukuni shrine for last six years. The Japanese FDI in China had a steady development during these years. How to explain the reduction of Japanese FDI to China in 2006? When the media says that the Japanese FDI in China decreased near 30%, it only means in the manufacturing sections. In general, Japanese FDI in China reduced only 6.3%. In 2006, Japan invested \$17.2 billion in Asia, near 36% of it was invested in China (\$6.2 billion) whereas only \$0.5 billion in India (Ministry of Commerce of China, March 1, 2006). China is still the third target country of Japanese FDI. The 6.3% decrease is a normal interval between two high tides in any bilateral economic relations. However, when the important variables from one side change, the other side needs to make a relative adjustment. First, Japan's FDI policy to China is part of its world FDI policy. Before 1990, 49% of Japanese FDI was in North America. Starting from 1990s, Japan gradually increased its investment in Asia. But it was not until 2004 that Asia surpassed North America and became the second target of Japanese FDI (Hao, 2006). In the early 1990s, China only accounted for 5% of Japan's Asian investment whereas Southeast Asian countries accounted for 47%, and NIEs 42%. However, in 1995, 43% of Japanese FDI was transferred to China (Xing, 2004). Japan will certainly change its policies on overseas investment based on the current variables. Second, Japan is not the first country to decrease its investment in China in recent years. The other two major investing countries, Korea and the U.S., started slowing down their investment in China two and four years ago respectively. Britain also reduced its investment by 25% last year. In 2006, there were 41,485 new FDI in China; reduced nearly 6% compared with that of 2005 (China Trade Remedy Information, 2007). The British weekly magazine "The Economist" published an article on January 13 this year saying that some manufacturing companies in the world adopt a "China+1" Asian investment strategy. The "China+1" strategy means that while investing in China, a company should also invest in another Asian country to avoid the

increased labor cost and risk in China (Xin Hua Wang, March 8, 2007). Another new FDI strategy is called “BRICs”, meaning investing in Brazil, Russia, India, and China at the same time. Third, as a FDI hosting country, situation in China has changed mainly in the following three aspects:

- 1) New tax law to replace the preferential law (1991-2007). As the FDI environment in China such as basic facilities was not quite ready then, in order to attract FDI, Chinese government passed a preferential law concerning FDI on April 9, 1991. The law was put into practice on July 1, 1991. According to this law, FDI in China enjoys a low tax compared with Chinese domestic companies. FDI pays 15% or 24% tax whereas the majority of Chinese companies pay 33% (those low profit Chinese companies pay 17% or 28%). But on March 8, 2007, Chinese government introduced a new law that stipulates the same tax rate of 25% for both Chinese and foreign companies. However, the new law includes a preferential tax of 20% towards small companies with low profits. Along with this new tax law there is a policy of Five Year Transition Period. Small FDI with low profits will only increase 1% or 2% tax every year from 15% to 20% or 25% in five years (Xin Hua Wang, 2007). The new law will become effective on January 1, 2008. The explanations for the new law are: 1) the FDI environment in China is much better than before; and 2) it will create a fair competition between Chinese companies and FDI. The new law symbolizes the new period of China’s absorbing FDI; China is going to take more initiatives on this matter.
- 2) The labor cost in China increased continuously in recent years. For example, between 2002 and 2006, labor cost in Beijing increased more than 7%. Other cities also raised the minimum wage. In the areas such as Shanghai and Zhu Jiang delta, the office rental fees and business cost also increased. In addition, the land supply for industry is in shortage. Whereas, some of the ASEAN countries especially the new WTO member Vietnam revised its FDI law in 2003 and in 2006 to improve the investment environment and gave FDI more benefits (Zhejiang Foreign Trade and Economic Cooperation Bureau, 2006). Vietnam became attractive to investing countries because of its low GDP (\$551), low cost (only higher than Indonesia among ASEAN countries), fast development (GDP growth rate is 15.8%), plenty of labor with high quality (the population only less than Indonesia with 90.4% of literacy), and stable political environment compared with Malaysia, Thai, Indonesia, the Philippines, and Burma (Shenzhen EIA PCB & SMT Association, 2006). Japanese media such as Asahi and World Weekly gave a very positive report on FDI environment in Vietnam and listed all the factors above mentioned. “The Vietnam-Japan Economic Seminar” in December 2006 and Yoshihide Suga’s visit to Vietnam in January this year already started the prologue of Japanese investment in Vietnam (Kantsuu Nihongo, 2006 and 2007).
- 3) The cumulative appreciation scope of RMB has achieved 4.78% since July 2005 when the Chinese government increased 2.1% of RMB’s value. Thus the cost of doing business in China increased and the competitiveness of Chinese products was reduced. So the appreciation of RMB is undermining the attractiveness of China being the destination of export-oriented FDI. And the majority of Japanese FDI in China is export-oriented.

