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## **The Rise of China and Its Effect on Taiwan, Japan, and South Korea: U.S. Policy Choices**

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# The Rise of China and Its Effects on Taiwan, Japan, and South Korea: U.S. Policy Choices

## Summary

The economic rise of China and the growing network of trade and investment relations in northeast Asia are causing major changes in human, economic, political, and military interaction among countries in the region. This is affecting U.S. relations with China, China's relations with its neighbors, the calculus for war across the Taiwan Straits, and the basic interests and policies of China, Japan, Taiwan, and South Korea. These, in turn, affect U.S. strategy in Asia. China, for example, has embarked on a "smile strategy" in which it is attempting to coopt the interests of neighboring countries through trade and investment while putting forth a less threatening military face (to everyone but Taiwan). Under the rubric of the Six-Party Talks, the United States, China, Japan, Russia, and South Korea are cooperating to resolve the North Korean nuclear crisis. Taiwanese businesses have invested an estimated \$70 to \$100 billion in factories in coastal China. China relies on foreign invested enterprises for about half its imports and exports. For Taiwan, Japan, and South Korea, China has displaced the United States as their major trading partner.

China interacts with Taiwan, Japan, and South Korea on four levels: human relations, economic and financial interaction, diplomatic and political intercourse, and military relations. The temperature of relations at each level ranges from cold to hot depending on the type of interaction and country or state being considered. At the human level the temperatures are mixed, at the economic level hot, at the diplomatic level cold for Taiwan to warm for South Korea, and at the military level, temperatures of interaction are cold.

The implications of China's globalization and rise as a major economic power can be seen in its impact both on Beijing and on policy deliberations in Taipei, Tokyo, and Seoul. The Chinese Communist leadership not only is having to cede space in its decision making process to industrial interests but the leaders themselves are coming into power with experience in the transformation of society that comes from development and modernization after opening to the outside world. China now depends on international investment and trade for the economic growth needed to maintain the party's legitimacy. For China's trading partners, dependency on the Chinese market means that Beijing is looming larger in all aspects of policy making. While this is not likely to challenge U.S. security ties with Japan, South Korea, and Taiwan, it raises several policy issues. One is how to deal with a modernizing and more powerful Chinese military financed by the growing Chinese economy. Another is how to explicitly incorporate into U.S. policy the greater weight that Beijing is being given in policy deliberations in Tokyo and Seoul. A further policy issue is whether to take explicit measures to offset the rising economic clout of China and attempts by Beijing to create East Asian institutions with China at the center and the United States pushed to the periphery. A positive result of the mutual trade and financial dependency that has developed in northeast Asia is that all parties now have much to lose by an international military crisis that would interrupt economic and financial flows in the region. All four governments, therefore, seek stability in international relations. This report will be updated as circumstances warrant.

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# The Rise of China and Its Effects on Taiwan, Japan, and South Korea: U.S. Policy Choices

The economic rise of China and the growing network of trade and investment relations in northeast Asia are causing major changes in human, economic, political, and military interaction among countries in the region. This is affecting U.S. relations with China, China's relations with its neighbors, the calculus for war across the Taiwan Straits, and the basic interests and policies of China, Japan, Taiwan, and South Korea. These, in turn, affect U.S. strategy in Asia.<sup>1</sup>

All nations pursue their fundamental interests of security and prosperity within a context of military, political, diplomatic, and economic forces combined with an underpinning of momentum, history, national ethos, and existing relationships. Added to this are the personalities of national leaders and their respective abilities to move their countries in particular directions. Over time, within this ever-changing intersection of forces, friendly nations may turn hostile, or enemies may turn into friends. As the old saying goes, nations have no permanent friends and no permanent enemies, only interests — and these interests can be achieved in a myriad of ways. For the United States, most frequently, instead of discrete discontinuities in relationships, there occurs a steady erosion or accretion in the degree to which these nations support or oppose U.S. policies interspersed by occasional tipping points in which relationships take dramatic turns in one way or another.

Indicators of the shifting ground and complex intersection of interests in northeast Asia are several. The People's Republic of China (PRC) has embarked on a "smile strategy" in which it is attempting to coopt the interests of neighboring countries through trade and investment while putting forth a less threatening military posture (except for Taiwan, toward which it has adopted a dual approach). Under the rubric of the Six-Party Talks, the United States, China, Japan, Russia, and South Korea are cooperating to resolve the North Korean nuclear crisis. China is using its low-cost production base to integrate Taiwan's economy into the PRC. Taiwanese businesses have invested an estimated \$60 to \$100 billion in factories in coastal China. South Korea is exporting more to China than to the United States, while Japan buys more from China than from the United States. Demand from China has played a key role in Japan's economic recovery. Elsewhere in northeast Asia, North and South Korea are cooperating in building the Kaesong special economic zone not far from the heavily fortified 38<sup>th</sup> parallel (demilitarized zone). Tokyo and Seoul are

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<sup>1</sup> The Kearny Alliance Foundation provided research support, and individuals, government organizations, and think tanks in Japan, China, and Taiwan provided information and analysis for this report.

both seeking some rapprochement with Pyongyang and a free trade agreement between their two nations.

The purpose of this report is to examine the rise of China and forces of globalization (the internationalization of markets, politics and legal systems) in an emerging new order in northeast Asia. China is rapidly becoming the economic heavyweight in Asia, and this is having a major effect on the PRC's relationships with Japan, Taiwan, and South Korea. The focus of this report is on the use of "soft power" (as contrasted with "hard" military power) in inducing China, Taiwan, Japan, and South Korea to pursue certain policy paths and how that affects U.S. policy and goals. This report examines trade and investment flows along with increased communication and travel to see how they are altering the basic cost-benefit calculations related to the security of these nations and how Taiwan, Japan, and South Korea are responding to the rise of China. A focus of this report is whether globalization is working to induce northeast Asia nations to behave in ways that promote peace and stability in the region and to ease tensions.

An argument could be made, for example, that for Beijing the potential costs in decreased trade, lower investment inflows, and lost jobs that would occur should it invade Taiwan are rising with each new Taiwanese factory opened. In this case, the economic forces can be seen as stabilizing. The military establishment in both Taiwan and Japan, however, are viewing the growing strength of the Chinese economy and the concomitant military buildup that it has enabled with some alarm. In that sense, globalization and the armaments it has financed has been destabilizing — both Taiwan and Japan have had to adjust their military capabilities to cope with a growing potential Chinese threat. In a larger sense, the lure of the Chinese market for Japanese, Taiwanese, and South Korean exporters tends to provide a stabilizing force as all would lose by a large disruption in trade flows.

For Congress, one question is how to promote and protect U.S. interests while northeast Asia undergoes rapid economic change and the imperatives of the containment of communism fade. The policy choices for northeast Asia include whether to:

- continue current policies of promoting market economies, enabling globalization, and encouraging democracy while projecting sufficient military power to keep the peace in the region;
- seek to contain China along the same lines of the containment of the former Soviet Union;
- actively counterbalance the rising economic influence of China and the trading networks it is building by pursuing free trade agreements and closer investment relations with Japan, South Korea, and Taiwan and by strengthening free trade process under the Asia Pacific Economic Cooperation (APEC) forum;
- bring China's external trade more into balance, ensure that China adheres to its World Trade Organization commitments, reduce the foreign exchange resources available to China's central government,

and slow the “bandwagon effect” by which Japanese, South Korean, and Taiwanese businesses are establishing factories in China with the intention of selling a part of the output in the U.S. market;

- facilitate the globalization of China in order to strengthen forces of change, create centers of power outside of Beijing, and increase representation in Beijing by business and international interests; and
- take into greater account the impact that the rise of China is having on the policies of Japan, South Korea, and Taiwan.

## **China’s Evolving Strategy**

Even before the 9/11 terrorist attacks on the United States, the People’s Republic of China was shifting its strategy with respect to its neighboring countries and Washington away from confrontation and strategic competition toward economic cooperation and a reduction of strategic aggressiveness. Following several crisis points in China’s international relations — including the 1989 Tiananmen Square repression, the 1995 seizure by China of Mischief Reef in the Spratly Islands, the 1995-96 live fire missile exercises in the Taiwan Strait, the 1997-98 allegations of Chinese espionage, the 1999 NATO bombing of the Chinese embassy in Belgrade, and the 2001 U.S. EP-3/Chinese fighter aircraft collision incident — Chinese relations with its northeast Asian neighbors and with the United States have now become fairly calm and constructive.

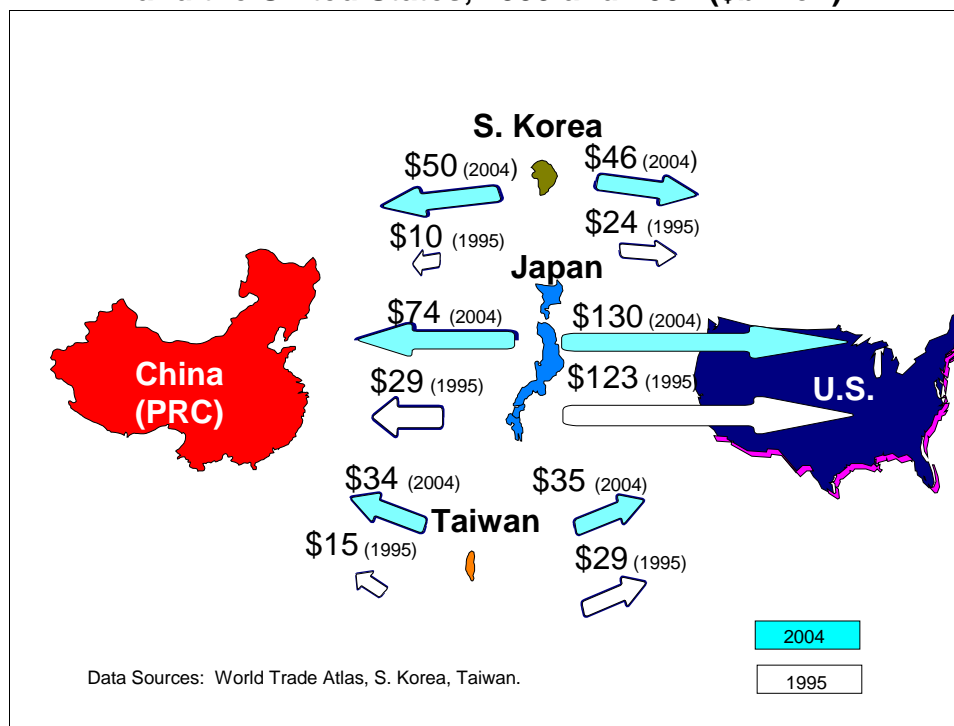
Why China has turned its focus toward its own “peaceful development” rather than blatantly asserting what it considers to be its territorial rights and periodically “poking fingers in the eyes of its neighbors” is a complex question that will be addressed partly below. It seems clear, however, that Beijing has recognized that its attempts to assert sovereignty over disputed islands or the test firing of missiles near Taiwan have proven to be counterproductive. Recent conflicts in Iraq and Afghanistan, moreover, have demonstrated anew that the United States is the premier global power and that the U.S. military holds a large technological lead in the conduct of war. Beijing sees a huge cost to an open conflict with the United States. In the post 9/11 environment, moreover, Beijing has been able to position itself in a way that puts it on the side of Washington in the global antiterrorism campaign — despite Beijing’s concerns over the growing American military presence near the western border of China in Central Asia. Beijing’s leaders also recognize that the legitimacy of their monopoly on government rests primarily on their ability to deliver a rising standard of living to their people. This not only requires continued economic growth but stability in the region and undisturbed flows of capital and goods between China and the rest of the world.

## **Globalization and the Rise of China**

The economic rise of China has generated a reorientation of international trade patterns in Northeast Asia. For Japan, South Korea, and Taiwan, China has

surpassed the United States as their number one trading partner. As shown in **Figure 1**, in 1995, South Korea exported more than twice as much to the United States as it did to China (\$24 billion vs. \$10 billion). By 2004, South Korea was exporting \$50 billion to China but \$46 billion to the United States.<sup>2</sup> Japan still exports more to the United States than to China, but the trend is moving toward China. In 1995, Japan exported over three times more to the United States than to China (\$123 billion vs \$29 billion), but by 2004, exports to the American market had risen to \$130 billion while those to China had risen to \$74 billion. With Taiwan, the story is similar. In 1995, Taiwan<sup>3</sup> exported twice as much to the U.S. market as it did to the PRC (\$29 billion vs \$15 billion). By 2004, Taiwan was exporting \$35 billion to the United States and \$34 billion to China. (Unlike Japan when it was industrializing, China is a major importer.)

