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# Responses to Regionalism in East Asia

Japanese Production Networks  
in the Automotive Sector

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Andrew J. Staples



## Responses to Regionalism in East Asia

*Palgrave Macmillan Asian Business Series*

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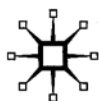
## Japanese Production Networks in the Automotive Sector

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*For*  
**Oliver, Emily**  
*and my wife,*  
**Naoko**



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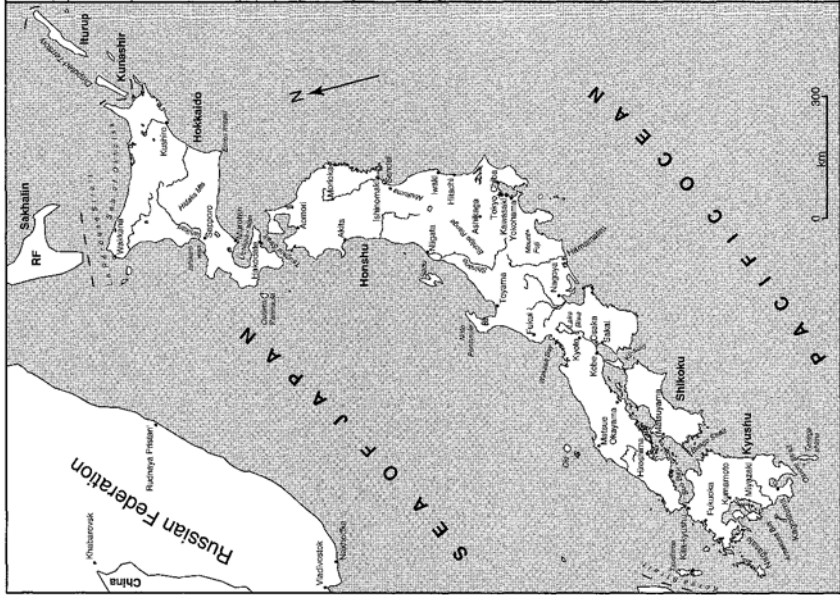
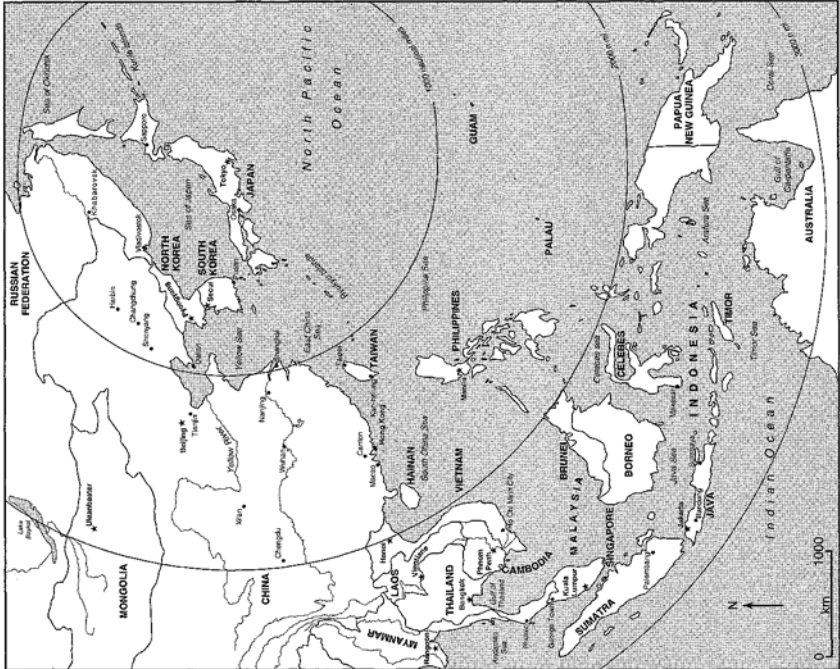
Andrew Staples

# Abbreviations and Acronyms

ADB	Asian Development Bank
AFC	Asian Financial Crisis
AFTA	ASEAN Free Trade Area
AIA	ASEAN Investment Area
AID	New Asian Industrial Development
AEP	Automotive Exports Program
AICO	ASEAN Industrial Cooperation Organisation
AJCCEP	ASEAN-Japan Committee on Comprehensive Economic Partnership
APEC	Asia Pacific Economic Cooperation
AMF	Asian Monetary Fund
APT	ASEAN+3
ASEAN	Association of South East Asian Nations
ASEM	Asia-Europe Meeting
AUV	Asian Utility Vehicle
BBC	Brand-to-Brand Complementation
BOJ	Bank of Japan
CBU	Completely Built Up
CEPEA	Comprehensive Economic Partnership in East Asia
CEPT	Common Effective Preferential Tariff
CKD	Complete Knock Down
CLMV	Cambodia, Laos, Myanmar, Vietnam
CMI	Chiang Mai Initiative
DAC	Development Assistance Committee
DFI	Direct foreign investment
EAEC	East Asian Economic Caucus
EAFTA	East Asian Free Trade Agreement
EAPE	East Asian political economy
EAS	East Asian Summit
EASG	East Asian Study Group
EAVG	East Asian Vision Group
EEC	European Economic Community
EHP	Early Harvest Programme
EPA	Economic Partnership Agreement
EPZ	export promotion zones
EU	European Union
FDI	Foreign direct investment
FG	Flying Geese
FTA	Free Trade Agreement

FY	Fiscal Year
G-8	Group of 8 advanced economies
G-24	Group of 24 developing economies
GATT	General Agreement on Tariffs and Trade
GCC	Global commodity chain
GDP	Gross Domestic Product
GM	General Motors
GMS	Global Manufacturing System
GNP	Gross National Product
GPN	Global production network
GTAP	Global Trade Analysis Project
GVC	Global value chain
HMC	Honda Motor Co., Ltd
HMCI	Honda Motor (China) Investment Co., Ltd.
ICT	Information and communications technology
IDE	Institute of Developing Economies
ILO	International Labour Organisation
IMF	International Monetary Fund
IMV	International Multi-purpose Vehicles
IPE	International political economy
IR	International Relations
IPRs	Intellectual Property Rights
ISEAS	Institute of Southeast Asian Studies
IT	Information Technology
JACEP	Japan-ASEAN Comprehensive Economic Partnership
JAMA	Japan Automobile Manufacturers Association
JBIC	Japan Bank for International Cooperation
JETRO	Japan External Trade Organisation
JKFTA	Japan-Korea Free Trade Agreement
JMEPA	Japan-Malaysia Economic Partnership Agreement
JPEPA	Japan-Philippines Economic Partnership Agreement
JSEPA	The Japan-Singapore Economic Partnership Agreement
JSG	Joint Study Group
JTEPA	Japan-Thailand Economic Partnership Agreement
JIT	Just in Time
JV	Joint Venture
KD	Knock Down
KIEP	Korea Institute for International Economic Policy
M&A	Merger and Acquisition
MAI	Multilateral agreement on investment
METI	Ministry of Economy, Trade and Industry
MITI	Ministry of International Trade and Industry
MMC	Mitsubishi Motors Corporation
MME	Mitsubishi Motors Europe

MNC	Multinational Corporation
MNE	Multinational enterprise
MOF	Ministry of Finance
MOFA	Ministry of Foreign Affairs
MPV	Multi-Person Vehicle
MUVs	multi utility vehicles
MRDE	Mitsubishi Research and Design Europe
NAFTA	North American Free Trade Agreement
NEA	Northeast Asia
NGO	Non-governmental organisation
NIE	Newly Industrialised Economy
NIDL	New International Division of Labour
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
OEM	Original equipment manufacture
OPTAD	Organisation for Pacific Trade and Development
PAFTA	Pacific Free Trade Area
PECC	Pacific Economic Cooperation Council
REITI	Research Institute of Economy, Trade and Industry
RPN	Regional production network
RTA	Regional Trade Agreement
SAR	Special Administrative Region
SEA	Southeast Asia
SME	Small and medium sized enterprise
SUV	Sports Utility Vehicle
TAFTA	Thailand-Australia Free Trade Agreement
TMAP	Toyota Motor Asia-Pacific
TMC	Toyota Motor Corporation
TME	Toyota Motor Europe
TMEME	Toyota Motor Engineering and Manufacturing Europe
TMMNA	Toyota Motor Manufacturing North America
TMNA	Toyota Motor North America
TMT	Toyota Motor Thailand
TMS	Toyota Motor Sales
TMP	Toyota Motors Philippines
TMSS	Toyota Motor Management Services
TNC	Transnational Corporation
UMNO	United Malays National Organisation
UNCTAD	United Nations Conference on Trade and Development
VER	Voluntary export restraint
WTO	World Trade Organization
YOY	Year on Year



# 1

## Introduction: East Asia, Regionalism and Foreign Direct Investment

That the processes of globalisation have been a defining feature of contemporary society is beyond doubt, and within this East Asia stands as a vivid example of a region transformed by these *global shifts* (Dicken, 2003). Globalisation is a much used and contested term but is employed here to describe the deepening integration of global (capitalist) economic activity facilitated by the rapid development of information and communications technology (ICT) and the underlying trend of neo-liberalism. The union of these two forces has resulted in global, if widely uneven, economic expansion. Globalisation may also be seen as a continuation of the constant struggle between states and markets and although it has been claimed that states are increasingly losing out to other economic actors in this process, the multinational enterprise (MNE) in particular, the growing trend towards regionalism appears to reaffirm the continuing relevance of states as central units of analysis. Indeed, regionalism, a defining feature of the late 1990s and early twenty-first century, is a state-level process.<sup>1</sup> At the same time, in East Asia<sup>2</sup> this political process has emerged, at least in part, as a response to globalisation and the deepening regionalisation of economic activity. This interaction between regionalisation and regionalism, between private and state actors, is a key dynamic of the East Asian political economy today. Regionalism may only be properly understood with reference to regionalisation and this in turn requires an investigation into the international division of labour in East Asia. This book is primarily concerned with this *regional nexus* and takes as its focus the responses to regionalism as observed among Japanese automobile makers and, more specifically, the regional production networks (RPNs) that they have established in East Asia.

The shock of the 1997/8 Asian financial crisis (AFC) continues to resonate throughout the region and beyond, yet it is the deeper, or more permanent, impact of these events that now deserves our closer attention. An earlier financial upheaval, the rapid appreciation of the Japanese Yen following the 1985 Plaza Accord, was a similarly seminal event that recast key

aspects of the region's fundamental economic structure. Then the inflow of export orientated Japanese FDI and host (developmental) policy led to the emergence of the RPN in Southeast Asia. Now, the continued evolution of the RPN is taking place against a backdrop of stalled multilateralism, of deepening regional economic integration, and the seemingly inexorable rise of the Chinese economy.

Japanese FDI has played a central role in the economic development of East Asia over the last four decades and a significant literature has emerged to examine this phenomenon adopting a variety of approaches. Political scientists, for example, utilise FDI as a proxy to consider aspects of Japan's international relations, development specialists focus on the mechanisms of FDI led economic growth through accompanying technology transfer and spill over effects, while economists might analyse how investment flows influence macroeconomic indicators. More recently, scholars of international political economy (IPE) have located their investigations into the internationalisation of (Japanese) production and the implications of this in the context of globalisation and regionalism.

### Questions and aims

It is within this context that this book investigates Japanese multinationals in East Asia in this era of regionalism. Why Japanese firms and why East Asia? First, any study of the international division of labour in East Asia necessitates a recognition of Japan's economic and political gravitas and the extent to which its firms have penetrated regional economies. This is particularly so in the automotive sector. Second, regionalism, on the back burner for many years has only recently begun to heat up. More specifically, it is suggested that in the post-crisis era the region's political economy has experienced, and continues to experience, a radical transformation and that this necessitates a re-evaluation of the way in which we can understand, or know, the complex interrelation between the regional political economy and international production. The central question of this book, then, is to what extent has the transformation of the East Asian political economy impacted on the strategies employed by Japanese multinationals in their East Asian operations? Furthermore, what are the implications of changing corporate strategies in the automotive sector for the Association of South East Asian Nations (ASEAN) economies in a period of rapid Chinese expansion? Finally the study proposes an analytical framework that focuses attention on the concept of the regional nexus, of which regionalism, regionalisation and the RPN are core, constituent components. This study thus aims to make an empirical and theoretical contribution to the literature and is positioned, broadly, in the field of IPE which, given the *catholic* nature of this field, further draws to greater or lesser degrees on the international business, political economy and economic geography literatures.

## Organisation and structure

This book is divided into three parts and nine chapters as shown in Table 1.1. This initial chapter introduces the subject area and aims of the study and overviews its organisation, structure and methodology.

Chapter 2 reviews mainstream and critical theories of FDI and presents the analytical approach that informs the study. It is argued that post-crisis trends and events at the multilateral (global), regional (East Asian), and national (Japan) levels collectively constitute a radical transformation of the East Asian political economy and that this necessitates a modified approach to issues concerning the international division of labour in the region. Mainstream theories of FDI and the variant flying-geese (FG) paradigm have made valuable contributions to our understanding of the international activities of firms, and of Japanese firms in East Asia, yet this new era may render aspects of the framework redundant or overly simplistic. A modified approach attempts to overcome these difficulties by drawing particular attention to the regional context and locating firm-level analysis firmly within this. More specifically, the approach identifies key aspects of the transformation of the region's political economy and relates them

**Table 1.1 Organisation of study**

Part	Content	Chapter	Content	
1	Overview and theory	1	Introduction	Aims, questions, structure, methodology FDI theory and analytical approach employed
		2	Theory and analytical approach	
2	Research context	3	The transformation of the East Asian political economy	Firm-level analysis
		4	Japan's role in East Asia	
		5	Japanese FDI in East Asia – the automotive sector	
3	Empirics and analysis	6	Responses to regionalism: general strategy and the organisation of production in East Asia	Firm-level analysis
		7	Responses to regionalism: the East Asian investment environment	Firm-level analysis
		8	Responses to regionalism: regional production, trade and economic integration	Firm-level analysis
4		9	Conclusions	Final comments

to corporate strategy. By doing so, a richer understanding of the contemporary<sup>3</sup> reality emerges. Chapter 3 is the first of three chapters that constitute Part II of the study and takes as its focus analysis of the region's political economy in the post-crisis period. This is achieved by first reviewing competing accounts of East Asian development, emergent regionalism and the regional division of labour as observed in RPNs. The chapter then considers six trends identified as core components shaping the contemporary landscape. These are: stalled multilateralism, deepening regional economic integration, financial, institutional and trade related responses to the AFC, and the rise of China. In this way this chapter presents a detailed picture of the forces shaping the region and constructs the context within which a more micro-, or firm-level analysis can occur. Chapter 4 adds to this process by reviewing Japan's role in East Asia and its responses to the trends detailed above. As such, this chapter reviews Japan's changing economic policy towards the region, its involvement in the growing trend toward free trade agreements (FTAs), trade and investment links, its role in the institutionalisation of regionalism and issues concerning regional leadership *vis-à-vis* China. This chapter thus provides a further vantage point from which to examine both region and (Japanese) firm. Chapter 5 concludes the review of the research context and prepares the ground for the presentation and analysis of empirical data in subsequent chapters. The aim of the chapter is to overview the automotive sector in general, the Japanese automotive sector and Japanese automotive sector involvement in East Asian economies. Given the scale and complexity of the automotive sector, these sections do not attempt a business history or comprehensive industrial analysis. Rather, the aim is to survey the industries and pertinent trends so as to locate the subsequent presentation of empirical data in the broader, global and regional perspectives. In Part III, Chapters 6, 7 and 8 present data collected from interviews with three leading Japanese automakers. The methodology employed is discussed in more detail below and the case studies are presented thematically so as to allow for clearer comparison and analysis. Chapter 9 draws together analysis of the case studies and considers this in light of its implications for the research questions as identified above. The chapter concludes the study by reviewing the validity of the approach taken and final comment is given on areas for further research.

### **Methodological issues and research design**

This book is the publication of a social science-based research project under the broad designation of Area Studies (Japan and East Asia) and as such needs to pay attention to its epistemological foundations. This section considers first some generic themes relating to research in the social sciences before turning attention to the model of science employed and its philosophical

foundations. This achieved, two further sections present the research strategy and offer justification for the methodologies employed.

## **Social science research**

Underpinning the range of methods available to the social scientist is implicit reference to questions that ponder ‘what characteristics distinguish science from non-science, what procedures should scientists follow, [and] what conditions must be satisfied for a scientific explanation to be correct?’ (Smith, 2000:5). Is it possible to be scientific, should we be? (Robson, 2002) and what is the role of science in society, what is it for (Chalmers, 1982)? All thought on social research stems from these central questions and any reference to methodology in social sciences must be accompanied by a clarification of its philosophical foundations, the particular assumptions and approach or perspective behind the work. As May notes, ‘to use a building analogy, if we do not understand the foundations of our work, then we are likely to end up with a shaky structure’ (May, 2001:3). Research approaches are guided in terms of their scientific paradigms, defined here as ‘a set of basic beliefs...[which]...defines, for its holder, the nature of the world, the individual’s place in it, and the range of possible relationships to that world and its parts...’ (Guba and Lincoln, 1994:105). In short, a paradigm is used to signify a model or principle to be followed and translates into a methodology (the technique that allows the researcher to gain knowledge of reality) through a statement of ontology and epistemology or the relationship between the inquirer and the known or unknown (Guba and Lincoln, 1994). As a model of science, this study may be described as top-down or hypothetico-deductive in nature as opposed to the bottom-up technique that describes inductionism. That is, a process that commences with a critical review of pertinent theories resulting in the identification of testable hypotheses or research questions. Observation (in this case data collated through interviews and questionnaires) is then used to test hypothesis or to build explanations which in turn feed back into the theoretical literature for further testing, replication, modification or falsification. While this is the ideal model promoted in the literature, it is always susceptible to the brute realities of research practice, which must in turn be pragmatic while nevertheless maintaining philosophical principles and academic rigour. With this statement in hand, attention now turns to consider in more detail the (social) scientific paradigm that guides this study.

## **Critical realism and international political economy**

As introduced above, this project is located within the broad field of IPE and this declaration has implications for the philosophical underpinning of the research design and methodologies employed. IPE’s area is essentially

the global economic, political and security nexus. This focus 'produces a concern with problems and issues such as international trade, international monetary relations, North-South relationships, transnational corporations, global economic problems, the foreign economic policies of states and a whole host of other specific topics' (Tooze, 1984:2). Central to an IPE perspective is a rejection of the separation of international and domestic, political and economic, security and trade issues and a call for more and better analytical tools than those employed in traditional, narrowly defined academic approaches.

An IPE approach, in contrast to the adoption of a specific methodology or theory, has been described as employing a set of questions. '[IPE]... denotes an area of investigation, a particular range of questions, and a series of assumptions about the nature of the international "system" and how we understand this "system"' (Tooze, 1984:2). In other words, 'IPE simply indicates a set of questions to be examined by means of an eclectic mixture of analytical methods and theoretical perspectives' (Gilpin, 1987:9). IPE's critique of mainstream (positivist) approaches to social research centres on the 'goal' of objectivity and value free theory. This is made clear by Cox who states that, 'theory is always for someone and for some purpose. All theories have a perspective...there is...no such thing as theory in itself, divorced from a standpoint in time and space' (Cox, 1986:128). Value free objectivity is seen as 'neither ultimately attainable nor, in fact, desirable...' (Tooze, 1988:3). Why is this? Surely if one is to be scientific in one's approach, objectivity and the replication of natural science like neutrality and detachment in the research methodology employed is a necessary aim? Yet it is precisely this rejection of detachment and assumed objectivity that makes an IPE approach not only attractive but necessary for the study of the issues outlined above.

The problem with the pursuit of value free objectivity in the social real world is illustrated by the example given by Hilpert and Haak (2002) of approaches to the question of whether Sino-Japanese relationships could be categorised as conflict or cooperation. The authors note that political scientists employing the dominant theoretical approach (realism) to international relations 'would probably conclude that the differences between China's and Japan's national interests were irreconcilable, and adjustment issues arising from bilateral economic closeness were just minor issues before a major, brewing storm' (2002:33). On the other hand, 'an economist looking at international trade under the assumptions of the neo-classical trade theory would see economic relations between Japan and China as basically complementary' (*ibid.*:33). Both approaches employ the dominant theoretical framework in their social scientific fields yet yield diametrically opposed versions of reality. Is it then possible, or desirable, to describe an IPE approach as scientific? As noted above, all social research has philosophical foundations and these are more or less conspicuous depending

on the area of research. Perhaps more immediately important to the construction of a research methodology is the adoption of a scientific approach to research. Indeed, having a sufficiently scientific attitude to social research could be considered in itself a scientific method.<sup>4</sup> 'By this I mean that the research is carried out systematically, skeptically and ethically' (Robson, 2002:18).

This suggests that the nature of the study and of the IPE perspective that informs it may be appropriately underpinned and bolstered with reference to *critical realism*, given its rejection of the positivist and empiricist traditions, acknowledgement of the importance of structural mechanisms, and call to reject the empiricist (that is, non-critical) reflection of the everyday world (May, 2001; Mingers, 2000; Sayer, 1992). As will become apparent in the following chapter, critical realism's reference to underlying structural mechanisms holds a particular resonance for this study and for IPE. This study is, essentially, seeking to understand and explain the mechanisms by which RPNs are evolving (regionalisation), the context, or structural mechanisms, within which this is taking place (regionalism), and the dynamics of the interaction between these two phenomena.

## The research strategy

In addition to the social scientific underpinning of this work as explored above, attention should also be given to the particular demands of research undertaken with and within business organisations. This section details the research strategy employed and considers some justifications for the methodologies employed with reference to this issue of research undertaken with business.

The original scope of this study was to conduct research with Japanese MNEs in both the automotive and electronics sectors yet it became apparent after an initial round of access seeking interviews and concomitant development of the research agenda that this would require some reconsideration and adjustment. The nature of production in the electronics sector is distinctly more fragmented than observed in the auto sector and thus the original intention to compare and contrast the two, it was felt, sat somewhat uneasily with reality and the proposed methodology. Additionally, Japanese electronics firms were, and still are, in a period of radical restructuring which has included the exiting of production of low-end (analogue) products and a refocusing on high-end (digital) products and services. As a consequence, and to ensure that the project remained manageable given time and financial restraints, it was decided that the electronics studies be shelved.

The first round of interviews was conducted in December 2002 (automotive) and June 2003 (automotive and electronics) in Tokyo, Japan. A total of four automotive and six electronics firms were included and initial

access gained largely through personal introductions. Where access was sought through cold calling, only limited success (one electronics firm) was met. This underlines a key difficulty with relation to conducting research with firms who may see little benefit to themselves in a given research project and/or are unable to accommodate the (very many) requests for access that they receive. This is the case with regards to MNEs in general and even more so with Japanese firms given the social and cultural environment within which they operate. Japanese business culture is often characterised as hierarchical, homogenous and uncertainty avoiding (Hofstede, 1994), meaning in practice that personal introductions are crucial. A brief summary sheet of the aims and objectives of the research project, and of the broad areas that I wanted to discuss, was sent in both Japanese and English to the contact after the initial communication following the introduction. This process was conducted exclusively by email. In addition to gaining relevant documentary data from the firms involved, a key objective of this round was to secure later access to key personnel beyond those employed in corporate communication departments in both Japan and Southeast Asia. Again with reference to the points raised above regarding access, Saunders makes the following point, 'simply obtaining physical access into an organisation will be inadequate unless you are also able to negotiate yourself into a position where you can reveal the reality of what is occurring in relation to your research questions and objectives' (Saunders *et al.*, 2003:115). For the purposes of this study, this has meant access to executives closely associated involved with the regionalisation of production throughout East Asia. As the results of the interviews were digested, and in addition to the decision regarding the electronics sector, it was further decided to drop the Nissan case study due to this issue. Consequently the final study presented here draws on research undertaken with three Japanese automakers. Although this whittled the planned number of firms and industrial sectors down to three and one respectively, the richness of the data and the distinct characteristics of the firms ensure the validity of the project. Both sets of interviews took place on company premises (initial 2002/3 and final 2004) and were conducted in a mixture of Japanese and English. As result of the initial round of interviews, continued literature review and collation of data from other sources, including trade organisations (The Japanese Automobile Manufacturers Association), the business media (*The Nihon Keizai Shimbun*; ASEAN Autobiz; Fourin Inc.) and official statistics (Ministry of Economy, Trade and Industry; Bank of Japan; ASEAN Secretariat), a questionnaire was drafted for use in the second round. As discussed below in further detail, the questionnaire was designed to gather corporate specific data on issues central to the aims and objectives of the study as outlined above and below. This period of fieldwork was located in Southeast Asia and came between seven and thirteen months after the Tokyo interviews. During this period, liaison took place with previous interviewees

with regards to access to relevant people in the region. Questionnaires were then sent to named participants approximately two weeks before the field-work session began allowing for the completion of written answers and the collation of relevant documentation. This strategy was followed in accordance with best practice as identified by Saunders *et al.* (2003).<sup>5</sup>

The second round of interviews followed the format as presented above with regards to language and recording but were differed in content in that the questionnaire formed the basis of the discussion. In most cases this resulted in a longer session of between ninety minutes and two hours. In one instance I was able to benefit from a considerably longer period of access to a senior executive and the company premises. In addition to working through responses to the questionnaire, certain firm specific issues arose and were discussed at times with supporting documentation, confirming as appropriate the decision to utilise the semi-structured interview technique.

## **Methodological justifications**

This study has drawn on both primary and secondary research to construct and present this examination of the regionalisation of production in East Asia as undertaken by leading Japanese auto manufacturers. This data then formed the empirical basis for the case studies as presented in Chapters 6, 7 and 8. It is appropriate then to provide some justifications and discussion of the methodologies employed at this point.

## **Interviews**

Four types of interviews are defined within the research methodology literature: structured, semi-structured, unstructured and group or focus (May, 2001; Robson, 2002). While most, if not all, of these techniques also coded and analysed quantitatively they are generally employed as qualitative methodologies. Structured interviews are associated with survey research and rely on a questionnaire that may have open or closed questions, or a combination of the two. This method was rejected as inflexible, overly limiting and consequently inappropriate to the research design. Unstructured and group or focus were also rejected given the number of participants and the previous identification of issues where data was required. The semi-structured interview by contrast offered a suitable methodology as this format, while designed to elicit responses through open or closed questions, also allows for the further discussion or investigation of responses as they arise. In other words, 'the interviewer [can] seek both clarification and elaboration on the answers given, [and] can then record qualitative information about the topic' (May, 2001:123). While semi-structured interviews may be vulnerable to concerns of reliability this is compensated for when recognition is gained for the richness and illuminating nature of the material collated

(Robson, 2002:273). A further logistical downside is the need for physical presence, in this case meaning fieldwork in Japan and Southeast Asia and the associated costs of travel, subsistence and accommodation. However, these were mitigated through the scholarships and other generous sources of funding acknowledged above. Moreover, and this is particularly true of the interviews undertaken in Southeast Asia, the time and financial costs were heavily outweighed by the benefits of visiting office and plant and of observing the regionalisation of production *in situ*.

## Questionnaires

As indicated above, a questionnaire was constructed for use in the second round of interviews and was designed in light of responses to the initial round, continued collation of secondary data and development of the research agenda. A broad range of questionnaire types are available for use although these can generally fall under one of the following three categories: self-completion, telephone, face-to-face (May, 2001). Given the complex nature of the issues under examination and of the data needed in support of explanations, telephone interviews were rejected as inappropriate and a hybrid strategy was employed that utilised both self-completion and face-to-face interviews. Questionnaire use is not without disadvantages (ambiguities in the understanding of questions, lack of anonymity, (negative) interviewer/respondent interaction) but the two-step process employed was designed to eliminate or at least mitigate these. Prior sending of the questionnaire allowed Japanese respondents sufficient time to prepare and respond to the questions while the follow-up interview allowed for clarification and further exploration of the proffered material and responses.

