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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

*Sino-Japanese Economic Relations
on the Eve of the Tanaka-Chou Summit*

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
September 1972

INTELLIGENCE MEMORANDUM

SINO-JAPANESE ECONOMIC RELATIONS
ON THE EVE OF THE TANAKA-CHOU SUMMIT

Summary

A. Over the past decade, Sino-Japanese trade has increased sharply, with Japan regaining its pre-World War II position as China's leading trading partner. These gains reflect mainly the shift in China's trade away from Communist countries, but in recent years Japan has been cutting sharply into the share held by others as well. Political developments over the past year, meanwhile, have given a further impetus to expanded Sino-Japanese economic ties, and both countries are rapidly moving to formalize commercial links.

B. In the wake of all this, many Japanese business and government leaders expect large increases in trade flows between the two countries over the next decade. Whether these expectations will be realized is far from certain, since trade trends will depend largely on Chinese political decisions. Peking will either have to let Japan take a much larger portion of the Chinese import market - an unlikely event considering Japan's already large share -- or change its policy against accepting credits to finance imports. The latter may occur as China continues to move out of its isolation, but so far Peking is staying with its policy of largely cash payment. In any case, Japan is likely to maintain its strong position in the Chinese market during the coming years, considering its geographic proximity and existing ties with China. We do not expect, however, that the Sino-Japanese rapprochement will significantly alter Taiwan's strong economic position.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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Discussion

Historical Perspective

1. Japan and China, historically, have had close economic ties. Resource-poor Japan has traditionally looked to China as a supplier of raw materials while the mainland's bustling coastal regions served as a major overseas market for Japanese exporters. This trade, already substantial during the late 19th century, increased sharply following the Sino-Japanese war of 1895. As a result of its victory, Japan was able to establish a vast network of enterprises in China proper and gained an especially strong foothold in Manchuria. By the 1920s, each country accounted for about one-fourth of the other's global trade. Japan was China's main trading partner and China was Japan's largest partner after the United States. Trade naturally remained high as a consequence of Japan's occupation of the mainland during the 1930s and early 1940s.

2. After World War II, Sino-Japanese economic ties were interrupted by the Communist takeover of the mainland. During the 1950s, Tokyo was committed to a "two Chinas" policy, while Peking was dramatically shifting its economic orientation away from the Pacific Basin and toward other Communist countries, especially the Soviet Union. By 1955, Japan accounted for a mere 3.5% of China's total foreign trade.

3. Following the beginning of Peking's rift with Moscow in the late 1950s, the situation again changed markedly. Within a few years, China sharply curtailed its trade links with Moscow and increasingly looked to Japan as a source of intermediate and capital goods as well as an outlet for its exports. Japan, for its part, seized the opportunity and moved rapidly into the Chinese import market. During the early 1960s, it had regained much of the ground lost during the previous decade.

4. At the same time, Japan expanded its historically close and separate ties with Taiwan. Between 1895 and 1945, the island was a tightly ruled colony of the Japanese Empire, serving as a major raw material supplier to Japan and a highly protected market for Japanese manufactures. Almost all of Taiwan's trade was geared to Japan, and nearly 10% of Japan's trade was with Taiwan during the 1920s and 1930s. Since the early 1950s, Tokyo has cooperated closely with the Chiang Kai-shek regime, and Japan-Taiwan economic relations have remained close. Almost all of Taiwan's raw materials exports continued to go to Japan, and the island vied with South Korea and Hong Kong as Japan's largest export market after the United States. In fact, except for a few years, Japan's trade with Taiwan has topped that with China.

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Emerging Economic Ties

5. By 1965, Japan had regained its former position as China's chief trading partner. Between 1960 and 1965, Japanese sales to the mainland increased ten-fold and a similar gain occurred in Chinese sales to Japan. Trade contacts expanded to include major Japanese businesses as well as the small-scale firms which handled trade in earlier years. Nonetheless, Peking continued to insist that trade be handled through approved Japanese firms which, on the surface at least, subscribed to China's international line. To accommodate Peking, most Japanese trading companies established legally separate dummy firms, and Peking went along with the charade. In addition to this "friendly firm" trade channel, Peking concluded a quasi-official trade pact in 1962 with members of Japan's ruling Liberal Democratic Party. This Memorandum Trade Agreement, which is renegotiated each year, was especially important during the mid-1960s, when it covered up to half of Sino-Japanese trade. It now covers only about 10% of the trade.