**Figure 1. Exports by South Korea, Japan, and Taiwan to China and the United States, 1995 and 2004 (\$billion)**



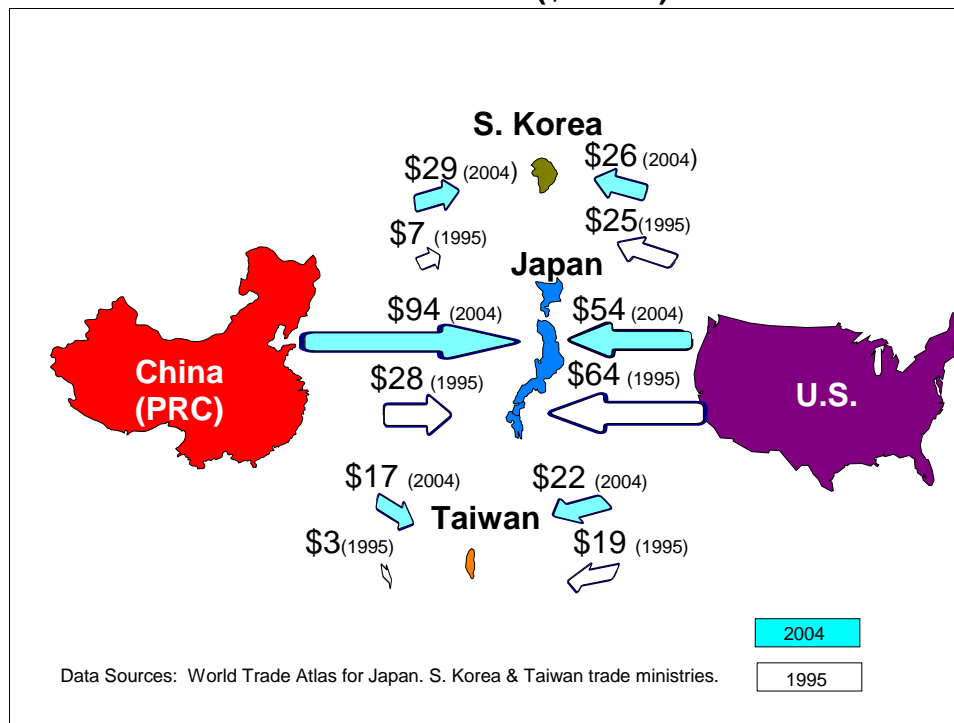
The situation with respect to China's exports to South Korea, Japan, and Taiwan is similar. As shown in **Figure 2**, China's exports to Japan more than tripled between 1995 and 2004 and at \$94 billion now exceed the \$54 billion in U.S. exports to Japan. The United States still exports more to Taiwan (\$22 billion) than does the PRC, but China's exports there have quintupled to \$17 billion in 2004 from \$3 billion in 1995. Likewise, China's exports to South Korea have quadrupled since

<sup>2</sup> For more information, see CRS Report RL30566, *South Korea-U.S. Economic Relations: Cooperation, Friction, and Future Prospects*, by (name redacted).

<sup>3</sup> Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu also called Chinese Taipei.

1995 and at \$29 billion exceed those from the United States (\$26 billion) — barely up from the \$25 billion in 1995. The pattern of exports from China and the United States to South Korea, Japan, and Taiwan replicate the import trends — China is rising while the United States is static as a source of supply for these markets.

**Figure 2. PRC and U.S. Exports to South Korea, Japan, and Taiwan  
1995 and 2004 (\$billion)**



These shifts in trade flows away from the United States indicate that dependency relationships also are turning toward China. Not only are Japan, Taiwan, and South Korea becoming more dependent on China, but China also is becoming more dependent on these economies for imports and exports. Many of the imports into China, moreover, are intermediate products and capital goods that are vital to China's industrial sector and economic growth and enable China to export to the U.S. and other markets. Exports to China, moreover, are important sources of aggregate demand for countries such as Japan — a nation that has been in and out of recession since 1992.

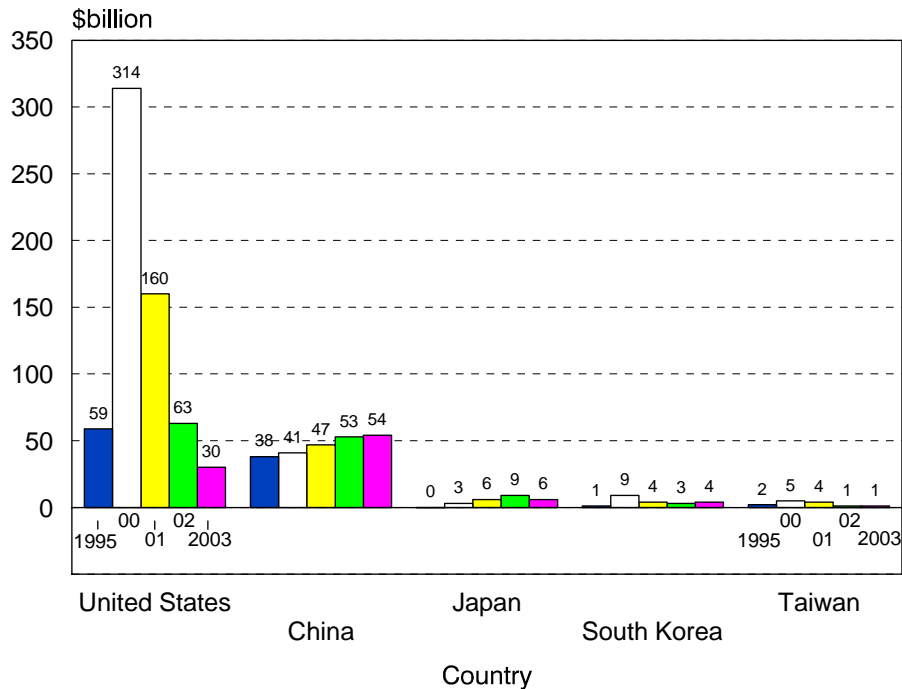
Another indicator of the shifting positions of the United States and China can be seen in foreign direct investment — FDI or long-term investment in controlling shares of companies. This is investment in companies that provide goods and services in which the foreign investor controls 10% or more of the shares. Looking first at the aggregate flows from all sources, **Figure 3** indicates that while the United States is still the preferred destination for foreign direct investment, the trend is turning toward China. In 2003, China received \$54 billion in FDI while the United States received \$30 billion. Both the United States and China swamp Japan, South



Korea, and Taiwan as destinations for FDI. The United States, however, is also a major provider of FDI. In 2003, Americans invested \$152 billion abroad while China invested \$2 billion in FDI. In addition, since the United States has long been a favored destination for foreign investors, its cumulative stock of inward FDI as of 2003 was three times that of China (\$1,554 billion vs \$501 billion).

These aggregate FDI inflows into China play a geopolitical role in that they raise the cost of instability both within the PRC and between the PRC and its neighbors, particularly Taiwan. More important than the total inflows from the world, however, are the flows to China from its neighboring economies. Of the \$53.5 billion realized foreign direct investment in 2003, \$5.1 billion came from Japan, \$4.5 billion from South Korea, and \$3.4 billion from Taiwan. China's largest investor, however, was Hong Kong with \$17.7 billion (some of this was actually Chinese money which "round tripped" in order to take advantage of incentives that favor foreign investments). The U.S. total of \$4.2 billion was slightly less than South Korea's \$4.5 billion but more than Taiwan's \$3.4 billion. The general trend of foreign direct investment within northeast Asia has been for it to increase or remain at a fairly substantial level. The United States is maintaining its rate of direct investment in China, but that level is just on a par with that of South Korea.

**Figure 3. Foreign Direct Investment Inflows into the United States, China, Japan, South Korea, and Taiwan, 1995, 2000-03**



Data Source: UNCTAD, Foreign Direct Investment Database

For Japan, China accounted for \$3.1 billion or 8.6% of its total \$36.1 billion in direct foreign investment in 2003. Japan still invests more than three times as much in the U.S. market (\$10.6 billion in 2003) as it does in China, but the trend is striking.

Between 1999 and 2003, Japan's foreign direct investment in the United States dropped by 52%, while its FDI in China rose by 314%.<sup>4</sup>

Other types of foreign investment are less significant in China than in countries with more developed capital markets. In 2003, foreigners put a total of \$2.64 billion in non-FDI investments in China (data are not available by country). This included \$0.27 billion in non-controlling shares, \$0.13 billion in leasing, \$0.01 billion in compensation trade, and \$2.23 billion in processing and assembly.<sup>5</sup>

In bank borrowing, as of June 2005, China had a total of \$98.6 billion (up from \$78.5 billion in June 2004) loans outstanding from various sources. Of these, Japanese banks accounted for \$17.4 billion — the largest source except for European banks who had \$45.2 billion in claims on China. U.S. banks had \$11.2 billion in loans to China (up from \$6.9 billion in June 2005). Other large northeast Asian borrowers from Japan include South Korea with \$17.0 billion and Taiwan with \$5.7 billion.<sup>6</sup>

In northeast Asia, therefore, a network of economic interdependence is developing in which China, Japan, South Korea, and Taiwan have strong vested interests in the smooth and continuous operation of the system. Economic integration there is not as extensive as that in the European Union or under the North American Free Trade Area (NAFTA), but it is developing rapidly. Not only are these economies trading more extensively with each other, but their production processes are becoming vertically integrated. China acts as the manufacturing platform while neighboring countries provide investment capital, finance, technology, management skills, and expertise.

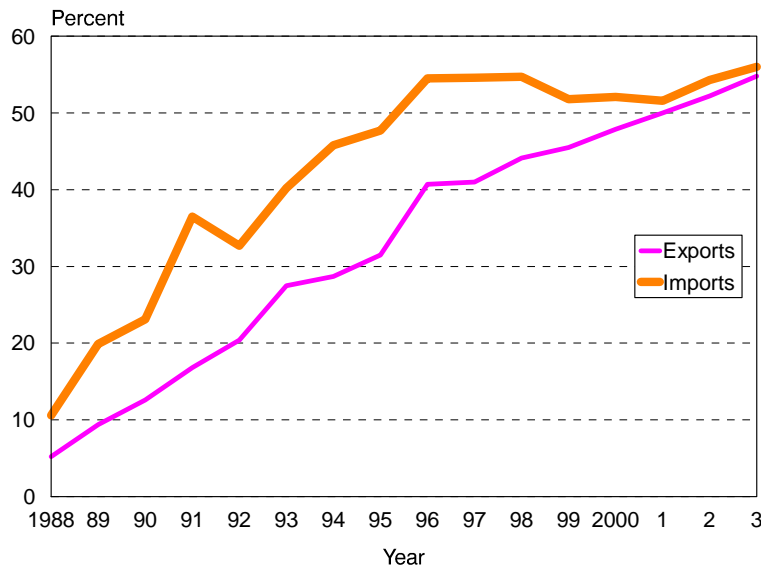
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<sup>4</sup> Japan. Ministry of Finance. Outward Direct Investment. Percentages based on yen figures (for the U.S.: ¥2,500.2 billion in 1999 to ¥1,195.5 billion in 2003; for China ¥85.8 billion in 1995 to ¥355.3 billion in 2003). [<http://www.mof.go.jp/english/e1c008.htm>]

<sup>5</sup> China Data Online. Yearly Macro-economy Statistics. Actually Used Foreign Investment. [<http://141.211.136.211/eng/default.asp>]

<sup>6</sup> Bank for International Settlements. *Consolidated Banking Statistics for Second Quarter of 2004*. October 2004.

**Figure 4. Percent of China's Exports and Imports Accounted for by Foreign Funded Enterprises in China, 1988-2003**



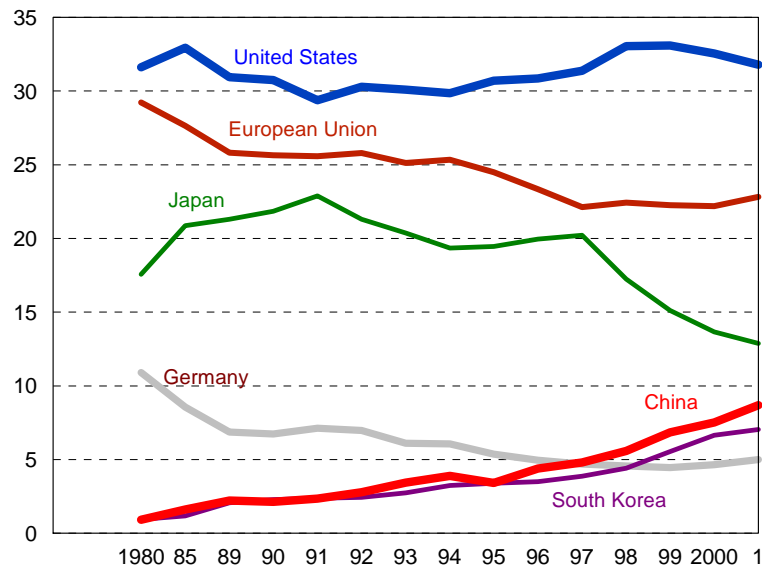
Source: Data from China Statistical Yearbook and China Customs Statistics.

Perhaps more important than the amounts of trade flows and foreign direct investment and loans flowing into China are the economic ramifications of that investment. Currently, more than half of China's exports and imports originate from foreign affiliated enterprises located in its economy. In 2003, as shown in **Figure 4** above, 55% of China's exports and 56% of its imports were accounted for by foreign funded enterprises. Among provinces and metropolitan areas, Guangdong, Jiangsu, Shanghai, and Fujian were particularly significant. All these are coastal areas with a large foreign presence.

China's level of technology also has benefitted greatly from foreign investment and imports of machinery and equipment. Although recent data are not available, China's global market share of high-technology products (aerospace, pharmaceuticals, computers and office machinery, communication equipment, and scientific instruments) has risen from less than 1% in 1980 to 8.7% in 2001 (see **Figure 5**). This was considerably less than the 32% for the United States, but exceeded that of Germany or South Korea.<sup>7</sup>

<sup>7</sup> National Science Board, *Science and Engineering Indicators, 2004*. Figure O-31.

**Figure 5. Global High Technology Market Shares 1980-2001**



Source: National Science Board, *Science and Engineering Indicators*, 2004.

Meanwhile, China is using the allure of its rapidly developing economy and trade relations to create a regional economic sphere revolving around China and with industries vertically integrated across countries. The major first thrust has been with the Association of South East Asian Nations<sup>8</sup> (ASEAN). China and ASEAN agreed in 2002 to negotiate an ASEAN-China free trade agreement (ASEAN + 1) to be implemented between China and the six industrialized ASEAN countries by 2010 and the rest by 2015. ASEAN also is considering the possibility of expanding this to an East Asia Free Trade Area (EAFTA or ASEAN + 3) that also would include Japan and South Korea.<sup>9</sup> Japan and South Korea also are discussing a free trade agreement between them,<sup>10</sup> and Taiwan has sought closer ties with Japan and South Korea. Taiwan is clearly concerned over what it calls the bandwagon effect — countries in the region “jumping on the bandwagon” to cement trade ties with China.