## Case study

The case study is an attempt to 'understand complex social phenomena' (Yin, 1994:3) and is a research strategy with its own logic, advantages and disadvantages. It is a 'strategy for doing research which involves an empirical investigation of a particular contemporary phenomenon within its real life context using multiple sources of evidence' (Yin, 1994 in Robson, 2002:178). Robson further defines a case study as 'a well-established research strategy where the focus is on a case (which is interpreted very widely to include the study of an individual person, a group, a setting, an organisation, etc) in its own right, and taking its context into account. Typically it involves multiple methods of data collection' (Robson, 2002:178). While positivism reigned supreme, case studies and other forms of qualitative research were likely to be regarded as inferior to quantitative methods and analysis, yet with the usurpation of positivism as the default philosophical basis for social research, this stance has been widely discredited (Guba and

Lincoln, 1994; May, 2001; Robson, 2002; Yin, 1994). Certainly in many areas of social research, the case study is an indispensable tool and strategy, though one not without certain disadvantages. One charge levelled at the case study approach is that it can be devalued through the inclusion of 'equivocal evidence or biased views [which then] influence the direction of the findings and conclusions' (Yin, 1994:9). The response to this lies in the earlier identified and stated aim of being sufficiently scientific (see above). The issue of generalisation based on a (singular) case study has also been raised. While the cases presented in this study may not provide grounds for generalisation on the issue of global production networks, they nevertheless offer insight into the responses to regionalism of key MNEs in the East Asian context. This is the main empirical contribution of this study, which when coupled with the principal theoretical contribution which explores the juxtaposition of regionalism and regionalisation in East Asia, define the original contribution of this work.

According to Yin (1994) case studies may be analysed by adopting one of two general strategies. The first relies on theoretical propositions and the second is the development of a descriptive framework for the organisation of the study. Saunders recapitulates these approaches as *pattern matching* and *explanation building* (Saunders *et al.*, 2003:390). While the former is considered by Yin as the 'more preferred strategy' (Yin, 1994:103) it is essentially concerned with prediction and the identification of dependent and independent variables. The explanation building strategy is considered more appropriate to this study as it 'involves an attempt to build an explanation while collecting data and analyzing them' (Saunders *et al.*, 2003:391). Explanatory research 'seeks an explanation of a situation or problem, traditionally but necessarily in the form of causal relationships; explains patterns relating to the phenomenon being researched; [and] identifies relationships between aspects of the phenomenon' (Robson, 2002:59–60). While the latter course is adopted here, it is anticipated that the areas for further research identified in Chapter 9 would be more suited to a strategy that calls more heavily on the testing of a predicted explanation, i.e., pattern matching. Both approaches, however, require the specification of theoretical propositions which are presented in Chapter 2.

## Ethics

Any scientific research exercise must pay attention to the question of ethical concerns or the 'code of behaviour appropriate to academics and the conduct of research' (Wells, 1994:284 in Saunders *et al.*, 2003:129). While formal approval from a university body was not required at the time of the research (this has since changed) the study was undertaken in compliance with the published guidelines and suggested good-practice then available. However, as the research was dependent on company employees for access, a

number of considerations did arise including that of power relations between myself and the interviewee, the right to privacy and the right to withdraw (Saunders *et al.*, 2003). Accordingly, all interviews were undertaken with informed consent, on the basis of information supplied regarding the nature of the research, the requirements of participation, the implications of taking part and participant's rights and about the use of the data collected and the way in which it will be reported (Saunders *et al.*, 2003:134).

**Part I**

**Theory and Approach**

# 2

## Foreign Direct Investment, Regionalism and (Japanese) Production Networks

The twin aims of this chapter are to review the relevant literature and subsequently to construct a robust analytical framework upon which the study can reside and proceed. The central thrust of this chapter is that the rapid transformation of the IPE as observed in East Asia in the late 1990s and early twenty-first century necessitates a revised approach to the regional activities of Japanese MNEs. Accordingly, the approach taken in this study builds upon the theoretical insights gained from the existing body of work as reviewed below but assigns a more explicit role to political economy (contextual) considerations by defining a regional nexus as the central locus of investigation. The approach thus locates firm-level empirical research in a broader, regional context in an attempt to gain a clearer, richer understanding of the contemporary reality.

Section one defines key terms of reference before attention shifts in section two to a review of mainstream (Western) theories of international production. Section three then introduces the Japanese response by reviewing in detail the emergence and development of the FG paradigm. Section four explores the contribution of critical traditions of theorising while subsequent sections delineate and develop the framework with reference to further conceptual and analytical frameworks.

### Defining FDI

Academic interest in the overseas activities of firms emerged in the late nineteenth century (Gomes-Casseres and Yoffie, 1993) and Lenin described the export of capital as the highest stage of capitalism in the pre- (Second) World War era (Lenin, 1939). Yet it was in the post-war period, as FDI flows rapidly increased and international trade once again expanded, that the modern theoretical framework emerged. This focused on the (Western) firm as the unit of analysis reflecting the fact that FDI was undertaken almost exclusively by Western firms at that time. However, as the Japanese economy recovered, developed and expanded from the mid-1950s an alternative

approach emerged that stressed the importance of comparative advantage in a macroeconomic framework and by doing so sought to shift attention away from the firm and onto issues concerning latecomer development. Both these approaches will be reviewed below as they inform the subsequent debate and analytical approach adopted in this study. Before we can proceed, it is important at this stage to clarify some terms of reference.

### **Foreign direct investment**

A number of definitions of FDI are utilised by the various organisations and institutions that constitute the global economic architecture although an accepted benchmark definition is offered by the Organisation for Economic Co-operation and Development (OECD):

Foreign direct investment constitutes a capital flow from a direct investor resident entity in one country to a direct investment enterprise resident in another country reflecting the objective of obtaining a lasting interest of the direct investor in the direct investment enterprise. This implies a long-term relationship and a significant degree of influence on the management of the enterprise. As a cut-off rule, foreign ownership of 10 per cent or more of the ordinary shares or voting power has been defined in the above mentioned guidelines (OECD, 1996:7).

A classic example of such an investment would be a wholly owned or joint venture production facility such as a greenfield Toyota plant in Indonesia. The International Monetary Fund (IMF) notes that an investment may still be accepted as FDI if ownership is measured at less than 10%. United Nations Conference on Trade and Development (UNCTAD) utilises the same definition while adding:

There are three components to FDI: equity capital (the foreign investor's purchase of shares of an enterprise in a country other than its own), reinvested earnings (the foreign investors proportionate share of earnings not distributed as dividends or remitted to the direct investor), and intra-company loans (short- or long-term borrowing or lending of funds between direct investor and affiliate enterprise (UNCTAD, 2001:275).

Additionally there are various non-equity forms of investment that include subcontracting, turnkey operations, management contracts, franchising, and licencing. It is important to note here that FDI is generally described as being a *long-term* (over one year), lasting investment that exerts a degree of *managerial control* or influence. This is crucial when distinguishing FDI from the more volatile portfolio investment.

## **Portfolio investment**

Portfolio investment, variously described as 'mad' or 'hot' money (Strange, 1998) is a purely financial transaction, in essence a loan that is repaid with interest. And while there is obvious stockholder interest in maximising the return on an investment (the capital), investors are unable to exert direct management influence or control and the investment may be terminated at short notice. Indeed, the rapid flight of portfolio investments from East Asian economies that began in 1997 has been identified as one of the prime causes of the AFC. The imposition of capital restraints by the Malaysian government<sup>1</sup> in response to the crisis reflected not only the view that such flows can be dangerously destabilising but also that some form of currency control may be desirable in developing economies. Ongoing globalisation has encouraged, if not demanded, the liberalisation of financial controls and many countries including Malaysia have welcomed portfolio investment as a supplement to domestic savings (Kim, 2000). Yet as Official Development Assistance (ODA) recedes and is increasingly replaced by private capital flows, FDI rather than portfolio investment has been singled out as the most desirable form of investment. The reasons for this are easy to ascertain; FDI implies the implementation of medium- to long-term corporate strategies to develop manufacturing facilities in a host economy. The benefits of this are not restricted to simple job creation and the host's anticipation is that such investment will spur economic development through the transfer of technology, knowledge and superior organisational skills. Greenfield developments are particularly encouraged.

It is important therefore to make clear distinctions between portfolio investment (capital flows, highly liquid, no managerial control) and FDI (long-term, more stable, managerial control). While both forms of investment have roles to play in a given economy, particularly so in developing economies, they are distinct in nature and practice. A consensus has emerged that favours FDI over portfolio investment in the process of development: 'FDI is a steady flow of long-term capital that, once invested, is not likely to be quickly withdrawn, while portfolio flows are volatile and foreign investors can quickly sell them' (Ito and Krueger, 2000:4).

## **Western theories of foreign direct investment**

As mentioned above, interest in the dynamics of FDI increased considerably as the world economy began once again to broaden and deepen in the post-war period. In this golden age of capitalism, the focus of investigation inevitably fell on the activities of Western multinationals as there were no or very few, instances of developing country FDI (Cherry, 2001; Heenan and Keegan, 1977) which only began to emerge in the 1960s.

Historically, overseas production had been viewed simply in terms of international currency and trade movements (Ohlin, 1933) yet this explanation, premised on a flow of funds from 'rich to poor', failed to explain why investment took place between developed economies. Moreover, as Kindleberger (1969) demonstrated, FDI could not take place in the perfectly competitive markets as suggested by the prevailing economic orthodoxy (Heckscher-Ohlin).<sup>2</sup> As a result of these shortcomings, Western scholars increasingly turned their attention to the firm as the unit of analysis: why were firms investing overseas and competing successfully with local competitors given the presumed 'cost of foreignness'? Initial attempts to answer these questions spawned both location theory (why firms invest overseas) and industrial organisation theory (how foreign firms can compete successfully with local equivalents) (Cherry, 2001).

### **Industrial organisation**

Of central importance to this survey is Hymer's doctoral thesis,<sup>3</sup> which built on earlier works by Southard (1931) and Dunning (1958), into industrial organisation theory. The importance of this is highlighted by Dicken: 'Before Hymer's pioneering study in 1960 there was no specific theory of why firms engage in transnational production: FDI was treated as just another variant of international capital theory' (Dicken, 2003:202). Hymer cited the removal of conflict (through the merger of firms), diversification (especially resource seeking) and, crucially, the possession of advantages (acquisition of low cost resources, knowledge, superior production processes) as causes for or motivations of international operations (Hymer, 1976). Of these Hymer focused on maximising advantages through the control of foreign operations as key to explaining overseas production. In short, the maximisation of these advantages over rival firms (domestic and foreign) was essential if the firm was to overcome the 'cost of foreignness', defined as being at a disadvantage to local firms who may have superior knowledge of the economy, language, laws and politics. This approach has since been described as a 'defensive oligopolistic strategy' (Dunning, 1977:397).

This issue of developing advantages in imperfect markets<sup>4</sup> was expanded by Kindleberger (1969)<sup>5</sup> who argued that market imperfections were essential for FDI to take place or, in other words, for firms to 'exploit their specific advantages through discriminatory pricing' (Phongpaichit, 1990:7). These 'firm-specific advantages' are not restricted to those noted above. The ownership of a well-known brand name, for example, may itself be a sufficient advantage to overcome the cost of foreignness (Caves, 1971; Horst, 1978). Caves further notes that overseas production (FDI) must offer greater benefits than other forms of realising a profit from an advantage, such as exporting and licencing arrangements. Additionally, Caves notes that the high cost of overseas operations results in smaller firms tending to utilise licencing

agreements, whereas large firms tend to undertake FDI. Collectively these approaches are referred to in the literature as theories of ‘firm-specific advantages’.

### **The product life cycle**

In an attempt to synthesise firm-specific theory with international trade theory, Vernon’s contribution (1966) marked a departure from the study of the firm alone and moved towards an approach that considered the importance of the product life cycle in an international context. As such it advanced the importance of geographical location. The product cycle is premised on the initial production of an innovative product by a firm located in an advanced economy. The scientific knowledge required for an innovative product is ‘an independent variable in the decision to trade or to invest’ rather than knowledge available to all as a perfect market would suggest (Vernon, 1976:47). The outcome of this is that certain firms can assume leading (innovator) roles. National market characteristics (labour costs and income levels among others) also influence product innovation and, furthermore, local producers will be better placed to innovate these products than their foreign competitors. The three stages of the product cycle are described below and presented in Table 2.1.

In the first stage of the cycle an innovative product is launched and production takes place within the home market due to a desire to control inputs, the relative lack of importance for production costs (as the firm enjoys a monopolistic position in the marketplace) and the strong ‘need for swift and effective communication on the part of the producer

**Table 2.1 Vernon’s product life cycle and FDI**

<b>Stage</b>	<b>New</b>	<b>Mature</b>	<b>Standardised</b>
<b>Location of production</b>	Local	Overseas	Overseas
<b>Production costs</b>	Less important than closeness to customer	Crucial	Crucial
<b>Competitors</b>	–	Emerging	Abundant
<b>Demand from</b>	Local	Local and overseas	Local and overseas
<b>Demand met by</b>	Local production	Local and overseas production	Overseas production (reverse exports)
<b>Time</b>	—————→		

Source: Author.

with customers' (Vernon, 1976:50). In contrast, during the second stage of the cycle, production costs assume greater importance as 'aggressive' competitors have subsequently entered the market. Accordingly, the locational variables described above become less relevant and the firm will seek to limit production costs through the utilisation of cheap labour. Simply put, overseas production becomes advantageous at this point as competitors begin to compete on price. In the final stage overseas production facilities originally designed to service local markets may also service third markets and eventually, if labour costs negate the additional cost of transportation, the original home market.<sup>6</sup> Vernon further notes that the 'threat' of competitors relocating production and 'stealing' market share is a prime motivator for overseas investment. Knickerbocker's (1973) work further emphasises this point noting that when firms in oligopolistic markets undertake such 'defensive' investments, competitors are likely to follow rapidly.

As will be examined below, Vernon's thesis (innovation > exports > foreign production), and Akamatsu's FG paradigm (imports > import substitution > export) essentially describe the same phenomenon yet from different viewpoints, namely advanced and developing (or catch up) economy respectively. Indeed, both concepts are often used interchangeably in the literature. Kojima (2000) notes that this is appropriate only when the investment in question may be categorised as 'pro-trade' in nature. A fuller discussion of this point may be found below.

The product cycle theory thus provided a credible theoretical framework for international production by combining both firm-specific and international trade theory. Yet challenges to this approach emerged with a recognition that product development and production is much more differentiated than suggested. Additionally, the rapid growth of developing country (Japanese) FDI from the 1960s onwards raised issues for the existing framework. Specifically, whereas Vernon had suggested the 'why' and 'how' of overseas investment, the 'where' factor had not been adequately explained. Similarly, why should firms undertake FDI in preference to other forms of overseas production such as licencing agreements and turnkey operations? These questions led to the emergence of microeconomic studies of the firm rather than the act of investment itself and marked a further stage in the development of FDI theory.

### **Internalisation theory**

Notable among these is Buckley and Casson's internalisation theory developed in the 1970s, positing that 'there were certain advantages inherent in the multinationalism of the multinational firm' (Phongpaichit, 1990:13). Essentially, transaction costs generated by market imperfections can be minimised by internalising business activities. This activity is not restricted

to production itself but also applies to intangible activities such as marketing, distribution, and R&D (Buckley, 1992). The advantage of minimising transaction costs is augmented by the fact that internalisation of markets also denies knowledge to competitors, further enhancing a firm's competitive position. The work of Hennart (1982) should also be noted for stressing that firms which generate and maintain advantages in intangible activities (knowledge) find FDI more conducive to profit generation than other 'new' forms of investment such as licencing. Indeed, internalisation theory suggests that firms would only choose to licence technology if host governments resisted FDI.

### **The eclectic paradigm**

This emphasis on market imperfections failed to offer a comprehensive explanation of international production. Commenting on theories of international trade and production Dunning notes that, 'no single hypothesis offers a sufficient explanation of non-trade involvement' (Dunning, 1977:297). Although Vernon and Horst had moved towards combining both trade and investment theory, Dunning was able to take the debate forward by adopting an eclectic approach to FDI that considered the role of ownership, locational, and internalisation advantages. His aptly named *Eclectic Paradigm of International Production* states that 'the extent, form, and pattern of international production was determined by the configuration of three sets of advantages as perceived by enterprises' (Dunning, 1987b:2).<sup>7</sup> The paradigm indicated that some combination of these three sets of advantages must exist for firms to undertake FDI.

By adopting this paradigm Dunning was able to demonstrate that FDI is sufficiently complex to require reference to all major theoretical approaches. With clear allusion to Hymer, Dunning's first set of advantages (over competitors) necessary for firms to undertake FDI are those described as 'ownership-specific'. These include the size of the firm (large firms tend to invest abroad while small firms tend to utilise licencing agreements as noted above), established market position (monopolistic or oligopolistic), possession of intangible assets exclusive to the firm possessing them (technology, knowledge, management), product differentiation (brand names, marketing proficiency) and access to necessary raw materials. The second set of advantages, internal, have been reviewed in detail above. Location specific advantages (the third set) are an attempt to explain the geographic distribution of direct investments in response to criticisms of internalisation theory and refer to spatial market failures (trade barriers, creation of regional trading blocks), structural market distortions (government intervention), access to production materials and competitive communications.

As will be explored in more detail below the rise in size and importance of Japanese FDI has presented a number of challenges to the mainstream

theoretical approach described above. Kojima and Ozawa (1984), leading proponents of the Japanese approach, note that while 'the concept of market internalisation has recently gained currency as a paradigm for the theory of direct foreign investment..., we feel that a call for the acceptance of internalisation as a general theory is premature' (Kojima and Ozawa, 1984:86). This is, they note, in stark contrast to Rugman (1980) who writes 'the process of internalisation explains most (and probably all) of the reasons for FDI' and that 'it is now time to recognise that internalisation theory is a general theory of FDI and a unifying paradigm for the theory of the MNE' (Rugman, 1980:376). However, questions remain as to the universal applicability of this assertion.<sup>8</sup> Kojima and others particularly take exception to two aspects of firm-based theories of FDI. First, the micro-economic focus on the individual firm (thus excluding FDI cooperation among firms or groups of firms), and second, the disregarding of macro-economic issues including the impact of FDI on the economic development of late developing economies. Consequently, negative aspects of FDI have been overemphasised at the expense of the developmental and mutually beneficial potential of Japanese FDI.

In the search for a theory of international production the inadequacies of classical international trade theory and the growth of MNE investment in the post-war period gave rise to an approach that analysed investment through the application of industrial organisation theory. Subsequent developments identified the role of market failures and the possession of competitive advantages as crucial factors for consideration in any attempt at producing a general theory of investment. Firm-specific advantages, internalisation of these advantages and the behaviour of firms in oligopolistic markets were central to this approach but failed to adequately consider country-specific factors and locational determinants. The role of the product cycle as a dynamic of FDI was identified by Vernon in an attempt to synthesise both the industrial organisation and international trade theory approaches while incorporating some of the issues neglected by purely microeconomic analysis. While Dunning's contemporary eclectic paradigm has been broadly accepted as a general theory of investment by many, others have questioned its applicability to Japanese style investment.

### **Japanese approaches to FDI**

In the same way that the rise in American MNE trade and investment encouraged the development of the approaches discussed above the emergence of Japanese FDI, particularly from the 1970s onwards, was accompanied by its own set of models and paradigms. A number of common themes in these variant approaches may be identified. First, there is the move away from firm-based theories towards a more 'macro' or political economy approach. Second, there is an assertion that Japanese FDI is qual-

itatively distinct from that undertaken by Western firms in that it is benign and developmental by design. A third theme concerns the international division of labour in East Asia based on comparative advantage.

The story of the development of Japanese theories of FDI emerged in the 1930s with Akamatsu's research into Japan's own experience of industrialisation. However, it was not until the 1960s and publication in English that foreign (Western) interest developed in this area. Of central importance is Akamatsu's (1962)<sup>9</sup> work on the economic growth of developing countries. This thesis introduced the 'flying geese'<sup>10</sup> metaphor that has been invoked, somewhat arbitrarily, by those seeking to explain both Japanese and wider East Asian economic development. Kojima<sup>11</sup> essentially broadened and deepened the original model and by doing so advanced the notion that Japanese FDI is inherently developmental in nature. As may be expected, asserting that a particular style of FDI (Japanese) is not only preferable to, but should be encouraged over, other sources of investment (Western) is likely to generate a range of critical responses. In this way, critique and defence of Kojima's empirical analysing and subsequent theorising has not only served to define the boundaries of this particular area of study but also reflects and informs the wider, 'grand theory' debates surrounding economic growth and development, dependency, neo-liberalism and institutional structuralism. The following section introduces Akamatsu's original FG thesis before tracing its development by Kojima and reviewing the critical response.

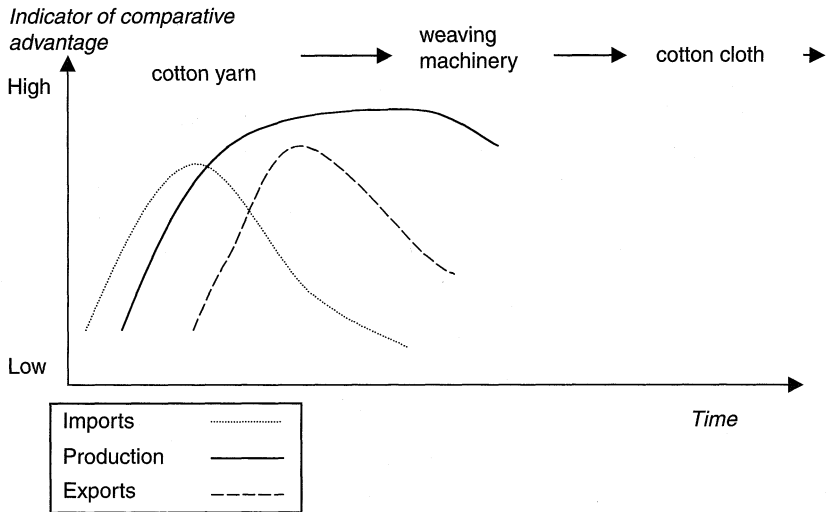
## **The flying geese model**

Akamatsu's 1962 paper, 'A Historical Pattern of Economic Growth in Developing Countries', introduced the wider English speaking world to the FG paradigm. The original thesis sought to explain 'a sequential development of manufacturing industries in developing economies' (Kojima, 2000:377). Three key aspects of the paradigm may be identified: intra-industry development, inter-industry development and international transmission.

### **Intra-industry development**

This basic model was based on an empirical analysis of Japan's experience of economic interaction with advanced Western economies from the Meiji era<sup>12</sup> to the outbreak of World War Two. Akamatsu discerned three stages in the growth and development of the four industrial sectors (cotton yarn, cotton cloth, spinning and weaving machines, machines and tools). Goods are initially introduced from overseas and domestic demand quickly emerges which encourages the initiation and development of local industry. As domestic production develops, the import structure moves from finished to semi-finished products. In a third and final stage imports drop off, domestic production increases to a plateau and exports commence. This sequence is illustrated in Figure 2.1. The original intention of the FG

Figure 2.1 Flying geese model – intra-industry aspect



Source: Akamatsu, 1962: 12.

metaphor, then, was a figurative representation of three time series curves denoting the import, domestic production, and eventual export of manufactured goods. It was trade rather than FDI which drove this process. In fact, FDI was regarded as playing a relatively minor role in economic development and greater attention was given to the importance of foreign technology and production management.

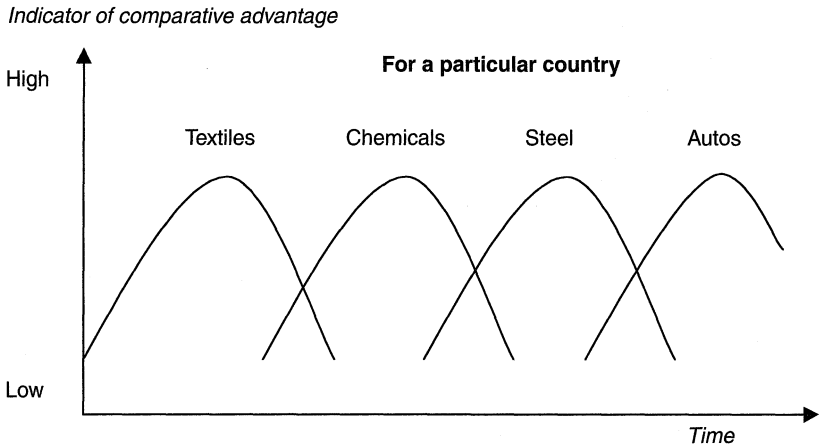
### Inter-industry development

The second pillar of the model concerns inter-industry development which is informed by the rise and fall of comparative advantage. This is illustrated in Figure 2.2. In the 1950s and 60s Japan was able to compete successfully in the manufacture of textiles but as foreign competition (from the Newly Industrialised Economies (NIEs) and elsewhere) eroded this comparative advantage, industry successfully moved into chemical and steel production. The importance of industrial policy underlies this process and forms the basis of the Japanese promoted developmental state model (examined below). This process of industrial upgrading is repeated as the industrial structure moves through the development of ever more sophisticated products with ever higher value added.

### International transmission

According to the theory, at the point of declining comparative advantage in Japan, production shifts overseas, first to Korea and Taiwan, onto the core ASEAN economies, and more recently into China and the later ASEAN

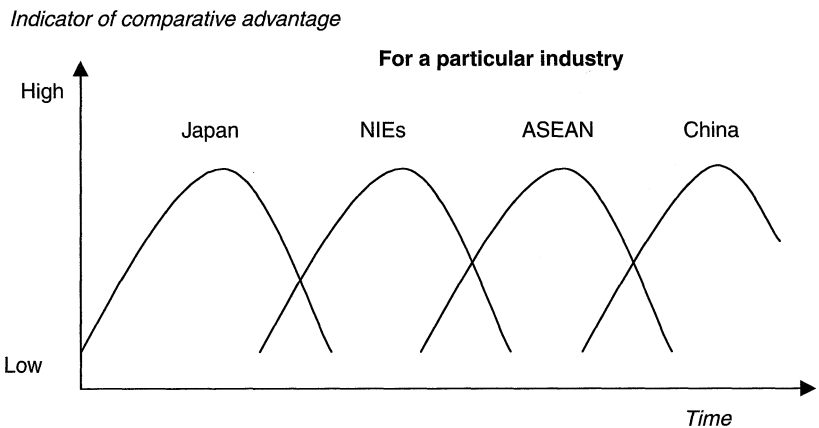
Figure 2.2 Flying geese model – inter-industry aspect



Source: Schroppel and Nakajima, 2002: 209.

members (described by Figure 2.3). This is the international aspect of the paradigm. The model thus presents a picture of harmonious, symbiotic and regional industrial development with Japan as the lead goose. A fundamental assumption of the theory, that interaction between advanced and developing economies will result in the economic growth and development of both, held obvious attractions for Japanese policy elites and private capital, and since the 1960s the FG paradigm has provided both theoretical rationale

Figure 2.3 Flying geese model – regional transmission aspect



Source: Schroppel and Nakajima, 2002: 209.

and expedient *raison d'être* for Japanese FDI in East Asia. It is this third aspect of the model that is most commonly understood and used today.