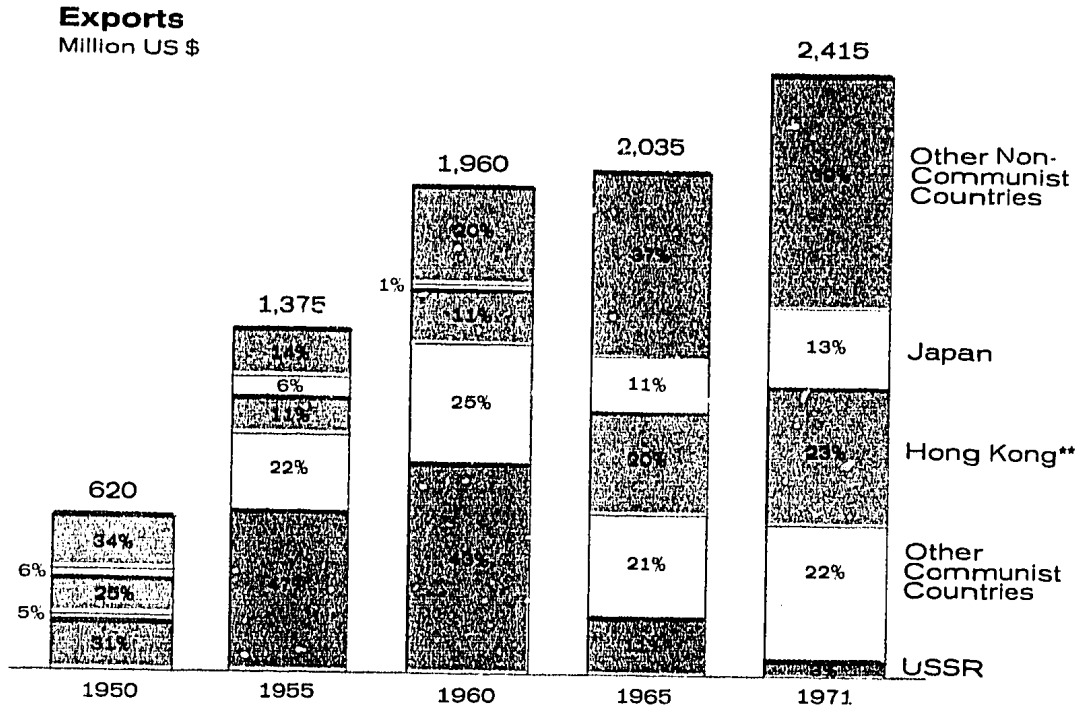
6. Working through these quasi-official channels, the countries continued to expand their trade at a rapid pace. Between 1965 and 1971, Japan doubled its share of the mainland's imports to 27% (see Figure 1). In contrast to earlier years, however, these gains came largely at the expense of non-Communist suppliers such as France, West Germany, and the United Kingdom. Japan's gains throughout the 1960s were particularly impressive given the fact that total Chinese imports hardly changed. Steel and chemical fertilizers led the Japanese export drive: in 1971 they jointly accounted for nearly two-thirds of Japan's exports to China of US \$577 million (see Figure 2). In addition, Japan became China's chief source of foreign technology. Japanese sales included whole plants supplied during the early 1960s for producing such items as vacuum furnaces, vinylon, micrometers, and magnetic tapes.