East Asian countries also are joining forces to protect their currencies and avoid a repeat of the 1997-99 Asian financial crisis. In May 2000, finance ministers from ASEAN plus China, Japan, and South Korea established the first regional financing arrangement in East Asia. Called the Chiang Mai Initiative, this consists of bilateral currency swap arrangements — mainly from Japan, China, and South Korea to other

<sup>8</sup> Established on August 8, 1967, ASEAN members include Indonesia, Malaysia, Philippines, Singapore, and Thailand (the five original members), as well as Brunei Darussalam (joined in 1984), Vietnam (1995), Laos and Burma/Myanmar (1997), and Cambodia (1999).

<sup>9</sup> Association of Southeast Asian Nations. Chairman’s Statement of the 8<sup>th</sup> ASEAN + 3 Summit, Vientiane, November 29, 2004.

<sup>10</sup> Japan has an Economic Partnership Agreement (a limited FTA) with Singapore and Mexico and is negotiating EPAs with the Philippines, Thailand, and Malaysia.

participating nations — during financial crises.<sup>11</sup> Another regional financial arrangement is the Asia Bond Fund. Announced on June 2, 2003, the fund began with \$1 billion in contributions from 11 central banks from the more developed countries of ASEAN plus Japan, China, South Korea, and Australia. Seven additional contributing countries (including India) have joined the fund. The fund is to invest in sovereign and quasi-sovereign bonds issued by Asian governments in international markets. Initially restricted to investments by central banks, in the second phase, the fund is to be opened to private investors (such as insurance companies and pension funds). The intention is to create greater liquidity, less reliance on dollar-denominated financial assets, deeper regional capital markets, and more stability in the Asian financial markets.<sup>12</sup> These financial arrangements are evidence of nascent cooperation and institution building among East Asian nations — with both Japan and China playing major roles.

Within China, moreover, economic success is affecting decision making and policies in the ranks of the Chinese Communist Party (CCP). The CCP is including more of China's business and other interests both in its membership and policies. An estimated 30% of China's entrepreneurs (several million) are now members of the CCP.<sup>13</sup> These entrepreneurs are not poor peasants; many are the business elite. In addition, numerous party members have, themselves, become involved in businesses or have strong business interests. China may still be a one-party state, but that one party is gradually recognizing that it must reflect the interests of the people — including those with business and economic interests — if it intends to remain in power.<sup>14</sup>

A further effect of the rapid development of China's economy is its growing appetite for raw materials and energy and other accouterments of modern life. In the market for petroleum, for example, China's demand already has reached 6.7 million barrels per day, and in 2020 is expected to climb to 12.0 million barrels per day or about 11 percent of world consumption.<sup>15</sup> Similar increases are occurring in Chinese demand for steel, gold, natural gas, and other commodities. This is pushing up world prices for these items.

One note of caution is that several negative factors are rising in China that could push the country into economic chaos or recession. While economic projections by econometric forecasting firms (such as Global Insight) foresee continued economic

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<sup>11</sup> Asian Development Bank. Progress and Institutional Arrangements for the Chiang Mai Initiative. October 6, 2003.

<sup>12</sup> Hong Kong Monetary Authority. The Asian Bond Fund. TDC Trade, Economic Forum [<http://www.tdctrade.com/econforum/hkma/hkma030603.htm>].

<sup>13</sup> Kennedy, Scott. Divining China's Future. *World Policy Journal*, Vol. XXI, Winter 2004/05, p. 83.

<sup>14</sup> The Three Represents — CPC's New Thinking. China Daily (Internet edition), December 2, 2003. Li, Cheng. China's Northeast: From Largest Rust Belt to Fourth Economic Engine? *China Leadership Monitor*, Winter 2004, No.9.

<sup>15</sup> Global Insight, Inc. *Global Petroleum Outlook*, Winter 2004-05.

growth in China at around 7 or 8% for the medium term,<sup>16</sup> China could encounter a political or security crisis (e.g., over Taiwan independence), a banking crisis, internal unrest, or just a hard landing from its rapid rates of economic expansion that could derail the optimistic projections that are the conventional wisdom of most China watchers.

## Bilateral Relationships in Northeast Asia

### Beijing-Taipei

In no area is the mix of economics and security more intertwined than across the Taiwan Strait. China's strategy has been to maintain a truculent position against Taiwan independence with credible threats of military action against what Beijing considers to be a "renegade province" should Taiwan attempt to make its *de facto* quasi-independent status into one more *de jure*. China has backed up its rhetoric by deploying an estimated 600 missiles that can be aimed at Taiwan along the south China coast and augmenting its ability to launch naval attacks. On the other hand, the PRC has encouraged Taiwan businesses to invest in the PRC in the hope that the increasing economic and financial interdependence would ameliorate the political forces for independence. In a white paper, Beijing said that with respect to Taiwan, "doors have been flung open to facilitate the flow of goods and people. Businessmen from Taiwan are welcome to invest or trade on the mainland. They are accorded preferential treatment and legal safeguards."<sup>17</sup>

By creating a dependency by Taiwan's businesses on Chinese workers, subsidiaries, sources of supply, and markets, China has sought to win the "hearts and minds" of Taiwanese business interests. In the process, however, China also has created its own dependency on Taiwanese businesses — particularly in information technology industries — for advanced technology, manufacturing methods, and export channels.

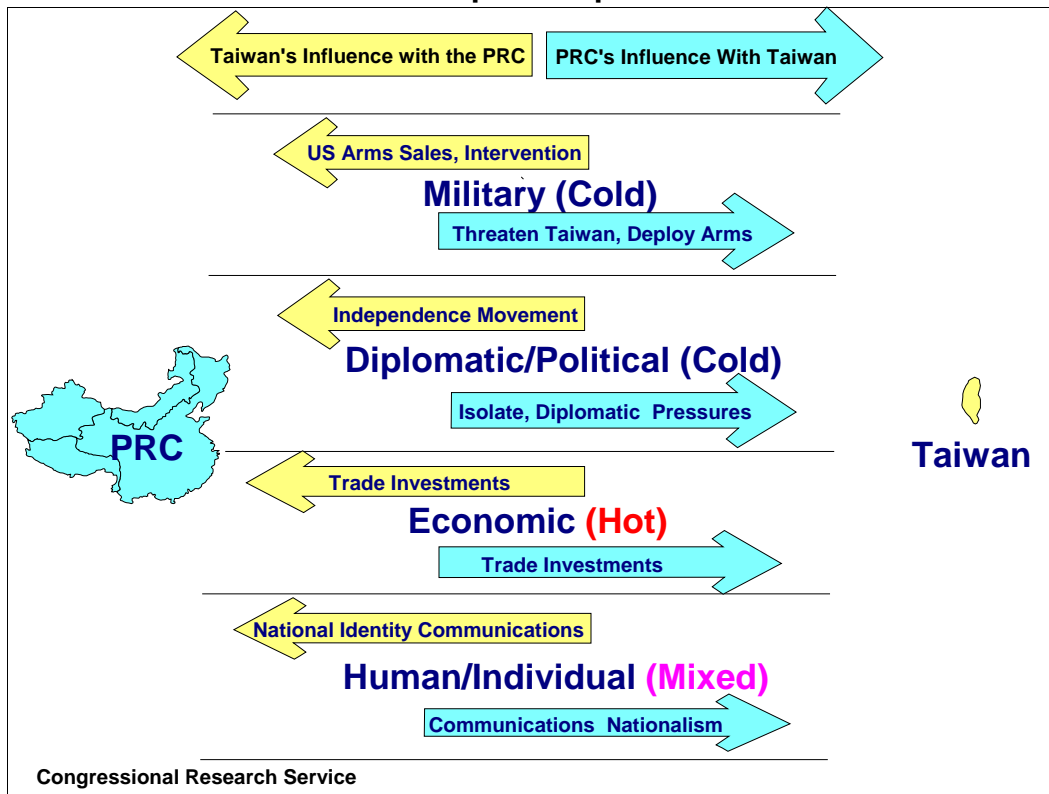
Cross-Strait relations occur at various levels. As shown in **Figure 6**, the strata of interaction between the PRC and Taiwan begin at the human or individual level and increase in the degree of institutionalization through economic interaction, diplomatic/political, and finally military. All cross-strait interaction takes place in a context of clashing attitudes that includes a rising sense of a separate national identity in Taiwan and a strong sense of territorial integrity and sovereignty in the PRC.

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<sup>16</sup> Global Insight. China — Summary of Detailed forecast.

<sup>17</sup> Peoples Republic of China. The Taiwan Question and Reunification of China, White Paper On Taiwan Issue, April 16, 2001. On Internet at [<http://english1.chinataiwan.org/web/webportal/W2037416/A2054766.html>]

**Figure 6. Temperature, Strata of Interaction, and Influence in Relations Between the People's Republic of China and Taiwan**



Human and individual interaction tends to be the least institutionalized and entails little government action (except to allow it). It includes direct human interaction, communication, development of attitudes (particularly nationalism and national identity), media, Internet, and family ties. Some indicators of the extent of human interaction across the Taiwan Strait are that in recent years around 13 million Taiwanese have visited the PRC and more than 250,000 people from the PRC have visited Taiwan.<sup>18</sup> In January 2003, the first charter flights flew between Shanghai and Taipei via Hong Kong to take Taiwanese business people home for the New Year holidays.<sup>19</sup> Flights were renewed for the spring festival in 2005. The interaction also includes more than 210,000 marriages — mainly between Taiwanese businessmen and Chinese women — with 90,000 PRC spouses now living in Taiwan.<sup>20</sup> This coincides with a multitude of other person-to-person contacts, reunions of relatives, communication, and entertainment.

At this level, the temperature of interaction is mixed. For communications, travel, and family ties, it is warm, while in terms of nationalism, the movement in

<sup>18</sup> CRS Issue Brief IB98034, *Taiwan: Recent Developments and U.S. Policy Choices*, by Kerry B. Dumbaugh.

<sup>19</sup> Lin, Miao-Jung. First Charter Flight to Land This Morning. *Taipei Times*, January 26, 2003, p. 1.

<sup>20</sup> Taiwan. Mainland Affairs Council. Press Release No. 55, August 20, 2004.

Taiwan toward a national identity separate from that of China and in attitudes toward each other, the temperature is cool. Human and individual interaction affects government policy on each side only as it is transmitted upward and institutionalized. Conventional wisdom holds that the more democratic and representative a government, the more influence such interaction is likely to have on national policy. Popular pressures on Taipei, therefore, may be relatively stronger than those on Beijing. But even decision makers in Beijing and elsewhere in China are experiencing increasing constraint from public sentiments. Also for Beijing, the widespread and strong attitudes toward territorial integrity and sovereignty place further constraints on the shape any resolution the Taiwan problem can take.

Human interaction often occurs within the context of the next higher stratum: economic and financial interaction. Economic and financial interests drive engagement at this level. The temperature of this type of interaction is very warm — even hot — with contacts extensive and growing. While governments determine the extent to which their economies are open to foreign trade and investments, businesses and individuals usually conduct actual transactions independently of government action. In economics and trade, both Taiwan and the PRC hold strong leverage over the other. The two economies complement each other and depend on each other for financing, technology, labor, and manufacturing expertise. Taiwanese businesses have invested between \$70 billion and \$100 billion in the PRC — about half of all Taiwanese overseas investment. About a million Taiwanese businessmen and their families reside in China — some 400,000 in the Shanghai area alone. China has not been as free to invest in Taiwan, but even that is gradually opening up. As the host of Taiwanese investment and because of the mutual dependency that has developed, Beijing holds Taiwanese businesses in a situation somewhat akin to a “hostage.” In case of hostilities, Taiwanese businesses cannot just pull up stakes and go home. Taiwan, however, also has leverage over Beijing. Without Taiwanese expertise, China would have a difficult time developing certain of its high technology industries.

This mutual dependency is readily apparent in the information technology (IT) sector. Taiwanese companies have invested heavily in manufacturing facilities in the Pearl River Delta adjoining Hong Kong and, more recently, in Shanghai. In 2003, 60% of Taiwan’s IT hardware was made in the PRC. Taiwanese-invested companies in the PRC produced more than 70% of the electronics made there.<sup>21</sup> The United States, China, and Taiwan increasingly are becoming an integrated market for semiconductor manufacturing and consumption. Both the United States and Taiwan keep their highest levels of technology at home, but China has become a major manufacturing platform for quite sophisticated computer chips. In semiconductor wafer foundries, for example, as of December 2004, eight of the nine major Chinese companies were able to manufacture 8-inch wafers. Two were making the latest generation of 12-inch wafers. Their sources of technology were Taiwanese (Taiwan Semiconductor Manufacturing Co., United Microelectronics), European (Philips,

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<sup>21</sup> Chase, Michael S., Kevin L. Pollpeter, and James C. Mulvenon. *Shanghai'd? The Economic and Political Implications of the Flow of Information Technology and Investment Across the Taiwan Strait*. Rand Technical Report, July 2004. P. xiii, xvii.



Alcatel), and Japanese (Oki, Sanyo, NEC, Fujitsu).<sup>22</sup> Taiwan also has allowed its companies to transfer production of notebook computers to China. China and Taiwan together dominate production of motherboards (72% global market share), graphic cards (77%), PC notebook computers (62%), flat panel monitors (67%), and are major producers of optical disk drives (41%), cellular phones (33%), ink-jet printers (53%), and PC desktop computers (23% of the global market) with most of each share being produced in China.<sup>23</sup>

For years, both sides restricted interaction, particularly any that involved the transfer of high-level technology. As China has liberalized its trade and capital markets, however, strong business pressures have developed in Taipei to do the same. For example, in 2002, after extensive lobbying by major Taiwanese semiconductor companies, the government in Taipei relaxed its ban on investments in semiconductor facilities in the PRC. Business also have asked Taipei to permit Chinese nationals to work for high-technology companies in Taiwan (which had been prohibited).<sup>24</sup> In January 2001, the two sides established the “three mini-links” which permitted direct transportation, commerce, and postal exchanges between two Taiwan-controlled islands and their coastal Chinese neighbors. In October 2001, Taipei announced new visa procedures that make entry and working in Taiwan easier for PRC professionals. Other events in cross-strait relations have included the decision by oil companies in the PRC and Taiwan to explore jointly offshore areas for oil and Taiwan’s opening to third-country and selected PRC and Taiwanese ships to carry cargo to and from designated ports in Taiwan and in the PRC<sup>25</sup> In 2001, Taipei replaced its “be patient” policy for dealing with two-way flows with China with one of “active opening with effective management.”

