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## Im Fokus

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# ***The End of Japan's ODA Yen Loan Programme to China in 2008 and its Repercussions***

## ***Die Beendigung japanischer ODA-Darlehensprogramme an China und ihre Nachwirkungen***

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### **Abstract**

In 2005 the Japanese government informed China that it wanted to end its ODA yen loan programme by 2008. This decision was taken against the background of a general as well as a China-specific reorientation of ODA, mounting grievances against Chinese political, economic and military policies, and the successful development of China's economy. However, the decision was taken in an abrupt manner and Tokyo ignored the usual procedures for 'graduating' a developing country from its ODA. In recent years, Japan's ODA – loans and grants as well as technical aid – to China has become increasingly focused on projects related to the environment and energy conservation. There are many circumstances which explain this focus (for example, transboundary pollution, territorial disputes in the East China Sea). Japan's need to fulfil its obligations under the Kyoto Protocol may lead to some kind of revival of energy-related loan programmes to China under the Clean Development Mechanism (CDM).

*Keywords: ODA, Japan-China relations, environment, energy*

### **Introduction**

Official Development Assistance (ODA) is the most important instrument of Japan's post-war diplomacy, and nowhere has this been more the case than in Japan's China policy, brought into effect after the start of Beijing's economic reform programme in 1978.<sup>1</sup> The amount of Japan's ODA to its neighbour is truly impressive: loans of JPY 3,133 billion (cumulative total until fiscal year (FY) 2004), grant aid of JPY 145.7 billion (cumulative total until FY 2004), and

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<sup>1</sup> This article draws heavily on Drifte (2006).

technical aid of JPY 144.6 billion (cumulative total until FY 2003) (MOFA 2008). Loan aid has not only been by far the largest aid segment to China, but also reflects a general feature of Japan's ODA. Together with its multilateral aid to China, one can certainly state that Japan's ODA has to be credited as one of the most important external contributions which has made China's economic development so fast and impressive. However, in 2005 the Japanese government informed China that it wanted to end the yen loan programme in 2008. Why and how was this decision taken? And might the need to fulfil international environmental obligations under the Kyoto Protocol and its successor lead to a revival of Japan's loan programme, at least for the transfer of environmental and energy conservation technologies to China?

### **The Beginning of the ODA Programme**

Japan's ODA programme began in 1979 with loans and a grant after the Chinese government had, in the previous year, opened the economy to greater foreign involvement. The Japanese government under Prime Minister Masayoshi Ōhira (1978-1980) conceptualized economic assistance as part of its policy to assist China with its modernization, expecting that this approach would make China a peaceful player which would follow a moderate policy consistent with Japanese interests. The provision of ODA was facilitated by Japan's high foreign currency reserves and trade surpluses. This approach also corresponded with Japan's political inclination to use economic power to create a peaceful international environment while playing down the realist aspects of its policy as embodied in its political and military alignment with the US. Domestically, there was full support for economic aid to China; public opinion was very favourably disposed towards China and willing to accept the political and economic rationales – although by 1979 the 'Panda euphoria' of 1972 had already waned somewhat. Japanese industry was also fully supportive and urged the government to provide loans to China in order to secure major orders from it. In particular, industry hoped to salvage as much as possible of China's huge plant contracts, which had been severely reduced by the Chinese government in spring 1979 when it realised that it had overreached itself.

Moral reasons were also put forward in order to justify ODA to Communist China. One was Japanese gratitude for the Chinese renunciation of reparations in 1972. This renunciation had been motivated by China's desire to win over the Japanese public, to avoid antagonizing the still very strong pro-Taiwan forces

in the Japanese ruling party, to strengthen its strategic position against the Soviet Union by establishing diplomatic relations with Japan, and to avoid appearing less generous than the Taiwan government, which had renounced reparation in the 1950s. However, this renunciation was also made with the mutual and implicit understanding that good relations between China and Japan would be good for China's future economic development. This unspoken understanding translated into Chinese expectations of economic assistance from Japan after China's economic opening in 1978. At the time of the establishment of diplomatic relations in 1972, however, there was no explicit link between this Chinese waiver of reparations and ODA because China was not yet even contemplating allowing foreign direct investment, let alone aid, into the country.