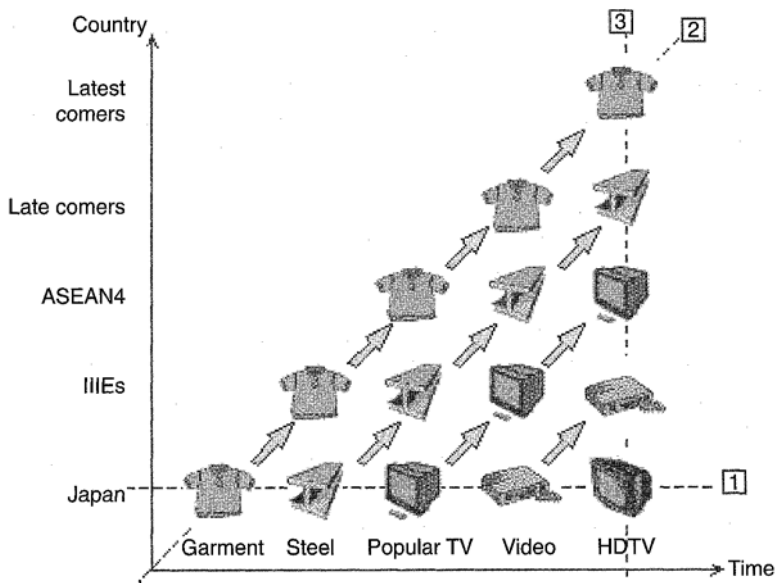
Akamatsu posited that the West, by first instigating and subsequently maintaining a heterogeneous relationship with Asian economies (namely Japan), cultivated an international and vertical division of labour. In other words, advanced Western nations were able to maintain hegemony over less developed nations by vigorously exploiting their comparative advantages in knowledge (technology, management), production, finance and in the case of colonies, military power. Resulting growth, continuing along a linear trajectory, is the result of a struggle between forces that seek to either homogenise or to maintain a heterogeneous economic relationship. Subsequent interaction serves as a catalyst for a sequential industrial development that leads from consumer to capital goods.

As noted above Akamatsu's sequential development is strikingly similar to Vernon's product cycle theory yet the two are not synonymous. Differences lay mainly in perspective and theoretical approach to the process of economic development. While the FG model focuses on sequential industrialisation in a developing country, the product cycle theory is more concerned with the location of production at a given stage in the product life cycle. Moreover the model is overtly concerned with the process of catch up development whereas the product cycle is more concerned with effective utilisation of comparative advantage and does not consider the process of industrial upgrading.

An important critique of this work is its assumption that economic and industrial growth and development is inevitable and spontaneous, perhaps reflecting the theoretical norm of the day with regards to developmental economics, i.e., the linear stage of growth model. While brief reference is made to the fact that 'some countries may advance quickly and some slowly, while others may stand still at a certain stage' (Akamatsu, 1962:25) and 'at the same time it should be noted that the industrial policy of a country has a great influence on the wild-geese-flying pattern, as, for instance, import restrictions cause a sharp decline in the import curve' (*ibid.*, 1962:25) these considerations are not promoted as central to the thesis. Moreover, although automatic progression was not guaranteed, the mechanisms necessary for progression along the FG pattern are not identified save for the absence or otherwise of tariff autonomy.

### **Kojima's macroeconomic approach**

Kojima (2000) summarises Akamatsu's paradigm as a 'catching up model' of industrial development and reiterates that the sequence is one of import (M), domestic production (P), and finally export of manufactured goods (E). Much of Kojima's work has been concerned with the refinement and elaboration of the original thesis through extensive empirical research and as



industry (intra-industry). Inter-industry diversification upgrades the national industrial structure (from labour intensive to capital and technology intensive production), whereas intra-industry diversification raises the value added (from simple consumer goods to complex capital goods, see Figure 2.4). Consequently, this process is described as the rationalisation of industry through enhancing the efficiency and competitiveness of production. Further, 'the interactions between, and parallel progress in, the rationalisation and diversification of production (i.e., the basic and variant FG patterns occurring at the same time) stimulate national development' (Kojima, 2000:379).

### **Kojima model II: Pro-trade FDI**

The regional transmission of FG style development, described by Akamatsu as the third pattern of FG development, is re-presented as Kojima model II. Both model II and subsequent model III, (below) have stimulated considerable debate. Model II as it pushes the 'superiority' of Japanese FDI over American/Western MNE and Model III as it provides an easy metaphor for East Asian development in a regional and historical context.

Model II, outlined in a succession of papers (notably 1973; 1975; 1985) delineates the supposed PROT attributes of Japanese style FDI. FDI may be defined as PROT if it 'is undertaken from an investing country's comparatively disadvantaged industry' and acts as a catalyst for 'foreign production in country B to achieve a stronger comparative advantage through providing appropriate capital goods and technology (a borrowed technology from the viewpoint of the host country)' (Kojima, 2000:383). As such, the model is explicitly based on the theory of comparative advantage (Ricardo, 1948).<sup>13</sup> Developing his earlier thoughts at a time of rapid growth in Japan's FDI, due in no small part to the 1985 Plaza Accord (see Chapter 4) and growing awareness of the importance and power of the MNE, Kojima introduces a 'macro-economic' approach in contrast to the (Western) 'international management', or microeconomic approach as described above. Of primary import is the categorisation of MNE/American style FDI as anti-trade (ANT) and of Japanese as PROT. MNE style FDI is described as ANT as it is based on monopolistic absolute advantage aimed at host market penetration which consequently reduces trade between the investing and host nations. Moreover, MNE FDI tends to take place in industries that *retain* a comparative advantage. A second characteristic are the internalisation activities carried out by the MNE to reduce transaction costs and increase profits. Third, MNE style FDI tends to reject shared ownership of investments, not only for point two above, but also in an attempt to retain technological advantages. Finally, MNE FDI gives no consideration to (macro) developmental issues and rather focuses on (micro) profit maximisation.

In contrast, Japanese FDI in manufacturing industries is based on the host's comparative advantage in labour costs and generates demand for

Japanese capital goods (especially as Japanese firms tend to buy from traditional suppliers, at least while the investment is relatively young). Furthermore, Japan's domestic demand for the product, now produced overseas, is partly satisfied through reverse imports, i.e., those originating from the investment located in a host country. Additionally, Japanese PROT FDI takes place in industries that have *lost or have diminishing* comparative advantage. In this way, structural adjustment is facilitated in the investing country (Japan) and capital, technology and managerial skills and so on are transferred to the developing country. Finally, Japanese FDI is described as PROT as it drives the creation of new export orientated industries.

Subsequent empirical studies give support to Kojima's theory but overlay the uniformity of Japanese investments. Many Japanese MNEs undertake FDI that would be classified as ANT under this system; Honda has made a policy of producing in part 'in the market, for the market'. And while market-orientated investments may reduce bilateral trade, though this is by no means clear, it does not necessarily follow that they fail to transfer technology, create linkages with local economies and facilitate macroeconomic growth. Indeed, criticism of this aspect of Kojima's theorising has been persistent. In his defence, Kojima acknowledges that not all Japanese FDI is PROT, indeed that there have been numerous examples of ANT FDI especially during the bubble period in America (real estate). In particular, FDI in advanced economies which accounts for the majority of global FDI is inherently ANT orientated and 'in reality, almost all Japanese FDI in U.S. manufacturing has been motivated, at least in part, by the desire to overcome protectionist trade barriers' (Kojima, 1986:98). Furthermore, the downturn of FDI in East Asia was anticipated and is in fact an integral part of the thesis. 'When the original idea of FDI is to play the role of a teacher, it becomes natural that it should fade out once its objective has been successfully accomplished' (Kojima, 1986:71).

### **Kojima model III: Agreed specialisation**

Kojima model III is augmented by the concept of the 'investment frontier' (Kojima, 1995). The concept refers to both *horizontal shift* and *geographical spread* of industry over time. In other words, these processes describe a deepening of an economy's industrial structure; from labour intensive products (textiles), to capital intensive intermediate goods (steel, chemicals) and finally to knowledge and capital intensive goods such as machinery. This is the horizontal shift. The geographical widening, or spread, of a given industry, 'takes place vertically over time' (Kojima, 2000:385) from lead goose to follower. The investment frontier promotes intra-industry trade leading to a form of 'agreed specialisation' between countries. This is the basis for the creation of the regional production networks described in Chapter 3. Imports sourced from such FDI may be seen as PROT as they

have the 'character of offshore-sourcing FDI' (Kojima, 2000:387). Agreed specialisation then is the 'natural order' of industrial restructuring. As examined below, a critical appraisal of this process concludes that Japan is locking in developing economies in a vertical, exploitative relationship where they are dependent on Japanese technology and capital, as well as US markets (Hatch and Yamamura, 1996).

The different concepts outlined above constitute the FG model as presented by Kojima. For Kojima the FG paradigm consists of a number of interrelated models that need to be considered as a whole. That this is the case is by no means clear and it appears that certain aspects of the paradigm (the regional transmission of economic development) have taken precedence over others, (Kojima Model II for example). As Kojima notes on the use of the term FG pattern of industrial development 'such a description is widely used, as if it is a self-explanatory phenomenon; however, the exact meaning of the term is not specified, and its origin is not clearly understood' (Kojima, 2000:375).

The 'Japanese school' has been summarised as approaching 'the analysis of Japanese foreign investment within a framework of comparative advantage. All argued, some more strongly than others, that there existed a basic complementarity between the economies of Japan and ASEAN. None of them paid much attention to the specific characteristics of Japanese firms and none invoked the analytic framework of the organisation school for more than a passing reference' (Phongpaichit, 1990:19).

Phongpaichit (1990) also notes that Kojima's enthusiastic appraisal of Japanese FDI has been criticised on two main fronts. First, there is disagreement on Kojima's emphasis on comparative advantage and determinants of Japanese FDI. In short, it has been proposed that Japan's investments in East Asia during the 1960s and 1970s 'reflected merely the stages of economic development of Japan and Asian countries at that particular period' (Phongpaichit, 1990:27). Secondly, the benign impact of Japanese FDI has been hotly contested. Komoda (1986) and Jomo (2001) among others have focused on the one-way nature of Japanese/host trade, the lack of reverse imports, the intra-firm division of labour that is more beneficial to the firm than the host and the lack of technology transfer. Lee (1990) also suggests that Kojima's model needs to take account of falling and rising comparative advantages due to technology and the forces of globalisation. Buckley (1991) has further criticised Kojima's model as 'unduly narrow in its assumptions, inapplicable to most (Japanese) direct investment, is unduly static and relies on key concepts from the internalisation rubric' (Buckley, 1991:103).

## **Critical approaches**

This review has so far focused on both macro and micro approaches to FDI as presented in the predominantly Western literature. A further examina-

tion of Japanese approaches (the Japanese school) has been undertaken and, prior to the penultimate section of this chapter which introduces the relevance of regionalism to the debate, it is pertinent at this point to consider a number of neo-Marxist, or critical, traditions of theorising. Doing so will a) help to locate the previous discussions in a broader context and b) establish key themes that can inform a more critical perspective on Japanese investment in East Asia to be further developed in the concluding section of this chapter.

The dynamics of global capitalism (the global *system* or *structure*) underpin and inform classic Marxist theorising and the development of subsequent neo-Marxist perspectives. The basic 'circuits of capital'<sup>14</sup> thesis identified by Marx, while presenting a convenient and valuable framework with which to analyse the internationalisation of economic activity, does not tackle specific issues of industrial organisation or geographic location. In an attempt to fill these lacunae and with particular reference to the post-war experience of development in the third (developing) world, a considerable literature has evolved which is based on Marxist theorising and which radically departs from the comfortable assumptions of classical and neo-liberal models of international trade and production. Chief among these are the 'dependency school', 'global reach theorists', and the 'new international division of labour school'. Attention now turns to consider these traditions in turn.

## **Dependency theory**

In contrast to the benign assessment given by neoclassical economists of the internationalisation of production the dependency school, which emerged in the late 60s, viewed such forces as evidence of a global system that inevitably locks third world countries into dependent relationships with the industrialised first-world.

By cooperating with first-world capitalists, third world bourgeoisies are seen by dependency theorists to be complicit in a global system that maintains and reinforces capitalist exploitation. Accordingly, 'by keeping the third world underdeveloped, the ruling bourgeoisies of the first world ensured a ready market for their finished goods and a cheap supply of raw materials for their factories' (Rapley, 2002:17). This third world dependency on first-world capital and markets describes a 'classical dependency' where third world countries export primary goods and import manufactured products. Dependency theorising is thus concerned with international (North-South) trade and political relationships including the internationalisation of production as practiced by the MNE. Multinationals, rather than seen as conduits of technology and managerial know-how, are viewed in this context as agents of dependency and first-world FDI must necessarily be viewed with suspicion and caution.

Yet even before the 'East Asian miracle', the experience of some Latin American countries including Brazil and Argentina appeared to contradict the basic tenets of dependency thinking which seemed not to allow for indigenous industrial development as promoted by structuralists.<sup>15</sup> The response, that industrialisation in these countries may not be seen as evidence for indigenous development but rather as the result of continued first-world dependency (for technology and in ownership), promoted a policy of national development to be insulated, crucially, from the global economy as the only viable path to genuine development. A distinction emerges, therefore, between two forms of state-led development: import substitution as promoted by the dependency school and export-orientated industrialisation as seen in the East Asian developmental state concept<sup>16</sup> which has been keenly promoted by Japan.

## **Global reach**

In contrast to the macro orientation of the dependency school, global reach theorists<sup>17</sup> set the focus of attention at the level of the firm or, more precisely, the allegedly malignant activities of the MNEs and those that manage them. FDI, according to global reach theorists, is an attempt by firms 'to protect and extend collusive networks. Thus, Transnational Corporations (TNCs) will exploit their market position to exploit patent protection, avoid taxation through transfer pricing, capture governmental regulations and raise entry barriers to competitors' (Hansen, 1998:26). This exploitation of firm-specific assets or advantages clearly has resonance with Hymer's thesis (and the ANT orientation identified by Kojima) and emphasises the negative (social and economic) aspects of the multinational. These include the inappropriateness of the technologies being transferred (either mature and outdated or state of the art and licenced at exorbitant rates), the possibility of MNE investments squeezing out domestic firms, the domestic trade orientation impacting negatively on local competitors, the undermining of local management practices and the loss of national self-determination (Hansen, 1998:26). On this final point the global reach tradition may be seen as influential in more recent debates concerning power relations between the state and the market, global governance and (corporate) globalisation.

A key focus of attention here is, therefore, the market power of the MNE in oligopolistic markets as institutions (Jenkins, 1987). Market imperfections, rather than existing as a result of government intervention, are created within firms and thus firms reduce efficiency 'by making markets less perfect as a result of their oligopolistic strategies' (Jenkins, 1987:24). MNEs, in this analysis, are pernicious abusers of power and must be controlled by the state (or coalitions of states) in the face of imperfect markets if development is to take place. This theme of power relations and of the need to 'harness' MNEs is returned to below.

## **New international division of labour**

The New International Division of Labour (NIDL) is distinguished from earlier phases<sup>18</sup> by its modernity, scope and organisation. As a school of thought, the NIDL emerged in the mid-70s (Palloix, 1977) with further important empirical contributions by Frobel *et al.* (1980); and Ernst (1980). Its key concerns are both structural unemployment in industrialised countries and industrialisation (or the lack thereof) in developing economies. As noted above, the internationalisation of production greatly expanded in the post-war period and FDI between developed (first-world/core) economies grew rapidly, exceeding growth in Gross National Product (GNP) and global exports by the 1960s (Dicken, 2003). Yet the emergence of FDI initiated by MNEs from industrialised countries in the developing world (third world/periphery) signified a qualitatively new development. NIDL analysis of this is that due to the conditions of capital accumulation and socio-economic crises in the West (persistently high unemployment, overcapacity, declining international competitiveness and domestic investment), capital fled from the North to the South *via* FDI. Given the nature of the 'push' factors behind this flight of capital, investments invariably centred on labour intensive, and thus low value added, production processes resulting in continued financial and technological dependence on the North. Moreover, in this analysis it is the MNE rather than the state that has organised, and thus controlled, investments. As such it shares with the global reach school a concern with the power relations between state and firm.

Frobel *et al.* (1980) posit that this process has been supported by the creation of a 'reserve army' of labour created through the rapid urbanisation of developing countries following earlier ill-fated attempts at development through industrialisation (see 'structuralism' above). In spite of the large outflow of capital from North to South it was the MNE, and not the recipient economy, that benefited through the maintenance of profit in spite of the otherwise adverse economic environment. Such investments offered little scope for technology transfer or the 'skilling' of the workforce and further reinforced structural trade imbalances. The NIDL therefore was not a simple exchange of commodities but a complex, international division of labour that once again engendered dependency.

Accordingly, the NIDL proposed a radical alternative to consumer-orientated growth based on improving and expanding plant, lower wages and limits on the growth of living standards as an agenda for harmonious and egalitarian development (Hansen, 1998). It is somewhat ironic that this essentially socialist agenda was promoted on the very eve of the Reagan/Thatcher 'revolution' that ushered in the current era of neo-liberalism.

Henderson critiques NIDL theorising as overly simplistic, deterministic and 'insufficiently sensitive to the empirical specificities of "development"' (Henderson, 1989:21). Additionally, NIDL's account of a firm's internationalisation strategy 'is both profoundly ahistorical and insensitive to the differences in the internal balance of social forces in particular national states, and hence to differences in their development strategies' (*ibid.*:22). This point is of particular relevance to the East Asian experience where, as the 1993 World Bank report points out '...the diversity of experience, the variety of institutions, the great variation in policies among the high-performing Asian economies means that there is no East Asian model of rapid growth with equity. Rather, each of the eight economies we studied used various combinations of policies at different times to perform the functions needed for rapid growth...' (World Bank, 1993:366).

Three further tenets of NIDL theorising deserve attention with regards to the East Asian experience of economic development and industrialisation. First, while also a common theme among contemporary anti-globalists (Klein, 2000; Korten, 2001), the assertion that 'the transnational organisation of production is structured in a hierarchy controlled by a small group of industrialised countries' (Frobel *et al.*, 1980:404) may be becoming less relevant as this claim fails to take account of the rise of first Japanese, then Korean, Taiwanese and latterly Chinese and Indian multinationals. Second, Frobel *et al.* assert that 'even if large sections of industrial manufacturing were relocated from the traditional industrial centres to the underdeveloped countries, only a small proportion of the potentially economically active population would be drawn into this process [of economic development]' (*ibid.*:404). This is to repudiate the well-documented impact of spillovers and the trickle down effect (Ito and Krueger, 2000) in East Asia to highlight but one regional body of empirical evidence to the contrary. Third, NIDL analysis appears to rule out autonomous 'national capitalist' development which is again at odds with the East Asian experience. Chapters 3 and 4 examine in more detail the issue of state developmentalism in East Asia and the Japanese model in particular.

The NIDL's overly deterministic and ideology laden analysis of what has more recently been defined and recognised as the processes of globalisation is thus compromised by the reality of East Asian economic development. Moreover, the regionalisation of production by Japanese firms in East Asia presents a further challenge to the static and deterministic analysis presented above. Henderson further notes that 'Frobel *et al.* miss the fact that rather than there being one international division of labour, a number of related spatial divisions of labour may be emerging within certain industrial branches' (Henderson, 1989:22). This point is returned to below as it identifies an important aspect of the international division of labour as observed in East Asia.

Three themes with direct relevance to this study emerge from this review of critical approaches and are recapitulated here:

- Dependency

The identification of dependent relations between developed and developing countries is the most important contribution of the dependency school, far more so than the largely discredited policy prescription of state directed import substitution led industrialisation. The East Asian experience and (fierce) criticism from the then ascendant now orthodox neo-liberal agenda has largely discredited this mode of industrialisation. However, and ironically, it is the same East Asian experience that has provided the material for the emergence of a redux or neodependency analysis. As explored in Chapter 4, Japan and Japanese firms stand accused of fostering a form of neodependency in East Asia (the 'embraced' Asia thesis) based on the regionalisation of both production networks and nothing less than the 'relational' model of Japan's political economy (Hatch, 2001). The continued and possibly deepening dependency of Southeast Asian countries on Japanese technology suggests that the relationship between the state and the firm in the context of regionalism and regionalised production needs further investigation. This is supported by the second theme to emerge; power relations.

- Power relations

As a result of the focus on the MNE itself, the main contribution from the global reach school concerns the identification of asymmetric power relations between the firm and the (developing) state and the resulting need for greater state control (national or multilateral) over the firm. Related to this is the policy recommendation that states maximise their bargaining power so as to gain the best terms for development with regards to inward investments. Yet regionalism, moving on a linear scale from shallow to deep, demands a concomitant relinquishment of national autonomy; this is the very basis of regionalism. How then can and should states manage their interaction with the firm, or more correctly, the regional production network? What asymmetries arise and how may these be managed or mitigated?

- Spatial and organisational concerns

The NIDL approach drew attention to the global structures and underlying mechanisms that influence the internationalisation of production. Although the key focus remained at the state level (both developed and developing) the MNE also played a prominent role. NIDL analysis also drew attention to

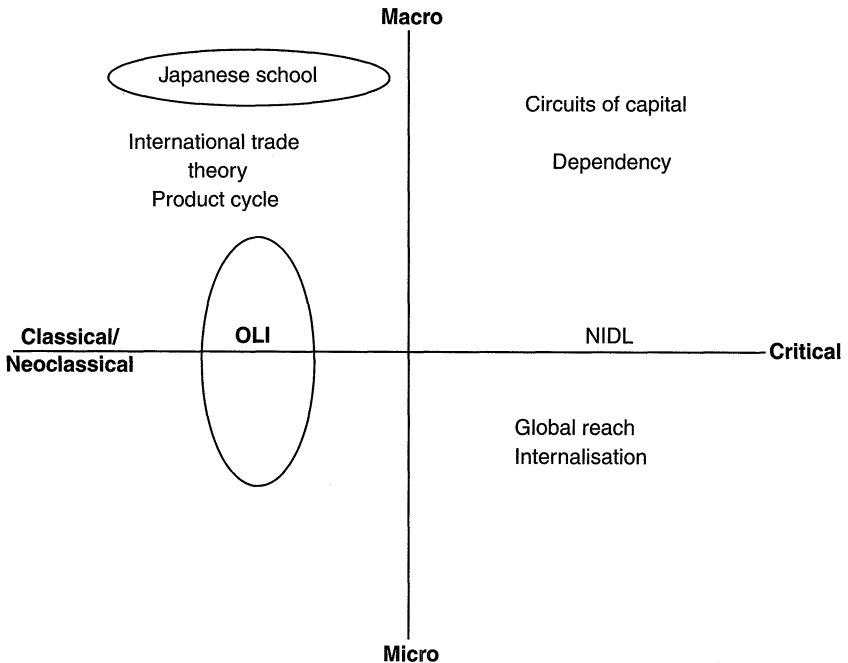
the role of technology in facilitating the globalisation of production and in many ways has acted as the precursor to the global value chain and global production network analysis to be examined below.

**Towards a modified approach**

As stated above, the primary aims of this chapter are twofold: to review theories of, and approaches to, the internationalisation of production with particular reference to the experience of Japanese MNE FDI in East Asia, and to present an analytical architecture to guide and inform the remainder of the dissertation. Before an attempt is made in the following sections to draw the various themes and concepts together so as to present the required theoretical contribution, a final summation of the models and approaches reviewed so far is presented here.

Figure 2.5 presents an attempt to locate the various theories, traditions and approaches reviewed above within the space created by two axes. The x-axis represents the ideological plain (from classical/neoclassical to critical) while the level of investigation (macro to micro) is located along the y-axis. Although inevitably somewhat arbitrary in nature and lacking any

Figure 2.5 Mapping competing approaches to the internationalisation of production



Source: Author.

historical narrative it is possible nevertheless to sketch out a rudimentary theory map to assist our visualisation and understanding of these concepts. Global reach theory and internalisation are both located in the bottom right quadrant given their critical characteristics and firm-level focus of attention. Above, while remaining in the critical plain and reflecting their preoccupation with the macro level of investigation, reside Marx's conceptualisation, the dependency school and the NIDL (this positioning is closer to the x-axis given the NIDL's further concern with the firm). Cutting across the x-axis but in the classical plain, Dunning's eclectic paradigm represents the only attempt so far examined to address both macro (locational) and micro (firm)-level issues. Finally, in addition to the Vernon's product cycle and classical trade theory, the Japanese school with its focus on tandem growth through FDI based on comparative advantage clearly warrants location in the upper right quadrant and as such, is readily incorporated within the prevailing neo-liberal orthodoxy.

As attention now turns to the second aim of this chapter and the development of the analytical architecture, it is important to remain cognisant of the theoretical foundations as presented in Figure 2.5. At the same time the static nature of the diagram reinforces the notion that there is a need for the inclusion of more dynamic approaches to the topic of investigation here. The following sections, then, focus on the distinct yet interrelated concerns that are regionalism and regionalisation, call for a more prominent role for (regional) contextual issues, consider the usefulness of the global production network concept and finally present the central research issues and questions that the dissertation addresses.

## **Regionalism**

Chapter 1 noted that globalisation refers to the interconnectedness of the world economy (deepening integration of finance, trade and production) and how this is facilitated by rapid technological change. *Globalisation* has been informed and furthered by the more politicised process of *globalism* as espoused by the neo-liberal agenda and the Washington Consensus. At the same time, the *regionalisation* of production has continued apace in the three main areas of global economic activity as, to greater or lesser degrees, has the more politicised advance of *regionalism*. This section considers definitions and theoretical explanations of these terms before examining how the concept of regionalism and regionalisation can be employed to further our understanding of Japanese MNE activity in East Asia.

Regionalism in the modern era (i.e., post-war) is traced back to the formation of the European Economic Community (EEC) by the Treaty of Rome in 1957. Other regional treaties emerged around the world during the 1950s and 1960s but most of these either lapsed or had little impact on member states. However, a second or 'new' wave of regionalism materialised in the 1990s (Breslin and Hook, 2002; Söderbaum and Shaw, 2003)

with the development of the European Union (EU) and the North American Free Trade Agreement (NAFTA) in 1992 and 1994 respectively. As multilateralism at the World Trade Organisation (WTO) floundered in the late 1990s, states increasingly turned to regional trade agreements further driving the regionalist trend. Old and new regionalism are qualitatively distinct as demonstrated in Table 2.2.

New regionalism is both a result of and influence on globalisation and this interaction is deeply complex. The result of both old and new regionalism is deepening regional economic integration but whereas in the past this may have given rise to protectionist notions, now this process is both multidimensional in nature and outward in orientation. Furthermore, both the old regionalist projects observed in Europe and North America were largely, if not exclusively, state-promoted whereas the East Asian experience, the standard bearer of new regionalism, has emerged from recent decades of regionalisation. Five stages of regional economic integration have been identified, which are further distinguished as 'shallow' or 'deep'.

Table 2.3 illustrates how European regionalism is the most advanced and ambitious project in the IPE. Although hotly debated in the region itself, an underlying theme of European regionalism is the construction of a federalist project or even a United States of Europe. As such, it stands in stark contrast to the more modest aims of NAFTA which is content to facilitate deeper trade and investment links between member states and in this sense does not have an overtly political agenda. East Asian regionalism has only recently emerged in any formal sense (see below) and remains in the earliest stages of shallow integration.

Regionalisation may be defined as 'the growth of societal integration within a region and [to] the often undirected processes of social and economic interaction' (Fawcett and Hurrell, 1996:39). Importantly, this growth is undertaken primarily by private actors (firms) through investment, production and trade. Deeper regional economic integration through this bottom-up process of regionalisation has been a key characteristic of

**Table 2.2 Features of old and new regionalism**

	Old	New
Context	Bipolar cold war context	Globalisation
Dynamic	Top down	Bottom up
Nature	Inward-orientated, protectionist	Outward-orientated, open
Direction	Specific objectives (security)	Multidimensional
Actors	Contiguous states	States and private actors

*Source:* Adapted from Hettne, 2003: 23–4.