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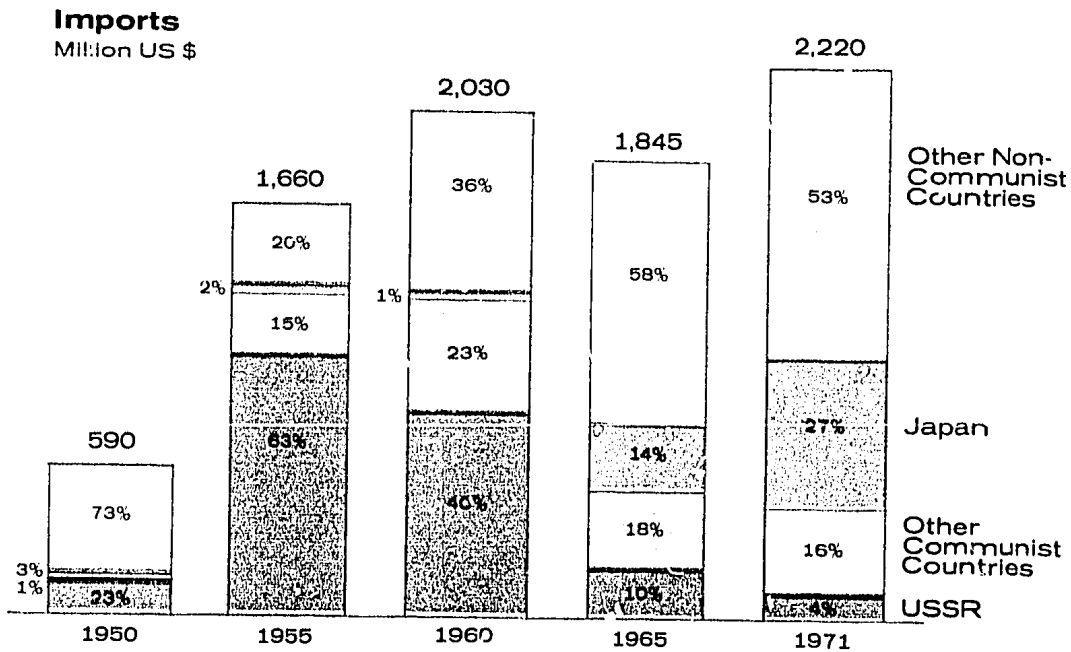
7. From the Japanese point of view, the Chinese market remains relatively small, even though sales to it rose a rapid 15% annually during 1966-71. Japan's overall exports grew even faster -- 19% annually -- and thus the China share declined somewhat. In 1971, exports to China were 2.4% of Japan's total exports (see Figure 3). Nonetheless, with sales highly concentrated in a few items, the China market is very important to several Japanese industries. The prime example is the chemical fertilizer industry, which sells more than 60% of its total exports to China. China also takes almost 10% of Japanese steel exports, ranking second to the United States as Japan's leading overseas market for steel.

Figure 1

People's Republic of China: Direction of Trade*



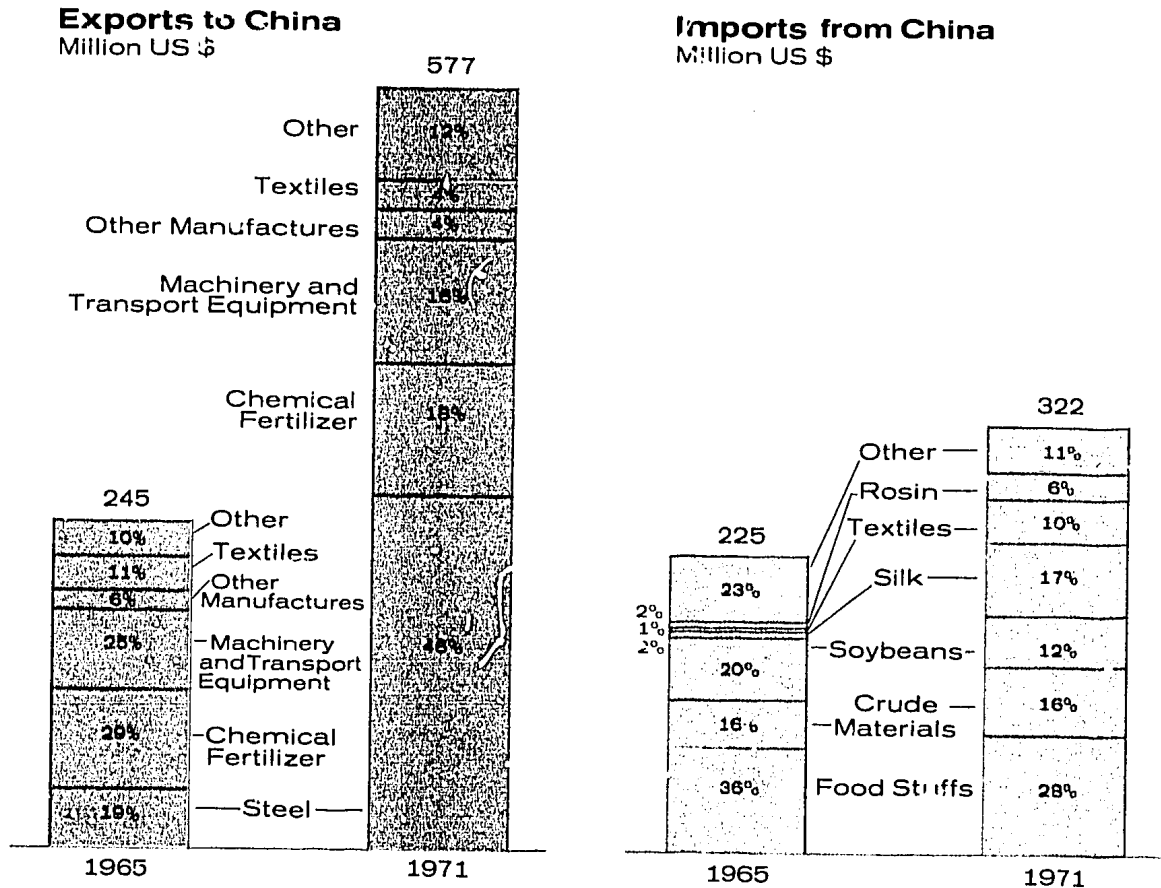
*Based on estimates of Chinese trade statistics.
 **Includes Chinese goods reexported by Hong Kong.