This implicit link on the part of the ODA programme is important to remember because the Chinese often referred to it in later years, particularly when the ending of the loan programme started to become a public issue in 2004/2005. After all, how can a moral debt be relinquished? It was therefore not surprising when in 2005 the Chinese Foreign Ministry spokesman criticized the Japanese intention of ending the yen loans by saying, 'Yen loans are a mutually beneficial arrangement that came into being under special policies and against a historical backdrop' (Kyodo, 3/3/05). The Chinese understanding of the ODA's link to the renunciation of reparations also considerably diminished China's gratitude for Tokyo's largesse in the following years because the aid was seen as something China was 'owed' for its generosity after having suffered so much from Japan's encroachment before 1945. For the Japanese, the opportunity to undo the harm of the past by providing ODA, which Japan gives to many other countries as well, may not have helped many Japanese to come to terms with the country's past, or at least not to a degree which would satisfy the Chinese.

### **Japanese Reasons for Ending the Loan Programme**

'Chinese ingratitude' for Japan's ODA was one of the reasons Japan gave for wishing to end the yen loan programme. Apart from the implicit link to reparations, the Chinese perceived the Japanese aid as benefiting Japan, and notably the yen loans have to be repaid, albeit at an internationally agreed-upon low interest level which qualifies them as 'development aid'. Moreover, Japan's ODA loans have been used mostly to build up China's economic infrastructure, which has often been linked to Japanese trade interests (for example, ports and roads).

However, more important reasons were the success of China's economic development and a series of Chinese political and military developments, all of which raised concern in Japan. It is natural that a successful aid programme has to end at some point. Moreover, some of the implications of China's economic achievement have been perceived as negative for Japan; these include China's growing competitive power, the hollowing out of Japan's manufacturing sector, the global competition for raw materials and energy, illegal immigration, transboundary crime, and the environmental degradation which has also affected Japan (acid deposits, yellow sand, marine pollution). Particular lightning rods in this context have been China's own aid programme and iconic achievements such as the beginning of manned space craft launches. The Chinese space flights in October 2003 and 2005 had a particularly negative influence on Japanese public opinion because of the budgetary extravagancy they displayed, particularly for a country beset with as many developmental problems as China, and because of the lack of anything comparable to the Chinese space programme in Japan. China's economic success, due to its demographic and geographic dimensions, has affected Japan's relative economic position and identity as the world's second-largest economic power. Finally, China's favourable economic situation has raised questions about the Chinese government's budgetary allocation choices as well as about the availability of loans at commercial conditions.

Other circumstances which have reduced Japan's incentives to continue loans to China are the increasing loss of leverage accruing to Japan as a result of ODA and China's own aid programme. In 2000 the temporary withholding of a decision on ODA in relation to Japan's demands for 'prior notification' regarding Chinese research vessels wanting to operate in Japan's Exclusive Economic Zone (EEZ) in the East China Sea helped the two parties to find a compromise. However, while from 1995 to 1997 Japan could still send an important political message to China with the suspension of its grant programme in response to China's resumption of nuclear testing (even if it had only a very limited impact on China), such influence has now become even more limited in view of China's economic success and its resulting assertiveness and self-confidence.

Since 2000, China's own aid programme has become an important argument for curtailing Japanese ODA. According to the Japanese Ministry of Foreign Affairs, China transferred USD 450 million (JPY 54 billion) in assistance to 58 countries in 2000 (AS, 28/10/01). Concern is focused not only on the fact that China considers itself able to do this, but also on the way this aid is being

provided. The latter concern is also shared by other Western donors. However, with respect to the principle of an ODA recipient providing ODA itself, Japan has to remember that it was itself still a recipient of economic assistance when it started to give ODA in 1954 after joining the Colombo Plan. It received World Bank loans for infrastructure projects (including the first Shinkansen line) until 1964. Moreover, the fact that India is providing ODA to other developing countries has not prevented Tokyo from making New Delhi the top recipient of yen loans since 2004.

Even more serious are various Chinese security policies which are perceived as negatively affecting Japanese interests. Most often referred to is the non-transparency of China's military build-up (two-digit annual increases since 1989) and its actions in the East China Sea. According to the 1992 Official Development Assistance Charter, when giving aid, consideration has to be given to defence expenditures, development and production of weapons of mass destruction and missiles, and the export and import of weapons. At least until the decision to end the loan programme, political considerations had prompted the Japanese government to mostly ignore the Charter. The territorial conflicts in the East China Sea around the ownership of the Senkaku/Diaoyu Islands and the delimitation of the maritime border, the Chinese naval build-up, and its military incursions into EEZs claimed by Japan continue to inflame Japanese public opinion.