As shown in **Figures 1 and 2**, trade between the PRC and Taiwan has been growing rapidly. China is now Taiwan’s largest export market, and Taiwan runs a trade surplus with the PRC of about \$25 billion. Because of goods flowing through Hong Kong, each side reports different numbers, but both indicate a rapidly rising trend. Both imports and exports have increased dramatically. Taiwan’s imports from the PRC have risen from \$3 billion in 1995 to \$16.7 billion in 2004. Over the same period, China reported that imports from Taiwan rose from \$15 billion to \$64.7 billion, while Taiwan reported a comparable rise of exports to China of \$0.4 billion in 1995 to \$34.0 billion in 2004. Since joining the World Trade Organization,

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<sup>22</sup> Nomura Securities, IEK/ITRI (November, 2004) cited by Eric Chen, Sunplus, Design Session, From a Fabless Perspective, Taiwan/China Semiconductor Industry Outlook, 2004, December 7, 2004, San Jose, California.

<sup>23</sup> Dataquest as cited by Walden Rhines in “Driving Semiconductor Industry Optimization from U.S.-Taiwan-China Relationships. Paper presented at the Taiwan/China Semiconductor Industry Outlook, 2004, December 7, 2004, San Jose, California.

<sup>24</sup> *Ibid.*

<sup>25</sup> CRS Issue Brief IB98034. *Taiwan: Recent Developments and U.S. Policy Choices*, by (name redacted).

Taiwan increased the items allowed to be imported from China from about 2,000 to over 8,500 (78% of total items produced) in 2004.<sup>26</sup>

The extent of Taiwan's rising integration and dependency on the PRC economy has been a cause of great concern in Taipei. The government there has attempted to diversify investments away from China with a "go-south" policy (invest in and trade with Southeast Asia instead of China), but the allure of the PRC with its low-cost labor, common language, and economic incentives continues to draw in businesses. Taipei cautions its businesses about the risks of investing in the PRC, but only intervenes to keep the latest technology from migrating there.<sup>27</sup>

At the diplomatic and political level, cross-strait relations have been cold (frigid). Beijing is using its rising economic and political clout as leverage in furthering its diplomatic agenda. China has held the upper hand in barring Taiwan from membership in most major international organizations (Taiwan's accession to the World Trade Organization was as a separate customs territory) and from receiving diplomatic recognition from the major countries of the world. The PRC has been particularly aggressive and uncompromising, even going so far as blocking Taiwan from receiving unofficial observer status in the World Health Organization and preventing the president of Taiwan from attending the annual meetings of the leaders of the 21 member states at the Asia Pacific Economic Cooperation forum. China's diplomats also are taking the lead in regional meetings, and China's economic clout is inducing countries that previously recognized Taiwan to shift their diplomacy toward Beijing.<sup>28</sup> Taiwan, on the other hand, has also been pressing for more room to maneuver on both the diplomatic and political levels. President Chen Shui-ban has emphasized that Taiwan is a sovereign state and should not be downgraded, marginalized, or treated as a local government.<sup>29</sup>

Overhanging the diplomatic and political level of interaction is the constant threat of military action as a deterrent, coercive force, and other means to forcibly accomplish what peaceful methods may not achieve. Partly in response to what Beijing views as Taiwan's inching toward independence, in March 2005, China enacted an Anti-secession Law codifying the use of force against Taiwan should it move toward formal independence.<sup>30</sup> At the military level, therefore, cross-strait relations are cold. The Pentagon reports that after close to 20 years of spectacular economic growth in China, Beijing's diplomatic successes, and steady improvement

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<sup>26</sup> Interview at the Mainland Affairs Council, Taipei, January 30, 2005.

<sup>27</sup> Taiwan's Ministry of Economic Affairs reviews investments in China valued at greater than \$20 million. If less than \$20 million, there is simplified screening only. Taiwan prohibits investments in China for infrastructure construction and high technology.

<sup>28</sup> Norton, Michael. China Wooing Caribbean Away From Taiwan. *The Washington Post*, February 27, 2005. pg. A.22. Edward Cody. China's Quiet Rise Casts Wide Shadow; East Asian Nations Cash In on Growth, *The Washington Post*, February 26, 2005. P. A1.

<sup>29</sup> President Chen's remarks of August 3, 2002, at the 29th Annual Meeting of the World Federation of Taiwanese Associations.

<sup>30</sup> Pan, Philip P. China Puts Threat to Taiwan Into Law; Move Could Reverse Recent Warming in Cross-Strait Relations. *Washington Post*, March 14, 2005. P. A1.

in China's military capabilities, the cross-Strait balance of power is steadily shifting in Beijing's favor.<sup>31</sup> For Taipei, the strategy is to maintain "effective deterrence" through "resolute defense" and to avoid having the military balance tip toward Beijing.<sup>32</sup> Taiwan's Ministry of National Defense, in its biennial defense report, places the possibility of a direct attack by the PRC across the sea as low, but warns of the PRC military buildup and the likelihood that an imbalance in the PRC's favor may induce Beijing to attempt to resolve the Taiwan issue through military means.<sup>33</sup>

The critical deterrence factor against military action has always been the weight of war damage and possible intervention by the United States. These factors still are preeminent, but the diplomatic, political, economic, and human costs of open hostilities have reached a level far beyond that of years past when China was more isolated and less interconnected with the rest of the world.

Some in Beijing have indicated that they would fight to retain Taiwan regardless of cost. In December 2003, a leading Chinese military strategist warned that a decision to attack Taiwan would not be affected by concerns about China's economic development and that Beijing was not concerned that foreign investment might drop or that an attack would set back its development by several years.<sup>34</sup> China's 2004 report on national defense states that Taiwan's independence movement is the greatest threat to China's sovereignty and is something that must be stopped "at any cost."<sup>35</sup> These references to the cost of open conflict with Taiwan seem to reflect the growing tension within China between the military and business and international trading sectors. A Chinese observer in a think tank in Shanghai, moreover, cautions that even though economic and financial ties are having a positive effect on security ties, in reality, the effect still is small. Right now it is more "hope than reality."<sup>36</sup>

The fact that China has not resorted to force to achieve one of its major national goals, however, indicates that Beijing currently can ill afford overt hostilities. The military deterrent, of course, is always in play, but as seen from the Taiwan side, other considerations are causing stability in the cross strait relationship to continue. First, the Chinese need stability to continue economic development, attract investment and deal with the challenges of WTO accession as well as with domestic problems such as unemployment and the urban-rural divide. Second, the

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<sup>31</sup> U.S. Department of Defense, FY2004 Report to Congress on PRC Military Power, *Annual Report on The Military Power of the People's Republic of China*, May 28, 2004. p. 46.

<sup>32</sup> Republic of China. Ministry of National Defense. *Statement of Policy for the MND*, November 17, 2004. Note: Taiwan's foot-dragging on purchases of arms from the United States is a sore point in U.S.-Taiwan relations. Taiwan still has not provided funding for weapons approved for purchase in 2001.

<sup>33</sup> MND Issues New Defense White Paper. *Taiwan Update*, December 23, 2004, Vol. V, No. 13. P. 5.

<sup>34</sup> Pomfret, John. China's Military Warns Taiwan. *The Washington Post*, December 4, 2003. p. A25.

<sup>35</sup> People's Republic of China. *China's National Defense in 2004*, December 27, 2004. Chapter II.

<sup>36</sup> Interview at the Pudong Institute on the U.S. Economy in Shanghai, January 28, 2005.

international business community also wants stability in the region for business reasons — a message they have conveyed to both Beijing and Taipei. A third reason is that Taiwan also needs stability to conduct its own internal political and economic reforms.<sup>37</sup> Hence, neither side is opting for overt hostilities.

The Taiwan side points out, however, that whether the growing economic interdependence across the strait combined with other deterrent forces leads to stability or instability depends on whether Beijing's decision makers are rational or irrational. If they are rational (as viewed by Taiwan), a cost-benefit analysis would likely overrule an unprovoked military action against Taiwan. If they are irrational (as viewed by Taiwan), however, anything can happen. History has shown that in campaigns, such as the 1966-76 Cultural Revolution, rationality (as might be viewed by others) does not always prevail in Beijing.<sup>38</sup>

One author who has examined the integration of the information technology industry between Taiwan and the PRC concludes that in addition to the fatalities and casualties resulting from open hostilities, a cross-Strait war would devastate Taiwan's economy and severely harm China's industrial progress. He points out that such a war also would cripple the digital economies of every developed economy in the world. His argument is that all international commerce depends on silicon-based computer and communications systems, while industries depend on new information technology products for future productivity gains. A cross-Strait war would suddenly cut into much of the world's supply of silicon-based products essential for global commerce and investments in new technology. The author surmises that any use of force to reunify China would cause such a jolt to the world economy that the United States would be forced to intervene preemptively to prevent it.<sup>39</sup>

Another study points out that China's desire to attract investment and technology from Taiwan is likely to decrease the likelihood of conflict in the Taiwan Strait by "making the costs of any potentially provocative move prohibitively high for both sides." In short, economic integration has made war so costly that neither side would "risk contemplating any action that might ignite a serious conflict."<sup>40</sup>

In a separate study, a Taiwanese professor points out that while cross-Strait integration has generated spill-over effects in terms of broadening exchanges to areas untouched in the past, economic integration has not resolved the sovereignty issue. It also, in his view, has precluded the Chen administration from making bolder moves toward independence because of Taiwan's dependence on the Chinese market. This professor believes that Beijing has become more confident and assertive and

<sup>37</sup> Meeting between delegation of American scholars and Tsai Ing-Wen, Chairperson, Mainland Affairs Council, in Taipei, January 9, 2003.

<sup>38</sup> Interview with David Huang, Mainland Affairs Council, in Taipei, January 30, 2005.

<sup>39</sup> Addison, Craig. *Silicon Shield*, Irving, TX, Fusion Press, 2001. P. x-xi.

<sup>40</sup> Chase, Michael S., Kevin L. Pollpeter, and James C. Mulvenon. *Shanghai'd? The Economic and Political Implications of the Flow of Information Technology and Investment Across the Taiwan Strait*. Rand, National Defense Research Institute Technical Report, TR-133, July 2004. P. 145.

appears willing to promote economic and other exchanges without attaching political strings as was the case previously. As it gains economic power, Beijing is feeling “more comfortable in relying on economic means to achieve its political goals.”<sup>41</sup>

Former National Security Advisor Henry Kissinger sees a type of historical evolution taking place as more and more of the Taiwanese economy is connected with the PRC and more and more exchanges take place. Over a period of ten years or perhaps more, he says, the conditions of life on the two sides of the Taiwan Strait will become more comparable, and the dialogue on the political level, therefore, easier. He does not feel the problem will be resolved by economic exchanges, since peace across the Strait depends on a political solution and an understanding of what is required for peace in Asia.<sup>42</sup>

Many military authorities continue to emphasize the risk that a cross-Strait crisis could trigger a global conflagration. What can be concluded is that the stakes of overt hostilities are now higher and that the cost-benefit calculation extends over all levels of interaction — not just the military.

## Beijing-Tokyo

The bilateral relationship between China and Japan is shifting dramatically. There is growing and consistent interaction at the human and economic level shaded by considerable political friction and historic tension as well as occasional naval clashes. As depicted in **Figure 7**, the temperature of interaction at the human and individual level is mixed. Communication and cultural exchanges tend to be warm, but anti-Japanese sentiments and nationalistic incidents in China continue emphasize the iciness of human relations. At the economic and financial level, however, relations are hot. These comprise the bulk of interaction, are self motivating, and take place without much official notice or fanfare. At the diplomatic and political level, relations are tepid — not warm but not cold either. China is supplanting Japan as the leader in Asia, and Japan is having to cede diplomatic territory to Beijing. Many in Tokyo are taken aback at what they consider to be high handed actions by Chinese leaders and their use of historical animosities that many in Japan feel are generated by the government-controlled Chinese press and educational system.<sup>43</sup> Prime Minister Koizumi of Japan has taken some actions that rile Beijing to underline the point that Japan is a leading industrialized nation and acts according to its own interests despite objections from China. At the military level, relations are cold as both countries seek to establish their claims to offshore islands and Japan watches the Chinese military buildup with deep apprehension.

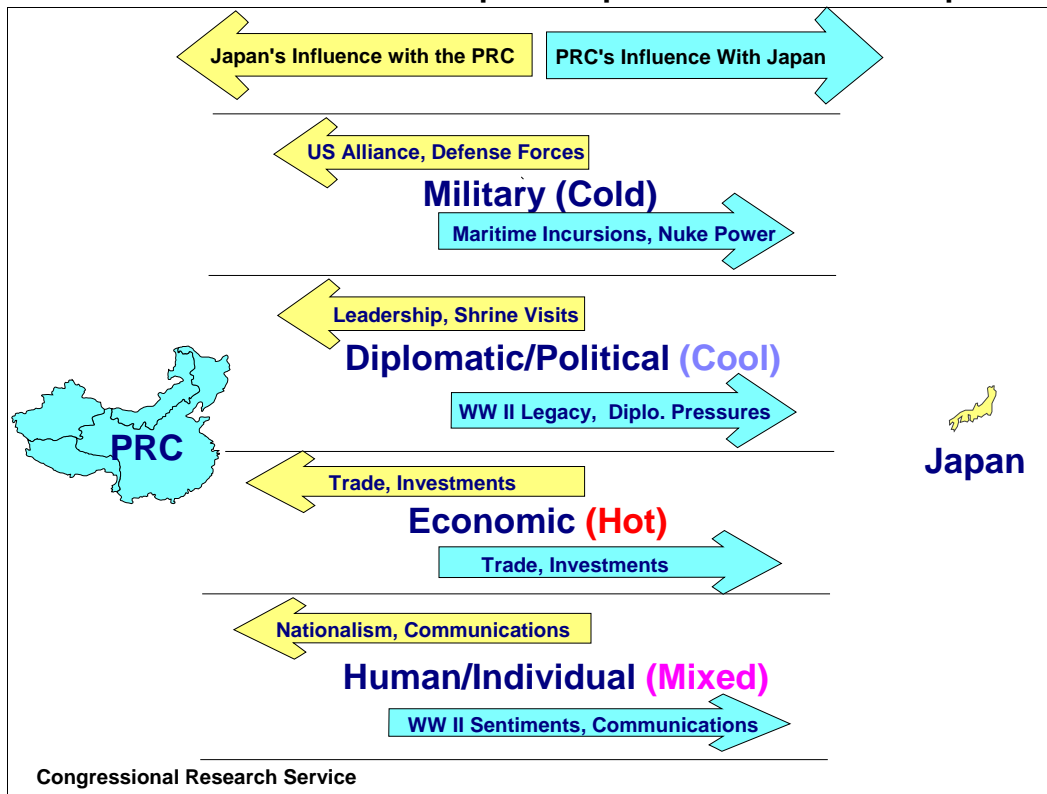
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<sup>41</sup> Chao, Chien-Min. National Security vs. Economic Interests: Reassessing Taiwan’s Mainland Policy under Chen Shui-bian. *Journal of Contemporary China*, November 2004, 13(41), pp. 697, 702.