Fourth, China's new tax law is a part of the revaluation of its economic development, and also a part of its new policies towards FDI. On November 9, 2006, for the first time that the Committee of Development and Reform of China (2006) published its "11th Five-Year Plan of Using Foreign Capital". The plan announced the important change of Chinese FDI policy: from attracting foreign currency to introducing modern technology, management know-how, and talented human resource. China is no longer interested in FDI of simple processing, assembly, and low technology manufacturing. As traditional manufacturing is getting saturated, and a traditional industrial topology is established, China is aiming at research and development, and advanced designs to upgrade its industrial structure, and to turn the country into a production base of high value-added products in the world. Meantime, China is going to encourage more FDI in service section especially bank and insurance (Cai, 2006). Fifth, when China changes its FDI policy, Japan has to adjust the strategy of its FDI in China. The followings are the justifications of changes from Japanese side:

- 1) In 2005, Japan increased its investment in electronic and automobile so much that the yearly FDI in China raised 19.8% than in 2004. It is difficult to keep the same growth rate under normal circumstances.
- 2) Manufacturing has accounted more than 70% of Japanese FDI in China, finance and insurance less than 1% (Xi Tong Zhi Jia, 2007). Since China changes its focuses in FDI, Japan started transferring some capital from manufacturing to service in 2006. It takes time for such a change.
- 3) China is expecting more technology intensive FDI than labor intensive FDI. So continuing investing in China has to be beneficial to China's industrial upgrade. About 80% of Japanese FDI in China is labor intensive (Xi Tong Zhi Jia, 2007). Japan needs time to digest this because that technology intensive FDI will cause the technology flowing out from Japan, which will be against Japanese government's policy on this matter.
- 4) From Japanese point of view, since the labor cost in Vietnam or other Asian countries is lower than China, and labor intensive FDI is welcomed there, transferring some capital from China to those countries is a solution for the time being.
- 5) The Japanese economy has started growing in recent years. There is a tendency of industrial return. Some Japanese companies are expanding their domestic production. In August 2006, "Economic News of Japan" did a survey among 160 major manufacturing companies, 58.8% of them are going to start new facilities in Japan, and 63.9% of them already decided to expand their domestic production scale and value (Xin Hua Wang, Aug. 19, 2006).

The trade between China and Japan has been growing as the above data shows. The structure of this bilateral trade is mainly between industries. In general, most of imports from China are low-price daily consumer goods, met the needs of Japanese, especially when Japan is during the economic recession. Imports from Japan occupies an important part in China's technology import. Part of it is for Japanese FDI in China. However, due to the optimization of the product structure of China's export to Japan, the trade within industries has been growing (Chen, Q. 2006). China has been modifying the structure of the goods for export. In 1990, the manufacturing products accounted 40% of Chinese export

to Japan. In 1999, this proportion was raised up to 80% (Bi Ye Lun Wen Wang) including the reverse import from Japanese FDI in China.