The decision to end the yen loans also has to be seen against the general background of the deteriorating bilateral relationship, notably during the era under Prime Minister Jun'ichirō Koizumi from 2001 to 2005, which saw anti-Japanese demonstrations in China and annual visits by Koizumi to the Yasukuni War Shrine in Tokyo. The deterioration of Japanese-Chinese relations has politicized ODA as a foreign policy tool. The role of the Japanese bureaucracy in general has become a popular target of criticism, and the China School of the Foreign Ministry has been singled out for being too soft on China. For the Foreign Ministry, ODA is the most important policy tool and the general decrease in the country's ODA is diminishing its budgetary as well as political weight.

Finally, there has been a general change in Japan's ODA policy which has also affected the ODA programme for China. In the 1990s, Japan's ODA underwent changes at the level of involved decision makers, aided sectors, distribution, quantity, and political conditionality. Japan's budgetary constraints (by 2006, the state's debt burden in relation to the country's GDP amounted to 170 percent) has prompted the government to slash the ODA budget by over 30 percent since

1999. As a result of several critical reports, ODA scandals, and public criticism of traditional ODA policy, the focus is now on poverty alleviation, environmental sustainability, and human security. Increasingly, the government relies on the distribution of ODA by NGOs, both Japanese or foreign. More attention is paid to the efficacy and accountability of ODA, as well as maintaining public support.

### **The Decision to End the Loan Programme in 2005**

It is against this background of a general as well as China-specific reorientation of ODA, mounting grievances against China, and a significant drop in new loan commitments to China that the official discourse from 2004 onwards began to refer to the ending of Japan's ODA. The year 2004 saw a further deterioration of the bilateral relationship, with China still refusing a summit meeting in either country because of the Prime Minister's Yasukuni Shrine visits, anti-Japanese outbursts at the Asian Cup soccer matches in the summer, the ratcheting up of the territorial conflicts in the South China Sea, the Chinese refusal to accept an EEZ around Japan's Okinotori Island in the Pacific, and the November intrusion by a Chinese submarine into Japanese territorial waters.

While there had been various demands from single politicians and think tanks to stop ODA to China, the first official references to the ending of the yen loan programme at the highest government level came in October 2004. On 3 October 2004, just after taking up the post of foreign minister, the hawkish Nobutaka Machimura told an ODA-related gathering in Tokyo ('Gaimusho Town Meeting') that China would graduate from Japanese aid 'someday' but that with many impoverished people still in the inland area it was still too early (JT, 4/10/04). This sentiment was echoed even more strongly by Prime Minister Koizumi on 28 November, on his way to an ASEAN meeting in Laos, when he said that 'the time to graduate' [from ODA] had come (DY, 29/11/04). To the many statements which followed and which contained similar criticism of Chinese policies, China reacted with displeasure and defiance. The Deputy Spokesman of the Chinese Foreign Ministry declared on 30 November that he hoped that ODA would play an active role in the development of the bilateral relationship. 'Irresponsible discussions will only damage Japanese-Chinese relations', he said. 'We cannot understand the Japanese domestic discussions. ODA has to be seen against a special political and historical background' (*Tokyo Shinbun* 2004). In March 2005 the government finally let it be known that it had told China about plans to begin cutting the size of its yen loans from the current fiscal year, aiming to phase

them out entirely by fiscal 2008, while grants and technical aid would be given for training and environmental protection programmes (AS, 3/3/05). Foreign Minister Machimura called his Chinese counterpart in March to inform him about Japan's decision, and there was a verbal agreement between the two made about it the following month (MOFA 2005a). The year 2008 was obviously chosen because of the Beijing Olympics, which in Japanese eyes marks a country's graduation from ODA loans, as it did for Japan when it staged the Olympics in 1964.

The impact of the deterioration of the bilateral relationship on the ODA loan programme was again illustrated in March 2006 when the Japanese government suspended the signing of the contract for the loan programme for the 2005 fiscal year because of the deterioration of relations, most notably the rising tensions over China's relentless development of gas and oil resources in the East China Sea (AS, 5/6/06). The suspension was only lifted in June 2006, and the loan amount was further reduced to JPY 74.8 billion.