<sup>42</sup> Public Broadcasting System, Frontline, Dangerous Straits, interview with Henry Kissinger. Early autumn, 2001.

<sup>43</sup> Interviews by the author in Tokyo, January 2005.

**Figure 7. Temperature, Strata of Interaction, and Influence in Relations Between the People's Republic of China and Japan**



As discussed previously, trade and investment relations have surged in recent years. Japan's economic recovery has been maintained partly by exports to China, and Japan's businesses also have incorporated China as an important manufacturing platform for their products. Including Hong Kong, Japan now trades more with China than with the United States. Statements by both Beijing and Tokyo indicate the desirability of mutually beneficial trade.

On the political side, however, tensions are high on a variety of historical and sovereignty issues, and many observers see a potentially destabilizing spike in nationalist animosity toward Japan among Chinese. Political and diplomatic relations are intertwined with historical grievances, particularly those centered around Japan's behavior during and preceding World War II, that continue to surface in the bilateral relationship. The most consistently divisive issue involves the visits of Japanese politicians to the Yasukuni Shrine, a Shinto shrine in Tokyo that honors Japanese who died in war. Those whose names are enshrined there include several Class A war criminals. Chinese leaders have emphasized repeatedly that Prime Minister Koizumi's Yasukuni visits constitute a huge stumbling block in moving political relations forward. On August 15, 2004, the anniversary of Japan's surrender in World War II, four cabinet level officials and 58 Diet members visited the controversial shrine. In response, the Chinese Foreign Ministry stated that "the

political basis for China-Japan relations is for both nations to have a correct understanding of that previous time.”<sup>44</sup>

In April 2005, large-scale anti-Japanese demonstrations broke out in at least nine Chinese cities, including a violent protest in Shanghai that damaged the Japanese consulate as well as shops that catered to the large Japanese expatriate community. Many observers noted that the Chinese authorities were unusually passive in allowing the protesters to organize, fueling speculation that Beijing quietly encouraged the demonstrations to channel dissatisfaction at its own governance toward a foreign target.

Koizumi’s fifth annual visit to Yasukuni on October 17, 2005, again drew angry protests from Asian leaders: both Beijing and Seoul cancelled upcoming bilateral meetings with the Japanese, but in China no widespread anti-Japanese demonstrations occurred. Some observers noted attempts by Koizumi to tone down the symbolism of the visit with less formal clothing and ceremony, perhaps as a concession to domestic pressure from pro-business interests who fear antagonizing China. Koizumi may also have been responding to an Osaka High Court ruling earlier in the month which claimed that his visits as Prime Minister to Yasukuni constituted a violation of the constitutional separation of church and state. Some reports have noted that the existing separation of church and state has been weakened in the draft revision of the constitution recently submitted by the governing LDP.

Since the mid-1990s, Tokyo and Beijing have feuded over Japanese history textbooks for school children. China and other Asian countries insist that the texts misrepresent Japan’s past by downplaying the atrocities committed by Japanese soldiers against civilian populations. When then-President Jiang Zemin visited Japan in 1998 — the last time a head of state of either country visited the other — he warned the Japanese hosts not to forget history.<sup>45</sup> Furthermore, Japan’s campaign to gain a permanent seat (without veto power) on the United Nations Security Council is facing opposition from Beijing.<sup>46</sup>

Even brushing aside disputes over territory and history, the medium and long-term outlook for stable security relations is uncertain. Recent Japanese defense documents and officials have cited concern about China’s ongoing military modernization. Japan’s Defense White Paper noted a need to pay attention to the modernization of China’s People’s Liberation Army (PLA). In writing Japan’s National Defense Program Outline (NDPO) for 2004, three scenarios in which China attacks Japan were posited: a confrontation over marine resources, territorial conflict

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<sup>44</sup> James J. Pryzstup. “Not the Best of Times,” *Comparative Connections*, 3<sup>rd</sup> Quarter 2004.

<sup>45</sup> “Asian Enmities,” *Washington Post*. August 29, 2004.

<sup>46</sup> Lynch, Colum. China Fights Enlarging Security Council, *The Washington Post*, April 5, 2005. P. A.15. Anti-Japan Protests Spread to Shenzhen; Thousands Take to Streets to Challenge Tokyo Bid for UN Security Council Seat, *South China Morning Post*, Hong Kong, April 4, 2005. P. 9.

in the Senkaku Islands, and an extension of a China-Taiwan conflict.<sup>47</sup> Japan's military thinkers, however, view a direct invasion of the Japanese mainland as quite unlikely at this time.<sup>48</sup>

A variety of other sensitive sovereignty issues have dominated recent bilateral relations. On November 10, 2004, the Japanese Maritime Self Defense Forces were sent to interdict and track a Chinese nuclear submarine that had been detected in Japan's territorial waters close to Okinawa. The incident prompted harsh criticism from both the ruling and opposition parties in Japan. Maritime research activities conducted by China in the East China Sea near the Exclusive Economic Zone (EEZ) claimed by Japan alarmed Tokyo and sparked debate during Japan-China ministerial talks. Expressing concern that China's development of natural gas fields would laterally siphon off resources from Japan's claimed territory, Japan began its own survey activities in July 2004. China has also reportedly carried out other naval activities which have crossed into Japan's EEZ, prompting some lawmakers to call for an increase for Japan's Coast Guard to protect the area around the disputed Senkaku/Diaoyu islands. In October 2005, there were reports that China completed construction on and had begun operating at least one new drilling platform in the contested area.

Shinzo Abe, Deputy Secretary General of the ruling Liberal Democratic Party in Japan, has been quoted in press reports as saying, "the conventional wisdom is to regard China as a threat on the military front." In addition, many analysts say that Japan's adoption of a missile defense system, as outlined in the Araki Commission report, creates a fundamental strategic conflict with China. In a separate development, following ministerial meetings in Washington, DC on security, the United States and Japan stated that a common strategic objective was to "encourage a peaceful resolution of issues concerning the Taiwan Strait through dialogue."<sup>49</sup> This was a rare statement by Japan of its interest in stability across the Strait and was viewed in Beijing as "brazenly interfering in China's internal affairs."<sup>50</sup> Beijing also has criticized the strengthening U.S.-Japan security relationship even as the three countries work together in the Six-Party Talks to deal with North Korea's nuclear weapons programs.

An obstacle to improved relations may also be a rising tide of nationalism among young Chinese. Although China's indignation at Japan's military occupation of the country in the 1930's and 1940's has long been expressed by the state-controlled Chinese press, observers have noted a rise in anti-Japanese fervor among the younger generation. Hostility towards the Japanese crystallized at the Asia Cup soccer finals in August 2004, when Chinese fans yelled violent anti-Japanese chants,

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<sup>47</sup> "Agency Anticipates China Attack on Japan," *Tokyo Shimbun* (translated by US Embassy service), November 8, 2004.

<sup>48</sup> Interviews at Japan Maritime Self Defense Force Staff College, Tokyo, January 25, 2005.

<sup>49</sup> U.S. Department of State. Joint Statement of the U.S.-Japan Security Consultative Committee, Washington, DC, February 19, 2005.

<sup>50</sup> Xinhua Daily Telegraph as cited in U.S. Department of State, INR, "Issue Focus: U.S.-Japan Joint Security Statement: Concerns over an 'Emerging China.'" February 24, 2005.



threw bottles at the team bus, and burned the Japanese flag outside Japan's embassy in Beijing. Rising Internet usage may also play a role as networks of young nationalists have formed online.<sup>51</sup> In another example, isolated remarks by the governor of Kanagawa Prefecture that Chinese holding student visas were "sneak thieves" spread quickly over the Internet through Chinese chat rooms.

A Japanese observer of major trends sees China as the single most formidable challenger to Japan. Although private economic relations are thriving, he sees rising friction at the government level. The two countries maintain a type of "cold peace," as China matures and attempts to reclaim its position in the world.<sup>52</sup>

Despite considerable tension between the political leadership, however, there appears to have been greater efforts to handle conflict and discord in the past few years. China's Vice-Foreign Minister reportedly expressed regret for the November 2004 submarine incursion into Japanese waters, citing "technical problems" that had caused the submarine to veer accidentally into Japanese waters.<sup>53</sup> In 2004, three of the thorniest wartime-related issues were resolved, generally in favor of the Chinese side. In the courtroom, the Hiroshima High Court awarded full damages to Chinese wartime forced laborers based on the violation of the plaintiffs' human rights. In a second case, a company settled with another group of Chinese wartime laborers on similar charges. After the Chinese Foreign Ministry complained to Japan that artillery shells from the Japanese Imperial Army were still injuring Chinese citizens, Japan acknowledged that the shells belonged to its erstwhile army and dispatched a weapons excavation team to central China.

Other government initiatives have suggested a priority on bettering bilateral relations. China's ambassador to Japan, Vice-Foreign Minister Wang Yi, is considered to be a potential future foreign minister, and is particularly well-regarded as an Asian specialist. Japan also recently expanded Chinese citizens' eligibility for 15-day tourist visas to visit Japan. Although Koizumi and Hu have not exchanged bilateral visits, they have met on the sidelines of other international meetings. Parliamentary exchanges also have been active, with over 100 representatives from both the LDP and Democratic Party visiting China following the 2004 Diet session. House of Representatives Speaker Yohei Kono received the red carpet treatment and met with top leaders in Beijing in September 2004.

The rocky patch in Sino-Japanese relations coincides with the United States asking more of Japan's military, including an overseas deployment to Iraq and active involvement in supporting coalition forces in the Afghanistan theater. Much of Japan's defense establishment has embraced the concept of Japan's defense forces becoming more active in maintaining regional and global stability. Many Chinese officials view the developments warily, particularly the anticipated debate in Japan

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<sup>51</sup> Lynch, David J. *Animosity Toward Japan Is Again the Rage in China; Past Brutality, Modern Disputes Feeding Nationalist Movement*, *USA Today*, February 24, 2005. P. A8.

<sup>52</sup> Taniguchi, Tomohiko. *Major Trends in Japan*. Slide presentation, December 2004.

<sup>53</sup> Cody, Edward. *Beijing Explains Submarine Activity; Japan Considers Account an Apology*. *The Washington Post*, November 17, 2004. p. A.22.

on amending Article 9 of the constitution, which renounces the use of force to settle disputes.

Analysts surmise that internal debates on how to best approach the regional rivalry go on in both capitals. In Tokyo, the disagreements are more transparent: figures such as former LDP Secretary General Koichi Kato and House of Representatives Speaker Yohei Kono have both publicly urged Koizumi to take China's concerns into consideration when deciding to visit Yasukuni Shrine. During Kono's visit to Beijing in September 2004, he expressed regret that the bilateral relationship was far more mature economically than politically.<sup>54</sup> In Beijing, the debate is carried out in less explicit ways. Some government-affiliated think tanks have advocated a more practical, less emotional approach to relations with Japan. *The Strategy and Management Journal* ran a series on Sino-Japanese relations in 2003 that highlighted the economic importance of the relationship and suggested a need to move beyond historical disagreements. However, some observers say that Chinese policy-makers, constrained by simmering public resentment towards Japan, are unwilling to take the political risk of appearing "soft" on Japan. Others surmise that Beijing uses anti-Japanese sentiment and allows popular demonstrations as a means to enable Chinese to "let off steam" rather than direct their frustrations and anger toward the ruling communist party.

Economic competition between China and Japan also is playing out in various ways upon the international scene. In view of China's increasing economic muscle and diplomatic friction with Japan, in 2005, Tokyo informed Beijing that it plans to phase out its yen aid loans (actually a form of war reparations) by 2008. These loans comprise some 90% of all Japanese aid to China and seem unnecessary for a country that itself is becoming a major aid provider.<sup>55</sup> Also in 2004, Russia chose Japan over China as a future oil customer by announcing that it would build a pipeline carrying Siberian oil to a Japan Sea terminus instead of to China.<sup>56</sup>

In Japan, economics and politics always have mixed. In many respects, the U.S. nuclear umbrella has allowed the country to pursue "checkbook diplomacy" by which Tokyo has used its trade, aid, and investments along side the strengthening of its military to develop what they have called comprehensive security. Japanese experience in the 1980s showed that while economic interdependence may not deflect trade and political friction, it puts incentives in place to resolve disputes

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<sup>54</sup> "Japan, China Need Harmony, Not Antagonism: Japan's House Speaker," *Xinhua News Agency*. September 23, 2004.