ODA (Official Development Assistance) is for the developing countries by DAC (Development Assistance Committee) of western developed countries. Japan is the most important ODA contributor in the world. K. Liu (2006) divides Japan’s ODA into different periods according to its main goals:

Early 1950s – early 1960s	Substitute Compensation
Early 1960s – early 1970s	Economic Development
Early 1970s – end of the 1980s	Regionalism
End of the 1980s – early 2000s	Global Vision

In terms of Japan’s intentions for its ODA to China, there are mainly two opinions: economic assistance or compensation (Drifte, 2006). In reality, however, Japan’s ODA to China played a political role of “safety valve” and “lubricant” to Sino-Japanese relations (Jin, X. 2006). Economically it has been the most important part of the Sino-Japanese cooperation. About half of the foreign ODA to China came from Japan.

Japan’s ODA to China (1979-2000)

Years	Amount (\$ Million)	Project Areas
1979-1984	3,244	Railway 39%; Commodity 39%; Port 21%;
1985-1989	5,294	Railway 29%; Energy 27%; Port 23%; Export Industries Promotion 13%; Telecommunication 6%
1990-1995	7,941	Road 31%; Energy 25%; Port and Airport 14%; Fertilizer Plant 11%; Telecommunication 7%
1996-2000	9,677	Road 29%; Energy 19%; Environment 16%; Agriculture 11%; Water Supply 10%; Port and Airport 8%; Urban Flood Control 5%

* The author did the statistics based on the source from Takamine, 2006.

Starting from 2001, Japan’s ODA to China was provided on yearly base as showed in the following chart:

Years	Amount (Billion JPY)	Project Areas
2001	161	Environment, Energy, Road, Education...
2002	121	Environment, Education, Helping the poor...
2003	97	Environment, Education, Broadcasting equipment...
2004	86	Environment, Education...

* Based on the data from J. Liu, 2006.

The above statistics show that road construction and energy development are the two main areas of Japanese ODA to China for the first twenty years; environment and education are the focus of recent years. Up to 2003, Japan provided China 2,950 billion JPY of loan (about 91%), 136 billion JPY of free

fun aid, and 140 billion JPY of technology assistant. The interest rate of loans was about 2.5-3% for the first 20 years and 0.75-1.7% for recent years (Liu, J. 2006). Since 1990, China has been paying back Japan's ODA including interests on time (Jin, X. 2006). Japanese ODA not only helped China to build up a capacity of long-term development, but also helped to reduce the economic differences between the coast and inland. The improvement of the environment in China is beneficial to both China and its neighbors including Japan. As Zhang (2001) commented that on one hand, Japanese ODA had been a great support to China's reform and openness, and its economic development. On the other hand, while conducting projects of ODA, it created many opportunities for Japanese companies to get into the Chinese market, enhanced Japanese FDI in China and mutual economic exchange between the two countries. Thus, it improves Sino-Japanese relations in general. ODA is an economic assistance based on the needs. According to Japan, China has made a huge progress economically in last twenty years; China is able to provide ODA to other countries; and China spend too much on military. So Japan has decided to stop providing ODA to China from 2008.

Cruxes of Improving Sino-Japanese Relations

There are three aspects that are most crucial to the Sino-Japanese relations. They are persisting the common grounds: peace and development, meeting each other's needs including mutual investment, and dealing with the controversies wisely.

Persisting the Common Grounds: Peace and Development

In the post Cold-War age, the major countries in the world put aside some value differences, and focused on their common interests. The common interests among countries from the East, West, South, or North are peace and development as Deng Xiaoping said (1993). Since the establishment of the People's Republic of China, successive Japanese governments, led by Yoshida, Hatoyama, Kishi, Ikeda and Satoo, consistently pursued a policy of engagement with China. Before World War II, China absorbed more than one-fifth of Japan's total exports. So the Japanese government wanted to regain its share of China's market. Yoshida also pursued official trade relations with China. Yoshida's successors continued seeking to establish official economic relations with China partly because of the business circles' persistency. As Takamine concludes (2006):

Thus, despite the Cold War international system that separated Japan and China into different and rival ideological camps, economic interests and geographical proximity, the fundamental sources of Japan's security concerns, consistently encouraged Japanese governments to pursue official relations with China during the period 1945-71.