*Table 1 Japanese Yen Loans to China on a Commitment Basis*

Year	Loans (unit: 100 million JPY)
2000	2,144
2001	1,614
2002	1,212
2003	967
2004	859
2005	748
2006	623
2007	463

*Source: MOFA (2007a); MOFA (2007c); AS, 7/6/06; MOFA (2005b); DY, 3/3/05; Gaimushō Keizai Kyōryoku Kyoku (2003).*

Although the decision to end loans was taken abruptly, the process had begun much earlier. Having peaked in 2000, at JPY 214.4 billion, they have now declined to JPY 46.3 billion in 2007. This brings the total allocated since 1979 to JPY 3.316 trillion (DY, 10/11/07). At the same time as the cumulative total is still growing, so is the repayment total. Moreover, as a result of the long time it takes from loan commitment to final disbursement – approximately five to seven



years – actual disbursement has still been increasing as well.

This development is hardly mentioned in the public discussion in Japan, and the incomplete information provided by the Japanese government, as well as the confusing terminology, is not helping either. The Japanese government does not disclose the interest element of loan repayments for a specific year, although it makes public the interest rate of a loan when the commitment is made (MOFA 2004).

Interestingly, there have been no demands to end grants and technical aid as well. According to the head of Japan International Cooperation Agency (JICA) in Beijing, Masato Watanabe, there are no yardsticks for ending technical aid and South Korea, for example, received such aid as late as 2001.<sup>2</sup> On 18 March 2005 the Foreign Ministry spokesman did, however, announce that non-project grant assistance would be terminated since China's GNP per capita would soon exceed the level under which the government would 'usually' grant assistance (MOFA 2005c).

The abrupt nature of the decision to end the yen loan programme is evidenced by the government's abandonment of the usual procedures for such policy changes. Japan normally applies a variable scale of economic achievement indicators which have been developed by the World Bank (WB) to determine when to finally end various categories of aid programmes (called 'graduation'). If an assessment of China's loan eligibility had been based on this scale, China would simply have lost some particularly concessionary loan entitlements. However, at least in public, the Japanese government did not refer to these criteria at all and instead sacrificed valuable political capital by simply telling the Chinese government about its decision.

In this context it is also interesting to notice that the Japanese government began in 2006 to actively lobby international banks like the WB and the International Monetary Fund (IMF) to reconsider their loans to China and to demand that China's own aid programme become more transparent. At a meeting of the WB and the IMF in Singapore in 2006, the Japanese delegate demanded a review of the graduation process for successfully developing countries like China and asked for increased transparency of assistance on the part of emerging donors (IHT, 18/9/06; Kyodo, 19/9/06).

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<sup>2</sup> Interview 28 November 2006 with Masato Watanabe conducted by the author.

## Future Loans for Environmental Aid?

As we have seen, since the 1990s Japan's ODA has been paying more attention to environmental concerns in general. This has also been the case for all three categories of Japan's ODA to China (Hirono 2007). The 2007 fiscal year yen loan package contains only environment-related projects such as waste treatment plants and air pollution countermeasures (MOFA 2007b). This new focus was also explained at the time the yen loan ending was announced. On 18 March 2005 the Foreign Ministry's spokesman declared that his country would 'continue to extend assistance to China, mainly for environmental projects and poverty eradication projects in the inland area, through various types of grant assistance' (MOFA 2005c).

There are various circumstances which explain Japan's particular interest in extending environmental and energy aid to China. First of all, Japan is directly affected by pollution generated in China. The irony is, of course, that Japan's ODA, and particularly its private investment, is indirectly and directly contributing to this pollution, although in the end it is the Chinese government's responsibility to achieve environmentally sustainable economic growth.

Secondly, Japan feels responsible for contributing to an improvement of the environment, at home as well as globally, because the Kyoto Protocol's name is directly linked with the country. It has become clear that the Chinese government is opposed to any international commitments to numerical targets related to the reduction of pollution, even under the successor agreement to the Kyoto Protocol (ending in 2012), and expects advanced countries such as Japan to help it make environmental protection as growth-neutral as possible by providing financial and technological aid (DY, 30/8/07). The Chinese are obviously very interested in Japan's technology, as was most recently expressed by China's ambassador to Japan in January this year (JT, 18/1/08).