Table 2.3 Stages of regional economic integration

Shallow Integration			Deep Integration	
Preferential Trade Agreement	Free Trade Area	Customs Union	Common Market	Economic Union
Partial preference to trading partners	Elimination of all tariffs and non-tariff barriers	Common level of trade barriers <i>vis-à-vis</i> non-members	Free movements of factors of production	Integrating national economic policies and a common currency
East Asia	→			
NAFTA	→			
European Union	→			

Source: Adapted from Das, 2001: 6.

the East Asian political economy and is primarily measured in terms of increasing intraregional trade and investment. In other words, while European integration is the result of a top-down political project to facilitate regionalisation, in East Asia regionalism is the result of ongoing regionalisation. While it is not claimed that Japanese MNEs are the prime movers behind regionalist developments in East Asia today, the creation of regional production networks by these firms, particularly in the automotive and electronics sectors, suggests that they are significant actors. Therefore, any investigation into the contemporary East Asian political economy must include an examination of both regionalisation and regionalism. Equally, any attempt to understand the actions of Japanese MNEs must be placed within the context of the regional political economy. This issue will be discussed further below and attention now turns to consider the effects and impact of regionalism on, briefly, trade and more importantly, FDI.

### Impact of regional economic integration

Regional integration has a number of economic implications for trade and classical analysis identifies static and dynamic effects (Viner, 1950). Static effects include trade creation, 'a union-induced shift from the consumption of higher cost domestic products in favour of lower cost products from the partner country' and trade diversion 'a union-induced shift in the source of imports from lower cost external sources to higher cost partner sources' (Bende-Nabende, 1999:43). Dynamic effects on the other hand include the stimulation of economic growth as an enlarged market promotes both scale

economies (supply side) and greater demand. In these ways regionalism is shown to influence regional and, by extension, global trading patterns. In addition, regionalism induces further positive developments including increased competition which increases efficiency, greater specialisation, and reduced risk. For developing countries, regionalism may be most effective by creating scale economies in markets that are otherwise too small and fragmented (El Agra, 1981).

### **Effects of regional economic integration on FDI**

The static and dynamic effects of regional economic integration also have an impact on FDI. Market expansion and scale economies (dynamic effects) enhance a region's locational advantages in addition to offering firms the opportunity to develop ownership advantages stemming from operating in an enlarged market with improving efficiency. Kindleberger (1996) suggests that MNE investment strategies are directly linked to the trade creation and diversion effects outlined above. Non-member firms will invest in the region in an attempt to counter diverted trade while FDI that regionalises production within the region is a response to trade creation (Yannopoulos, 1990). FDI will be encouraged into the region and diverted from other locations. The experience of Japanese FDI to Europe in the late 1980s and 1990s may be seen as an example of this. Fear of 'Fortress Europe' and the potential benefits of producing in a unified market pulled high levels of Japanese investment into the region. In other words, as Yannopoulos (1990) suggests, 'the static and dynamic effects of regionalism enhances the locational advantages of production based inside a trading bloc and by generating these advantages, the formation of a customs union affects the firm's choice of strategy in servicing foreign markets' (Bende-Nabende, 1999:50). Additionally Dunning (1992) identified both primary (supply side benefits of internal tariff removal) and secondary (restructuring value added) effects of regionalism on the activities of MNEs.

Four types of investment response to regional economic integration have been identified (tariff jumping investment, optimum location seeking investment, market seeking investment and efficiency seeking investment) and are presented in Table 2.4.

Eden and Montelis (2000) supplement this analysis with an examination of the impact of regional integration on the locational decisions of MNEs in NAFTA. They conceptualise a model of 'shock' and 'response' whereby the impact of regional integration (shock) necessitates adjustment by the MNE (response). The response, they hypothesise, is determined by three variables: investment motivation (market-, resource-, efficiency-, or strategic asset-seeking), nature of value adding activity (from strategic management through development and production to sales, distribution and servicing), and nature of the firm (MNE/local, insider/outsider). Their research sug-

Table 2.4 Effects of regional economic integration on FDI strategy

<b>Effect of regional economic integration</b>	Intra-regional trade more attractive than extra-regional trade	New configuration of locational advantages among members	Cost reduction and efficiency gains	Market expansion, demand growth and technical progress
<b>MNE's response</b>	Defensive export substituting investment (tariff jumping)	Re-organisation investment (optimum location seeking)	Rationalisation investment (efficiency seeking)	Offensive export substituting investment (market seeking)
<b>Net FDI effect</b>	Positive for increased investment in locally based affiliates	Neutral for the region as a whole	Positive as MNEs increase sourcing in the region	Positive for increasing investment in locally based affiliates

Source: Adapted from UNCTC, 1990:3 and Bende-Nabende, 1999: 54.

gests that for those firms engaged in the manufacture of complex products (e.g., the automotive sector) the range of activities within that process (the value chain), regional integration is likely to have the effects summarised in Table 2.5.

Although developed to examine MNE FDI in NAFTA, this framework clearly has relevance and applicability to East Asia and is further explored below. East Asia has only recently embarked on its regionalist project and remains at the very early or shallow stage of integration. The only multilateral agreement in the region is Asean Free Trade Area (AFTA) which, as will be discussed in detail below, has been adopted on the basis of already regionalised production and not in the contemplation or expectation of the experience as observed in Europe. The link between regionalism and FDI appears to be stronger as the level of economic integration deepens and the level of economic development increases. Accordingly, the impact on FDI appears to be most strong in Europe, where regionalism among advanced economies is at its deepest. In other words, it appears as yet too early to investigate at the macro-level the impact of formal regionalism as a determinant of FDI in East Asia. This is not to say that the theoretical advances in this field may not be applied in some way to an investigation of the contemporary East Asian political economy. Indeed, this book draws upon the regionalism literature to inform the modified approach adopted throughout and specific research questions are developed with reference to it.

Table 2.5 Effects of regional integration on value adding activities

Value adding activity	Function of investment	Impact of formation of FTA
Fabrication	Manufactures parts and sub-assemblies	Rationalisation based on localisation localisation to achieve economies of scale. Closure of inefficient plants/upgrading of efficient plants. Increase in intra-regional horizontal trade. Need to meet new rules of origin.
Final assembly	Assembly for final sale	Closure of tariff factories and replacement with exports from hub country. Shift focus from national to regional markets. Rationalisation of product lines. Possible world product mandate.
Distribution, sales and service	Imports and/or distributes products in local market	Increase in downstream FDI into previously closed markets. Decentralisation.
Support services	Provide support to MNE group	Increase in downstream FDI into previously closed markets. Regional centralisation in hub country.
Technology development	R&D centre	Possible centralisation of R&D activities.
Strategic management	Strategy formulation and implementation	National headquarters replaced with regional HQ.

Source: Adapted from Eden and Montelis, 2000: 180–1.

## A regional and contextual perspective

Our understanding of the international activities of firms, and of Japanese firms operating in East Asia, has deepened and expanded through the steady development of the theoretical approaches documented above. Dunning's Ownership, Location, Internalisation (OLI) paradigm, the FG model, the critical tradition and the approaches suggested by regionalism all offer insights into difficult and complex issues around international investment, production and trade. These are issues central to the IPE and more specifically to the 'new' political economy of East Asia (Islam and Chowdhury, 2000). In contrast to the 'old' political economy of the region which focused on understanding sources of economic growth, this new variant seeks to better understand *post-crisis scenarios*. This quest for a richer understanding of the contemporary reality underpins and guides this work.

It is becoming increasingly clear that the dramatic changes in the regional political economy since the latter half of the 1990s have fundamentally altered the way in which we can and should investigate Japanese FDI. Kojima's criticisms of micro-based investigations of the firm remain valid. At the same time, and in spite of the descriptive power of the FG model, the regionalisation of production, globalisation and technological change render the model overly simplistic and consequently of limited analytical value. East Asia, driven by a renewed political vigour in the wake of the crisis, is rapidly integrating. Yet given that this regionalism is at present at a shallow, preparatory stage, it is as yet too early<sup>19</sup> to examine the relationship between economic integration and FDI using the existing approaches that focus on market size, market growth and tariff discrimination as determinants of inward FDI flows. This is not to suggest that it is incongruous to employ a regional approach but rather to propose that it is the juxtaposition of the regional political economy and the regionalisation of production that becomes the core framework for examining (Japanese) MNE activity. In other words, placing greater emphasis on the dialogue or interaction between the firm and the context will afford us a better vantage point from which to analyse the forces shaping the East Asian political economy *and* the impact of these forces on MNE activity.

Susan Strange is clear on this point: 'The explanation for the internationalisation of production is not to be found within the firm but in the context, in the changing political economy within which the firm operates and competes with others in a global market for goods and services' (Strange, 1993:104).

Yet, in terms of a theoretical architecture upon which to base the study, Strange's dictum can only take us so far and a further component is required if we are to grasp the experience of the regionalisation of production. This is to be found in the global production network literature to which attention now turns.

### **Global value chain/commodity chain and global production network analysis**

While the concept of the value chain emerged from business and management studies (Porter, 1990), global value chain (GVC)<sup>20</sup> and global commodity chain (GCC)<sup>21</sup> analysis<sup>22</sup> stems from a concern with inequality in developing countries arising from the ongoing processes of globalisation, or more precisely, the globalisation of production activity. Following this, GVC and GCC analysis seek to identify positive policies for the development of countries and/or regions and as such may be seen as pulling together key themes from the critical tradition (NIDL analysis in particular) and recapitulating them for the era of globalisation. Chain analysis further recognises that solely macro- (trade and investment statistics) or micro-level (firm,

institutional) studies fail to grasp the complexity of the global economy (Gereffi, 1994; 1999, Gereffi and Kaplinsky, 2001; Kaplinsky and Morris, 2000) and by going beyond sectoral or discipline specific analysis it is better placed to tackle the dynamism of cross-sector linkages. Accordingly, chain analysis has been described as 'a meeting ground for economics, business administration and industrial sociology in the study of one important aspect of globalisation, namely the simultaneous economic integration of countries, and disintegration of production processes' (Wood, 2001:41).

## Analytical tools

The concept of the value chain initially acts as a heuristic device to 'plot the flow of goods and services up and down the chain, and between different chains' (Kaplinsky and Morris, 2000:25) yet has more recently transformed into an analytical tool through the identification of the following three core components: how 'rents' are captured and distributed in the chain, the coordination and subsequent 'governance' of activities within the chain, and the diversity of chain type (buyer and producer driven).<sup>23</sup> The value chain/commodity chain literature has thus identified an organisational and spatial shift in the global economy and provided the analytical tools with which to assess it.

## Global production networks

Yet for Henderson *et al.*, the global production network (GPN) describes more accurately than either the GCC or GVC<sup>24</sup> the 'post-fordist forms of activity' (2002:444) and the non-linear, complex and spatially diverse nature of the flow of materials, products and services that characterise economic globalisation. Furthermore, it represents an attempt to move away from the firm-centric (Porter's value chain) or state-centric (GVC, GCC) literature from which it has emerged. It is, then, 'a conceptual framework that is capable of grasping the global, regional and local economic and social dimensions of the processes involved in many (though by no means all) forms of economic globalisation' (*ibid.*:445). GPN analysis is thus concerned, methodologically, with networks, distribution of power, the significance of labour and value creation, the institutions that influence firm strategy and the implications of these areas for technological upgrading (development) for those actors involved in the chain (Henderson *et al.*, 2002:447). Investigation of these areas is guided with reference to three conceptual categories identified as *value* (creation, enhancement, capture), *power* (corporate, collective, institutional) and *embeddedness* (territorial, network).

The GPN framework stresses the importance of the notion of 'flow' and 'space', which describes the interaction between the GPN and the space within which it operates. Henderson *et al.* note that 'we must comprehend

how places are being transformed by flows of capital, labour, knowledge, power etc. and how, at the same time, places (or more specifically their institutional and social fabrics) are transforming those flows as they locate in place-specific domains' (2002:438). While the GPN framework offers a research agenda rich with possibilities, it is this point in particular which is of immediate interest for this study. This is not to deny the validity and relevance of the methodologies and frameworks proposed by the GPN approach. Indeed Chapter 9 concludes that key issues raised in this study would benefit from further analysis utilising the GPN framework. However, by drawing on the GPN concept, an examination of the dialectic between the flow and the space may offer important insights into the operations of Japanese regional production networks in East Asia.

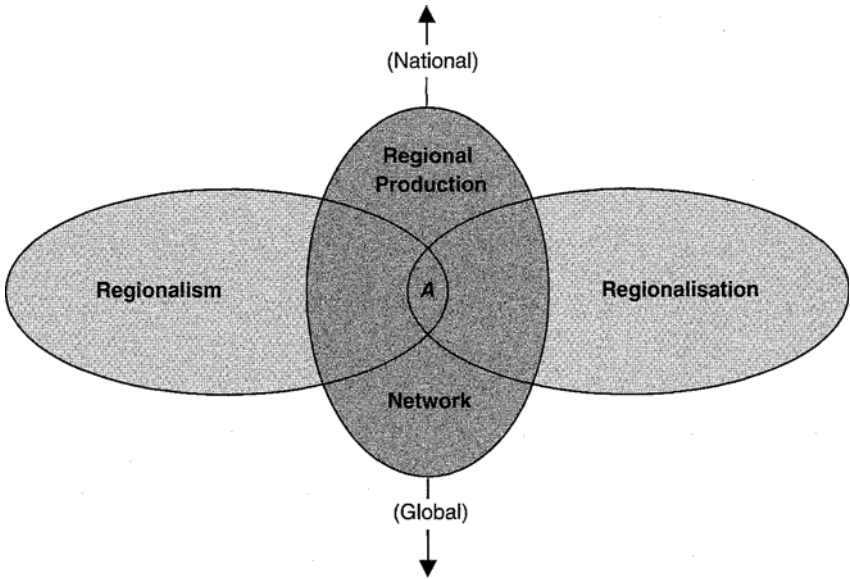
### **The regional nexus**

The GPN concept of flow and space thus offers a further plank to the approach being developed here. A final contribution is received from Coe *et al.*, who develop this concept by suggesting that regional development occurs as a result of a 'strategic coupling' of endogenous growth factors (technology, organisation and territory) and the strategic needs of actors found within global production networks (Coe *et al.*, 2004). This process is 'mediated by a range of institutional activities across different spatial scales' meaning that 'regional development depends on the ability of this coupling mechanism to facilitate processes of value creation, enhancement and capture' (Coe *et al.*, 2004:481). Regional institutions, then, are identified as the 'facilitators' of strategic coupling between regional assets (space) and global production networks (flow). This conceptual framework therefore formalises the convergence of both 'regionalist' and GPN analysis and, methodologically, pinpoints the interaction between the two as the locus of investigation.

Figure 2.6 is an attempt to reformulate this as the 'regionalism/regionalisation' juxtaposition or 'regional nexus'. However, one important clarification is called for. In this model, it is the regional, rather than global, production network that has been identified. While the firms investigated in this study are global in their reach and presence, the nature of operations within ASEAN are more correctly, to greater or lesser degrees, described as regional. These activities include design, manufacturing, marketing and servicing. Indeed, as will be determined from the case studies presented below, this is a deepening trend and important characteristic of (Japanese) auto production in the region.

Figure 2.6 shows the relationship between regionalism, regionalisation and the regional production network. *A* denotes the juxtaposition of the dynamics of these three fields and may be seen as the dependent variable. That is, the dynamics of *A* will be determined by independent (national)

Figure 2.6 Locating the regional production network



Source: Author.

characteristics insofar that these exist within, or are constrained by, the regionalised space. For comparison, European states, given the deep stage of regionalism that exists in the EU, will be more constrained and thus less able to independently determine A than those in East Asia where the regionalist project remains at the shallow stage. Put another way, the national nuances of constituent member states of East Asia would appear to have a greater potential for influencing A than those in Europe. The relationship between these variables is described by Figure 2.7.

It is important to note the abstract nature and limitations of this model. There is, for instance, no immediate reference to underlying global structures (multilateralism, the neo-liberal agenda), competing visions of capitalism or the particular characteristics and guiding logic of the regional

Figure 2.7 State influence of regional nexus

<i>Stage of integration</i>	
Deep	Shallow
Low	High
<i>Potential to influence A</i>	

Source: Author.

production network (sectoral, national). Nevertheless, the model draws attention to focus on investigation and augments the framework suggested by GPN and strategic coupling analysis.

## **The research agenda**

The central aim of this study is to better understand the dynamics shaping the post-crisis era, or 'new', East Asian political economy. More specifically, the core thesis advanced here is that the dynamics of the contemporary East Asian political economy as they pertain to investment, production, trade and economic development may only be adequately grasped through an examination of the regional nexus of which the (Japanese) regional production network, deepening regionalisation and ongoing regionalism are constituent components. This is attempted through the adoption of a theoretically informed analytical approach, the principle aspects of which are represented below.

The approach thus:

- embraces a political economy focus which locates firm-level empirical data in the context of industrial and regional factors,
- stresses the importance of the transformation of the East Asian political economy (recognising Japan's role within these processes) and of regional integration on firm-level strategy and operations,
- draws on the GPN literature and its particular concerns with the concepts of 'flow and space', 'strategic coupling' and the continued relevance of the nation state, and
- critically examines the continued relevance of Japanese (flying-geese) concepts of Japanese FDI in East Asia.

Following from this, the research agenda asks:

- to what extent the transformation of the East Asian political economy (to be examined in detail in Chapters 3 and 4) has impacted on the strategies employed by Japanese auto manufacturers, and more specifically, the extent to which regional integration has created grounds for the rationalisation and regionalisation of existing production networks,
- to what extent are ASEAN economies losing investment to China,
- what can be ascertained from an examination of the regional nexus with regards to national and regional economic development, and
- the extent to which the FG paradigm remains a valid metaphor for Japanese FDI in East Asia.

This concludes Chapter 2 and Part I of the study. In Part II which follows the above presented approach is developed through an examination of the transformation of the East Asian political economy.

## **Part II**

# **Establishing the Context**

# 3

## The Transformation of the East Asian Political Economy

This chapter seeks to document and analyse key trends and issues in the contemporary East Asian political economy (EAPE) with a particular focus on ASEAN. Two key aims are identified: first, to present a descriptive account of events and trends in the post-crisis region and second, to analyse the emergence of a nascent East Asian economic entity.<sup>1</sup> An underlying theme, first enunciated in Chapter 1, is that this analysis points both to a radical transformation of the EAPE and further, that this transformation necessitates a modified, holistic approach to any investigation of MNE activity in the region. To facilitate these aims, this chapter considers six key trends and issues that taken as a whole constitute this radical transformation: stalled multilateralism, deepening regional economic interdependence, responses to the crisis in the fields of finance, politics and trade liberalisation, and the significance for the region of China's continuing economic ascent. A final brief section offers a summary and some concluding thoughts.

Before this, attention turns to briefly overview pertinent aspects of the pre-crisis EAPE as presented in the literature. While it is not the intention to systematically review this broad area, the subsequent examination as outlined above would be handicapped without at least a 'potted' narrative to inform it. Accordingly, this first section considers the East Asian experience of economic development through industrialisation, models of development, East Asian regionalism and RPNs.

### **Accounts of East Asian economic development**

Cummings (1984) stressed the importance of adopting a political economy approach to our understanding of East Asia and its economic development. Specifically, he identified the legacy of Japanese expansionism and the dynamics of the Cold War as critical factors that have shaped, and continue to shape, the region, particularly in Northeast Asia (NEA). In the field of international relations, hegemonic stability theory offers an explanation of how the US, through its security alliance with Japan and active resistance

of communism, has constructed the framework within which post-war economic development in the region has occurred. In the post-Cold War era, first globalisation and now regionalism may be seen as defining regional characteristics although the pre-existing security<sup>2</sup> and political<sup>3</sup> framework remains largely in place.

The East Asian experience of development has been temporally and geographically diverse. Japan emerged as an industrial power around the turn of the nineteenth century, emphasising this by defeating Russia at war in 1905, but industrialisation in other countries was to wait until the second half of the twentieth century. Additionally, East Asian economies remain politically diverse though, with notable exceptions, appear to be converging on similar, (market) democratic ideals. On matters of culture, religion and language, the region exhibits far greater diversity than observed in the other two nodes of economic activity: the EU and North America. Therefore, when we talk of an East Asian experience, these caveats concerning diversity must be employed. Moreover, as will be discussed below, the mode of economic development for each nation retains distinctive characteristics abrogating regional generalisation.

Japan's remarkable post-war reconstruction was followed by rapid growth in the 'Tiger' economies<sup>4</sup> from the mid-1960s, the Southeast Asian economies of ASEAN<sup>5</sup> from the 1980s and more recently the emergence of China as recorded in Table 3.1 below. This was documented by the World Bank in the 1993 'miracle' report discussed more fully below. While the national experience differs, it is clear that the region has experienced one of the most remarkable and sustained periods of development in economic history. Indeed, 'never before had so many people been plucked out of poverty over such a short space of time' (Rigg, 2002:137). Unsurprisingly, understanding

**Table 3.1** GDP percentage growth and decline rates in East Asia

	1980-90	1990-95	1996	1997	1998	1999	2000	2001	2002	2003
Japan	4.0	1.0	3.8	-0.7	-2.5	0.5	2.4	0.6	-0.2	2.7
Hong Kong	6.9	5.6	4.7	5.0	-5.1	2.9	10.2	0.5	1.9	3.2
Singapore	6.4	8.7	6.9	7.8	0.3	5.4	10.1	-1.9	2.2	1.1
South Korea	9.4	7.2	7.1	5.5	-6.7	10.7	8.5	3.8	7.0	3.1
Taiwan	-	-	5.4	6.8	4.6	5.4	6.3	-2.2	3.6	3.2
Indonesia	6.1	7.6	8.0	5.0	-13.2	0.2	4.8	3.5	3.7	4.1
Malaysia	5.2	8.7	8.6	8.0	-7.5	5.4	8.5	0.3	4.1	5.2
Philippines	1.0	2.3	5.5	5.1	-0.5	3.2	3.9	3.0	4.4	4.5
Thailand	7.6	8.4	5.5	-0.4	-10.4	4.2	4.4	2.1	5.4	6.7
China	10.2	12.8	9.5	8.8	7.8	7.1	8.0	7.3	8.0	9.1

Source: Asian Development Bank Key Indicators, various years.

**Table 3.2 Approaches to East Asian economic development**

The Washington Consensus	State developmentalism	Culturalist
Fiscal discipline and austerity	Efficient public administration	East Asian values
Public expenditure priorities	Disciplined government	• Confucianism
Tax reform	intervention	• Filial piety
Financial liberalisation	Government/business	• Thrift
Exchange rate reform	cooperation	• Hard work
Trade liberalisation	Investment in building	• Loyalty
FDI	human capital	• Self-sacrifice
Privatisation	Investment in physical capital	• Education
Deregulation	High domestic savings rate	
Property rights	Catch-up development	

Source: Adapted from Rigg, 2002: 143.

how and why this growth occurred is a more contentious issue than simply reviewing Gross Domestic Product (GDP) data (see Table 3.1). Indeed, three main approaches that attempt to explain East Asian development are identified in the literature and presented in Table 3.2.

The neo-liberal (Washington Consensus) approach focuses on core economic fundamentals: low taxation, liberal trade and investment regimes, deregulated markets, enforced property rights and fiscal discipline. In other words, East Asian economies enjoyed rapid growth as and when they opened up and pursued market friendly policies. This position stands in contrast to the developmental state concept<sup>6</sup> as promoted most loudly by Japan. In this scenario, the state plays the key role in guiding economic development through a mixture of strategic economic policy and market sector ‘guidance’. Industrial policies protected domestic industrial sectors from external competition but an export orientation exposed these firms to competition globally, thus driving innovation and productivity gains. This ‘alliance’ capitalism fostered the long-term relationships that allowed for investment and growth over short-term profit taking. A third approach, more closely related to the developmental state concept but sharing some features with the neo-liberal explanation (fiscal austerity, hard work), is found in the culturalist position promoted variously by Singaporean Prime Ministers and Indonesian dictators. All three approaches faced re-examination in the wake of the financial crisis as will be discussed below.

### **Models of East Asian development**

Although these three approaches attempt to describe a model of East Asian development, Japan, the NIEs, ASEAN and China have all pursued markedly different routes. How far Japan developed because of or in spite of the developmental state concept remains a matter of debate but it is clear that the

**Table 3.3 Trade as a percentage of GDP in Japan, South Korea and UK (2003)**

	Japan	South Korea	UK
Trade as % of GDP	11	37	26

Source: Compiled from OECD, data available online at [www.oecd.org](http://www.oecd.org).

neo-liberal approach has little authority in its explanation. In contrast to the 'Japanese' model that excluded foreign interference in domestic markets and industrial organisation, Southeast Asian nations have demonstrably thrived on inward investment. Korea's *Chaebol* and Taiwan's array of small and medium-sized enterprise (SMEs) point to further differences in industrial structure. Although exports have played a major role in both NIE and ASEAN growth, trade as a percentage of GDP in Japan has consistently remained below that in other OECD economies standing at approximately 11% in 2003 (see Table 3.3).

Japan's promotion of its developmental state concept, based on the FG paradigm, is considered fully in Chapter 4 but is briefly mentioned here as it encapsulates many of the aspects of a presumed 'East Asian' model. These include a pattern of industrialisation that moves from labour intensive to knowledge and capital intensive industries, market friendly policies that encourage inwards FDI and crucially, technology transfer, an outward orientation for trade and a defined role for government. Most of these are included in the World Bank's assessment of East Asian success which is presented in Table 3.4 below.

Clearly, then, no single model or ideological approach (neo-liberal/statist/culturalist) can be identified to account for East Asian development and any assessment invariably reflects the internal bias of the commentator. Yet to some extent and in response to the financial crisis, these views

**Table 3.4 The (World Bank) recipe for East Asian success**

Fundamentally sound macroeconomic policy	High levels of domestic savings and investment	Tax policies favouring investment	Secure, bank-based financial system with strong regulation and supervision
Pro-export trade incentive structure	Openness to foreign technology and investment	Legal and regulatory environment hospitable to private investment	Competitive real exchange rates

Source: Adapted from Rigg, 2002: 143.

have experienced a degree of convergence. Indeed, the crisis necessitated a review in each camp as it presented a challenge to each stated assessment; if the neo-liberal/statist/culturalist approach explained economic development then does it follow that it can be identified as the cause of the crisis?

The neo-liberal approach castigated East Asian economies for failing to deal with 'crony' capitalism and alleged that the corrosive effect of this was the weakening of otherwise sound economies. Asian values in this analysis became synonymous with corruption and a lack of transparency. Additionally, a failure to reform economies for liberalisation was seen as a major cause of collapse. On the other hand, the rapid pace of globalisation had challenged the capacity of governments to implement reform and this suggests that, to some extent, the neo-liberal assessment would accept the need for phased restructuring (liberalisation) by governments. Here neo-liberal interpretations share ground with the statist who argued that whereas rapid economic development could be attributed to intimate state involvement as economies matured and moved into higher value added sectors, the state should in time step back. That it had not had time to do so in many East Asian economies explained the resulting crisis. Proponents and promoters of Asian values also accepted that rapid growth had presented the opportunities for a degree of corruption but continue to argue that East Asian style development offers an alternative to Anglo/American, Washington Consensus style globalisation. In the post-crisis period, neo-liberal, statist and culturalist approaches have all required re-examination and modification. The result is that the distance between them has reduced to a greater or lesser degree and that the more radical and evangelical fringes have been rounded off. In other words, the crisis has moved the debate on and the investigation of East Asian development now increasingly takes place within the context of regionalism.