After the normalization of the diplomatic relations between the two countries, from 1972-1978, China and Japan were building up mutual trust for a long-term peace. On September 28, 1972, the day before the three historical documents were signed, Chinese Premier Zhou wrote six characters in

calligraphy as a gift to Japanese Prime Minister Tanaka, saying, “keep the promise, and act with results”. Tanaka also wrote six characters in calligraphy as a return to Zhou, saying, “Trust is the root of all the things” (Zhang, 2005). Japan took a very cautious step to economic engagement with China during this period. The reasons behind this phenomenon are China’s lack of foreign currency reserves to pay for purchases of Japanese goods, and the social-political conditions in China during that period, for example, the political dominance by the Gang of Four and the other international political issues (Takamine, 2006). Thus, the “honeymoon” of the Sino-Japanese relation did not bring the great economic results.

In 1978, China announced the transition of domestic focus from “class struggle” to economic development. The Sino-Japanese Peace and Friendship treaty was concluded after a few years’ efforts from both sides. It finally cleared the road to Sino-Japanese economic cooperation, created an environment that Japan felt comfortable and sufficient for the business transaction. In 1980s, in addition to high level officials of the two countries visiting each other, other discussion groups were also established: 1) The meeting of Sino-Japanese Government Officials, held once every two years in Beijing or Tokyo in turn; 2) The meeting of Sino-Japanese vice minister of foreign affairs, discussing diplomatic issues once a year in Beijing or Tokyo; 3) The meeting of Sino-Japanese nongovernmental people, held by famous politicians, scholars, and other friendly people, also once a year; 4) the Committee of Sino-Japanese in the 21st century as consultants to their governments.

Neither China nor Japan wants to see another war between them. In 1980 Deng Xiaoping pointed out that China really needed a peaceful environment to realize its four modernizations (Li, 1999). In 1982, China initiated three principles of Sino-Japanese relation: Peace and friendship; equality and mutual benefits; long-term stability. In 1983, Japanese Prime Minister Nakaso Ne suggested to add the fourth principle: mutual trust.

Under the premises of having a peaceful environment, development or economic gain is the most important concern of a bilateral relationship. In comparison to Sino-Japanese trade from 1972 to 1978, the volume from 1979 to 1982 grew sharply. After Tiananmen Square incident, Japan joined the western countries to sustain the normal relation with China. However, as a close neighbor, Japan shares more common interests in economy with China than its value-sharing western countries. In fact, only three months later, a delegate headed by the congressman Ito Masayoshi visited China. Deng Xiaoping promised Japanese visitors that no matter what happened, the Sino-Japanese friendship would never change because it was important to both countries, both Chinese and Japanese people and the world as well, and because a long-lasting Sino-Japanese friendship was the national policy of China (Li, 1999).

Japan has played an important role in the development of China. Starting from 1960s, Japanese scientists introduced new technology to China through science conferences and technological exchange and cooperation. Japan provided various loans to China including JPY loan, energy loan, free assistance, and “Black Character Return” loan. With the help of Japanese loans, China could speed up

the construction of its infrastructure and other broader areas such as environment protection, nuclear energy, etc. Japanese FDI produced many high quality goods that Chinese consumers enjoy. Japanese FDI in China hired 9.2 million people directly or indirectly. In 2004, Japanese FDI paid 49 billion RMB for the tax revenue (Bei Qing Wang, 2005).

Close China-Japan economic relations have also helped Japanese economy. The statistics of Sino-Japanese trade, China's export to Japan, China's import from Japan, and Japan's GDP (X. Zhang, 2006) show that there are correlations among them. China-Japan trade promotes Japanese GDP's growth. When the volume of China-Japan trade increases 10%, Japan's GDP increases 2%; when the import from China increases 10%, Japan's GDP increases 2.4%; and when the export to China increases 10%, Japan's GDP increases 2.3%. As 60% of import from China are the products of Japanese FDI in China, therefore it has a strong affect on Japan's GDP's growth. If China continues to be the second largest trade partner of Japan, this bilateral trade will drive the economic development for both countries.