<sup>55</sup> Such aid peaked at 214 billion yen (about \$2 billion) in 2000. "Japan Has Notified China That it Intends to Terminate the Extension of Yen Loans in Fiscal 2008, Citing the Country's Remarkable Economic Development, It Was Learned Thursday." Jiji Press English News Service. Tokyo, March 3, 2005. p. 1

<sup>56</sup> Watkins, Eric. Japan, Russia Start Talks on Oil Pipeline Details, *Oil & Gas Journal*, January 24, 2005. Vol. 103, Issue 4. p. 26.

amicably. Economic and financial relations formed a base from which Japan could approach diplomatic, political, and security relations with other states.<sup>57</sup>

For both Japan and China, one key question is to what extent the extensive economic interactions and diplomatic sensibilities will prevent political tension from escalating into outright hostility or even military conflict. Some experts point to tentative evidence that Japan-China security relations are stabilized by growing economic ties. One study of the Sino-Japanese relationship concludes that cooperation in the economic realm has not developed into cooperation in the security realm, but the author also notes that confrontation in the security realm also has not brought friction in economic relations. Japan's China policy is striking a balance between military security and commercial policy.<sup>58</sup> Another study concludes that economic interaction has, on the whole, proven effective in promoting stable political relations. The economic nexus has not only provided the foundation for the political relationship, but it has served to maintain that relationship during times of trouble. In times of crisis (such as the 1989 Tiananmen Square crackdown), Japan's political retaliation was scant so as not to disturb the economic synergy and political stability. The author also concludes that as the two economies become more profoundly intertwined with each other, they are likely to reach out to each other in areas such as regional security affairs in order to maintain the peace.<sup>59</sup> One example of such cooperation could be China's cooperation with Japan (and the United States, South Korea, and Russia) in the Six Party Talks on North Korea.

In short, economic interaction appears to have induced the two sides to keep the political rhetoric to a manageable level and adroitly tiptoe around potential military clashes. Both sides, however, continue to build their military capabilities. The question, then, becomes whether economic and cultural ties will continue to induce military restraint as China grows into a major regional power and Japan begins to deploy its military outside of its homeland defense perimeter. Another question is whether economic and cultural ties will overcome historical animosities or whether economic ties, themselves, will become a target of boycotts and popular demonstrations in either country.

## Beijing-Seoul

The relationship between China and South Korea (The Republic of Korea or ROK) provides a model for how deepening economic relations can bring two capitals together politically. **Figure 8** outlines the major strata of interaction, channels of influence, and the temperature of relations between the PRC and South Korea. As is the case with Japan, the major daily interaction is in communications and

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<sup>57</sup> Matthews, Ron. Business Focus Turning Point for Japan, *Jane's Defence Weekly*, May 29, 1993.

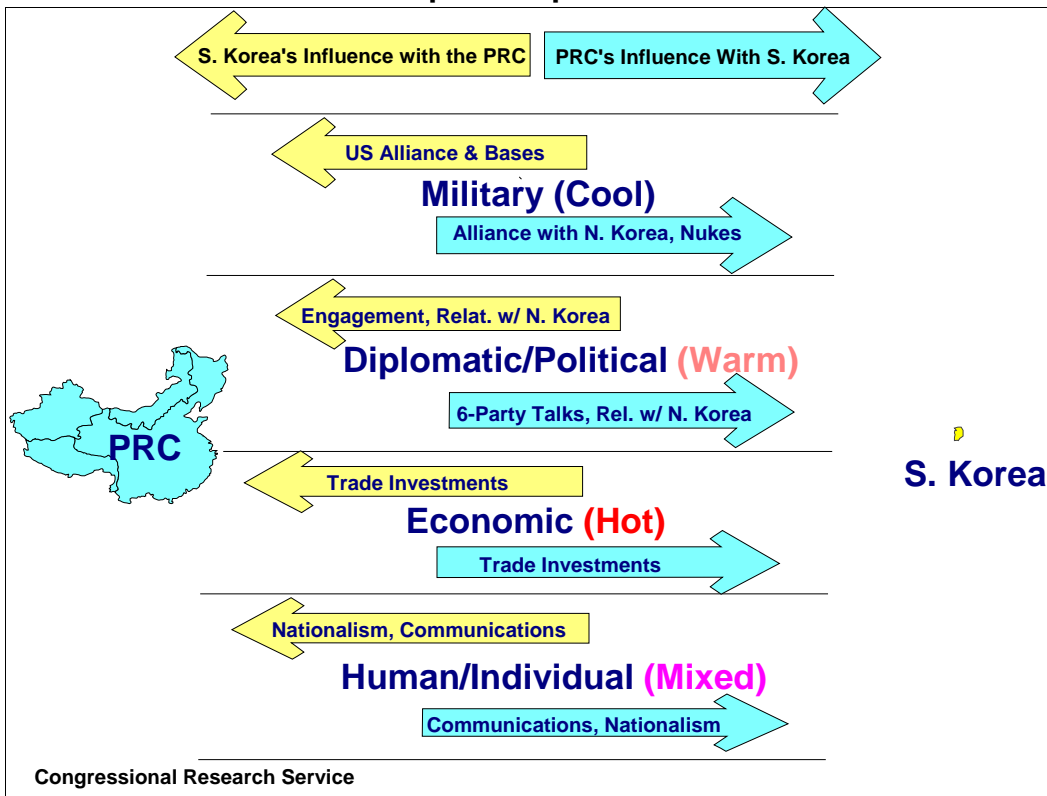
<sup>58</sup> Choi, Woondo. Persistence and Change in Japan-China Relationship. *Journal of International and Area Studies*, 10(1), 2003, p. 90.

<sup>59</sup> Burns, Katherine G. China and Japan: Economic Partnership to Political Ends, *Economic Confidence-Building and Regional Security*, edited by Michael Krepon and Chris Gagné, The Henry L. Stimson Center, 1999. P. 56-57.

economics while disputes over historical issues occasionally cloud the relationship. At the human and individual level, the temperature of relations is mixed with rising warmth in cultural exchanges and communications but occasional cooling in nationalistic disputes. Cultural ties have also increased multifold: tourism in both directions has increased markedly, and the number of South Korean students studying Mandarin has skyrocketed. Historical ties between China and South Korea are not as fraught as those between China and Japan, but disputes still surface.

The temperature of economic and financial relations has been hot as China has displaced the United States as South Korea's major trading partner, and South Korean businesses have moved labor-intensive production processes to Chinese factories. Each economy has grown increasingly dependent on the other for trade and investments. In 2004, South Korea exported \$49.8 billion in goods to China, \$42.8 billion to the United States, and \$21.7 billion to Japan, while importing \$46.1 billion from Japan, \$29.6 billion from China, and \$28.8 billion from the United States.<sup>60</sup>

**Figure 8. Temperature, Strata of Interaction, and Influence in Relations Between the People's Republic of China and South Korea**



At the diplomatic and political level, relations have generally been warm (cordial) since the normalization of ties in 1992, but disputes over treatment of North Korean refugees seeking passage through China and other issues have sometimes cooled relations. Frequent reciprocal visits by top officials have solidified the

<sup>60</sup> Korea International Trade Association (KITA) [<http://global.kita.net>].

political relationship, and cooperation in attempting to resolve the North Korean nuclear crisis has gained Beijing further favor in Seoul.

Korea's history with China is not always viewed as a positive influence on contemporary bilateral relations. A controversy in 2004 over the origins of the Koguryo Kingdom sparked a major political dispute, the largest since the normalization of relations. The flap arose because of a PRC claim that the Koguryo Kingdom (37 B.C. - 668 A. D.) was a part of Chinese territory and history, not, as Koreans claim, an independent Korean entity that produced many of Korea's long-standing traditions. Angry reaction in South Korea came from many quarters, including the public, members of the National Assembly from both parties, and the Ministry of Foreign Affairs and Trade. Many claimed that the controversy exposed Beijing's "hegemonic ambitions," and erased an earlier impression of China as a benevolent economic partner.<sup>61</sup> Officials on both sides scrambled to calm the controversy and Beijing dispatched Vice Minister Wu Dawei, former ambassador to South Korea, to negotiate a resolution. The resulting five-point agreement soothed Korean concerns at least temporarily. With the North Korea problem still at a sensitive stage, government officials were relieved to patch up the relationship. Still, the incident exposed strong underlying sentiment in both populations and could indicate a shift away from the cozy political relationship the two capitals enjoyed for over a decade since normalization.

At the military and security level, relations are cool but warming. Despite China's intervention in the Korean conflict and alliance with North Korea, security relationships between Seoul and Beijing are improving. In 1999, China and South Korea agreed to hold annual discussions on regional security issues.<sup>62</sup> China holds a large wild card in the security relationship because of its influence with Pyongyang. Similar to Japan, however, South Korea also is concerned about the potential adverse behavior of China two or three decades into the future when it is expected to achieve major power status.

The threat of instability posed by the North Korean nuclear program has induced the major powers in the region to cooperate in bringing Pyongyang to the negotiating table. These six-party talks build on common security and economic interests and have brought the governments of China and South Korea into a loose partnership. Both countries oppose the development of a nuclear arms program by North Korea. Each fears the consequences of a collapsed Kim regime in Pyongyang which could create instability for their own governments. Because Japan generally has hewed closely to the more hardline U.S. position, Seoul and Beijing have found themselves advocating a similar approach of engagement and laying out in explicit terms what Pyongyang could gain if it abandoned its nuclear weapons program. Observers note the irony that with respect to the North Korean nuclear issue, Sino-North Korean relations have become somewhat of a burden for Beijing while ties with South Korea have become economically beneficial. The two countries have found this common

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<sup>61</sup> Snyder, Scott. "A Turning Point for China-Korea Relations?" *Comparative Connections*, 3<sup>rd</sup> Quarter 2004.

<sup>62</sup> Foley, James A. "China Hedges Its Bets on North Korea," *Jane's Intelligence Review*. November 1, 2004.

ground despite strong disagreement on how to handle current North Korean refugees who try to defect to third country embassies in China in attempts to gain passage to South Korea.

As in the case with Japan, the U.S.-South Korean military alliance weighs heavily on the growing ties between Beijing and Seoul. In essence, both have been able to deepen the economic relationship with full knowledge that the United States also seeks stability in Northeast Asia. China and South Korea's cautious political alignment on the six party talks has taken place, however, as cracks have begun to appear in the U.S.-South Korea alliance. With the election of President Roh Moo-Hyun and the subsequent victory of his Uri Party in the National Assembly elections, some in South Korea and elsewhere have seen a shift from Washington to Beijing as Seoul's favored partner both economically and diplomatically. South Koreans who favor a stronger partnership with China point out the cultural and historical affinities, economic interdependence, and the similar desire to maintain stability in the region, including keeping Japan from resuming a more forward defense posture.

However, both Washington and Seoul policymakers insist that the alliance is strong, and President Roh has kept his promise on sending troops to perform humanitarian work in Iraq. Disagreements over the global realignment of U.S. forces that will change U.S. military presence in South Korea appear to have been smoothed over with further consultations and compromises. Although China may look like an appealing alternative when relations with the United States waver, some observers point to China's history of shifting alliances, as well as its entry into the Korean War in 1950 that ultimately preserved the division of the peninsula. Further, China has not yet accepted Seoul's 1999 proposal to hold joint maritime search and rescue exercises,<sup>63</sup> although talks have continued.

One indicator of the warming relations between Seoul and Beijing is the Roh administration's new geopolitical strategy (with the support of China) of seeking to play the role of a balancing force in Northeast Asia. President Roh reportedly would like South Korea to play the role of stabilizer for peace and prosperity and to place exchanges between South Korea and China on the same level as those with Japan. While Korean officials insist that ties with the United States remain unchanged, concerns have been voiced that this strategy implies a shift toward China — possibly because of policy differences with the United States.<sup>64</sup>

Expert studies also point to the growing strength of the economic relationship in Chinese foreign policy. One expert concludes that since successful implementation of reform and open-door measures for China requires stability,

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<sup>63</sup> Lee, Sung-yul. Korea, China Seek Military Exchanges and Cooperation. *Korea Herald*, Aug. 24, 1999. P. 1.

<sup>64</sup> Ahn, Sung-kyoo. Security Aide Explains Vision of Balancer Role. Seoul JoonAng Ilbo (Internet version). April 14, 2005. (Reported by FBIS.) Seoul Downgrading U.S. Alliance in Favor of Closer Military Ties with China, Russia. East-Asia-Intel.com (subscription e-mail service). April 12, 2005. ROK Presidential Committee Head Views ROK's 'Balancing Role' in Northeast Asia. *Chosun Ilbo* (Internet Version in Korean), April 12, 2005. (Translated by FBIS).

Beijing has few options other than to pursue a pragmatic diplomatic policy rooted in economic benefits, although clearly China shows no intention of compromising or negotiating over matters related to its sovereignty. In this respect, China regards peace and stability on the Korean peninsula as indispensable to its continued economic advancement. It seeks to preserve the Pyongyang regime while taking measures to resolve the North Korean nuclear problem. Also, the talk of reunification between South and North Korea places pressure on Beijing to keep on the good side of South Korea to avoid the prospect of a nuclear-armed, unified Korea as an unfriendly neighbor. The PRC also would like to wean South Korea away from its close military alliance with the United States in order to weaken what it views as an important link in the U.S. “encirclement” of China. Beijing, therefore, has placed great importance on its economic and trade relations with South Korea while maintaining its support of Pyongyang and expanding diplomatic and political contacts with Seoul.<sup>65</sup>

## Policy Discussion

From the above discussion, it is apparent that the rise of the PRC as an economic powerhouse has brought significant changes in China’s relationships with Taiwan, Japan, and South Korea. The interests of all four of these governments are being influenced by the rapid development of trade, investment, and financial flows. These relationships are self-motivating, self-perpetuating, and self-sustaining. They arise primarily out of the self interests of businesses and operate largely independently of government intervention (except for government regulation, ownership of enterprises, and financing). Many of these economic flows are generated by the forces of globalization that are affecting all parts of the world. Within the four strata of interaction (military, diplomatic, economic, and human), economic relations between China and the other states are the warmest; human interaction is both warm and cool; diplomatic relations range from warm to cold, and military relations generally are cold or absolutely frigid.

