



A Deepening Rift Between China and Japan

Nicholas R. Lardy says China could face a backlash in Asia over its use of economic leverage against Japan to obtain release of a seized Chinese fishing trawler captain.

Edited transcript, recorded September 23, 2010. © Peterson Institute for International Economics.

Steve Weisman: Is a new rift opening up between China and Japan, or maybe between China and its other neighbors? Nicholas Lardy, senior fellow at the Peterson Institute for International Economics, is here with me—this is Steve Weisman—to talk about interesting new developments in East Asia. Thanks, Nick.

Nicholas Lardy: Thank you, Steve.

Steve Weisman: We're talking about the dispute over territorial waters that erupted when Japan seized a Chinese fishing trawler and China placed a trade embargo on exports to Japan of certain minerals called rare earth elements. Is this the beginning of some kind of economic warfare between China and Japan?

Nicholas Lardy: It's certainly a big step on a downward slope. Whether it turns into warfare, I don't know. I think the Chinese appeared to be determined to humble the Japanese and they're willing to use this embargo on exports of rare earths to make their point and bring Japan around. They want the Japanese to release this captain unconditionally and immediately and they have been escalating the pressure on the Japanese over a period of several days culminating in this embargo on rare earths.

Steve Weisman: Is it going to backfire or is it going to work?

Nicholas Lardy: I think the Japanese probably will figure out a way to release this fishing captain [he was released subsequently—edit] and so in that sense maybe you could say that it will have worked. But I think in a broader sense, it's going to backfire because it's seen in the rest of the region as reflecting an increasingly belligerent China.

Steve Weisman: And throwing its weight around, I suppose.

Nicholas Lardy: Throwing its weight around, and particularly where they've had a kind of modus vivendi about fishing in this area. And the Japanese, at least the way the Chinese described it, have violated these implicit rules. And now they're escalating, with [Premier] Wen Jiabao refusing to meet with the Japanese leader on the sidelines of the General Assembly meeting at the United Nations, and relentlessly increasing the pressure, culminating in the refusal to supply rare earths to Japanese companies.

Steve Weisman: China has long insisted that economic sanctions are not proper to achieve political ends. It's taking that position with Iran and North Korea and other cases. Does this undercut that position?

Nicholas Lardy: I certainly think it tends to. Of course, the Chinese want to rewrite the rules all the time to their favor, so perhaps we shouldn't be too surprised. On the other hand, you could make a counterargument, and that is that in many sanctions regimes, including those against Iran, we don't really have enough leverage to bend the other side. But in this case, China is really almost a monopolist in the supply of these very valuable materials. They're supplying over 90 percent of the world market. So if Toyota can't get these rare earths or doesn't have enough stockpile[s] of them, Toyota will be out of production of its Prius vehicles in a very short period of time. There are a lot of rare earths in the sophisticated electronics in these electric cars. So this may be a case where sanctions do work, because you really do have a lot of power over this particular narrow range of [a] very important commodity.

Steve Weisman: Secretary of State Clinton offered to mediate the dispute over the territorial waters and was rebuffed by China. Is there a chance that the United States or anyone else can mediate?

Nicholas Lardy: Secretary Clinton's offer applied to a different part of the waters of China—the South China Sea, not where this fishing incident occurred. But I think the two incidents are closely related. Essentially what they show is that the United States is stepping up its willingness to help other countries in the region, particularly the ASEAN [Association of Southeast Asian Nations] countries that have territorial disputes with China. China, of course, would rather pick off these countries one by one, and negotiate bilaterally where China has overwhelming economic and political power. So the United States stepping in and saying, "We'll try to arbitrate this," really changes the toll. It would change the whole game for China and that's of course why they have rejected it. In the case of the Japanese incident, I think essentially what this is going to do is drive Japan even more strongly under the United States security umbrella. If they're going to have more disputes with a belligerent China, they're going to want to make sure that their military and defense arrangements and general security arrangements to the United States are in top shape.

Both in the South China Sea and in this Japanese incident, I think the Chinese are going to come out losers. It's going to underscore the importance of the United States to other countries in the region. The other countries in the region are more wary of, as you say, China throwing its weight around.

Steve Weisman: There was a different aspect of that in the internal election in the ruling party in Japan when the candidate, Mr. Ozawa, who advocated a closer relationship with China, was defeated. Now it seems Japan is going ahead and carry[ing] out the treaty agreement on security with Okinawa military bases.

Nicholas Lardy: Yes, and I think it's important to also recognize that the Obama administration is moving very cautiously, but nonetheless systematically to—I don't want to say put China in its place, that's the wrong phrase—but to indicate to China that, "We're not prepared to let them hold sway over all issues in the region, that we are going to be a force in the region and that this will strengthen our alliances."

Steve Weisman: Is that at the cost of cooperation with China, for instance, on the currency issue?

Nicholas Lardy: The tendency of this administration and previous administrations has been to deal with the security and economic issues on somewhat separate tracks. So if you hit a stalemate in one domain, you might be able to continue to make progress on the other. But you could never really completely separate them. So I do think inevitably, if you have more and more problems on the security front, it makes it difficult to make progress in the other areas. When you have these big security disputes, no negotiator on the Chinese side is going to want to sit down with his or her counterparts in the United States and reach an agreement that solves a problem because it seems to go counter to the more general trend. So, I think inevitably there is a degree of linkage across the various issue domains.

Steve Weisman: Is it worrisome for China to use its economic leverage for political ends? The amount of US debt that China holds has always been a source of concern. Do you think there are grounds for connecting the two issues?

Nicholas Lardy: To some extent, but it's not a strong case because it takes a case of the United States needing to sell its debt in order to finance our external imbalance. There are lots of other purchasers of US treasury bonds and other corporate bonds and financial assets. So if the Chinese step out of the market and aren't willing to buy them, the issuers of those instruments maybe will have to pay a slightly higher interest rate but that can easily be absorbed. However, the costs are not too high.

Steve Weisman: But is this a sign that China might be willing to act in furtherance of political ends as opposed to economic ends?

Nicholas Lardy: I think they've been willing to do that in a number of cases, but I think their leverage on this rare earth is unprecedented...because they do supply over 90 percent of the global supply at least in the short run and that puts them in the driver's seat. And they're not in the driver's seat in most of the other issues, for example, the purchase of US debt.

Steve Weisman: Nick, thanks.

Nicholas Lardy: Thank you, Steve.