Meeting Each Other's Needs

As a manufacturing power, Japan has played an important role in upgrading China's industry and technology, and increasing China's exports and imports. China has provided Japanese companies opportunities of making profits and reaching a huge market, and contributed Japan's economic recovery. A mature economic integration improves the current economic relations constantly and looks for the opportunities for further development. In China it came to a turning point of utilizing foreign capital from quantity increase during last two decades to quality renovation. China is no longer satisfied with being an assembly factory of the world but wants to be the center of value-added manufacturing base. At the 11th Conference of Sino-Japanese Economy (2006) held by People's Daily of China and Economic News of Japan, the former Minister of Economy of Japan and the Director of Strategy of LDP congress, Nikai Toshihiro, said that Sino-Japanese relations have come into a stage where the two countries cannot be separated, which can be described as China is in Japan, and Japan is in China. The Minister of Commerce in China, Xilai Po made a same comment on Sino-Japanese economic relation after the anti-Japanese demonstration (Bei Qing Wang, 2005; Cheng, 2006).

To meet each other's needs, China and Japan can work together in many aspects. First, Japanese manufacturing occupies a superior position in the world. As technology intensive FDI becomes the main interest of China, Japan can transfer some of the labor intensive FDI from China to other Asian countries, and use these countries as its new production bases to serve for an upgraded Sino-Japanese economic cooperation; and the labor cost has less affect on the technology intensive FDI. Second, the service sectors such as finance, environment, and agricultural productivity will be the new areas of Sino-Japanese economic cooperation. The U.S. secretary of finance Henry Paulson visited China three times within seven months between 2006 and early 2007. One of his goals was to open the financial market in China. Since 2006 Japan started diversifying its FDI in China, and investing more in real estate, circulation industry, bank, and the stock market (Tie He Jin Shang Wu Wang, 2006). However, in order

to win the competition, Japan needs to come up a better strategy. Third, besides environmental and labor protection, energy-saving and comprehensive utilization are the win-win areas for Sino-Japanese cooperation. The rate of energy consumption in China is six and an half times that of Japan. It will reduce the competition on energy between Japan and China when China lowers this rate, and improve the environment of both countries and the rest of the world. Fourth, in terms of FDI regions, the central and west China will have more opportunities for labor intensive FDI of Japanese manufacturing after the technologies in the coast areas are upgraded. China also just announced that the industrial structure of northeast China needed to be transformed. It is an area to Japan’s advantage geographically and technologically.

Another area where the two sides can meet each other’s needs along with the maturity of this regional integration is the direction of the Chinese and Japanese FDI. Mu (2006) summarized three commons and five differences between Chinese and Japanese FDI. The three commons are: 1) to avoid trade disputes; 2) to establish new FDI first, and then buy an existing company of the host country; and 3) under the pressure of increasing the value of currency. The five differences are: 1) Japan increased the value of JPY dramatically from 250JPY: \$1 in 1985 to 80JPY: \$1 in 1995; whereas China increase the value of RMB gradually; 2) Japan started its foreign investment when its economy reached the highest level with a mature market and massive extra capital; whereas China is only at its preliminary stage of foreign investment, so Chinese FDI is very limited in scale; 3) Japan encourages its companies to expand abroad, whereas China had never encouraged its companies to invest in other countries but only did so in recent years; 4) Japanese companies are very much motivated to open up international markets because of its small and saturated market, whereas the main goal of Chinese FDI is not the market but the resource, technology, or/and the brand; and 5) Japanese investors mainly are the private companies, whereas most Chinese investors are the state-owned big companies.