### **Emerging regionalism**

East Asia is a relative latecomer to regionalism even though competing visions of an economic community of some form have been under consideration for decades. Leaving aside Sino-centrism and Japan's abortive Greater East Asian Co-Prosperity Sphere, modern day regionalism may be traced back to the Organisation for Pacific Trade and Development (OPTAD) and the concept of the Pacific Free Trade Area (PAFTA) promoted by Kiyoshi Kojima, erstwhile student of Kaname Akamatsu, in 1968 one year after the establishment of ASEAN. These were largely academic musings in a region yet to experience 'take-off' and split keenly by Cold War realities. The Pacific Economic Cooperation Council (PECC) was established in 1980 as a forum for senior business leaders, bureaucrats and academics to debate matters pertaining to economic cooperation and development. However, these 'talking shops' failed to significantly move any regionalist agenda forward and it was

only with the inception of Asia Pacific Economic Cooperation (APEC), jointly promoted by Australia and Japan, in 1989 that regional economic cooperation in the Asia-Pacific received serious attention. In many ways, this move can be seen as a defensive reaction to growing regionalism elsewhere (Europe and North America) and was premised on the concept of open regionalism.<sup>7</sup> APEC has taken as its guiding principle (expressed in the Bogor declaration of 1994) the goal of 'free and open trade and investment in the Asia-Pacific by 2010 for developed economies and 2020 for developing economies' (APEC Secretariat). Throughout the 1990s, APEC was the regional forum and gained greater currency with the establishment of annual heads of state summits in 1993. By 1999, membership had reached 21 and included Japan, Korea, Hong Kong, China, Russia, the ASEAN 6, Vietnam, Australia, New Zealand, Papua New Guinea, Chile, Peru, Mexico, the US and Canada. However, APEC's geographical scope was not matched by its breadth of policy and remained an organisation without a formal, binding agreement and committed to the principle of voluntary action. APEC members agreed to move towards the goals of the Bogor declaration by adopting voluntary Individual Action Plans.

Although monetary and macroeconomic coordination were not on APEC's agenda, its apparent impotence in the face of the crisis, and the inaction of the US, seriously undermined the grouping's credibility. It is at this point that the Asia-Pacific vision began to give way to the emerging East Asian reality under an ascendant ASEAN. In contrast to the open, voluntary and Asia-Pacific aims of APEC, the ASEAN+3 (APT) process (examined in detail below) commits East Asian member states to a formal, rules-based future of deepening economic integration.

## Regional production networks

The final issue to be considered in this introductory section concerns the regionalisation of production in East Asia through RPNs. East Asian regional integration is usually described as a *de facto* 'bottom-up' process in contrast to the *de jure* 'top-down' political experience observed in the EU. That is, deepening trade and investment linkages have created a firm economic basis upon which a more political process of negotiated agreements can institutionalisation take place. By creating vertical and horizontal divisions of labour between and within countries, RPNs thus provide a rationale for trade and investment liberalisation, financial coordination and cooperation, or in other words, the facilitation of regional economic integration.

MNEs regionalise production in pursuit of scale economies and the maximisation of advantages afforded by national comparative advantage and Japanese multinationals, particularly in the automotive and electronics sectors, have been the most prolific regionalisers of production in East Asia. This process is facilitated by FDI and has proceeded in step with the liberal-

isation of investment regimes in East Asian economies from the 1980s. ASEAN has made numerous attempts to create a more favourable business environment for Japanese multinationals through the implementation of various schemes, the AFTA being the latest and most comprehensive of these. In certain respects, AFTA is simply formalising pre-existing regional production structures but by doing so the intention is to encourage further inward FDI and regionalisation of production.

RPNs, in addition to the information technology (IT) revolution and globalisation in general, have presented a serious challenge to the FG paradigm which assumes the transference of 'full-set' industrial structures from lead to following economy (Bernard and Ravenhill, 1995). By dividing up production regionally, Hatch and Yamamura (1996) charge that Japan has locked ASEAN economies into a structure of dependency. While this may be an overstatement it is clear that Japanese multinationals, by replicating to some degree their domestic *keiretsu* structures, have assumed dominant positions in key industrial sectors. Yet even this assessment is subject to change and more recent research suggests that, outside of Japan, transactions are increasingly occurring outside of traditional *keiretsu* style relationships (Charoenporn, 2001).

RPNs, then, have both contributed to regional economic interdependence (intra-regional trade and investment) and provided a rationale for deeper regional integration. The impact of the transformation of the EAPE on these networks is returned to below.

This first section has provided an overview of key aspects of the EAPE and highlights the contested and diverse nature of the region. Competing approaches to the East Asian experience of economic development and resulting models have been reviewed as have issues surrounding regionalism and regionalised production. This brief overview completed, the following sections go on to examine how this structure has responded to the transformation of the region in the post-crisis era.

## **Stalled multilateralism**

While a multitude of institutions oversee or govern global economic activity,<sup>8</sup> this section takes as its focus the WTO and in particular the multilateral trading system that lays at its heart. Multilateralism has defined the global economic environment within which multinationals operate and has held particular significance for East Asian economic development where economies have thrived through export-led industrialisation within a liberal trading system. Given this, stalled multilateralism, defined here as failure to progress the WTO agenda, is an important contextual component of the transformation of East Asia's political economy. Indeed, this study directly links stalled multilateralism with the growth of bilateral and regional FTAs observed in the area today.

Depending on one's ideological perspective, trade liberalisation has been either the engine of global economic growth and development in the second half of the twentieth century or a pernicious vehicle for the continued domination and exploitation by the rich (advanced countries) of the poor (developing countries). Undoubtedly, trade liberalisation has lifted millions out of poverty and this has been most clearly demonstrated in East Asia. It is not so much resistance to trade liberalisation *per se* – developing economies are desperate to gain access to markets in the developed world and would welcome liberalisation in key sectors, notably agriculture – but the resulting lopsided impact that has given rise to growing discontent with the inequalities and costs of such globalisation. With this in mind, a brief review of WTO activity follows.

The late 1990s can to some extent be seen as the high water mark for WTO led globalisation. Trade liberalisation had been progressing steadily under the General Agreement on Tariffs and Trade (GATT) since just after the Second World War<sup>9</sup> and the Uruguay round (1986–1994) achieved the most ambitious agenda in its history. Uruguay agreements included those on services (General Agreement on Trade in Services), intellectual property (Trade Related Aspects of Intellectual Property Rights) and trade related investment (Trade Related Investment Measures) in addition to trade in agricultural and textile products. The establishment of the WTO (1995) was a further consequence of this round. Yet attempts to launch a new 'development' round of negotiations in Seattle (1999) were dashed as the conference descended into violence and acrimony. Seattle was marked as much by an inability or unwillingness by developed countries to agree on basic principles, to the chagrin of the developing world, as the disparate yet highly visible collection of malcontents enraged at the prevalence of the neo-liberal agenda, the so-called Washington Consensus and globalisation in general. It was only at Doha in 2001, where pressure was on for the global community to present something approaching a united front barely three months after the September 11<sup>th</sup> terrorist attacks, that the new round was launched. However, these talks progressed little and ultimately collapsed two years later at Cancun over rich world protection of agricultural sectors and developing world rejection of the Singapore issues.<sup>10</sup> In other words, in the nine years following the conclusion of the Uruguay Round, the WTO failed to make any significant headway in promoting further trade liberalisation, and it is precisely in this period that the popularity of bilateral and regional FTAs expanded.<sup>11</sup> Between 1952 and 1995, forty-one regional trade agreements (RTAs) were notified to the WTO, a rate of approximately one a year. This increased to an annual rate of approximately seven per year between 1995 and 2004 when a further sixty-six RTAs were notified (see Table 3.5).

A further, and predictably unsuccessful, round of Ministerial level talks was held in Hong Kong in December 2005, four years after the launch of

Table 3.5 Regional free trade agreements and WTO

Period	Total	Asia-Pacific	WTO activity
1955–1989	20	4	Successive rounds
1990–1994	21	3	Conclusion of Uruguay round
1995–2000	26	1	Seattle (1999)
2000–	40	6	Doha (2001), Cancun (2003)

Source: Compiled from WTO, data available online at [www.wto.org](http://www.wto.org).

the Doha development round and almost a year after the self-imposed January 1<sup>st</sup> 2004 deadline.<sup>12</sup> As the *Economist* noted at the time, the 2005 conference represented perhaps the final opportunity to conclude negotiations given that US presidential ‘fast track’ authority was due to expire in 2007 and that its renewal was far from assured, particularly in light of recent US subsidies (agriculture) and tariffs (steel) (*Economist*, 2005a).

A further issue relevant to the discussion on stalled multilateralism is found in the multilateral agreement on investment (MAI). The MAI emerged from the OECD in the mid-1990s and was subsequently adopted for discussion by the WTO. It was a proposal to locate and govern FDI within a multilateral framework similar to the management of global trade. A central provision was the requirement of ‘national treatment’ that would have severely curtailed the ability of host nation policy makers to impose conditions on inward investment. In practice this would have barred hosts such as Thailand or Malaysia from requiring inward investors to source a certain percentage of components for final products from the local market. The MAI was dropped by the WTO after fierce resistance in Seattle 1999 and marks a further point of resistance to multilateralism that is conceived of as reinforcing developed country dominance, or as ‘kicking away the ladder’ to economic development (Chang, 2002).

In summary, it is possible to conclude that the late 1990s and early twenty-first century witnessed a slowing of multilateralism in terms of WTO led trade liberalisation. Moreover, positions appeared to have hardened on the most intransigent issues: agriculture and trade facilitation. At the same time the rise in the number of RTAs indicates that an appetite for further liberalisation exists but that negotiating countries have lost faith in the WTO’s ability to deliver. While it is not strictly in the remit of this study to speculate on the desirability or otherwise of WTO led multilateralism, it does appear clear that RTAs are ‘second bests’ and that even as they facilitate some forward movement, developing countries will inevitably lose out to larger, better organised and more powerful negotiating partners from the developed world. There is also the concern that RTAs will

undermine the multilateral process by creating a 'spaghetti bowl' effect (Bhagwati and Panagariya, 1996).

### **Deepening regional economic interdependence**

East Asian regionalism is based on the regionalisation of production, trade and investment that has steadily proceeded over the past three decades. An increasing share of economic activity in the region is now accounted for by intra-regional flows. In other words, it would appear that the region is becoming more deeply integrated and interdependent and less reliant on traditional extra regional markets. This in turn suggests that in place of the disparate collection of national economies that had previously existed, East Asia is progressing towards an economically and now politically defined regional entity. Accordingly, it may no longer be presumptuous to refer to East Asia as the third pole in the global triad. This section examines the sinews of this economic interdependence: intra-regional trade and investment structures. Both may be considered building blocks of the emerging East Asian economic community.

The nature of intra-regional trade needs further qualification as two forms can be identified. First, intra-regional trade and second intra-industry trade. Intra-regional trade is that which takes place within and between the APT countries (and also Taiwan) whereas intra-industry trade, though occurring in the same geographical space, refers to transactions within a given industry. For instance, the RPNs of Japanese auto manufacturers by necessity conduct intra-industry trade as components are moved from one production site in, say, Indonesia to another in Thailand. Detailed econometric analysis of intra-regional trade in East Asia is available elsewhere (see in particular Isogai, 2000, 2002) and the intention of this section is to review pertinent issues as they pertain to the overall scope of this chapter.

### **World, intra-regional and intra-industry trade**

East Asian economic growth may be measured in terms of the region's share of total world trade. In the decade between 1987 and 1998, East Asia's share of global exports increased from 10% to 17% while its share of imports rose from 10% to 18% (see Table 3.6). Although this growth was interrupted by the AFC, East Asia's share of exports reached 19% in 2002.

East Asia's growing share of world trade broadly reflects the export orientation of the region's industrialisation. However, a rising percentage of this growth is accounted for by intra-regional trade within which intra-industry trade figures prominently; the share of total trade growth attributed to intra-industry trade rose from 42.5% in 1986 to 75% in 2000 (IMF, 2004:9)

Table 3.6 World trade share by region

	Exports		Imports	
	1985–87	1995–98	1985–87	1995–98
World	100	100	100	100
Japan	10	9	6	6
East Asia	10	17	10	18
NIEs	5	6	4	7
ASEAN 4	2	4	2	4
China & Hong Kong	3	6	4	6

Unit: Percentage of world trade

Source: IMF Direction of Trade Statistics, available online at [www.imf.org](http://www.imf.org).

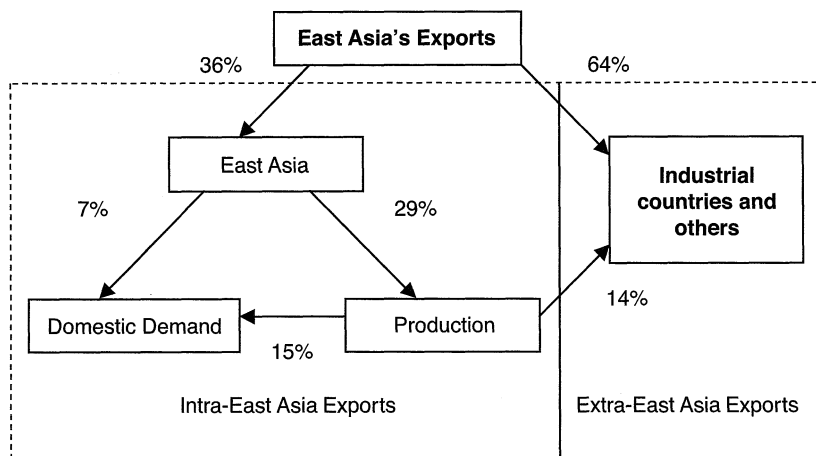
Table 3.7 Intra-regional trade in the global triad

	Intra-regional trade as a percentage of global trade		Intra-regional exports as a percentage of region's total exports		Intra-regional imports as a percentage of region's total imports	
	1990	2003	1990	2003	1990	2003
East Asia	8.4	12.7	40.1	50.5	47.5	59.7
NAFTA	6.7	8.5	41.4	55.4	35.0	39.9
EU	29.1	23.3	66.0	61.4	66.6	63.5

Source: IMF Direction of Trade Statistics, available online at [www.imf.org](http://www.imf.org).

(see also Table 3.7). Intra-East Asian exports rose from approximately 20% of the total in the 1970s to 40% in 2002 (IMF, 2004) while exports to the US, the EU and Japan have declined (US, Japan) or remained broadly stable (EU). However, as intra-regional trade is dominated by intra-industry trade in intermediate goods, these external export markets remain crucial for finished products. This supports the observation that East Asia is a developing region that must move into higher value added production if the aim of development is to gain parity with advanced economies in North America and Europe. In other words, demand in export markets (for manufactured products) is as important a driver of intra-regional trade as export-orientated growth policies and AFTA implementation. This continuing dependency on extra markets is illustrated in Figure 3.1.

Figure 3.1 East Asian export shares



Source: IMF, 2004: 17.

Table 3.8 Intra-Asian trade 1980–2000

		Exports			Imports		
		EA3	EA2	EA1	EA3	EA2	EA1
EA1	1980	–	–	18.9	–	–	15.3
	1990	–	–	22.2	–	–	19.6
	2000	–	–	26.0	–	–	25.3
EA2	1980	–	21.7	–	–	18.2	–
	1990	–	32.0	–	–	30.1	–
	2000	–	36.9	–	–	41.5	–
EA3	1980	32.0	–	–	31.8	–	–
	1990	39.6	–	–	42.9	–	–
	2000	46.5	–	–	53.1	–	–

Unit: Percentage

Notes: EA1: NIE 4 + ASEAN 4, EA2: EA1 + China, EA3: EA1 + EA2 + Japan

Source: McKinnon and Schnabel, 2002: 9.

As illustrated in Table 3.8, McKinnon and Schnabel (2002) distinguish between three regional groupings: the NIEs and ASEAN 4, the NIEs, ASEAN 4 and China, and finally, all the above. In all three, intra-regional trade has increased in the period examined but most noticeably within the second grouping confirming both China's rapid emergence and the overall regional trend.

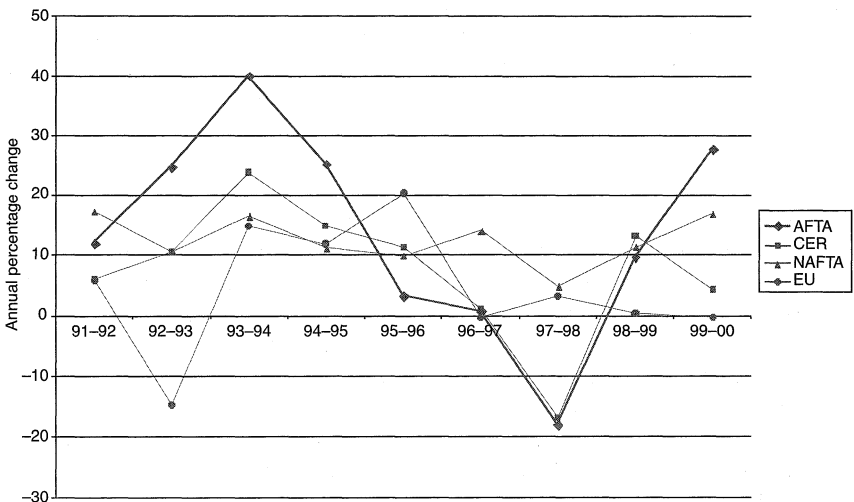
### The impact of AFTA on intra-ASEAN trade

An examination of the AFTA is presented in greater detail below but it is important to note here that through the Common Effective Preferential Tariff mechanism, average tariff rates between AFTA signatories (ASEAN 6) fell from 11.44% in 1993 to 2.89% in 2002. Although the later ASEAN members have not yet liberalised trade to this extent, their inclusion raises the overall tariff rate only slightly (to 3.33% in 2003). Intra-regional trade has expanded as tariffs have reduced. Intra-ASEAN exports accounted for 19.8% of total ASEAN exports in 1991, rising to 23.2% in 2000. Intra-ASEAN imports rose from 16.3% to 21.8% of the total in the same period. Rising intra-ASEAN trade can therefore be observed but it is also true that the impact of the AFTA to date has been rather modest. On the other hand, both intra-ASEAN and extraregional trade have grown at a faster rate than that observed in other regional trading agreements as shown in Figures 3.2 and 3.3. The financial crisis in 1997/98 had an immediate and negative impact on intra-regional (and extraregional) trade. Although growth rates have yet to return to pre-crisis levels, a reversion to a positive trend became apparent even as the crisis continued to play itself out.

### FDI and process of regional integration

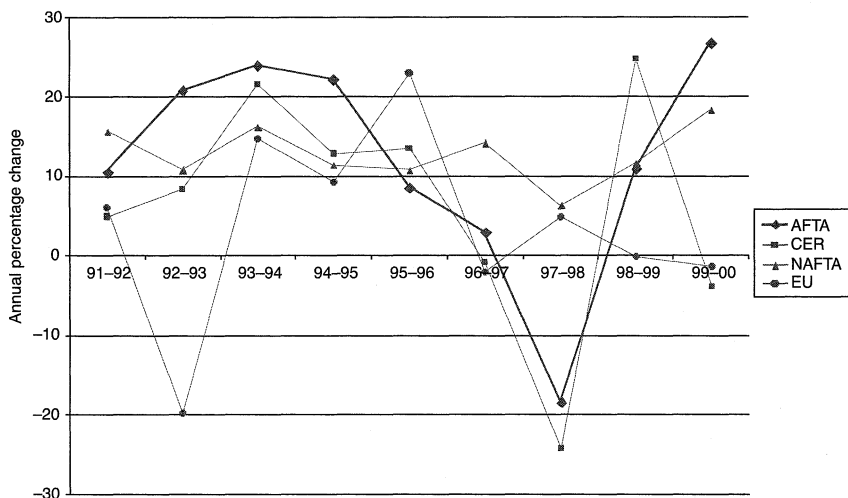
Chapter 2 examined the literature surrounding the link between FDI and regional economic integration and while it is clear that a positive correlation

Figure 3.2 Annual change in intra-regional imports (%)



Source: Compiled from Bank of Japan (BOJ), data available online at [www.boj.or.jp](http://www.boj.or.jp).

Figure 3.3 Annual change in intra-regional exports (%)



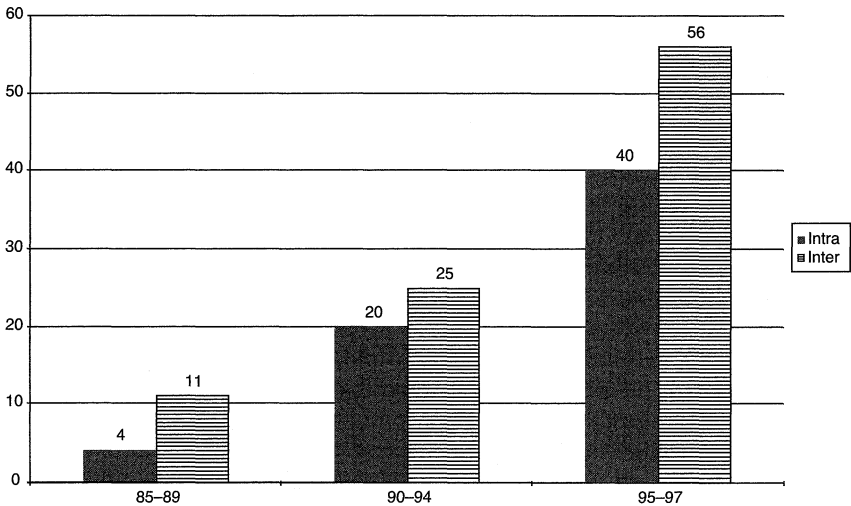
Source: Compiled from BOJ, data available online at [www.boj.or.jp](http://www.boj.or.jp).

exists between FDI flows and integration, it is not clear that regionalism encourages FDI in the East Asian (ASEAN) experience. In contrast to the positive impact of AFTA on intra-regional trade, it appears that the agreement has had little impact on inward investment flows (Scally and Wickramanayake, 2004:60), although it should be noted that this assessment was based on data covering only the period between 1992 and 1997. However, as ASEAN implements the ASEAN Investment Area (AIA) it is anticipated that regional integration will be accelerated by increased investment and regionalised production as ASEAN's locational advantages are enhanced, encouraging a 'crowding in' of investment.

## FDI in East Asia

FDI has played a crucial role in the development of East Asia and this is particularly true for Southeast Asian nations (Ito and Krueger, 2000; Freeman and Bartels, 2004). FDI into the region increased rapidly in the 1980s and throughout the 1990s up to the crisis for the ASEAN 4 and China in particular. Moreover, the share of intra-regional investment has been increasing steadily relative to the share of inter-regional investment over the past two decades as recorded by Figure 3.4. Within this structure China is most dependent on intra-regional FDI, mainly from the NIEs and Japan (68% in 1995-1997) while the ASEAN 4 received only 24% of their inward investment in this way. The NIEs are even less dependent on intra-regional FDI which accounted for only 12% in the same period. A conclu-

Figure 3.4 FDI in East Asia from inside/outside the region



Units: US\$ billion

Source: Compiled from BOJ, data available online at [www.boj.or.jp](http://www.boj.or.jp).

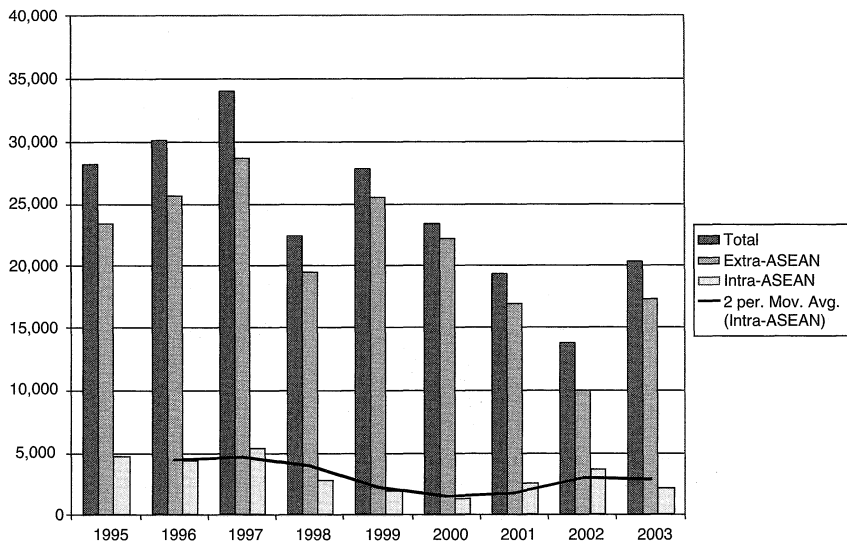
sion to be drawn from these figures is that once FDI to China is stripped out, East Asia is still dependent on FDI from outside of the region.

## FDI in ASEAN

Total FDI to ASEAN dropped significantly in 1998, recovered somewhat in 1999, but then subsequently fell for the next three years and only registered an upturn in 2003 as recorded in Figure 3.5. While the gap between intra-East Asian FDI and that sourced externally continues to narrow, intra-ASEAN FDI which accounted for 16.65% of total ASEAN inflows in 1995 fell to a 10.69% share in 2003. Concurrently, the share of investment from the rest of the world to ASEAN increased from 83.42% to 89.31%. In terms of intra-regional investment flows therefore, East Asian economic integration has proceeded quicker and more deeply than that observed in ASEAN.

ASEAN's response to this downturn, in addition to accelerated AFTA implementation, has been to promote regional investment cooperation as part of the broader movement towards regional economic integration. The Framework Agreement on the AIA was signed in 1998 and legally entered into force in 1999 on ratification at the 7<sup>th</sup> ASEAN Summit in Hanoi. The agreement made provision for a ministerial level council (the AIA Council) and a Coordinating Committee to support the council within the ASEAN Secretariat. Thus by the late 1990s, ASEAN, uniquely in East Asia, had constructed a regional approach to FDI promotion. In addition to

Figure 3.5 Total ASEAN FDI inflows



Unit: US\$ million

Source: ASEAN Statistical Yearbook, 2004.

the central aim of making 'ASEAN a competitive, conducive and liberal investment area' (ASEAN Secretariat), the agreement also includes provisions for investment facilitation, investment liberalisation, enhancing transparency and removing structural impediments. In this way, the AIA both mirrors and complements AFTA as a device for regional economic integration. The fact remains, however, that FDI to ASEAN has not recovered to pre-crisis levels and while China enjoys an investment boom, the prognosis cannot be overly optimistic. For the purpose of this section, the important issue to note is that, regardless of the current situation, ASEAN has proactively sought to enhance its ability to attract and retain FDI through the promotion of a regional agreement.

Regional economic interdependence, as measured by intra-regional trade and investment flows, continues to deepen in East Asia and East Asia's share of world trade continues to increase. Within this benign assessment, however, closer structural examination reveals that a large proportion of intra-regional trade is in fact vertically organised intra-industry trade in intermediate products, that NIE investment in China accounts for much of the increase in intra-regional investment and that while intra-ASEAN trade is increasing, inward FDI has been on a downward trajectory. Moreover, the region remains dependent on external markets for exports of finished goods. This picture, then, confirms that the region is moving towards deeper economic integration while remaining somewhat confused in detail.

## **Responses to the Asian financial crisis I – Finance**

In depth analysis of the causes and immediate impact of the AFC may be found elsewhere (Henderson, 1999; Krugman, 1999; Furman and Stiglitz, 1998; Pempel, 1999; Robison *et al.*, 1999; Noble and Ravenhill, 2000; Jomo, 2003) and the debate rumbles on as to where to apportion blame (crony capitalism or 'mad money'). But it is the deeper trends emanating from the event that have specific relevance to the issues investigated in this book. The crisis brought home to East Asian policy makers, in the cruellest possible way, the extent of their global and regional interdependence and the implications of their collective failure to deal with the crisis at a regional level. But perhaps more importantly, it has served as a catalyst for subsequent closer regional cooperation. This trend is most clearly seen in the financial sector and it is to this that attention now turns.

Before this, it is important to note the political fallout from the crisis and resultant perceptions of the global financial architecture as this informs to some extent current developments as discussed below. Mahathir's invective aside, many East Asians saw in the lacklustre response of the US and inappropriate IMF conditionalities as an indifference to their plight and this has had a lasting legacy. The crisis exposed certain domestic structural weaknesses in addition to highlighting valid criticisms of the global financial architecture. On the one hand, domestic economic and financial systems were shown to be weak or immature, as were aspects of corporate governance, and lacking the transparency demanded by the market. These structural deficiencies may be seen as the result of policies pursued to facilitate the high-speed growth that the region had hitherto been enjoying. As was the case in Japan, when an economy is growing comfortably, defects in economic structure, corporate governance and management are either not easily detectable or can be ignored. Once the economy slows or contracts, these become more easily apparent and may not be ignored, necessitating reform and restructuring.