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Figure 2

Japan: Trade with the People's Republic of China, by Commodity*



*Based on Japanese trade statistics.

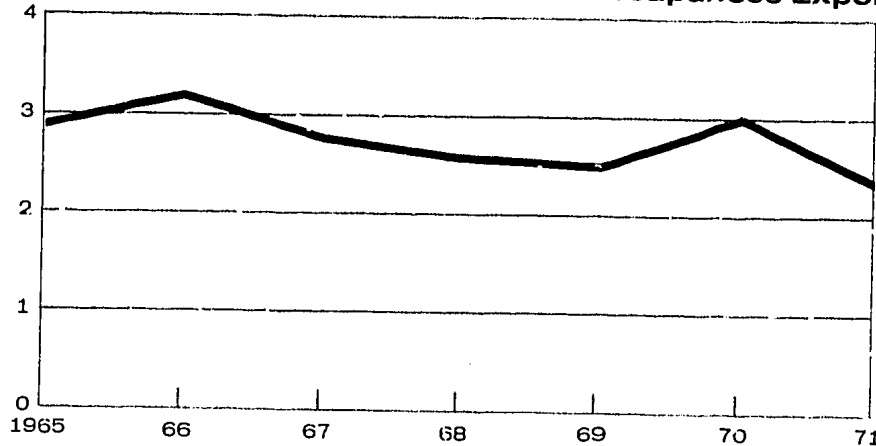
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8. While Japanese exports to China increased rapidly, purchases from it increased only modestly (see Figure 4). By 1971, they amounted to \$322 million, compared with about \$225 million in 1965 or a 6% annual growth rate. This slow growth reflects mainly the fact that Japan is now self-sufficient in rice, which was traditionally China's chief export item to Japan. Partly offsetting the loss of this market, however, have been rapidly growing Chinese exports of other foodstuffs, especially fish products, fruits, and vegetables. Raw silk exports have also increased sharply in recent years as Japan phased out its own production; China is now Japan's largest raw silk supplier after South Korea. Other key exports to the Japanese market include soybeans, rosin, and raw materials such as salt. Although the Chinese

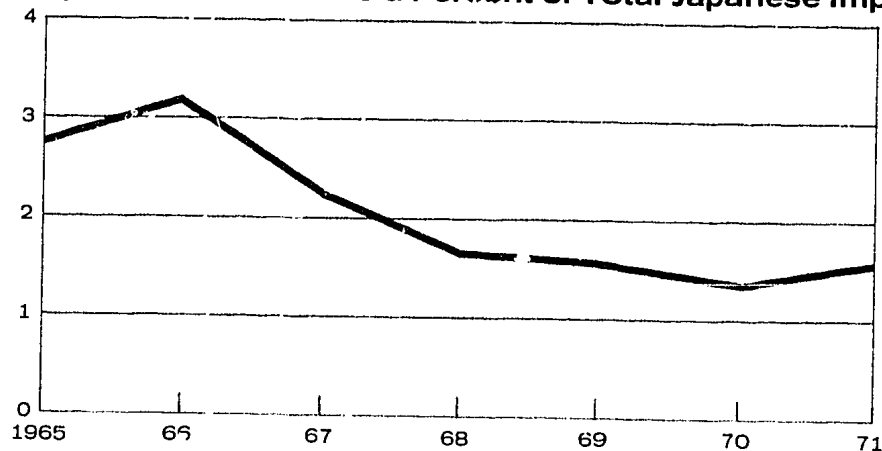
**People's Republic of China:
Share of Japanese Trade***