In the past decades, Japan and China had reversed directions of their FDI policies. Due to the increased value of JPY, trade conflicts with European countries and the US, and the limited domestic market, Japan encouraged its companies to invest overseas but was very strict on absorbing the foreign investment. Since the economic reform, China has focused on attracting foreign companies to invest in China to set off its shortage in capital and technology. China did not have companies with extra capital to invest overseas. Meanwhile, Chinese companies more focused on the domestic market. However, China now has more than \$100 billion foreign exchange reserve, attracting foreign capital is no long the main focus of its FDI policy. While continuing to welcome foreign investment, China also encourages its strong companies to invest overseas. At the third conference of the Ninth People’s Delegation in 2000, China announced its national strategy of supporting companies “Going Abroad”. In recent years, the Chinese government also introduced a series of rules and laws guiding this process (Mu, 2006). Some big companies in China have accumulated enough capital and foreign currency so they have the economic strength to expand their business abroad. However, in more than twenty years up to 2005, the amount of Chinese FDI was only about \$50 billion while Japan invested \$67.5 billion in 1989 alone. Since joining WTO, China has speeded up its FDI development: \$1.8 billion in 2000, \$4.8 billion in

2004, \$6.2 billion in 2005, and \$14 billion in 2006 (Chen, Z. 2006). In 2005, Chinese electronic company Lianxiang (Legend) bought IBM's whole PC business, and the Ocean Petroleum Company of China bought American Petroleum Co. of Uniko. Under the pressure of increasing the value of RMB along with accumulation of extra capital, more Chinese companies will establish FDI in other countries. Although Japan is technologically much more advanced than China, it probably can find certain areas that are more beneficial to let Chinese FDI do business in Japan. In March 2006, the Japanese government made a plan for expanding FDI in Japan. According to government's estimation, the total capital of FDI in Japan will reach 13,200 billion JPY, amount to 2.5% of the country's GDP. And this number will increase to 30,000 billion JPY by the end of 2010 (Yomiuri News from China Forex Online, 2006). Encouraging foreign investment in Japan also became one of the main goals of JETRO in recent years. If China and Japan can encourage their FDI development in both directions, it will generate more business opportunities for each other. It will also expand each other's markets and bring more exports and imports to both countries. Japan and China will become both important FDI hosting countries as well as world investors like the U.S. and Britain.

Dealing with the Controversies Wisely

In Sino-Japanese relations, history issue, nationalism, territory conflicts, different social systems, military and security issue are the existing or potential problems. A harmonious Sino-Japanese relationship needs to be dealt with in a wise and strategic way in those areas. First, no one can change history and contemporary people are not responsible for what their predecessors have done. In order to walk out of this shadow, both sides have to put aside historical issues, and do not let them become a burden on the bilateral relationship. On one hand, history should not be forgotten. It is an important part of education and it is the base of understanding a nation or a culture. On the other hand, some of the sensitive issues should not be mentioned again and again. The common sense that uncovering old scabs causes the pain is applicable to a bilateral relationship. The former Prime Minister Koizumi visited Yasukuni shrine every year between 2001 and 2006; meantime, he also gave apologies to Asian people for what Japan did in history in public on Oct. 8, 2001, Aug. 15, 2003, April 22, 2005, and Aug. 15, 2005 (L. Zhang, 2006). This is like repeating the process of uncovering the scab and then comforting it. However, can Asian people including Chinese accept Japan's sincere apology once for good and not consider the Yasukuni shrine visit as a political issue but a cultural event? Or can Japan come up a better way not to uncover this historical scab, yet preserve the tradition of visiting shrines? Both countries should "not haggle over the historical gratitude and grudges" (Deng, 1993). Second, nationalism can be an important spiritual prop especially when a nation is in difficult times or in danger. However, it is not a card to use in dealing with a bilateral relationship. Changing historical facts in textbooks and creating an anti emotion in the media are abuses of nationalism. Thus there were many history textbook incidents and Japanese Foreign Minister's protest to China's anti-Japanese propaganda. The anti-Japanese demonstration in April 2005 is an extreme manifestation of nationalism. It took the form of physical attacks against the Japanese diplomatic premises and Japanese commercial establishments (Consulate-General of Japan in Houston, 2005). After the anti-Japanese demo, the Minister of