The Chinese economy is growing so fast and becoming so large that other Asian countries are jumping on the bandwagon to ensure that their industries both capture some of the Chinese market and use the low-cost Chinese manufacturing platform to keep their exports competitive in third country markets. Governments in the region are increasing their economic engagement with China while hedging their bets by strengthening their own military forces to offset the arms buildup in China. They are keeping military clashes that do occur — often related to claims to disputed islands — from escalating into political crises. China is increasingly engaging in strategic cooperation, particularly in the global war on terrorism and in using its influence with North Korea in hosting the six-party talks. Potential flashpoints, however, still exist — particularly across the Taiwan Strait and with North Korea — and a menacing frown could appear from behind China’s “smile diplomacy” once the PRC modernizes its military and reaches its goal of becoming a mid-level industrialized nation.

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<sup>65</sup> Kim, Taeho. The Rise of China and Korea’s Strategic Outlook. *Korea Focus*, 10 (3), May-June 2002, p. 79-81.

Throughout northeast Asia, however, the costs of disrupting economic and financial activity by a military or other crisis are rising. This is not to assert that economic activity stops wars, since trade between Britain and Germany certainly did not prevent either world war in the last century. The situation now, however, is fundamentally different because industrial processes are integrated across countries; financial markets are global; and people are more mobile. Disrupting economic relations between Taiwan and the PRC, for example, not only would affect their trade in computers, cell phones, and other final products, but it also would affect the global information technology industry and production processes in other countries (including the United States) that rely on China and Taiwan for critical components.

The main concerns with respect to rising Chinese economic power and the growing trade and investment network in northeast Asia seem to be:

- China's so-called "peaceful rise" is occurring below the radar screen for many policymakers. China seems to be taking advantage of a "distracted America" to build relationships with other countries that could have far-reaching effects on U.S. interests and strategy.
- The growth of the Chinese economy is so rapid and broad-based that it has the potential of fundamentally altering national interests among countries. It already is affecting economic relationships both among countries and within industries.
- China is displacing the United States as the primary trading partner for many Asian countries. Everyone in Asia seems to be jumping on the "Chinese bandwagon." China's market has become so extensive that Taiwan, Japan, and South Korea have all joined the Chinese-based economic network rather than try to work against it. While the U.S. market will always be a major export destination, Japan, South Korea, and Taiwan have progressively turned toward China for imports and exports, and their companies increasingly are dividing their manufacturing processes to take advantage of lower costs in China.
- The progressively large economic and financial relationships between China and its neighbors in northeast Asia is altering the cost-benefit calculus of military action that might cause instability in the region. The economic costs of instability are rising. Each is being induced to seek stability, although the PRC is adamant in preventing Taiwan's independence.
- China's growing economy provides the resources for Beijing to modernize its military, and it is expected, before too long, to be able to tip the balance of power across the Taiwan Strait in its favor. Once that occurs, China may be willing to sacrifice external peaceful relations to accomplish other national goals — such as forced reunification with Taiwan.
- While the economic, political, and military relations in northeast Asia occur largely on separate tracks, the sheer magnitude of the economic flows is affecting relations at other strata of interaction. Already, economic interests have induced more cooperation on political disputes between China and Japan and South Korea. While economic interests generally do not trump security interests, they



tend to induce countries to seek stability and refrain from taking rash military or political actions that might lead to instability, sanctions, surcharges in international financial markets, and other penalties — whether imposed by the market or by foreign governments.

American interests in northeast Asia are a subset of the comprehensive U.S. interests of security, prosperity, and value preservation. These translate into specific U.S. goals of maintaining stability under a favorable balance of power, promoting democracy and access to markets, and developing amicable and cooperative relations with other nations. In China the ruling communist party has strong interest in maintaining its hold on power, enabling rapid economic growth, maintaining stability, and exercising sovereignty over what it considers to be its national territory. Japan and South Korea seek security and stability in the region, particularly with respect to North Korea and the growing military strength of China, rapid economic growth, open trade and investment relations, as well as to maintain their representative governments and systems of political pluralism. Taiwan shares interests in economic security; it is distinguished by an all consuming focus on maintaining cross-Strait stability. For the United States, a question is how to promote and protect U.S. interests while northeast Asia undergoes rapid economic change.

During the Cold War, the countries of Northeast Asia and the United States tended to make policy decisions relative to security, politics, and economics under a bipolar strategic lens that placed security first in international relations. In most cases, the overriding question for the West was whether the policy being considered added to or detracted from the containment of the Soviet Union and curtailed the spread of both Russian and Chinese-style communism. This colored, for example, efforts to reconstruct post-World War II Japan, to intervene in the Korean conflict, to provide support to the Republic of China on Taiwan, to escalate the Vietnam War, to sometimes wink at trade barriers in Japan and South Korea in exchange for their support of the U.S. military, and to promote closer trade ties with Japan and South Korea rather than have them rely on China, their traditional trading partner. During that time, the best predictor of whether a nation had amicable relations with the United States was the degree to which it opposed communism. Now that the last remnants of the Cold War are disappearing in Asia, national policy among countries in Northeast Asia seems to be evolving more to reflect the practical interests of individual states rather than their ideological bent. China's Deng Xiaoping stated it clearly when he said that it doesn't matter if a cat is black or white, so long as it catches mice.

## Policy Choices for Congress

For Congress, the rise of China presents several geopolitical policy choices.<sup>66</sup> These include what strategies the United States should pursue to accomplish long-term interests given that the economic rise of China is likely to continue and what combination of economic, diplomatic, and security measures should be employed to best protect U.S. interests and accomplish particular U.S. policy goals.

The policy choices with respect to northeast Asia include whether to:

- continue current policies of promoting market economies, enabling globalization, and encouraging democracy while projecting sufficient military power to keep the peace in the region;
- seek to contain China along the same lines of the containment of the former Soviet Union;
- actively counterbalance the rising economic influence of China and the trading networks it is building by pursuing free trade agreements and closer investment relations with Japan, South Korea, and Taiwan and by strengthening free trade process under the Asia Pacific Economic Cooperation (APEC) forum;
- bring China's external trade more into balance, ensure that China adheres to its World Trade Organization commitments, reduce the foreign exchange resources available to China's central government, and slow the "bandwagon effect" by which Japanese, South Korean, and Taiwanese businesses are establishing factories in China with the intention of selling a part of the output in the U.S. market;
- facilitate the globalization of China in order to strengthen forces of change, create centers of power outside of Beijing, and increase representation in Beijing by business and international interests; and
- take into greater account the impact that the rise of China is having on the policies of Japan, South Korea, and Taiwan.

**Status Quo.** Current U.S. policies toward the economic rise of China are based both on "idealism" and "realism." The Pentagon's military planning, of necessity, tends to be power- and threat-based and realistic. It considers and prepares for several scenarios, including the "worst case" in order to provide for the security

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<sup>66</sup> For current legislation, see CRS Report RL32804, *China-U.S. Relations: Current Issues and Implications for U.S. Policy* and CRS Issue Brief IB98034, *Taiwan: Recent Developments and U.S. Policy Choices*, both by (name redacted); CRS Issue Brief IB91121, *China-U.S. Trade Issues*, by (name redacted); CRS Issue Brief IB98045, *Korea: U.S.-Korean Relations—Issues for Congress*, by Larry Niksch; and CRS Issue Brief IB97004, *Japan-U.S. Relations: Issues for Congress*, coordinated by Richard Cronin.

interests of the United States. Current policies stress contingent military planning, export controls, strong alliance relations with Japan and South Korea, and rising levels of engagement.

Other U.S. policies toward China tend to be idealistic. They are aimed at promoting U.S. ideals of democracy, a liberal market economy, and human rights in China. Many of these policies are based on the globalization-peace hypothesis<sup>67</sup> that posits a progression in the political and economic development of nations that starts from a low-level agrarian economy that becomes globalized and enters a phase of sustained economic development which then leads to the rise of a middle class (mostly urban) and to greater internal demands for democracy and representative government. The hypothesis posits that democratic governments do not fight each other. Therefore, in this view, efforts to establish democracy ultimately lead to more peaceful relations with other nations. This is one rationale for current U.S. policies of liberalizing trade, facilitating China's membership in the World Trade Organization and other international institutions, encouraging communications at all levels, and engaging Beijing on a multitude of fronts.

**Containing China.** Those who focus on the China threat often advocate a policy of deterrence and containment — some have called it “constrainment.”<sup>68</sup> This is analogous to the containment doctrine pursued by the West during the Cold War. While containment usually is couched in terms of military strategy, it also can extend to economic and political issues.

Certainly, China's economic rise has provided the resources for it to build a modernizing and more powerful Chinese military. While the end of the Cold War and rapprochement with Russia has reduced greatly the probability of a big-power conflict in Asia, the rise of China as a regional nuclear power, in the minds of some, merely shifts the threat to China. The PRC also looks toward the Pacific Ocean and sees U.S. forces in South Korea, Japan, and Guam with the Seventh Fleet steaming around Taiwan and Southeast Asia. China is one of the few nations actively arming itself for a possible military confrontation with the United States.<sup>69</sup> U.S. and Japanese military planners are considering the implications of China as a military power and, for example, the manner in which the two nations could address a possible China-Taiwan conflict.<sup>70</sup> Discussion of U.S. military strategy with respect to China, however, is beyond the purview of this report.

On the economic side, containing China is like trying to put a genie back into a bottle. China's economy already has broken loose from most of its moribund communist strictures and has become well integrated into the global economic

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<sup>67</sup> This is an extension of the democratic-peace hypothesis.

<sup>68</sup> Segal, Gerald. East Asia and the “Constrainment” of China, *International Security*, Vol. 20, no. 4 (Spring 1996).

<sup>69</sup> Cody, Edward. China Builds a Smaller, Stronger Military, *The Washington Post*, April 12, 2005. P. A1.

<sup>70</sup> Japan-U.S. Security Statement to Seek Greater Cooperation in the Asia-Pacific. *The Nikkei Weekly*, December 27, 2004 and January 3, 2005, p. 6.

system. Since the late 1970s, the PRC has developed from an inward-looking, protectionist economy to a world-class trading nation. Rather than China being constrained, the PRC is using its economic ties and cross border investments to ensure that its influence spreads. China is coopting its neighbors with its trade and manufacturing resources. Taiwan is being forced to cope with the *de facto* integration of its economy with the PRC, and Japan, despite historical enmity by the Chinese people remnant from World War II, has little choice but to invest in China and incorporate the Chinese market into its trade and investment strategy. South Korea, despite the legacy of the Korean War and China's support of the regime in North Korea, has little choice but to enter the economic game with China. The United States, likewise, is increasingly dependent on the Chinese market as a manufacturing platform, an export market, and as a buyer of U.S. debt securities. The Chinese economy is becoming the center weight of Asia. Any economy that does not hook into it runs the risk of being left far out of the action. Measures certainly can be pursued to ensure that China acts in ways consistent with its international economic obligations, but the PRC seems to have moved beyond the point where economic containment could be effective.

**Counterbalancing the Rising Economic Influence of China.** There is little doubt that China is using its rising economic and political power backed by its modernizing military to attempt to reduce U.S. influence in its periphery and to establish itself as the central power in the region. This is not only because Beijing has just now gained the resources to allow the country to flex its muscles with credibility. A view in Japan and Taiwan, particularly among private-sector opinion leaders, is that China is taking advantage of U.S. "inattention to Asia" to better position itself to become the leader of Asia and to wean neighboring countries from their dependency on Washington and move them toward Beijing. Those who express this view assert that the United States needs to send a strong signal to countries in the region that Washington is not distracted by the Middle East and that it has enduring interests in Asia.<sup>71</sup>

There are many ways that signals can be sent. One is through realist channels such as military strength and actual trade and investment flows. Another is through idealist channels such as diplomatic and political contacts as well as multilateral institution building. On the realist side, bolstering U.S. alliance relationships and military capability as well as a full discussion of motives for U.S. troop reductions (those in South Korea were interpreted by many in Asia as indicating a lower priority for Asia than for Iraq) could be useful. Also, measures to increase U.S. trade and investments in the region could help maintain or augment U.S. influence in northeast Asia.

If Japan, South Korea, and China continue to move toward a free trade arrangement among themselves and with countries of Southeast Asia, the United States may consider speeding up the initiation of discussions of bilateral free trade agreements (FTAs) with Japan, South Korea, and Taiwan. While such FTAs would not slow down the Chinese juggernaut, they might ensure that higher U.S. tariff rates do not divert trade away from the United States and toward the region. While the

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<sup>71</sup> Interviews by the author in Tokyo and Taipei, January and February 2005.

relatively low levels of U.S. tariff rates (about 2%) make trade diversion not a significant problem, the proliferation of FTAs in the region could create shifts in trade flows away from the United States and toward the region. Of course, FTAs involve many more issues,<sup>72</sup> some negative and some positive, than just a signal to China.

The United States also may seek to reinvigorate the Bogor Declaration of the Asia Pacific Economic Cooperation (APEC) forum under which 21 economies bordering the Pacific Ocean are working cooperatively to reduce barriers to trade and investment; ease the exchange of goods, services, resources, and technical know-how; and strengthen economic and technical cooperation. In the 1994 Bogor Declaration, the leaders of APEC declared their intention to establish free trade and investment in the region by the year 2010 for industrialized members and 2020 for the others.<sup>73</sup> In essence, the Bogor Declaration would create a huge Asia-Pacific FTA that would include both the United States and China.

China's rising economic influence is occurring primarily at the expense of Japan. Despite the fact that Japan still has the second largest economy in the world (third if the European Union is counted as a single economy<sup>74</sup>) and has a gross domestic product three times as large as China's, a decade and a half of recession has diminished the rising Japanese economic star considerably. Efforts to restart Japanese economic growth and to induce Tokyo to take a stronger leadership role could offset some of China's allure as a regional leader.

