



SEISMIC SHIFTS IN THE PACIFIC

Chinese economy overtakes Japan as global #2

By Professor Jean-Pierre Lehmann - August 2010

IMD

Chemin de Bellerive 23
PO Box 915
CH-1001 Lausanne
Switzerland

Tel: +41 21 618 01 11

Fax: +41 21 618 07 07

info@imd.ch

<http://www.imd.ch>



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It's official. As of the second quarter of this year the Chinese economy has taken over Japan's as number one in Asia and number two in the world. This has been foreseen for a few years, hence it is not a total surprise; but it is a shock nonetheless. It upsets the status quo that prevailed for over a century.

Historically China was the great power, the Middle Kingdom, the country looked upon with awe and of whose great riches many tales – such as Marco Polo's – were told. As late as 1820, China still accounted for over 30% of world GDP. Japan was a mere appendix that owed much of its civilization to borrowings from China.

Then the great divergence occurred. When the industrializing imperialist Western powers came, the Chinese resisted, while the Japanese adapted. From the 1840s China entered a downward spiral of decline in every respect, while Japan shone as the only non-Western nation to have succeeded in industrializing and to become an imperial power in its own right. In 1894/95 Japan won its first war against China of which more was to follow.

Japan, so to speak, lost World War II, but won the peace. Thanks to the Chinese communist victory in 1949, the outbreak the following year of the Korean War and the spread of the Cold War, Japan was rapidly metamorphosed from the US' erstwhile hated enemy to its pampered protégé.

With the US-Japan Security Treaty signed in 1952, Japan was able to enjoy unqualified military protection from the US and concentrate instead on growing its GDP. And so came what was dubbed the Japanese economic miracle. The Tokyo Olympics of 1964 symbolized the return of Japan to the global community, the following year it was accepted into the club of rich nations, the OECD, and two years after that, in 1967, to great national elation it overtook Germany to become the world's second biggest economic power. Though it did not reach the position of

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number one, as pundits thought it might during its amazing growth of the 1980s, when Japan made the world shudder, it maintained the number two position from 1967 to today.

Meanwhile, under the reign of Mao Zedong (1949-1976), the Chinese economy was closed off from the rest of the world. China remained “interesting” from a geopolitical viewpoint – and witnessed the rise of would-be “Maoists” across all continents – but from the business viewpoint it was by and large irrelevant.

Three years after the death of Mao the new leadership did a literal 180° turn in economic policy. The truly amazing results of the reforms adopted and pursued relentlessly over the last three decades are unprecedented anywhere and at any time in history. From having been a closed economy 30 years ago, and initially only partially opened, it is now the world’s biggest exporter, having surpassed Germany in 2009. For the last 20 years it has been either number one or number two in terms of flows of inward direct investments. In the second quarter of this year, according to the *Financial Times*, BMW made more than 30% of its profit from the Chinese market, while GM sells more cars in China than in the US.

Paradoxically, just as China has emerged from some 150 years of decline and embarked on a vertiginous ascent, Japan bucked its historical trend and has gone into a spiral of descent, having experienced two “lost decades” and seemingly entering its third. What little fire there is in the Japanese economic belly comes mainly from its trade with and production in China.

This is the greatest economic story of the last century or more. It would have been impossible to imagine as recently as a decade ago; at least not that it would happen this quickly.

An earth-shattering economic event cannot happen in isolation. It is bound to have numerous geopolitical ramifications. For one thing, the US-Japan Security Treaty that has been the

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bedrock of US strategy in the Pacific for over half-a-century may now become less viable. Though Japan never committed military support, because of its economic clout and wealth it was able to engage in what a former MITI Vice-Minister Naohiro Amaya dubbed “chequebook diplomacy”.

And while the main story in Asia has been the economy, it also contains many geopolitical fault-lines: the Korean Peninsula, Taiwan, the South China Sea, China and India, among many others. The great seismic shift in the Pacific is occurring at a time when the US is also suffering from economic woes, policy confusion and is mired in Afghanistan. Japan may have been an economic rival and trade tensions were high in the 1980s, but geopolitically it was docile and obedient. China’s geopolitical agenda is by no means as clear. Is it friend? Is it foe? Is it both, depending on the issue? Which issues? How, to cite only one example out of many, will China and the US address the energy questions of the 21st century?

It remains to be seen whether China will also eclipse the US economy in the next couple of decades, as predicted by many, including Goldman Sachs. The Chinese economic colossus also harbors a number of fragilities. But one thing seems certain: while the 19th was the European century and the 20th the American century, the world seems now to have entered what may become known as the Chinese era. These will certainly be interesting times that will require close following.

What does this mean to managers? In 1967 the French thought leader Jean-Jacques Servan-Schreiber published a book that had a huge impact – translated into 15 languages – entitled *Le Défi Américain* (The American Challenge). The message was that survival required adapting to the American challenge. European business schools, such as IMD, were instituted as a means to meet the American challenge and by learning from the United States. China is unlikely to replace the United States in the immediate future. Yet there is undoubtedly a “*Défi Chinois*”. This refers not only to the Chinese market and Chinese production, but to China’s rapidly

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growing presence in all global markets. Doing business in, say, Brazil, will require dealing with the challenge of Chinese competitiveness. Lots of homework needs to be done.

Jean-Pierre Lehmann is Professor of International Political Economy at IMD, the leading global business school based in Switzerland, and the Director of the Evian Group at IMD. He teaches on the Leading the Global Enterprise program, among others.

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