Commerce of China, Xilai Po tried to convince Chinese that resisting commodity is hurting both producers and consumers; that Sino-Japanese economic and trade relations are mutual benefits; and that Chinese government has to protect legitimate rights and interests of all FDI including Japanese ones (Bei Qing Wang, 2005). Nationalism has its special connotation under a certain historical context. However, its core is to strengthen a nation but not to disparage or weaken another nation. Some of the Chinese scholars expressed their concerns on the Internet long before the anti-Japanese demonstration. They criticize the irresponsibility of some medias in creating an anti-Japanese atmosphere. They warn the media that arousing the hatred between the two nations would reduce the confidence and enthusiasm of Japanese investors and the Sino-Japanese trade. Thus Japan will lose, but China will lose even more. It is not the way to solve the problem but delay its resolution as well as China's development (J. Zhang, 2001). Third, territory conflicts happen among bordering neighbors. There are two major territory issues between Japan and China: Diaoyu Island and East Sea area. As Sino-Japanese economic relations are getting more mature, both sides need to deal with these controversial issues with focuses on peace and development or mutual benefits. For example, as for the oil reserve issue in the East Sea area, the best way is to have a cooperative project, and share the gains and interests. In terms of Diaoyu Island, Deng Xiaoping suggested, “If our generation cannot solve this problem, leave it to the next generation” (J. Zhang, 2001). Fourth, social system is a domestic issue. A country decides its own social system. However, it is a very important element in terms of international relations. China and Japan share many things in history and culture, but they do not share the system and ideology. Although the social system has not been a severe barrier to Sino-Japanese relations since normalization, it is a disappointment to a reliable and trusty bilateral relationship. As Z. Chen (2006) points out, the best way for China as a rising power to ease the world's anxiety of her being a threat is a structural reform to realize a constitutional government. The return China gets by doing this is a long-term stable world order, which will make China a real rising power. Nevertheless, China and Japan should not haggle over the differences in social system and ideology. Fifth, security became more of an issue in recent years. As both China and Japan are powers in the region, it creates a unique phenomenon of security dilemma between China and Japan. Japanese officials including the former Prime Minister Koizumi expressed their opinions on this issue in public that China is not a threat but an opportunity to Japan. However, both sides still consider each other as a potential security threat. Thus they establish security allies with third parties. In order to come out of the security dilemma, Japan and China should either be in a same security pact or not have any security alliances with any third parties. If both Japan and China can deal with the five issues in a diplomatic way and with a far-seeing viewpoint above mentioned, there would have a long-lasting healthy Sino-Japanese relationship that benefits both countries.

Conclusion

The closeness of geography and culture provides the congenial condition of a good Sino-Japanese relationship; the complementarities of between Chinese and Japanese economies in terms of Japanese high technology and extra capital and Chinese resources and market create a socially induced condition of a beneficial Sino-Japanese relationship. The sense and the convenience of the Sino-Japanese

cooperation should make the two countries the best of partners in a relationship that can be found nowhere else in the world. The past should not be in the way of the future. The interests of Japan and China should be expressed by the two countries themselves not another country. The cooperation and unification of Japan and China will make either of them stronger, and make the region the most prosperous, and will be a role model of international relations.

The function of international economic integration can be summed up as having two aspects: firstly, the promotion of development for a West-East-North-South economy, and the orientation towards economic variety and balance; secondly, the foundation for the transition from a world with opposite systems to international political integration. Japan belongs to the North and West, and China is categorized as the East and South. The economic integration of Japan and China can be a golden match of regional integration as well as a model of West-East-North-South cooperation. It can move the East Asian region and the Pacific Rim to a positive interdependence and integration. Meanwhile, the whole area will be also engaged with other areas such as Europe, America, and Africa, and the Middle East in the future. The general trend of international economic integration is international integration, in other words, interdependence and mutual development of international relations in the fields of economy, politics, ideas and culture, etc. When international integration is fully realized, it will be the very day of great harmony for the whole world.

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