Figure 3

Exports to China as a Percent of Total Japanese Exports



Imports from China as a Percent of Total Japanese Imports



*Based on Japanese trade statistics.
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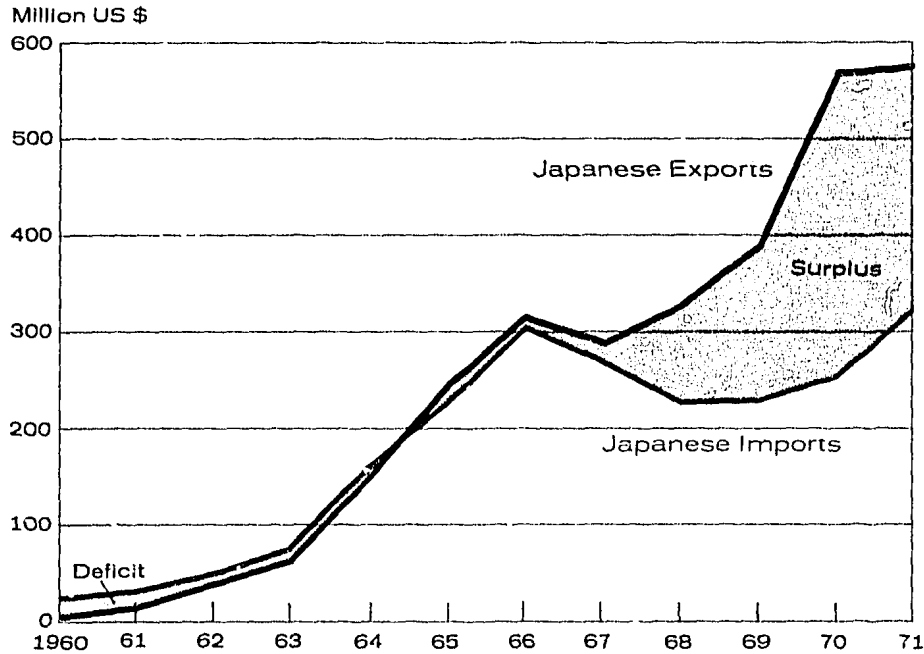
sell some manufactured goods such as textiles, these are generally labor-intensive items that are restricted by Tokyo's import controls.

9. As a result of these trade trends, China's trade deficit with Japan has mushroomed in recent years. In 1965, the deficit stood at \$20 million, and by 1971 it had jumped to some \$255 million. By and large, Peking has financed this imbalance by running surpluses with other major trading

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Figure 4

Japan: Trade with the People's Republic of China*



*Based on Japanese trade statistics.

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partners, especially Hong Kong and Singapore. In fact, China has rarely run an overall trade deficit over the past decade and last year registered a worldwide trade surplus of almost \$200 million.

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Recent Developments

10. Sino-Japanese economic ties have been given further impetus by political developments over the past year. Following the mid-1971 announcement of President Nixon's visit to China, Tokyo felt free to open its own dialogue with Peking, greatly stimulating Japanese economic interest in China. Many Japanese see China as a huge untapped market, and they fear that the recent US trade initiatives will undermine their own position in the Chinese market.

11. In line with this thinking, Japanese business leaders responded quickly to the changing political scene. By mid-1972, most major Japanese

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firms had nominally accepted Chou En-lai's "four principles," which essentially call for limiting economic ties with Taiwan and South Korea. Consequently, these firms are now in a better position to deal with China. At the same time, a steady stream of high-level Japanese business delegations have visited China to discuss expanding trade links. The momentum built up in these talks no doubt accounts for the fact that Sino-Japanese transactions concluded at last spring's Canton Trade Fair amounted to a record \$200 million. Bilateral trade rose 17% during the first half of 1972 over the same period of last year after adjusting for the international currency realignment.