Thirdly, environmental aid is considered to be a self-interested means which neutralizes some of the political damage caused by the ending of the yen loans. Fourthly, environmental aid is linked to providing energy conservation technology, for which there exists commercial interest in Japan and which is seen by the Japanese government as somewhat reducing the enormous speed of Chinese energy consumption growth, thus reducing pressure in the Japanese-Chinese competition for energy resources. In addition, the Japanese government has been using the offer of energy conservation and energy storage technology in order

to give China incentives for an amicable resolution to the territorial conflict in the East China Sea. In 2006 Tokyo hosted a Japan-China forum for technical experts on energy-saving technologies, and on the occasion of Prime Minister Wen Jiabao's visit to Japan in April 2007, an energy dialogue was organized at short notice. The latter was attended by about 650 Japanese and Chinese business executives from oil, gas, electricity, and other energy-related companies and is to be held annually (JT, 13/4/07). The second comprehensive forum on energy conservation and environmental protection was held on 27 September 2007 in Beijing. Both forums took place alongside a bilateral ministerial meeting of the ministers in charge of energy.

Finally, Japan is obliged under the Kyoto Protocol to reduce its own emissions but finds it impossible to do. However, some of the reduction can be done abroad through the Clean Development Mechanism (CDM), under which industrialized countries are able to use their own technologies and funds for projects based in developing countries to cut greenhouse gas emissions and use these reductions to offset their own output.

In order to finance part of the CDM, the Japanese and Chinese governments reached a basic agreement in January, which is to be finalized during President Hu Jintao's forthcoming Japan visit, under which the Japanese government and domestic firms would purchase a portion of China's greenhouse gas emissions quotas that fall under reductions achieved by the country through Japanese yen loan projects. According to the *Yomiuri Shinbun*, these projects refer to ongoing yen loan projects which will continue to run until well after 2008 because of the long period between contract conclusion and final disbursement/completion (DY, 3/1/08). However, this author would not be surprised if Japan eventually revives yen loans in some form in order to help China as well as itself to achieve environmental goals.

## Conclusions

The Japanese government's 2005 decision to end all ODA loans by 2008 was clearly taken for political reasons, which is obvious from the fact that the government at no point referred to its usual guidelines for ending ODA loans or explained the standard by which China would be considered to have graduated to become a developed country.

It would have demanded considerable political foresight on the part of the relevant government agencies and politicians, in Japan as well as in China, to

face the inevitable need to graduate China from yen loans to avoid the hijacking of the decision-making process by the deterioration of Japanese-Chinese political relations, as it happened in the end. However, apart from inertia, there were strong political and bureaucratic interests which worked against such political foresight and wisdom. It is natural that there was no interest on China's part in initiating any discussions with Japan about ending Japan's ODA yen loans because these loans have been so useful to China. For Japan's Ministry of Foreign Affairs, the ending of yen loans (and thus the possible opening of the Pandora's Box of a total ending of ODA to China) would deprive the ministry of its most potent foreign policy instrument vis-à-vis China while also sending (more) negative signals to China and setting a precedent for either other ODA cuts or the reinforcement of the restructuring of ODA policymaking at the expense of the Foreign Ministry. The Japanese bureaucracy (notably the Japan Bank of International Cooperation (JBIC)) was also not interested in losing a debtor which so far had always punctually repaid its loans from Japan. Although there are certainly countries which have a greater need than China for yen loans, China, with its excellent repayment record, will be difficult to replace.

This lack of foresight or political wisdom contributed in 2005 to the deterioration of Japan's perception of China; further inflamed the history issue (reparation-ODA linkage), which was already at a critical point because of Koizumi's Yasukuni Shrine visits; and further reduced China's willingness to properly appreciate Japan's ODA loan programme. Instead of being able to celebrate the successful closure of Japan's main ODA category and serving as a welcome opportunity to reduce tensions at a difficult moment in the bilateral relationship, the programme ended under what the Chinese perceived as a punitive cloud. However, in the end the Chinese government had no other choice than to accept the Japanese decision in order to at least maintain the other ODA categories.

The greatest loss to Japanese-Chinese relations may be that, in the longer term, the decline of ODA and the very much China threat-motivated reinforcement of the Japanese-American security cooperation will further unbalance Japan's engagement policy towards China by putting more emphasis on political and military power balancing to enhance Tokyo's leverage over China, at the expense of the political and economic enticement elements of that policy. This will also reinforce Japan's dependence on US policies. China cannot escape its share of responsibility for this development.

It is therefore a positive development that Japan's strong interest in environ-

mental and energy aid is offsetting, at least to some extent, the ending of the yen loan programme to China and may even lead to an eventual revival of loans to China. Even though private Japanese companies will have to shoulder most of the CDM expenditures, the government will have to supplement the transfer of environmental and energy conservation technology to some extent.

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