On the other hand, it is clear that the trend for financial sector liberalisation and the inherent instability of financial markets resulted in an 'undermining of monetary and financial governance' which may be identified as the principal of the crisis (Jomo, 2003:2). A broader debate on the appropriateness of the continuing dominance of the neo-liberal agenda in the global financial architecture is beyond the scope of this work, yet it is important to note that, broadly speaking, East Asian development stands in contrast to the 'primacy of the market'. While the region had hugely benefited from the global, liberal trade regime backed by the US, it had not been prepared for the ravages of a financial crisis which in many cases stripped away the thin veneer of capitalist development.<sup>13</sup> Understandably, if not always accurately, the region could point to 'globalisation' or 'the West' as the authors of their distress. Consequently, through contagion

and collapse, the crisis has led to something of a sense of unity in the region and this can be identified as a key dynamic shaping moves toward greater and deeper regional cooperation in general and particularly in the financial sector.

## **Regional solutions**

The last few years of the 1990s witnessed a flurry of activity in East Asian financial sectors as governments attempted to first deal with the immediate crisis and second, to take steps to prevent a further or future event. These measures are discussed below and can broadly be categorised as steps to develop regional financial facilities (bilateral swap agreements under the Chiang Mai Initiative (CMI)), capacity for crisis management and prevention (economic monitoring, surveillance, information sharing and peer review) and the longer-term development of regional (and deeper) financial cooperation (Asian bond market, exchange rate mechanisms). It should also be noted that these developments are not exclusively in response to the crisis as intensifying intra-regional economic activity provides a further rationale for a strengthened regional financial architecture.

## **Financial liquidity facilities**

The CMI proposed by the APT in 2001 grew out of Japan's failed Asian Monetary Fund (AMF) proposal (see Chapter 4 below) and instigated a regional network of bilateral currency swap agreements that are largely IMF compliant (reflecting Japan's position *vis-à-vis* that organisation and the US). This network continues to grow as indicated in Table 3.9. Bilateral swap agreements allow signatories to draw down funds in the event of a liquidity crisis and thus are designed to pre-empt the 1997/8 situation where existing arrangements proved ineffective. However, there is speculation as to the adequacy of the arrangements given the huge amounts at the disposal of speculators and more political constraints have emerged from Singapore (perceived lack of need) and China (status *vis-à-vis* Japan and Korea). Moreover, CMI funds are contingent on IMF packages being already in place; in other words, after a crisis has hit.

## **Crisis management and prevention**

One reason for the IMF conditionality of the CMI swap agreements is that donor countries (Japan, China and Korea) demand the reassurance that their funds will be repaid as 'allowing funds to be lent to countries whose operations were not under regular review and scrutiny was unacceptable' (Amyx, 2003:4). This then leads to the second set of measures that aim to develop and enhance regional monitoring and surveillance capacity.

**Table 3.9 East Asian bilateral swap agreements under the Chiang Mai Initiative, 2003**

Country	Year	Agreement	Amount*	Currency
China-Thailand	2001	one-way	2	US\$-Baht
China-Philippines	2003	one-way	2	US\$-PHP
China-Indonesia	2003	one-way	4	US\$-Peso
China-Malaysia	2002	one-way	1.5	US\$-Won
China-South Korea	2002	two-way	2	RMB-Won
Japan-China	2002	two-way	3	Yen-RMB
Japan-Indonesia	2003	one-way	1.5	US\$-Rupiah
Japan-Malaysia	2001	one-way	3.5	US\$-Ringgit
Japan-Philippines	2001	one-way	3	US\$-Peso
Japan-Thailand	2001	one-way	3	US\$-Baht
Japan-South Korea	2001	one-way	7	US\$-Won
Japan-Singapore	2003	one-way	1	US\$-Singapore \$
South Korea-Indonesia			under negotiation	
South Korea-Malaysia	2002	two-way	1	Won-Ringgit
South Korea-Thailand	2002	two-way	1	Won-Baht
South Korea-Philippines	2002	two-way	3	Won-Peso

Unit: \*US\$ billion

Source: Ministry of Finance (Japan), ASEAN Secretariat.

The ASEAN Surveillance Process established in 1998 has the objective of strengthening regional cooperation by:

- i) exchanging information and discussing economic and financial development of Member States in the region;
- ii) providing an early warning system and a peer review process to enhance macroeconomic stability and the financial system in the region;
- iii) highlighting possible policy options and encouraging early unilateral or collective actions to prevent a crisis; and
- iv) monitoring and discussing global economic and financial developments which could have implications on the region and propose possible regional and national level actions (ASEAN Secretariat available at <http://www.aseansec.org/739.htm>. Accessed 07/09/2004).

This process, then, is an exercise in regional capacity building and institutional strengthening. A coordinating unit analyses economic and financial

conditions and is supported by the Asian Development Bank (ADB), thereby putting the whole structure under the watchful eye of Japanese bureaucrats. Surveillance of the type demanded by the IMF is regarded by some ASEAN member states as 'intrusive and politically sensitive' (Amyx, 2003:5) and this resistance means that progress in the implementation of a rigorous and transparent monitoring and surveillance structure (one that would be credible in the eyes of the market) has been slow.

A further mechanism, the APT Economic Review and Policy Dialogue Process, was initiated by APT in 1999 and provides a forum for finance ministers to meet, exchange information and discuss policy issues. Both mechanisms lack an independent secretariat and are located within the existing ASEAN Secretariat and APT framework (see below). Finally, the Manila Framework Group, established to complement and support IMF surveillance, consists of APT finance, central bank officials and representatives from the World Bank and IMF and had met ten times by March 2003. Although concrete and progressive developments in this area are few and far between, it should be remembered that the situation has vastly improved when compared to the pre-crisis period. At the very least, the relevant actors are in regular contact and knowledge and understanding of the region's financial architecture has been deepened. The structure has yet to be tested but its rationale is that it should not have to be. By signalling to the market the determination of member states to cooperate in the face of speculative attacks, these mechanisms have already partly achieved their aims.

### **Further measures**

Although the establishment of some form of regional exchange rate or currency basket agreement has been the subject of much speculation, to date little progress has been observed apart from the establishment of the ASEAN Task Force on Currency and Exchange Rate Mechanism (March 2001). This is largely due to disagreement on policy and appropriate arrangements but perhaps reflects the tentative nature of going beyond increasing capacity to monitor and deal with any future financial crisis. A regional exchange rate agreement would inevitably be viewed as movement towards monetary union and this remains a far distant proposition in East Asia. Moreover, suspicion remains that Japan, by promoting a common currency arrangement, is in reality continuing to push for a yen bloc. Again, while no serious steps have been taken 'it is significant that the idea has become thinkable' (Hamilton-Hart, 2003:233).

East Asia enjoys the world's highest domestic savings rate, yet to date a local currency Asian bond market that draws upon this has failed to emerge. A proposal emerged in 2003 to create an Asian bond fund and this was backed by finance ministers meeting at the 2003 APT summit. The proposal was received enthusiastically and strongly supported for two main

reasons: first, a regional bond market would reduce the risk of contagion in the event of a further crisis as reliance on short-term bank lending (in US dollars) would be reduced; second, it would 'eliminate the currency mismatch problem that contributed to the regional crisis' (Amyx, 2003:7).

Japan's response to the AFC, the Miyazawa initiative, has informed the measures and mechanisms that have emerged in the following years. While the region is far from an integrated financial unit, important steps have been taken and it is clear that East Asia is better prepared to face any future crisis as a consequence. Political difficulties constrain further and deeper integration but it is anticipated that as the APT process transforms into the East Asian Summit framework, the concerns behind these constraints will be met and that deeper cooperation will result albeit on a gradual and incremental basis. That said, it is important to review the current situation in East Asia in a comparative framework, particularly in light of the European experience. Financial cooperation leading to an exchange rate mechanism, tax harmonisation, a common currency is a process fraught with difficulties in even the most homogenous of regions.

## **Responses to the Asian financial crisis II – Institutionalism**

A primary response to the crisis within East Asia has been the trend towards the institutionalisation of regionalism. As discussed above, East Asian regionalism has been an ill-defined and contested concept. In the wake of the crisis, the deepening regional economic interdependence and the growth of a 'lattice' of bilateral and multilateral FTAs, a clear rationale for more regionalist projects has emerged. This section considers the primary vehicle for East Asian regionalism, the APT process, from its inception as the East Asian Economic Caucus (EAEC) through to the proposed East Asian Summit (EAS).

### **From EAEC to APT**

A proposal emerged from Malaysia in 1990 to establish an East Asian Economic Group (EAEG), subsequently renamed the EAEC, that enunciated an attempt to create an exclusively East Asian (on racial grounds) economic and political entity. That is, to draw the region out of the US dominated Asia-Pacific vision promoted at APEC. This proposal should also be viewed in the context of the then Prime Minister Mahathir's 'look East' (i.e., to Japan) initiative and growing concerns at European and North American regional integration. While eventual acceptance of the stated objectives<sup>14</sup> was secured within ASEAN (1995), Japan was unable to support it and the proposal ultimately languished (Hook *et al.*, 2001).

Yet in 1997 the APT framework emerged which may accurately be described as the EAEC in all but name (see Table 3.10). The setting was an informal

**Table 3.10 ASEAN+3 Summits**

	ASEAN event	APT event	Parties included for first time	Result
1997	2 <sup>nd</sup> ASEAN Informal Summit (Kuala Lumpur)	1 <sup>st</sup> APT Summit	Heads of Government/ State Finance Ministers	
1998	6 <sup>th</sup> ASEAN Summit (Hanoi)	2 <sup>nd</sup> APT Summit	Economic Ministers	EAVG established
1999	3 <sup>rd</sup> ASEAN Informal Summit (Manila)	3 <sup>rd</sup> APT Summit	Trade Ministers	Joint Statement on East Asia Cooperation
2000	4 <sup>th</sup> ASEAN Informal Summit (Singapore)	4 <sup>th</sup> APT Summit		EASG established
2001	7 <sup>th</sup> ASEAN Summit (Brunei Darussalam)	5 <sup>th</sup> APT Summit (Three ASEAN+1 Summits)		EAVG Report presented
2002	8 <sup>th</sup> ASEAN Summit (Phnom Penh)	6 <sup>th</sup> APT Summit		ASEAN+3 Unit established in ASEAN Secretariat Willingness to explore evolution of the ASEAN + 3 Summit into an East Asian Summit expressed EASG Report presented
2003	9 <sup>th</sup> ASEAN Summit (Bali)	7 <sup>th</sup> APT Summit		10 <sup>th</sup> ASEAN-Japan Commemorative Summit (Tokyo)
2004	10 <sup>th</sup> ASEAN Summit (Vientiane)	8 <sup>th</sup> APT Summit	Energy Ministers	Feasibility study on EAFTA initiated. Decision to convene the first East Asia Summit (EAS) in Malaysia in 2005 Vientiane Action Programme
2005	11 <sup>th</sup> ASEAN Summit (Kuala Lumpur)	9 <sup>th</sup> APT Summit (1 <sup>st</sup> EAS)		Kuala Lumpur Declaration
2007	12 <sup>th</sup> ASEAN Summit (Cebu)	10 <sup>th</sup> APT Summit (2 <sup>nd</sup> EAS)		Energy Security Declaration

Source: Compiled from ASEAN Secretariat, available online at [www.aseansec.org](http://www.aseansec.org).

summit between ASEAN leaders and their counterparts from Northeast Asia (China, Japan and Korea) at the Second ASEAN Informal Summit<sup>15</sup> in Kuala Lumpur, held while the region was in the grip of the financial meltdown. A second meeting was held a year later in Hanoi (7<sup>th</sup> ASEAN Summit) where consensus emerged that a regular meeting was both useful and necessary. The APT framework became institutionalised in 1999 (Manila, 3<sup>rd</sup> Informal Summit) when the grouping issued the Joint Statement on East Asia Cooperation committing it 'to enhance this dialogue process and strengthen cooperation with a view to advancing East Asian collaboration in priority areas of shared interest and concern' (ASEAN Secretariat). More concretely, the statement committed the group to economic, monetary and financial cooperation, social, human, scientific, technical and cultural development and dialogue on political and security related issues.

However, APT lacked a dedicated secretariat despite a proposal from Malaysia in 2002 to instigate an ASEAN office to deal exclusively with Northeast Asian economic relations. Resistance emerged from some ASEAN members wary of duplicating existing responsibilities and thus undermining ASEAN itself, while Japan remained somewhat ambivalent reflecting the usual divergent views of its bureaucracy (Terada, 2004:18). This is an important issue as the APT process continues as the core of regionalism in East Asia, yet while it remains rootless (i.e., lacking its own secretariat), it also remains ostensibly an ASEAN and not East Asian project. As something of a compromise, an APT Unit was established at the ASEAN Secretariat in December 2003 'to assist the ASEAN Plus Three Co-chairs to coordinate and monitor ASEAN Plus Three cooperation' (ASEAN Secretariat). Of central importance here was the decision of the APT group to follow the recommendation of the East Asian Study Group in 2002 to initiate an EAS which, it was advertised and anticipated, would become the key vehicle for East Asian integration.

### **East Asian Vision Group (EAVG) and East Asian Study Group (EASG)**

The EAVG was established in 1998 after a proposal by Korean President Kim Dae-Jung and consisted of eminent intellectuals from APT countries. Its purpose was to consider means of promoting closer regional economic cooperation. The EASG was established two years later to 'explore practical ways and means to deepen and expand the existing cooperation among ASEAN, the People's Republic of China, Japan and the Republic of Korea, and prepare concrete measures and, as necessary, action plans for closer cooperation in various areas' (ASEAN Secretariat). The EAVG reported to the 5<sup>th</sup> APT Summit where its recommendations were warmly received. The EASG reported in the following year and included an assessment of the EAVG recommendations.

This report distilled the EAVG recommendations into twenty-six concrete proposals of which seventeen were identified as short-term measures

and a further nine medium to long-term measures. The 8<sup>th</sup> APT Summit reported that four short-term measures had already been implemented throughout 2003–04.<sup>16</sup> Of the longer-term measures the leaders 'expressed willingness to explore the phased evolution of the ASEAN+3 summit into an East Asian Summit' (ASEAN Secretariat). This then marks the beginning of the evolution of the APT framework into the EAS which, as noted above, locates for the first time East Asian regionalism outside of the existing ASEAN process. The report went on to stress the need for a gradual and incremental move towards the establishment of the EAS so as to gain consensus and acceptance and not to marginalise ASEAN. With the decision of the 8<sup>th</sup> APT Summit to establish the EAS in 2005 however, leaders have given a strong indication that they wish to progress the institutionalisation of East Asian regionalism as expediently as possible.

### **East Asian Summit**

Held in Kuala Lumpur in December 2005, the inaugural East Asian Summit should have marked a new stage in East Asian regionalism as discussed above. The relevance of holding the summit in Malaysia (who assumed the rotating leadership of ASEAN in 2005), the home of the original EAEC proposal is not lost on observers. Yet due to competing visions of membership (whether or not to include India, Australia and New Zealand), status of that membership (as core members or peripheral observers), and the fundamentally competitive nature of Sino-Japanese relations; the reality was that little was achieved save for a commitment for further annual meetings to be retained within the ASEAN framework. At best, therefore, the inaugural summit defined the scope of the grouping and a commitment to future engagement which, given the anticipation of the event beforehand, fell well short of expectations. Among other agenda issues including energy, finance, education, and avian flu, the second summit (set for December 2006 in Cebu, Philippines but postponed until January 2007 due to a typhoon) reaffirmed commitment to economic development and regional integration and to studying the Japanese proposal for the establishment of a Comprehensive Economic Partnership in East Asia (CEPEA). Prior to the Cebu Summit, there was speculation that the second EAS would be held in China, which would again deliver a diplomatic coup to the Chinese leadership at Japan's expense. These issues are not merely procedural; with both China and Japan vying for regional leadership and ASEAN demanding to be in the 'driving seat' of the EAS framework, the location and organisation of initial summits will be crucial. As the summit 'beds down' some ASEAN members (notably Indonesia) and China anticipates that, in the same way that a rationale emerged for the APT process, extraregional countries (India, New Zealand, Australia) will become part of an expanded EAS grouping.

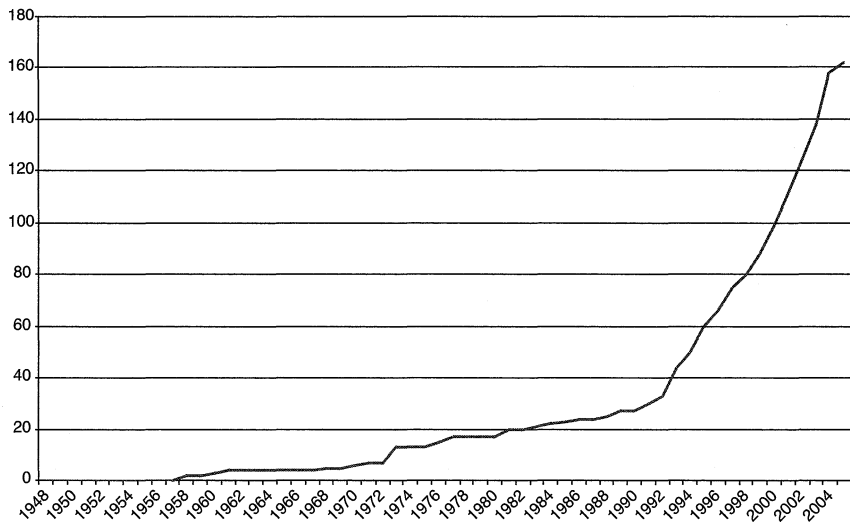
The APT framework emerged in the midst of the region's financial crisis in an attempt to stabilise the region through greater political interaction and cooperation and subsequently developed into the primary vehicle for East Asian regionalism. ASEAN has become the hub for both FTA activity (discussed in the following section) and regional cooperation. The establishment of the EAS elevates East Asian regionalism to new heights with accompanying expectations. Yet steady progress towards the establishment of an East Asian Community, as envisaged by the APT, will not be a linear process. The speed and depth of integration will be challenged by domestic resistance to ever closer interdependence, continuing ambiguity on key 'directional' leadership and the search for a consensus on the aims and objectives of any future regional bloc. Moreover, this brief analysis has not referred to the perception of East Asian regionalism from outside of the region, most importantly, from the US. While Japan rejected the original EAEC proposal in 1990 due to its overriding imperative to maintain stability in Japan-US relations and the then unacceptable challenge to APEC, post-crisis regionalism appears to be proceeding with the acquiescence of the US, but this should not be taken as given and a clear US position on the process remains to be communicated. However, for the purposes of this book we can conclude that in the space of eight years, East Asia has moved from a region defined by private sector (MNE FDI) regionalisation to one with a firm and growing regionalist agenda.

### **Responses to the Asian financial crisis III – Growth of FTAs**

As noted above the increasing popularity and prevalence of FTAs in East Asia is part of a global trend that emerged in the 1990s (see Figures 3.6 and 3.7). The WTO confirms that 'sluggish progress in multilateral trade negotiations under the Doha Development Round appears to have accelerated further the rush to forge RTAs' (WTO, 2005:1). While the EU and the US forged their own regional FTAs in the early 1990s, East Asia has been a relative latecomer to the trend. However, the region has become an enthusiastic promoter of FTAs in the post-crisis period as indicated by Table 3.11 and the emerging network of agreements is a defining characteristic of 'lattice' regionalism (Dent, 2003:1). This section reviews and analyses the growth of FTAs in East Asia and considers the phenomenon as a key component of the region's transformation.

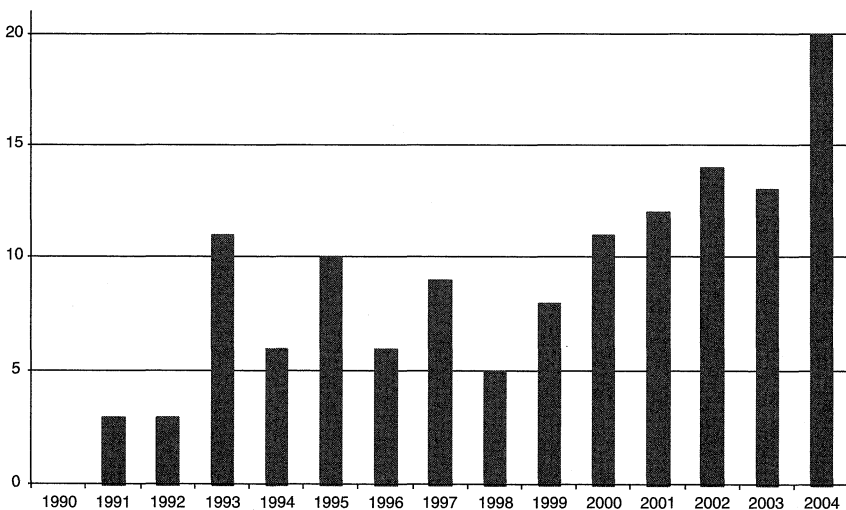
The recent and growing popularity of FTAs in East Asia should not simply be seen as a response to the AFC. As indicated above, frustration at the lack of progress at the WTO is a strong motivator and a number of further, regional specific drivers are identified. Chief among these is the desire to create a seamless regional market and investment destination, particularly in ASEAN. At a broader level, FTAs are seen as a stepping stone towards the eventual establishment of an East Asian Community with all

Figure 3.6 Global FTA growth



Source: WTO, available online at [www.wto.org](http://www.wto.org).

Figure 3.7 FTA growth from 1990



Source: WTO, available online at [www.wto.org](http://www.wto.org).

the accompanying status and bargaining power that this would confer *vis-à-vis* the world's most important regional economic entities; NAFTA and the EU. FTAs are also woven into the fabric of East Asian developmentalism

**Table 3.11 Free Trade Agreements in East Asia**

In action	Under negotiation	Under study
AFTA (1992)	Australia-China	ASEAN-CER
Australia-Thailand (2005)	Australia-Japan	ASEAN-India
Bangkok treaty (1976)	India-Thailand**	ASEAN-EU
China-ASEAN* (2005)	Japan-Chile	ASEAN-US
China-Hong Kong (2004)	Japan-Korea	Australia-Chile
Japan-Malaysia (2005)	Japan-Thailand	Australia-Indonesia
Japan-Mexico (2005)	Korea-Singapore	Australia-Japan
Japan-Philippines (2006)	Singapore-Canada	Australia-Korea
Japan-Singapore (2002)	Singapore-Mexico	China-India
Korea-Chile (2004)	Singapore-India	Indonesia-New Zealand
Korea-ASEAN (2006)	Thailand-US	Japan-ASEAN
Singapore-Australia (2003)	Thailand-Australia	Japan-Indonesia
Singapore-EFTA (2003)	Hong Kong-New Zealand	Korea-EU
Singapore-New Zealand (2001)		Korea-New Zealand
Singapore-US (2004)		Malaysia-India
Taiwan-Panama (2004)		Singapore-Chile
		Singapore-Taiwan

\* Early harvest trade in goods programme. Trade in services negotiations ongoing.

\*\* Agreement in principle, 2005.

Source: Urata, 2003; ASEAN Secretariat, 2004; Bilaterals.org, 2007.

and are seen not only as a means to strengthen competitiveness but also to pull along, and lock in, both emerging (CLMV<sup>17</sup> group) and more established economies (ASEAN 4, China). However, it is the case that the trend towards FTAs has accelerated in the post-crisis era and that the crisis has given greater impetus to these regionalist projects.

A variety of agreements exist or are under negotiation in the region as recorded in Table 3.11. The Japan-Singapore economic partnership agreement is promoted as a 'WTO plus' or 'super' FTA in that it goes beyond trade liberalisation to include non-trade issues (human resource development, services, investment). This form of comprehensive economic partnership is seen as a blueprint for the region and reaffirms the developmental intention of regional cooperation in contrast to trade liberalisation between distant economies. The China-Hong Kong agreement on the other hand is a straight FTA with no additional 'add-ons' and merely seems to

confirm existing agreements. Both bilateral and multilateral (regional) agreements are in place or at some stage of study or negotiation reflecting the complex nature of FTA strategies in the region. Moreover, interregional agreements with the US, Australia and the EU can also be observed indicating that an increasingly complex, if not 'spaghetti bowl' type network is emerging.

However, the trend towards FTAs is neither unopposed nor unstoppable. Stubborn opposition to increased liberalisation remains throughout the region, particularly so in some ASEAN countries and Japan, from industrial sectors and special interest groups. While constraints on Japan's FTA strategy are reviewed in detail below, Malaysia secured a deferment on AFTA implementation for two years in an attempt to protect its indigenous automotive sector and Indonesia, experiencing an outflow of FDI as multinationals 'rationalise' their production capacity away to other member states, questions the pursuit of further and deeper liberalisation. The stark differences in development between the ASEAN 4 and the CLMV group also demands that liberalisation be phased in and facilitated through outside assistance as serious questions regarding institutional capacity in these countries are raised. Furthermore, the lack of 'directional' leadership as a result of Sino-Japanese rivalry creates a vacuum within which progress can stall. The number of FTAs existing or proposed grows at almost a daily rate making a comprehensive review impractical but three significant agreements are surveyed below.

### **Asean Free Trade Area (AFTA)**

ASEAN agreed the region's first preferential trading arrangement in 1977,<sup>18</sup> yet little of practical value was achieved thereafter reflecting the lack of economic complementarities and trade between members. ASEAN member states at this time (with the exception of Singapore) had yet to abandon import substitution for more liberal regimes based on inward FDI and an export orientation. Accordingly impetus to pursue regional trading agreements remained low. However, as a result of recessions and booms in the region throughout the 1980s, liberal reformers in member states gained ascendancy and moved towards a consensus that a more liberal trade and investment regime was both necessary and achievable (Stubbs, 2000). Subsequently, an agreement was reached in 1992 to pursue the AFTA and this may be seen as the result of domestic political realignment and an attempt to realise greater trade and investment competitiveness in the globalising economic environment. The key aim then as it is today, was to create an attractive and viable regional market. As with previous (and ultimately ineffective) industrial regimes (BBC, AICO) AFTA offers multinationals the opportunity to realise scale economies in a regionalised market

by dividing up the production process and locating capacity according to comparative advantage without incurring intra-regional transaction costs.

AFTA's central mechanism is the Common Effective Preferential Tariff (CEPT) which allows for all goods with at least a 40% local content rate to be traded at preferential rates (0–5%). Eighty-one per cent of ASEAN trade was covered by the CEPT in 2002 rising to 96% in 2003. At its launch in 1992 the target implementation date was 2008 though this was brought forward in 1995 to 2003 and, in the wake of the crisis, to 2002 in 1998 and Table 3.12 records progress made on tariff rate reduction between 1998 and 2003. The CLMV group secured a more gradual timescale for implementation in recognition of their economic status but are expected to liberalise trade with ASEAN members by 2010. As of 2004, 99.45% in the CEPT Inclusion List (IL) are traded at between 0 and 5% in the ASEAN 6, 66.57% in the CLMV group, with an overall total for ASEAN of 90.17%.

A number of products remain outside of the IL but these are subject to review to ensure compliance with Article 9(b)1 of the CEPT agreement which allows for a General Exception List, a Temporary Exclusion List and a Sensitive List in accordance with WTO compliance (ASEAN Secretariat) (see Table 3.13).

In addition to trade liberalisation through the CEPT, AFTA, as a rules-based trade agreement, includes a dispute resolution mechanism as well as trade facilitation measures including the harmonisation of tariff nomenclature.