12. Tokyo's new political leaders are encouraging expanded economic ties with Peking. Within a month of coming to power, the Tanaka government approved the first Japanese Export-Import Bank credit for China since 1964 for the purchase of a synthetic vinylon fiber plant. [REDACTED]

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[REDACTED] In addition, Tokyo has initiated negotiations for a commercial air agreement with Peking aimed at making the mainland more accessible to Japanese businessmen. Beyond this, Japan has made clear its interest in negotiating a treaty of commerce and navigation as well as a formal comprehensive trade agreement to replace the present quasi-official Memorandum Trade Agreement.

13. All this activity has heightened Japanese enthusiasm about future trade relations with China. The Japanese feel that they are in a good position to strengthen their hold on the mainland's import market, and Japanese firms are especially optimistic about boosting sales of steel, agricultural and heavy electrical machinery, power generating equipment, and oil drilling equipment. At the same time, they expect exports of such items as ball bearings, chemical fertilizers, and internal combustion engines to grow fairly quickly as China continues its industrialization process. Japanese traders also see China as a potentially important source of needed raw materials such as non-ferrous metals and crude petroleum.

14. Peking, for its part, has clearly indicated its interest in expanding trade and other economic relations with Japan. In recent months, several trade delegations have been sent from China to tour Japanese shipping, petrochemical, and textile facilities, and additional visits are now being planned. Beyond this, Peking has indicated an interest in signing long-term trade agreements covering such items as steel and has suggested a greater willingness to accept trade credits from Japan. [REDACTED]

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Some Implications

15. Encouraged by recent developments, Japanese trade experts are projecting a roughly 15% annual growth in sales to China during the decade with the total reaching \$2.4 billion in 1980. Whether these expectations will be realized is far from certain because the trade expansion will depend in large part on political decisions in Peking. For Japan to achieve this growth rate, either total Chinese imports will have to increase much more rapidly than in the past or Japan's share of the import market will have to become even greater than at present. Peking is reluctant, however, to become once again very heavily dependent on a single supply source, as it did in the 1950s. Also working against Japan's expanding its market share will be increasing competition from US suppliers. In the past, the Japanese were able to sell plants based on US technology, but, with trade channels now opening up, US suppliers will be dealing with the Chinese themselves.

16. Japan will have a better chance of achieving its expectations if overall Chinese imports considerably accelerate. But this would require a change in Peking's policies of economic self-sufficiency and balanced trade. There is no sign of any significant change in either policy at this juncture. We also presently foresee no surge in China's overseas sales which would allow it to purchase much more goods abroad. In fact, the Japanese are having a difficult time identifying Chinese products which might be available in appreciably larger quantities. Traditional agricultural exports, which make up the bulk of overseas sales, are likely to increase, but not at a dramatic pace. Chinese exports of minerals are also not expected to increase much, because of rising domestic needs.

17. The only likely way Japan will be able to maintain its rapid sales to China in the next few years is by a change in Peking's policy against the use of extensive foreign credits. Tokyo is now willing and able to provide these funds, but Peking is still hesitant to become indebted to anyone except for some short-term commercial credits which normally accompany most foreign trade transactions. This attitude may change as China continues to emerge from its years of isolation. Even without radical shifts in Chinese policies, Japan's continued position as Peking's leading trading partner appears assured. More formal economic ties resulting from signing a long-term trade agreement and a treaty of commerce and navigation should help to firm up Japanese access to the China market.

18. Taiwan meanwhile is unlikely to suffer much as a result of improving Sino-Japanese economic relations. Taiwan-Japan trade has continued to increase sharply despite Tokyo's rapprochement with Peking, which has not seriously pressed the Japanese to sever economic ties with Taiwan.

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In any event, the Japanese will seek a low economic profile with respect to Taiwan.

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Taipei undoubtedly will undertake a scathing propaganda attack against Tokyo, after it recognizes Peking, but this is unlikely to disrupt economic relations seriously. Taiwan officials have taken a highly pragmatic view of the China recognition question, understanding that the country's economic prospects are favorable.*

[REDACTED]

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