**Bringing China's External Trade More into Balance.** The United States could work more with nations of Asia and Europe to bring China's external trade more into balance.<sup>75</sup> Although China claims that it ran a surplus in 2004 of \$33 billion in its merchandise trade with the world, the United States alone incurred a deficit of \$162 billion and the European Union (15 countries) a deficit of \$63 billion with China. Even when taking China's surplus of \$89 billion with Hong Kong — much of which is entrepot trade that is trans-shipped to other nations, China's reported trade surplus seems to be understated. For 2005, preliminary data indicate that China's trade surplus tripled to \$102 billion.<sup>76</sup> Regardless of the exact trade figures, more might be done to ensure that China adheres to its World Trade

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<sup>72</sup> For further information on FTAs, see CRS Report RL31356, *Free Trade Agreements: Impact on U.S. Trade and Implications for U.S. Trade Policy*, by (name redacted).

<sup>73</sup> See CRS Report RL31038 *Asia Pacific Economic Cooperation (APEC), Free Trade, and the 2004 Summit in Santiago, Chile*, by (name redacted). APEC members include the United States, Canada, Mexico, Chile, Peru, Japan, South Korea, China, Taiwan, Hong Kong, Indonesia, Brunei, Malaysia, Singapore, Thailand, the Philippines, Vietnam, Australia, New Zealand, Papua New Guinea, and Russia.

<sup>74</sup> GDP in 2003 for China was \$1.4 trillion, for Japan was \$4.3 trillion, for the United States was \$10.9 trillion, and for Germany was \$2.4 trillion.

<sup>75</sup> For discussion of this issue, see CRS Issue Brief IB91121, *China-U.S. Trade Issues*, by (name redacted).

<sup>76</sup> McGregor, Richard. China's Trade Surplus Triples to Record Dollars 102bn. *Financial Times* (London), January 12, 2006, P. 7.

Organization commitments (especially enforcement of intellectual property rights) and allows more flexibility in its foreign exchange rate (to reduce China's trade surplus and the dollar assets available to China's central government). A higher value for China's currency also could dampen the lure of the Chinese economy as a low-cost manufacturing platform that causes a "bandwagon effect" by which Japanese, South Korean, and Taiwanese businesses establish factories in China with the intention of selling a part of the output in the U.S. market. These measures may not slow down China's growing trade and investment network, but it could help to ensure that trade is conducted according to world standards.

The current attention on the upward valuation of the Chinese yuan is a separate topic that is receiving considerable attention already.<sup>77</sup> At a time that the U.S. dollar is depreciating in response to the U.S. current account deficit of around 6% of GDP, the peg of the yuan to the dollar shifts the burden of adjustment to Europe, Japan, South Korea, and other countries. What is particularly ironic is that the bilateral U.S. trade deficit with China at \$162 billion is not subject to the market forces normally exerted by exchange rate adjustment. Also, since the Japanese yen and South Korea won already are floating, the Chinese peg to a declining dollar gives Chinese exports a relative price advantage not only in the American market but in Japan and South Korea as well. Between January 2002 and January 2005, the dollar depreciated 22% against the Japanese yen and 20% against the South Korean won. Since the Chinese yuan has been tied to the dollar, it too has depreciated by like amounts against the yen and won. This gives Chinese exporters an artificial advantage in Japanese and Korean markets.

In 2005, Beijing announced that it had dropped its currency peg. China said it had revalued the renminbi by 2.1% from 8.28 yuan to 8.11 yuan per dollar and that its currency would be "referenced" to a basket of currencies and allowed to fluctuate within a 0.3% trading band around the U.S. dollar. The main components of the reference currency basket consist of the dollar, euro, yen, and Korean won, but the relative weights of each were not revealed. Since July 2005, there has been little further appreciation of the yuan.

**Facilitate Globalization/Democracy.** The United States could encourage even more globalization in China in order to foster internal change. The forces of globalization and economic development in China are causing fundamental shifts in power and interests. Irrespective of whether the rise of China's business and working class (as opposed to peasants and the military) will lead to an end to one-party rule, it is clear that the ruling Chinese Communist Party (CCP) is being compelled to pay greater attention to business and worker interests. The CCP has attempted to coopt these interests by allowing businessmen to join the party and by seeking to broaden representation to include all segments of society.

In addition to ceding space in its decision making process to industrial interests, the current CCP leadership is coming into power with experience in the transformation of society that comes from development and modernization after

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<sup>77</sup> See CRS Report RL32165: *China's Exchange Rate Peg: Economic Issues and Options for U.S. Trade Policy*, by Wayne Morrison.

opening to the outside world. The core of Chinese leadership has progressed from revolutionaries, to technocrats, to educated administrators and politicians. For these people, the country's dependence on international investment and trade for the economic growth needed to maintain the party's legitimacy has become an important consideration in policy making — including security policy. Still, over the long term, whether this will induce Beijing to pursue policies of stability in security relationships and to open its society even further to international forces is yet to be determined.

Globalization also is creating stresses with Chinese society that could spell trouble for Beijing. Widespread inequality in incomes both between the rich and poor in particular regions and the gaping gulf in wealth and income between the coastal and inland provinces could cause unrest. Without the recent rapid economic growth, the rising ranks of China's unemployed would have been even larger. These unemployed in combination with a poor social safety net, dangerous working conditions in many industries, corruption, and religious repression generated about 160 public protests per day in 2003.<sup>78</sup> Rapid economic growth in China may lead to more democracy, but it also could lead to civil disorder and repression. One policy question is how to encourage alternative power bases outside of the Chinese Communist Party and to sympathize with assorted public protests without inviting another Tiananmen Square type of crackdown. The United States is steering a fine line between partnership and pressure in supporting democratic forces in China.<sup>79</sup> In this endeavor, enlisting more support from Japan and South Korea could be useful, and the constant flow of information into China on democracy in Taiwan (and Hong Kong) can not help but have an accumulating effect on perceptions across the Strait.

**Third Country Policies.** The rise of China is having decided effects on the policies of Japan, South Korea, and Taiwan. Bilateral relations between these states and China tend to divide into strata with economic relations charging ahead while security and political relations lag behind. The economic and financial activity, however, is affecting security interests. In the six-party talks with North Korea, for example, the United States has had to rely on the good offices of China with Pyongyang and to accommodate South Korea's policy goals, which in some areas, seem to coincide more with those of Beijing than those of the United States. Another example is the movement by East and Southeast Asian nations to organize into a free trade area (ASEAN + 3) that includes China but excludes the United States. This East Asian Community based on a regional trade and financial system already is helping to induce Asian nations to invest in local and European currencies as reserves rather than the dollar.<sup>80</sup>

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<sup>78</sup> Two Concepts of Liberty? *The Economist* (London), March 5, 2005. P. 12.

<sup>79</sup> U.S. efforts to promote democracy in China include bilateral diplomatic efforts, multilateral action, and support through government and nongovernmental channels. The United States also seeks to strengthen China's judicial system, further the rule of law, and encourages democratic political reform. See U.S. Department of State, *Supporting Human Rights and Democracy: The U.S. Record 2004 - 2005*. March 28, 2005.

<sup>80</sup> Miyauchi, Teiichi. U.S. Wary as East Asian Community Nears Reality. *The Nikkei Weekly*, December 13, 2004. P. 27

This is not to say that U.S. influence is still not great in the region. China realizes that forcing Asian states to choose between Beijing and Washington can be counterproductive — particularly those tied to the United States with security agreements. Since 2001, therefore, Chinese diplomacy has appeared to be less anti-American,<sup>81</sup> although Beijing continues to work toward a multipolar world less dominated by the United States. It is apparent to Beijing that its national economic and military power is still too small to exercise much direct leverage over the United States and nations supportive of U.S. efforts. But China appears to be taking advantage of its rising economic clout and growing trend toward regionalism to attempt to develop some mechanism to check what it considers to be U.S. hegemony.<sup>82</sup> This could be some sort of Asian community or more formal organization.

One observer concludes that regionalism in Asia is less a matter of formally organizing separate nations into something akin to the European Union or NATO than a matter of integrating countries on the fringes of China into a vast China market.<sup>83</sup> Because of the wide disparity in types of government, levels of economic development, security orientation, and relations with the United States, the most likely plurilateral institutions for Northeast Asia seem to be free-trade agreements with China at the center and deeper currency and other financial arrangements cooperation such as the Chiang Mai Initiative and Asian Bond Fund.

A test of the growing influence of China appeared in the plans to hold the first East Asian Summit on December 14, 2005. One group of organizing countries led by Malaysia (with sympathies from China) wanted to limit the membership to ASEAN plus China, Japan, and South Korea (ASEAN + 3). Another group led by Singapore, Indonesia, Vietnam (with sympathies from Japan) wanted to make the gathering more inclusive — partly to dilute the influence of China. Ultimately, India, Australia, and New Zealand were added to the attendee list. The United States was not even accorded observer status. After the summit, China appears to be retreating toward ASEAN + 3 as the East Asian structure most conducive to and consistent with its regional goals in Asia. In either the East Asian Summit or ASEAN + 3, China appears to be maneuvering to position itself at the center of any East Asian economic and political arrangement that might become institutionalized while nudging the United States to the periphery.<sup>84</sup>

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<sup>81</sup> Sutter, Robert G. *China's Rise in Asia - Promises, Prospects and Implications for the United States*. Asia-Pacific Center for Security Studies occasional paper, February 2005. 11 p.

<sup>82</sup> Rozman, Gilbert. Democratization in Greater China: The Northeast Asian Regional Context. *Orbis*, Spring 2004, p. 229-30.

<sup>83</sup> Woo-Cumings, Meredith. Three Mirrors for Korea's Future, in *Confrontation and Innovation on the Korean Peninsula*, ed. by the Korea Economic Institute, 2003. P. 138.

<sup>84</sup> CRS Report RS22346, *East Asian Summit: Issues for Congress*, by (name redacted). Wain, Barry. Asia Wrangles Over Whom to Include in Forum. *The Wall Street Journal*, April 5, 2005. P. A15. Vatikiotis, Michael. East Asia Club Leaves U.S. Feeling Left Out. *International Herald Tribune* Paris: April 6, 2005. pg. 8. East Asia Summit Expansion Bid may fuel Friction. *South China Morning Post*, April 6, 2005. P. 4.



The growing influence of China is also being reflected in issues such as the lifting of the European Union's arms embargo on China. Japan has sided with the United States in opposing the lifting of the embargo, but the apparent ease with which Beijing garnered initial support in the European Union and the silence on the issue from South Korea seems to reflect the allure and magnitude of the Chinese market — in combination with other factors (such as European pique over the Iraq War and their desire for a more multipolar world).

With containment of communism no longer an imperative and the probability of a conventional military attack on homelands diminishing, attitudes in Japan and South Korea toward U.S. forces also are changing. In both countries, public support of the U.S. presence is still strong but weakening. The basic alliances are still solid, but some are viewing the role of U.S. forces as less of a bulwark against outside attack and more as a backup safety measure just in case some country opts to take a hostile and disruptive action in the region.<sup>85</sup>

A serious problem exists in Northeast Asia that diminishes the ability of the democratic states in the region to counter Beijing's influence. The problem rests on the basic trust of Japan. In South Korea, in particular, there exists such an overhang of acrimony for Japan's 50-year occupation that hardly any bilateral activity seems to go well. Talks on a South Korea-Japan free trade agreement seem to be stalled (ostensibly because of agricultural issues), and a dispute over possession of an island has again flared up. In calls for Japan's apologies, in interpreting history in Japanese textbooks, and other such issues, Seoul sides squarely with Beijing. The United States could work more with Japan and other countries in the region to resolve historical issues and dampen popular forces of nationalism in order to keep those nations from drifting toward an explosive enmity that could be avoided and could threaten U.S. interests. From one perspective, as long as the nationalistic and emotional outbreaks are kept under control, however, the United States actually could benefit. In this view, the more the Asian nations squabble among themselves, the more they tend to view the United States as a distant, third party whose history of relatively non-imperialistic policies can be welcome.

International economic relations are like streets — they go both ways. While Beijing has been trying to coopt its neighbors, particularly Taiwan, by enticing them into the Chinese economic and trading network, Japan, South Korea, and Taiwan have effectively coopted China by making it dependent on their technology, financing, markets, and trade expertise. The net result of this mutual dependency is that all parties now have much to lose by any crisis — be it military or financial — that would disrupt economic and financial flows in the region. Economic activity abhors instability. The “electronic herd”<sup>86</sup> is likely to stampede at the first whiff of a serious military clash in Asia. Stock markets would fall; bond ratings would suffer; interest rates would rise; capital would flee; and a risk premium would be applied to

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<sup>85</sup> Kawashima, Yutaka. *Japanese Foreign Policy at the Crossroads, Challenges and Options for the Twenty-first Century*, Washington, Brookings Institution Press, 2003. Pp. 45-46.

<sup>86</sup> See Friedman, Thomas L. *The Lexus and the Olive Tree : Understanding Globalization* (Anchor Books, 2000).

investments in the region. All four governments, therefore, seek stability in international relations. Without peace, it is difficult for economic engines to churn out wealth, and even a rumor of war triggers penalties from international financial markets. It should not be surprising, therefore, for South Korea and Japan to seek to improve relations with North Korea or carefully constrain their responses to incursions by Chinese naval ships into their exclusive economic zones. It also implies that sanctions or saber rattling that disrupt growing economic relations are not likely to be welcomed in the region.

In summary, protecting U.S. interests in security, prosperity, and value preservation can be consistent with the economic rise of China. The key lies in channeling the burgeoning Chinese economic clout into paths consistent with U.S. goals in the region. In these efforts, the forces of globalization and economic interdependency among the economies of northeast Asia appear to align roughly with U.S. interests in stability, economic freedom, and the promotion of democracy in China. These same forces, however, have created the resources to fund military buildups and have created convenient targets for tension (e.g. anti-Japanese demonstrations in China) often unrelated to political issues at hand. A key for U.S. policy seems to be to pursue policies with a sufficient dose of realism to account for the rising economic, political, and military power of China, while also maintaining long-term idealistic goals of fostering more representative government in Beijing and inducing countries to pursue peaceful relations, not only because of the U.S. military deterrent, but out of their own self interests.

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