A central aim of AFTA is to create and promote the region's attractiveness as a sizable, integrated market of over 500 million people. The

**Table 3.12 Average AFTA/CEPT tariff rates**

	1998	1999	2000	2001	2002	2003
Brunei	1.35	1.29	1.00	0.97	0.94	0.87
Indonesia	7.04	5.85	4.97	4.63	4.20	3.71
Laos	5.00	5.00	5.00	5.00	5.00	5.00
Malaysia	3.58	3.17	2.73	2.54	2.38	2.06
Myanmar	4.47	4.45	4.38	3.32	3.31	3.19
Philippines	7.96	7.00	5.59	5.07	4.80	3.75
Singapore	0.00	0.00	0.00	0.00	0.00	0.00
Thailand	10.56	9.75	7.40	7.36	6.02	4.64
Vietnam	6.06	3.78	3.30	2.90	2.89	2.02
ASEAN	5.37	4.77	3.87	3.65	3.25	2.68

Source: ASEAN Secretariat.

Table 3.13 AFTA: Common Effective Preferential Tariff (CEPT) list for 2001

Country	Inclusion List	Temporary Exclusion List	General Exception List	Sensitive List	Total
Brunei	6,284	0	202	6	6,492
Indonesia	7,190	21	68	4	7,283
Malaysia	9,654	218	53	83	10,008
Philippines	5,622	6	16	50	5,694
Singapore	5,821	0	38	0	5,859
Thailand	9,104	0	0	7	9,111
<b>ASEAN-6 Total</b>	<b>43,675</b>	<b>245</b>	<b>377</b>	<b>150</b>	<b>44,447</b>
<b>Percentage</b>	<b>98.26</b>	<b>0.55</b>	<b>0.85</b>	<b>0.34</b>	<b>100</b>
Cambodia	3,115	3,523	134	50	6,822
Laos	1,673	1,716	74	88	3,551
Myanmar	2,984	2,419	48	21	5,472
Vietnam	4,233	757	196	51	5,237
New Members					
Total	12,005	8,415	452	210	21,082
<b>Percentage</b>	<b>56.94</b>	<b>39.92</b>	<b>2.14</b>	<b>1.0</b>	<b>100</b>
<b>ASEAN TOTAL</b>	<b>55,680</b>	<b>8,660</b>	<b>829</b>	<b>360</b>	<b>65,529</b>
<b>PERCENTAGE</b>	<b>84.74</b>	<b>13.40</b>	<b>1.28</b>	<b>0.55</b>	<b>100</b>

Source: ASEAN Secretariat.

attractiveness of this market is twofold; as a consumer market and as an investment destination. The four ASEAN economies of Indonesia, Malaysia, the Philippines, and Thailand are among the fastest growing emerging markets in the world, in addition to Singapore which enjoys a per capita GDP of just under US\$28,000 (*ppp*) and all enjoy an expanding middle class. A further assumption is that an integrated market will encourage inwards FDI by facilitation improved scale economies and competitiveness. In this way, AFTA can be seen as something of a defensive measure against the rapid rise of the Chinese economy, reflecting deep ASEAN fear of FDI diversion. In the same way that China's vast size and economic structure allows it to compete across the value chain, AFTA will unite ten countries at various stages of development and technical ability. These range from the CLMV group with comparative advantages in labour intensive production to Thailand and Malaysia competing globally in asset intensive industries and Singapore occupying innovative and knowledge intensive sectors. AFTA success is dependent on steady and sincere implementation by member economies and further progress on reducing non-tariff barriers, customs harmonisation and other measures. It remains to be seen how any backsliding will be tackled in traditional conflict averse and consensus-

based ASEAN. That said, AFTA remains the only multilateral agreement in place within the region and is increasingly viewed as the 'hub' for subsequent 'spoke' development and as recorded above, intra-ASEAN trade under AFTA has increased from US\$44.2 billion in 1993 to US\$95.2 billion in 2000 representing an annual increase of 11.6% (ASEAN Secretariat). On this basis AFTA may be seen as successfully fulfilling the agreement's original aims.

## China-ASEAN FTA

China and ASEAN agreed in 2002 an outline proposal to establish a free trade area by 2010, with China being the driver of this proposal. This was later signed into agreement in December 2004. China's gambit to ASEAN was seen by observers as something of a diplomatic coup; at once wrong-footing Japan and going some way to alleviate growing concerns among ASEAN member economies as to the impact of China's rapid economic growth.

An important aspect of the proposal is the Early Harvest Programme (EHP) launched in January 2004 whereby ASEAN could enjoy early and preferential access for 560 products in China's agricultural markets. Tariffs were reduced to zero between China and Thailand in June 2004 with Malaysia, Indonesia, the Philippines and Brunei joining in January 2005. China exported agricultural products worth US\$2.1 billion to ASEAN in 2004 while imports rose 41% to US\$3.72 billion (*China Daily*, 2005). It was also reported that ASEAN producers, particularly of fruits, were increasing production capacity to deal with surging Chinese demand. The EHP's role as a confidence building measure is clear and it is also the case that trade in agricultural products is largely complimentary given the products traded. The real challenge for ASEAN stems from the eventual aim of the China-ASEAN FTA to reduce or remove tariffs on industrial and manufactured goods. Here, trade structures are much more competitive and concern among ASEAN manufacturers is palpable. In this sense to suggest, as China does, that the EHP is a solid foundation towards FTA implementation is somewhat overblown.

The China-ASEAN FTA is distinguished from other proposals in action or under negotiation in two respects. First, the standard *modus operandi* is for countries to follow a process whereby an initial proposal is made at ministerial level followed by the instigation of a joint study group. The subsequent report then forms the basis for a series of in-depth negotiations, perhaps over a number of months or years leading to an agreement in principle to be signed into force at a subsequent date. As noted above, in this case an agreement was signed in contemplation of a FTA before any negotiations had taken place. Second, it is highly unusual for the party at a lower stage of development (measured by per capita national income) to unilaterally

offer trading concessions. China's US\$840 per capita GNP is considerably less than the US\$3,290 average for the five ASEAN economies included in the EHP. Moreover, a number of sensitive issues have been left out of the framework as has any conflict resolution mechanism. Accordingly, speculation has arisen that this is a 'dirty' FTA that has put the cart before the horse for overtly political reasons and that consequently it is of limited value to either party. That said, ASEAN estimates that the FTA will result in a 48% increase in exports from ASEAN to China and a 55% increase in imports which could translate into a 0.9% boost to ASEAN's GDP (0.3% for China).

## **East Asian FTA**

The logical conclusion of the trend of bilateral and regional FTAs would appear to be the establishment of an East Asian FTA (EAFTA). Yet this remains a distant possibility at the time of writing largely due to its contingency on a Northeast Asian FTA. With negotiations between Japan and Korea stalled, largely due to Korean fears and domestic opposition, and a Sino-Japanese agreement not even under serious and sustained contemplation in a designated study group, this final section of a regional agreement will not emerge in the foreseeable future. This goes to the heart of regional dynamics in East Asia; the lack of leadership from Japan and China. Put simply, although Japan's policy for the past three decades has revolved around assuming a 'quiet' leadership role, it is not a regional hegemon and while China's economy is growing exponentially, that country is not in a position to eclipse Japan's *de facto* economic dominance. Further questions remain as yet unanswered and include membership issues concerning Taiwan, New Zealand and Australia. Models suggest that an EAFTA would have a positive impact on the majority of participants with Japan and Korea standing to benefit the most through rising GDP, better terms of trade and decreasing import costs (Nakajima, 2005).

The trend towards FTAs in East Asia has been rapid and dramatic. This is driven by a range of global (stalled multilateralism), regional (responses to AFC, leadership rivalry) and national dynamics. As discussed above, ASEAN has emerged as a 'hub' for FTA negotiations in the region through the APT framework though it seems likely to concede this status to the anticipated East Asian Summit process to be launched in December 2005.

Ultimately, AFTA by itself will not have a great impact on regionalism in East Asia as the resulting market is still dwarfed by Japan or China. It is the inclusion of these two players that will confirm the emergence of a more clearly defined and competitive regional economic entity. FTAs in East Asia, then, are a defining feature of and significant development within the region's contemporary political economy and inform any subsequent analysis of trade and investment structures in the region.

## Significance of the rise of China for East Asia

The rapid growth of the Chinese economy presents perhaps the most challenging issue for individual East Asian nations and ASEAN in particular. This challenge extends across fundamental aspects of the region's political economy: politics, economics and security. Whilst acknowledging the centrality and indivisibility of security issues in the IPE and especially in East Asia (Korean Peninsula, Taiwan, Mischief Reef for example) they remain beyond the scope of this current volume and focus in this section is on the economic implications for East Asia of the rise of China as a primary aspect of the region's transformation.

The rapid growth of the Chinese economy is illustrated with reference to some simple trade data. Between 1978 and 2003, for example, trade increased by a factor of 25 and is projected to be larger than combined NIE and ASEAN trade by 2020 suggesting that China will be Asia's biggest exporter by 2010. Before this, China will become the region's largest importer, particularly of raw materials, energy resources and intermediate products. China's share of world trade increased from 2.9% in 1995 to 3.9% in 2001. Table 3.14 records growth in Chinese imports and exports between 2001 and 2003, further demonstrating rapid expansion.

The question of whether China represents a threat or an opportunity depends on the further question of; for whom? Certainly, as examined in greater detail below, Japan's economic recovery in the early twenty-first century is attributable in no small measure to demand from the expanding Chinese economy. Moreover, Japan's economic structure (knowledge and capital intensive) is largely complementary with China's (labour intensive). However, such a benign assessment cannot be made of ASEAN's position. Here, the two economies are by contrast largely competitive.

Recent research by the ADB (Weiss and Gao, 2003) indicates that China's expansion has resulted in increased competition with ASEAN in the key Japanese and US markets, in both labour intensive and, less so, high technology sectors. This increased competition was observed to be especially

**Table 3.14 Global inward FDI in East Asia**

	2002	2003	Growth rate
East Asia	74,661	79,701	6.8
China	49,306 (66)	47,077 (59)	-4.5
NIE	19,249 (26)	28,623 (36)	48.7
ASEAN	6,094 (8)	4,001 (5)	-34.3

Unit: US\$ million

Notes: Figures in parenthesis represent share of East Asian (excluding Japan) inward FDI.

Source: JETRO White Paper on International Trade and Investment, 2003.

keen in the electrical and electronics sectors which is of particular concern for ASEAN given that these sectors account for approximately two-thirds of ASEAN's exports to the US. It is inevitable that existing regional trade structures will be transformed as a result of China's growth and accession to the WTO, and this implies that ASEAN economies will lose, perhaps dramatically, market share in a number of currently crucial industrial sectors. On the other hand, an expanding Chinese economy is expected to present fresh opportunities for ASEAN development of new industries, particularly in the service sector. From a modest starting point, trade between China and ASEAN in 2000 increased by 45% over 1999 figures to reach approximately US\$40 billion and ASEAN maintains a trade surplus with China. Moreover, some competition is to be welcomed as it can promote both mutual development and structural adjustment. WTO accession also locks China into a rules-based trading structure complete with an effective dispute settlement mechanism and offers further opportunities for ASEAN.

However, while the picture is mixed with regards to trading relations, it appears more clear cut on the matter of FDI. As noted above, while FDI into East Asia is on an upward trend, China accounted for 66% of the total in 2002 and 59% in 2003 (China became the world's largest recipient of FDI in 2003) while that directed to ASEAN is on a downward trend, dropping by 34.3% in 2003. FDI to ASEAN has fallen from 51% of total East Asian FDI in 1990 to 11% in 2001 while China's share has rocketed from below 5% to over 40% in the same period. As discussed below Japanese FDI also increasingly favours China over ASEAN. It has been argued that China does not receive a disproportionate level of investment given the size of its economy (Wu *et al.*, 2002) and that FDI in East Asia is not a zero-sum game but the fear of FDI diversion from Southeast Asia is not baseless and remains a key concern for ASEAN governments.

Interestingly, outbound ASEAN investment to China also continues to expand although has yet to recover to pre-crisis levels. In 2001 ASEAN invested US\$3.4 billion in China while receiving only US\$1.9 billion from China. This pattern, though disappointing for ASEAN, would conform with standard economic theory which generally predicts that investments flow mainly between developed economies or from developed to developing and rarely from less developed (China) to relatively more developed (ASEAN).<sup>19</sup> ASEAN FDI in China may reflect the prevalence of ethnic Chinese business groups in the region, notably Singapore, Malaysia and Indonesia and indeed Singapore is the largest ASEAN investor in China. While these business networks may provide an alternative to Japan's RPNs and preferential access to the Chinese economy, sociocultural fault lines within the region remain tense and resistance to the establishment of a Greater China Economic Circle remains high (Harvie and Lee, 2002).

The rise of China has been a headlining event in the EAPE and is perhaps the defining issue for the region in the twenty-first century. The range of

competing scenarios for China's future within Asia makes any prediction both difficult and speculative. Will an EAFTA emerge? How will security concerns be met? What arrangement will China and Japan reach on issues concerning leadership? Chinese economic development suggests both opportunities and challenges for the region as a whole and its constituent parts. If managed correctly, that is, within a regional dialogue, it would appear that the benefits should outweigh the challenges. The opportunities surrounding China's growth are considerable and include the development of domestic market demand, demand for resources, technology, management, and skills. It is possible that the Chinese market could serve to end the dependency of the region on external markets; China has already replaced the US as Japan's largest trading partner. As Chinese business develops, it will inevitably seek to expand outwards suggesting that the imbalance between ASEAN and Chinese FDI will be reversed. The China-ASEAN FTA as discussed above also promises a win-win situation. Additionally, competition from China for both export markets and FDI should spur on industrial upgrading and economic reforms in the region which, as the experience of the last three decades has shown, can deliver significant development.

## **Conclusions**

This chapter has surveyed a number of key trends and issues that, taken collectively, equate to a radical transformation of the EAPE in the wake of the AFC. The aims of this chapter were twofold: to present a descriptive account of events in the post-crisis region and to analyse the emergence of a nascent East Asian political economy entity. By doing so, this chapter has sought to demonstrate the breadth and depth of the transformation and has been informed by an underlying trend suggesting that this not only sets the agenda for the coming decades but also necessitates a revised, holistic approach to our understanding of the region and ultimately of the activities of firms within it.

Set against a background of stalled multilateralism at the WTO, the deepening of intra-regional trade and investment relations, still evolving responses to the AFC (finance, institutionalism, FTAs) and the rise of China, the region is now pursuing an overtly East Asian and regional vision of the future in stark contrast to the previous Asia-Pacific norm. In the same way that AFTA forms the basis for expanded trade liberalisation (and economic partnerships), the APT framework remains the foundation stone of East Asian regionalism. In other words, in addition to the competition between the two core economic poles (China and Japan) Sino-Japanese rivalry over the assumption and provision of directional leadership means that ASEAN has emerged as a third pole in East Asian regionalism.

Thus, ASEAN is the hub for the ongoing development of East Asian regionalism. How far this will continue, given the anticipated realisation of

the Asian Summit Meeting process, is debatable and it is conceivable that within this framework the rivalry between China and Japan for 'directional leadership' will intensify in a way that it could not under the APT framework. Somewhat regardless of political developments, the implementation of an increasing number of FTAs signifies a 'ratcheting up' of economic relations and the continued deepening of regional interdependence. The impact of AFTA on corporate strategy is a key consideration of the case studies presented in Part II but it is clear from this chapter that continuing efforts to create a regional and 'seamless' market in Southeast Asia point to a radically remodelled business environment within which firms can pursue their economic objectives. This is further facilitated by the development of a regional financial architecture that potentially offers enhanced protection against any future crisis. While the rise of China presents a variety of opportunities and challenges for ASEAN and other economies to deal with, when the broader, regional perspective is taken, the emergence of a second major economic actor confirms that not only will key global growth occur in this third member of the triad, but that this will be an overwhelmingly East Asian experience.

Chapter 4 shifts the unit of analysis from the regional to the national and considers Japan's role in the EAPE and its responses to the recent and ongoing transformation as described above. What are the implications of this for the region as a whole and for the investigation of Japanese multinational FDI in particular?

# 4

## Japan and the Transformation of the East Asian Political Economy

Chapter 3 investigated a range of trends, issues and processes observed in post-crisis East Asia that cumulatively suggest a transformation of the region's political economy. This chapter will concentrate on analysis of Japan's links with and policies towards East Asia in the context of this transformation. By doing so the unit of analysis shifts from the regional to the national before, in subsequent chapters, shifting once more to the corporate level. A first section reviews Japan's role in East Asian development and its promotion of the developmental state concept through ODA<sup>1</sup> and FDI in the period up to the AFC. Consideration is given to critical approaches to Japan in East Asia, notably the benign partnership versus embraced Asia debate. Subsequent sections consider the contemporary situation by utilising the framework established in Chapter 3. In other words, Japan's economic and political relationships with East Asia are analysed in terms of its responses to stalled multilateralism, the AFC, deepening regional economic interdependence and the rise of China.

### Japan's role in the development of East Asia

Whether Japan's development in the post-war period (and before) occurred because of or in spite of the developmental state concept is a debate that continues to inform our understanding of economic development in Japan and beyond (Johnson, 1982; Amsden, 1989; Wade, 1990; Katz, 1998; Pempel, 1998; Vogel, 1999; Porter *et al.*, 2000) It is clear, however, that the concept has underpinned Japan's approach to its economic relations with individual East Asian (particularly Southeast Asian) nations and to the region as a whole. This section reviews the political economy of Japan's role in East Asia by examining, in the context of the promotion of the developmental state concept, the use of ODA and the phenomenon of FDI in the period up to and including the AFC. What role has Japan played in the economic development of East Asia? What mechanisms has Japan employed in this? Finally, how can we interpret and assess Japan's promotion of FG style catch up development in the era of regional transformation?

## The developmental state concept

The provenance of the developmental state concept lays in the Meiji restoration and the story of Japan's rapid industrialisation (Beasley, 1990; Franks, 1992) yet is better understood with reference to the period of economic recovery and expansion in the post-war era. Essentially, the concept assigns a central role to state intervention in the market with the express goal of catch up development. Industrial policy is communicated through powerful ministries i.e., the Ministry of International Trade and Industry (MITI) to private industry by means of 'administrative guidance'. Further measures, among others, include credit allocation and foreign exchange controls. In this way, the government's role is to 'guide the market' and 'pick winners' (key industrial sectors) that will lead to the development of new industries and beget economic growth. Thus, steel production became the immediate post-war focus of the government as this facilitated the re-establishment of heavy industries such as ship-building. Subsequent foreign exchange earnings from export sales allowed Japan to import technology for new industries (e.g., the transistor).

Something approaching a consensus has emerged in the literature that the mechanisms and structures described by the developmental state are no longer relevant to or valid in the era of low growth and globalisation (Katz, 1998; Hook and Hasegawa, 1998; Porter *et al.*, 2000). Moreover, there is an assumption that these now impede industrial upgrading and should be subjected to rigorous 'structural reform' (Krugman, 2000; Sakakibara, 2003; Mulgan, 2002).<sup>2</sup> Yet even as this consensus emerges domestically, Japan continues to promote state developmentalism throughout East Asia, albeit a nuanced and pragmatic variant of the original concept in the post-crisis era. This apparent contradiction is explained by recognition that Japan's 'follow-the-leader' policies have always been based on an approach that is more 'do as I say' than 'do as I do'. Attention now turns to consider the regional transmission of Japanese style state developmentalism.

## Regional transmission

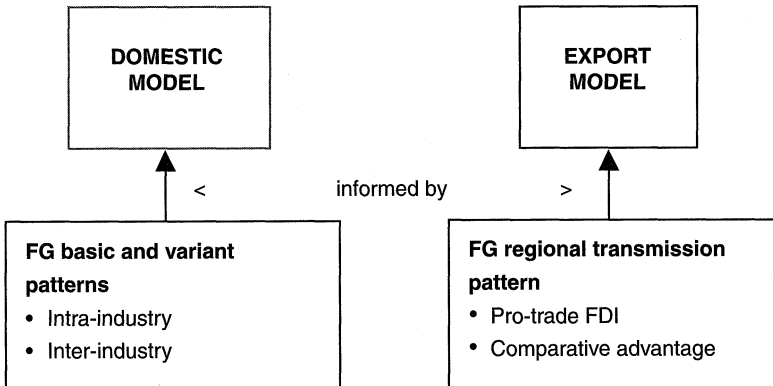
The theoretical basis for Japan's promotion of the developmental state concept in East Asia may be found in the third pattern of the FG model as presented in Chapter 2. To recap, the basic pattern describes a three stage sequence of imports, domestic production and exports of a given product. In a further fourth stage domestic production is assumed to decline as production commences overseas. The second, variant, pattern describes this sequence with reference to movement through industrial sectors from low to high value-added. The decline in domestic production and rise in overseas production thus provides the opportunity for the lead goose (Japan) to export high value-added products (capital goods). Both lead and following

geese are thus locked in a heterogeneous (differentiated) relationship based on comparative advantage. The third pattern, added later to the basic model, focuses on the regional transmission of industrial development. The mechanism for this is Kojima's 'pro-trade' FDI as described in Chapter 2. Pro-trade FDI is described as such as it is both export-orientated and based on the host nation's comparative advantage and differs from the 'anti-trade' investments from Western countries that are predominantly domestic market-orientated.

Two strands of the developmental state concept, intricately linked yet distinct, thus emerge; the domestic and export models (See Figure 4.1). The domestic model is characteristic of Japan's post-war industrialisation as partly<sup>3</sup> described by the basic and variant patterns of the FG paradigm. That is, the sequence of national catch up product cycle style development. The export model on the other hand is based on the third pattern and describes the regional transmission of catch up development through (primarily) pro-trade FDI.

The considerable capital that this theory held in Japanese policy circles throughout the 1970s and 1980s should not be underestimated. As noted by Cumings, 'for Japan the product cycle has not been mere theory; it has melded with conscious practice to make Japan the pre-eminent example of upward mobility' (Cumings, 1984:150). Evidence in support of this assertion was provided by former Japanese Foreign Minister Saburo Okita in a famous speech to PECC in 1985 where he asserted that, 'the division of labour in the Pacific region has aptly been called the FG pattern of development' (Kojima, 2000:385). Successive White Papers from MITI and the Economic Partnership Agreement (EPA) also promoted the concept which became 'the development orthodoxy among Japanese economists and

*Figure 4.1* Domestic and export models of the Japanese developmental state concept



Source: Author.

intellectuals in the early and mid-1990s' (Jomo, 2001:476). The Asian division of labour, then, is promoted by Japan as a harmonious partnership based on comparative advantage and one which is explicitly developmental in nature. It is constructed through the judicious use of ODA and FDI and supported through intra- and inter-regional trade patterns.

Japan's contemporary engagement with East Asia is premised on the Fukuda doctrine (1977) which emphasised a commitment to peace and the development of Japan-ASEAN relationships through political, economic, social and cultural cooperation (Hook *et al.*, 2001). This political doctrine has been underpinned by an economic strategy informed by the developmental state concept and three broad rationales for Japan's regional promotion of state developmentalism may be identified: the normative position of Japanese policy elites that state-led development is both appropriate and applicable in East Asia, the assumption that the adoption of developmental policies in East Asian nations would benefit Japanese firms, and that promotion of the model would enable Japan to forge a leadership role in the region.

To greater or lesser degrees the model became embedded throughout the region, most notably in Northeast Asian economies throughout the 1960s and 1970s and later in the developing economies of Southeast Asia. The 1993 'miracle' report (World Bank, 1993) was an attempt by Japan to gain a wider acceptance and appreciation of its model but the results were mixed. Much to Japan's chagrin the report failed to single out state developmentalism as the key to economic growth in East Asia. Debate continues between neoclassical accounts of East Asian development that emphasise market-driven, export-led industrialisation and the utilisation of endogenous factor endowments such as cheap labour coupled with liberal FDI regimes, and a developmental state interpretation that stresses the role of industrial policy and the tight business-bureaucracy-political nexus (Yoshimatsu, 2003a).

The AFC presented a serious challenge to the Japanese model. A number of immediate assessments of the crisis, largely informed by neoclassical orthodoxy, identified the model as a root cause. 'Crony capitalism' replaced 'Asian values' and condemnation replaced commendation (Jomo, 2003). Japan in particular was singled out for failing to defend its developmental model (Hughes, 2000). Indeed, Japan was roundly critiqued on many fronts; for failing to act quickly enough, for failing to absorb imports from ASEAN economies and for the domestic sclerosis behind years of economic stagnation. However, in subsequent years Japan has made repeated efforts to reaffirm its vision of economic development through various channels including aid programmes and funding of development institutions, the promotion of industrial policy-based strategies, and the creation of institutions to link Ministry of Economy, Trade and Industry (METI) and ASEAN counterparts (Yoshimatsu, 2003a). Japan's trade policy, discussed below, is indicative of this. By promoting comprehensive 'economic partnerships' in

East Asia, Japan continues to stress the importance of forward and backward linkage between advanced (Japan) and developing economies.

### **Japan's overseas development assistance**

Japanese ODA is rooted in wartime reparations<sup>4</sup> and the conclusion of the 1952 San Francisco peace treaty (Hook *et al.*, 2001). Early Supreme Commander of the Allied Powers (SCAP) policy was to uproot any remaining industrial capacity for transportation to formerly occupied countries although this was halted under the reverse course and Japan instead agreed to provide services, goods and monetary aid, notably to Burma, the Philippines and Indonesia (Beasley, 1990:244–245; Suehiro, 1999a). As Japan's economy first recovered then expanded from the 1950s onwards, outflows of ODA increased. Japan became the world's largest donor country in 1995, disbursing in 1997 US\$9.36 billion in grants and low interest loans to developing countries, exceeding the US\$6.9 billion from the US (OECD).<sup>5</sup> Japan's ODA policy is premised on an assumption that economic growth is the main determinant of development and ODA projects have been largely directed at infrastructure development over poverty alleviation. ODA is thus seen as a catalyst and facilitator of private investment (FDI). Simply put, Japanese ODA allows late developing countries to establish the infrastructure necessary to attract and accommodate private investment. This structure was somewhat formalised by the New Asian Industrial Development (AID) plan initiated in 1987 (Arase, 1995). As a consequence of this focus, Japanese ODA has been criticised for being 'tied'. That is, disbursement of funds for given projects are conditional on the appointment of Japanese contractors. In this way, Japanese firms have been able to shape and influence the nature of the project in hand, although in response to international pressure Japan has taken steps to untie and depoliticise its aid in recent years.

East Asia has been the main beneficiary of these outflows, accounting for 69% of the total in 1997 and the top ten recipients of Japanese ODA in this year were all Asian (see Table 4.1). This composition had barely changed by 2003 as indicated in Table 4.1. Japan has been unapologetic of its geographical and structural preferences, regarding ODA as an integral component for the regional transmission of the developmental state concept. Moreover, ODA has been administered by four ministries at the heart of the developmental state concept: the Economic Planning Agency, MITI, the Ministry of Finance (MOF) and the Ministry of Foreign Affairs (MOFA) (Arase, 1995).<sup>6</sup> Japan has also furthered its aims by directing development assistance through the ADB.<sup>7</sup>

### **Japan's foreign direct investments in East Asia**

Japanese FDI has played a critical role in the development of East Asia and in the regionalisation of economic activity, particularly in the last two

Table 4.1 Top ten recipients of Japan's ODA, 2003

Rank	Country	Amount
<i>Total</i>	<i>Global</i>	9,283
1.	China	1,202
2.	India	841
3.	Thailand	758
4.	Indonesia	748
5.	Philippines	666
6.	Vietnam	429
7.	Bangladesh	309
8.	Pakistan	256
9.	Sri Lanka	244
10.	Brazil	171

Unit: US\$ million

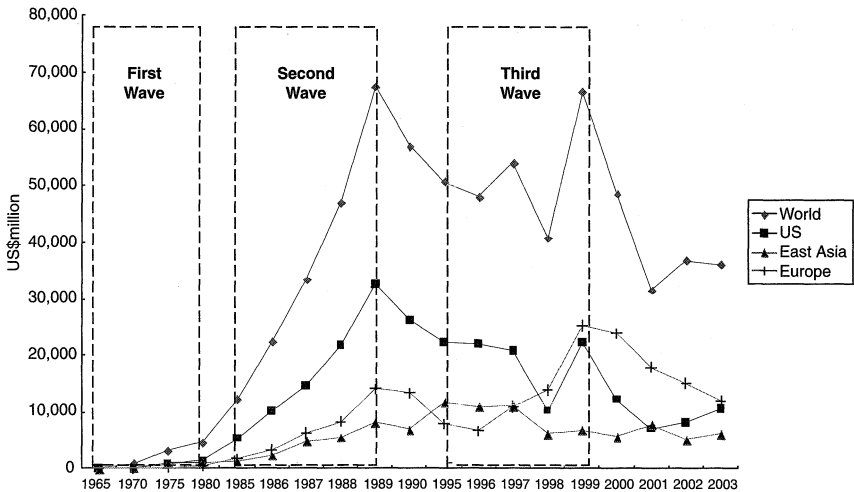
Source: OECD, 2004.

decades of the twentieth century (Ito & Krueger, 2000). Facilitated by ODA as investigated above, FDI has furnished East Asian economies with the capital for investment, technology and managerial know-how necessary for economic growth through industrial development. Japanese FDI in East Asia has taken place within the context of the regional transmission of the developmental state concept as outlined above and the regionalisation of production by Japanese multinationals has served as the foundation of East Asian economic integration and the current *de jure* processes of regionalism. This section examines the historical pattern and determinants of Japanese FDI in East Asia up to the onset of the AFC.

### Post-war investment

Although 1945 marks a convenient conjunction in Japanese history any account of Japan's post-war economic role in East Asia would be remiss without at least a passing reference to the pre-war situation. Indeed, Japan's imperial expansion into the Korean peninsula and Formosa (Taiwan) has been identified as key to our understanding of the region's political economy (Cumings, 1984). Japan's quest for raw materials to feed its military-industrial complex may be seen as a major contributing factor to the onset of hostilities in the region. Furthermore, Japan's defeat bequeathed to the North Korean regime an industrial base which sustained the North's economic pre-eminence over its predominantly agrarian southern neighbour until the early 1970s. It should also be remembered that many of the post-war era Japanese businessmen had experience and knowledge of local markets right the way across East Asia from Korea to Burma, Thailand and Indonesia. In other words, Japan's role in the post-war era was in fact a

Figure 4.2 Japanese total FDI outflows, 1980–2003 (selected years)



Source: JETRO *White Paper on International Trade and Investment*, various years.

re-engagement rather than a beginning, albeit under radically different terms.

As noted above, Japan re-established economic relations with East Asia in the post-war period initially through ODA. Subsequent waves (Figure 4.2) of FDI followed from 1949 as the growing Japanese economy, starved of raw materials at home, looked again to South and Southeast Asia for resources. The initial wave of post-war investments thus focused on natural resources procurement as illustrated by Table 4.2. FDI at this time was constrained by foreign exchange controls (lifted in the early 1970s) which afforded relevant ministries (MITI) the opportunity to 'direct' capital in accordance with prevailing (developmental state) policy norms. Further measures to liberalise FDI included the lifting of the requirement for prior approval (1969) and the raising of limits for automatic approval from US\$200,000 in 1970 to US\$1 million in 1971, eventually leading to complete liberalisation by 1973. Outward FDI steadily increased throughout this period with East Asia being the main recipient followed by the US and Europe (see Table 4.3). By 1980, however, Japanese FDI to the US eclipsed that to other countries and regions and the US remained in this dominant position until the late 1990s.

The late 1960s and early 1970s, then, saw the first substantial wave of outward FDI. Although rising labour costs, environmental protection laws and yen appreciation all conspired to *push* FDI out from Japan, it was also *pulled* into the region in response to the import substitution policies pursued by most of Japan's trading partners. The second major wave of

**Table 4.2** Japan's major imports from ASEAN countries, 1985

Country	Product	Imports from ASEAN country	Share of ASEAN country	Total imports of Japan	Share of ASEAN country
		US\$ million	%	US\$ million	%
Indonesia	LNG	3,995	39.5	7,200	55.5
	Crude & partly refined oils	3,889	38.4	2,019	29.6
Malaysia	Wood	1,179	27.2	3,700	31.9
	Crude & partly refined oils	1,157	26.7	34,599	3.3
	LNG	1,122	25.9	7,200	15.6
Philippines	Bananas	247	19.9	297	83.4
	Iron ore	151	12.1	1,228	4.9
	Copper ore	133	10.7	1,209	11.0
Singapore	Petroleum products	1,015	63.7	5,975	1.9
Thailand	Raw rubber	273	26.6	408	67.0
	Fish & shellfish	179	17.4	4,610	3.9

Source: Alonzo, 1987: 4.

**Table 4.3** Japan's FDI to selected regions, 1965–1985

	1965	1970	1975	1980	1985
US	33 (1)	94 (2)	846 (2)	1,484 (1)	5,395 (1)
East Asia	32 (2)	165 (1)	1,077 (1)	1,176 (2)	1,414 (3)
Europe	4 (3)	35 (3)	190 (3)	521 (3)	1,760 (2)

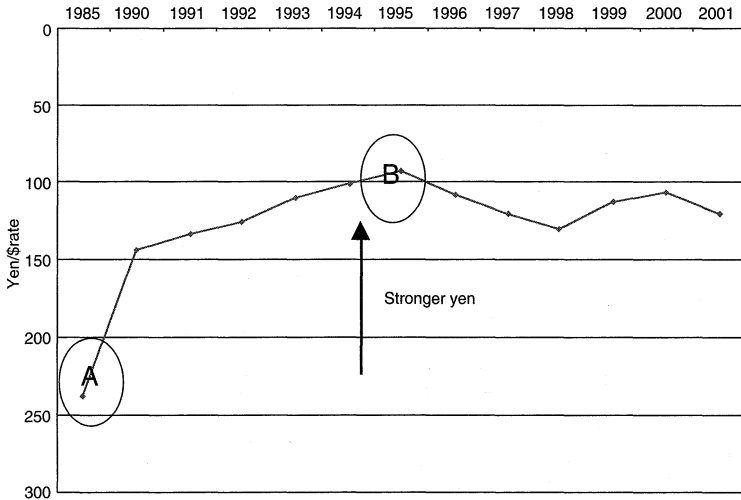
Notes: Figure in parenthesis indicates rank

Unit: US\$ million

Source: JETRO *White Paper on International Trade and Investment*, various years.

investment emerged in response to increasing trade friction, nascent regionalism and, most importantly, yen appreciation. The 1985 Plaza Agreement resulted in a rapid appreciation in the value of the yen against the dollar and led to a surge of FDI, notably to the US and EU. Japan's trade surpluses with the EU and the US became political issues and provided a rationale for the overseas relocation of manufacturing industries. Automobile and electrical goods manufacturers in particular relocated operations to the US, Europe and East Asia in an attempt to reduce trade friction, escape the high

Figure 4.3 Yen/US dollar rates, 1985–2001



Notes: A: Plaza Accord, B: yen reaches 94.1 to the US dollar

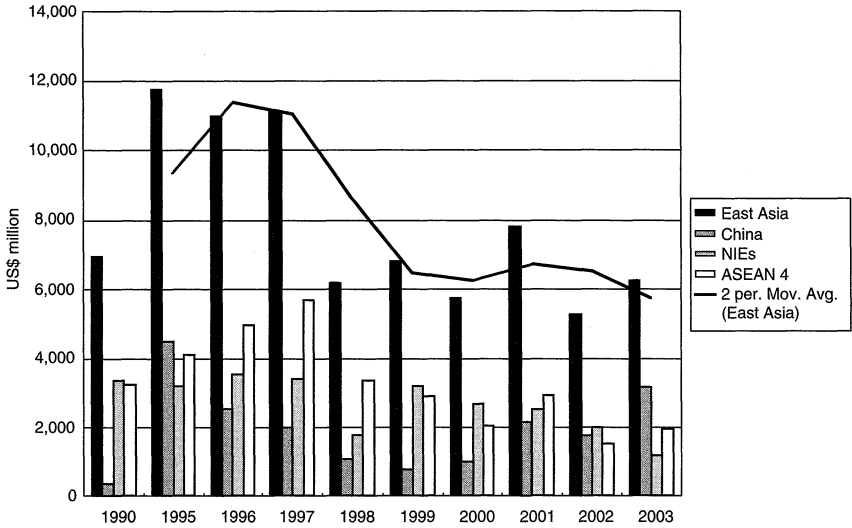
Source: MOF online database available at <http://www.mof.go.jp/> accessed 12/12/03.

costs imposed by yen appreciation (Figure 4.3) and, in the case of East Asia, to serve as export platforms to American and European markets.

At the same time Southeast Asian countries began to liberalise their investment regimes and turn from import substitution to export promotion. Accordingly Japanese FDI to East Asia which had stood at US\$1.4 billion in 1985 jumped to US\$8.1 billion in 1989. This mirrored the global trend with total outflows increasing from US\$12.2 billion to US\$67.5 billion in the same period and indeed East Asia's share of the total remained largely constant at between 10 and 15%. Within the region, the NIEs continued to account for the largest share of the total but Japanese attention was increasingly turning to the ASEAN 4. Although early investments to ASEAN countries in the 1960s and 1970s had been directed to resource procurement, this new wave was firmly based in manufacturing industries. A growing share of this surge was accounted for by smaller Japanese firms who had been encouraged or cajoled to follow their *keiretsu* partners to the region and it is at this point that the regionalisation of production in East Asia significantly deepens. Although increasing levels were targeted at China, the Tiananmen Square incident in 1989 dampened interest for a period, although by 1995 investment in China peaked at US\$4.4 billion, eclipsing for the first time that in either the NIEs or the ASEAN 4.

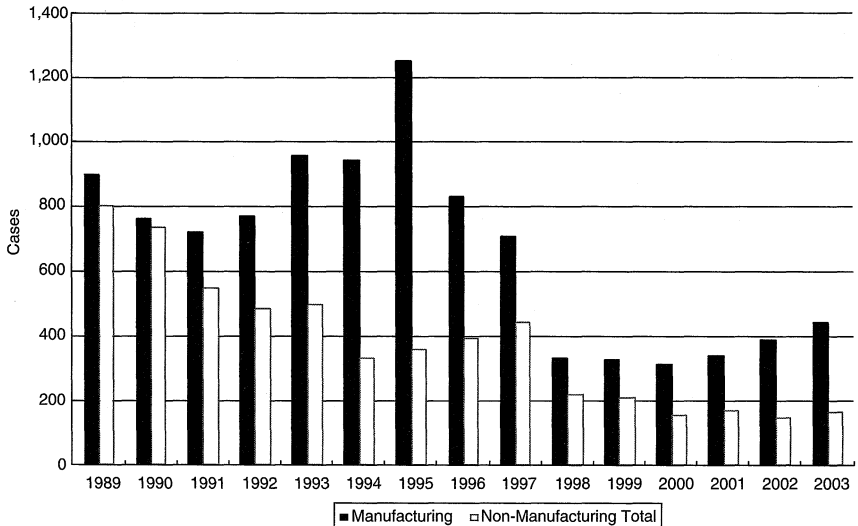
Total outflows began to decrease in 1990 in response to the severe economic condition Japan caused by the collapse of the bubble economy, yet East Asia's share of this increased from 12% in 1990 to 22% in 1995

Figure 4.4 Japan's FDI to East Asia, 1990–2003



Source: JETRO White Paper on International Trade and Investment, various years.

Figure 4.5 Japanese FDI to Asia by sector, 1989–2003



Source: MOF online database available at <http://www.mof.go.jp/> accessed 12/12/03.

Table 4.4 Japanese FDI to East Asia, 1985–1995

	1985	1986	1987	1988	1989	1990	1995
China	100 (3)	226 (3)	1,226 (2)	296 (3)	438 (3)	349 (3)	4,473 (1)
NIEs	718 (1)	1,531 (1)	2,580 (1)	3,264 (1)	4,900 (1)	3,355 (1)	3,179 (3)
ASEAN 4	596 (2)	553 (2)	1,030 (3)	1,966 (2)	2,782 (2)	3,242 (2)	4,111 (2)

Notes: Figure in parenthesis indicates rank

Unit: US\$ million

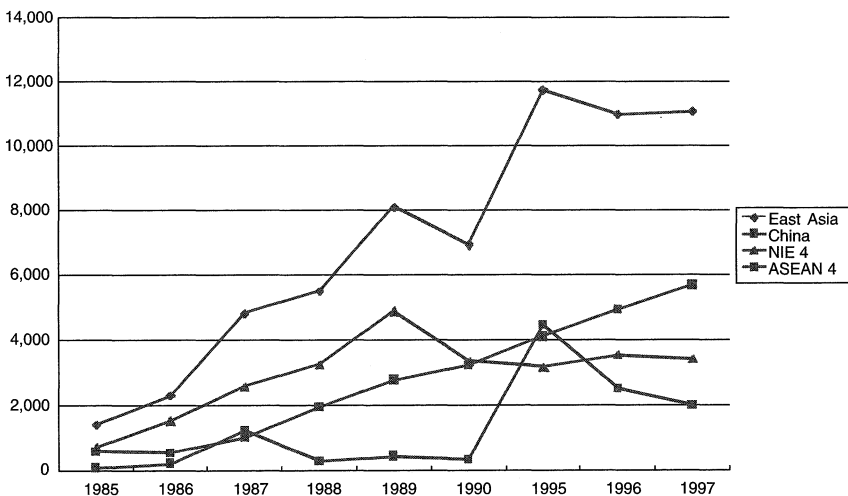
Source: JETRO *White Paper on International Trade and Investment*, various years.

(Figure 4.5 and Table 4.4). A corresponding decline in FDI to Europe was recorded at this time although the US share remained mostly constant.

A further short wave occurred between 1995 and 1997 bracketed by a further surge in the value of the yen, reaching a rate of 94.1 yen to the dollar in 1995, and the onset of the AFC in 1997. The ASEAN 4 share of Japanese FDI to the region increased from 36.7% in 1993 to 51.3% by 1997, indicating the increasing attractiveness of these countries prior to the crisis (see Figure 4.7). FDI to the region in the wake of the crisis is covered below but it is pertinent here to indicate some general trends.

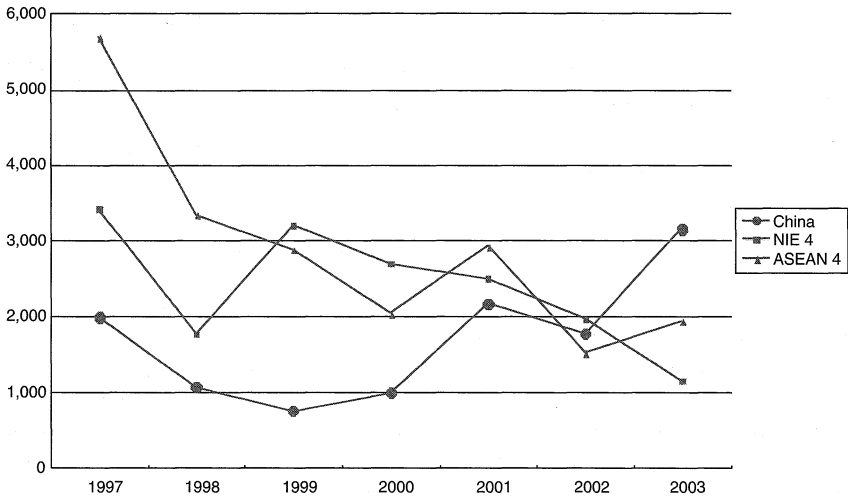
Outflows of total FDI declined in 1998 but rallied in 1999 before resuming a downward trajectory until 2002. FDI to East Asia declined rapidly in 1998 and remained depressed with only occasional and slight upturns (1999, 2001). However, after declining from a spike in 1995, FDI to China

Figure 4.6 Japan's FDI to East Asia, 1985–1997



Source: JETRO *White Paper on International Trade and Investment*, various years.

Figure 4.7 Japan's FDI to East Asia, 1997–2003



Unit: US\$ million

Source: JETRO White Paper on International Trade and Investment, various years.

recorded an increase in 2000, exceeded that to the ASEAN 4 in 2002 and the NIEs in 2003, and reached US\$3.1 billion in 2003 representing an increase from 11.5% of the total in 1997 to 50% in 2003. The rise of China and the implications of this for East Asia were considered above and are further reviewed with reference to Japan below.

### Critique of Japan's promotion of flying geese style development

From a Japanese perspective, Japan has a natural leadership role to play in East Asia and its experience of industrial development stands as a beacon to countries throughout the region. Japanese policy has endeavoured to promote a developmental model through use of ODA, trade and FDI as this has been viewed by Japanese policy elites and corporate leaders as both appropriate and applicable. Although the AFC presented a number of challenges to Japan's promotion of the model, it remains committed to the fundamental principles of developmentalism even as the domestic situation demands a disengagement of the state from the market. This apparent contradiction is explained with reference to Japan's advanced and mature status which stands in contrast to the still emerging markets elsewhere in East Asia, in the Southeast in particular.

Criticism of the FG paradigm as a theory of FDI was noted in Chapter 2 and it remains here to survey broader political economy responses to Japan's activities in East Asia. In contrast to the benign and sequential

development suggested by the FG paradigm/developmental state concept, a critical response has emerged that sees in Japan's economic relationship a more insidious attempt to 'embrace Asia' (Hatch and Yamamura, 1996). The establishment of regional production networks has led to a vertical division of labour which locks developing countries into dependent relationships with Japan (for capital and technology) and, mainly, the US for export markets. In this way the regionalisation of Japanese production 'embraces' developing East Asian countries in a neo-co-prosperity sphere.<sup>8</sup> Moreover, Japanese dominated regional production networks, far from being the idealised horizontal division of labour, are in fact a negation of the FG model which supposes transfer of full-set industrial structures. In other words, the East Asian experience is not so much a network of heterogeneous relationships based on comparative advantage but rather a regionalisation of Japan's political economy itself (Bello, 1996). While the FG analogy provides an accessible and evocative metaphor for East Asian industrialisation an examination that focuses more on process than outcome reveals that key assumptions remain unproven (Bernard and Ravenhill, 1995). Furthermore, the paradigm fails to recognise that the regionalisation of production in East Asia is determined not 'according to the requirements of integrated industrial development in each country or region, but rather in line with the profit interests of Japanese capital' (Hart-Landsberg and Burkett, 1998:91). Further aspects of FG/developmental state models emerged in the wake of the AFC as noted above.

As proposed in Chapter 2, the transformation of the contemporary East Asian political economy suggests that the FG model fails to offer an accurate explanation of the regionalisation of production and Japan's role within this. While acknowledging the inherent dependency of East Asian countries on Japan and the strength of these 'ties that bind' (Hatch and Yamamura, 1996), it is possible to question the extent and dominance of this structure. There is, for instance, an over reporting of Japan's role in the region at the expense of other factors, most importantly the role of the US. The NIEs, while exhibiting certain similarities with Japan, have for the most part pursued development without locking themselves into Japan's embrace; Korea in particular has resisted inward FDI and in this sense has followed a purer Japanese model than Southeast Asian nations. China presents considerable challenges to the model as it appears capable of operating right through the value chain. Indeed, parts of China's eastern seaboard match or exceed NIEs on a number of economic indicators while the interior lags far behind ASEAN 4 economies. In short, although Japan continues to promote a model of development that stands in contrast to the still prevailing neo-liberal agenda pursued by the IMF, World Bank and American policy elites, it is a variant that largely recognises the emergent reality of East Asian regionalism and as such moves further away from the perhaps simplistic and historically contingent FG model.

This section has examined aspects of Japan’s role in the economic development of East Asia by focusing on the promotion of the developmental state concept, ODA and FDI in the period up to the AFC. While it is clear that Japanese public and private funds have played critical roles in East Asian development and that Japanese policy makers have enunciated a clear rationale for this, it is less clear that the resulting network of relationships can any longer be explained with reference to the FG model. Not in doubt though is Japan’s dominant position in the region and the legacy of its efforts to promote and maintain a *de facto* regional economic entity. With this brief overview concluded the following sections analyse Japan’s responses to the transformation of the East Asian political economy in the post-crisis era.

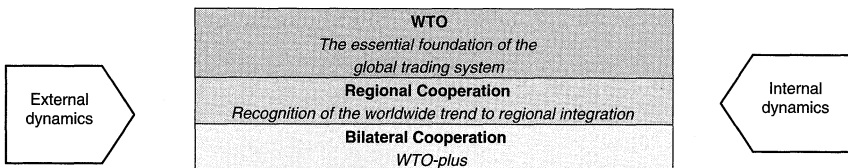
## Japan and the transformation of the East Asian political economy

### Stalled multilateralism

Chapter 3 described how global trade and investment liberalisation stalled at the multilateral (WTO) level in the latter half of the 1990s and Japan’s key response to this has been a pragmatic adoption of a ‘multilayered’ external economic policy (METI, 2002; Krauss, 2003). Previously, Japan had resolutely backed the multilateral vision and had rejected regional<sup>9</sup> or bilateral alternatives. Yet by 2002 significant developments in Japan’s basic external economic policy signified a departure from the usual norms and the multilayered approach described in Figure 4.8 emerged. This approach, shaped by both external and internal factors, has three principal components: maintenance of a core focus on the multilateral process at the WTO, recognition of the global trend towards regionalism and the development of bilateral initiatives. Although this describes Japan’s external economic policy in general, the focus is overwhelmingly on East Asia as will be discussed below.

The foundation of the multilayered approach remains with the WTO and multilateralism continues to be regarded by Japanese policy makers as the best option for both Japan and the global trading system. Yet, as one of the advanced economies that have failed to open its agricultural sector, Japan’s

Figure 4.8 Japan’s multilayered external economic policy



Source: Adapted from METI, 2002.

commitment to multilateralism may be questioned by those developing countries that have sought to link deregulation and liberalisation of trade and investment structures (key advanced country demands) with improved access to markets in the developed world. As a major trading nation, maintaining trade surpluses with all its main trading partners, Japan's persistent protection of its agricultural sector has clearly been one of the contributing factors to deadlock at the WTO.

In the context of Japan's promotion of the developmental state concept there is also the suggestion that, at root, Japan may not be in agreement with developing economies, those in Southeast Asia in particular, over the importance to economic development of exporting agricultural products and would anyway prefer to omit agricultural issues from negotiations citing the need to maintain a minimum food self-sufficiency rate and 'non-trade' concerns. This ambiguity is reflected here:

Japan will encourage developing countries to observe WTO rules and participate in the negotiations by showing the advantage of free trade based on its own experience of development through trade and investment (MOFA, 2002a).

Thus, although Japan maintains a *de jure* position that multilateralism remains at the core of this revised policy, there may be legitimate questions over its *de facto* commitment to it. The second layer is premised on recognition of the worldwide trend towards regional economic integration that accelerated in the late 1990s. NAFTA and the EU are the clearest examples of this, yet other groupings exist or are at some stage of consideration or negotiation.

As the multilateral process ground to a halt these regional economic groupings continued to integrate and develop intra-regional trade and investment structures. Japan remained outside of this process and the multilayered policy represents an acknowledgement that while the multilateral process remained stalled, it would be in Japan's economic interests to additionally pursue a regional agenda. Specifically this equates to promoting regional economic integration in East Asia. While talk of a yen bloc has receded in recent years there is no doubt that Japan remains the principal economic actor in the region, even as China continues its rapid ascent, and that the policies it pursues are designed to carve out a new role for itself (Gilson, 2004). Japan's growing interest in East Asian regionalism is manifested in its FTA strategy and its role in the institutionalisation of regionalism, both examined in detail below. The economic partnership agreement with Singapore was Japan's first FTA and negotiations continue with most of its neighbours.

The third layer of the policy is located at the bilateral level. Operationally this means the negotiation of bilateral FTAs or economic partnerships with

individual countries. It is possible to conclude that bilateral agreements offer for latecomer Japan a relatively easy path into the world of FTAs and it is no coincidence that Japan's first FTA is with a city state (Singapore) at broadly the same level of development and technical capacity as Japan. Additionally bilateral negotiations afford Japan a more dominant bargaining position over the potential partner, especially if that potential partner is a developing or emerging economy. While developing nations might long for access to Japan's markets, they might well consider the costs of this to be too high (dismantling of tariffs on auto components for example) but feel that they have little alternative. This is precisely why failure to conclude the Doha 'development' round must be seen as a negative outcome for developing countries.

### **Internal dynamics**

So far, Japan's multilayered policy has been reviewed largely in terms of external dynamics and attention now turns to consider internal factors. As Japan approached the end of its 'lost decade', Koizumi's electoral gambit was to make the case for and subsequently pursue a policy to drastically and urgently restructure the Japanese economy.<sup>10</sup> This clamour for structural reform now also informs Japan's external economic policies. Two instances of this may be observed. First, Japan now officially welcomes and promotes inward FDI and Koizumi in particular regards foreign capital, ownership and management as a catalyst for reform. Japan's corporate world has endured a series of rude shocks in recent years including strategic alliances in the auto sector (Renault/Nissan, Ford/Mazda, DaimlerChrysler/Mitsubishi) and elsewhere (Ripplewood) that have challenged assumptions of industrial organisation and the Japanese 'model' in general. In other words, in the corporate and financial worlds at least, Japan is becoming a more globalised economy.

Second and again linked to the issue of structural reform, Japan now associates economic development through regional and bilateral initiatives in East Asia with the regeneration of the Japanese economy.<sup>11</sup> In this analysis East Asian economic dynamism equates to growth in (Japanese) corporate profits which leads to investment in facilities and R&D and, ultimately, to the improvement of the domestic economic environment. Liberalisation through formal agreements, or in METI's parlance a 'systemisation of the East Asian business zone' (METI, 2002:297), reduces transaction costs and positively impacts on corporate profits. The 'systemisation' of Japan's economic partnership with East Asia is based on WTO compliance and is pursued through regional (APT, APEC) and bilateral efforts (see below).

Final mention must also be made that these internal dynamics constrain Japan's external economic policy. Resistance to trade liberalisation from special interest groups (agriculture, construction) is both organised and significant. In the same way that the multilateral process has stalled on

these contentious issues, it is reasonable to assume that in the absence of any meaningful and lasting reform in these sectors, which implies a drastic revision of Japan's traditional political economy, bilateral and regional FTAs will also encounter considerable difficulties. Indeed, this was seen to be the case even in negotiations with Singapore.<sup>12</sup>

Japan's response to stalled multilateralism has been to re-evaluate the previous norm preference of WTO-led liberalisation leading to the promotion of a multilayered external economic policy. This policy is most relevant in East Asia where Japan is actively pursuing regional and bilateral agreements and may be explained by a combination of external and internal dynamics.

### **Deepening regional economic interdependence**

East Asian regionalism is constructed on a framework of regional economic interdependence, which itself continues to deepen and widen as documented in Chapter 3. Intra-regional trade, investment and production structures are the economic sinews of this interdependence and Japan's role within this is the subject of this section.

### **Japanese global trade structures**

Japan is a major trading power accounting for 6.5% of global exports and 5.1% of global imports in 2002 (see Table 4.5). However, it is also true that Japan's share of global trade has followed a decreasing trend throughout the 1990s and into the twenty-first century.

Japan continues to maintain a surplus in the balance of trade with its triadic trading partners (see Table 4.6) although this naturally masks country level realities. Japan runs a small deficit with Canada (North America) and an increasing deficit with China (East Asia) for instance. Note should also be taken of the impact of currency fluctuations on Japan's trade balance and also of offshore or 'hollowed out' production.

**Table 4.5 Total Japanese trade (imports/exports) and share of global trade**

	1996	1997	1998	1999	2000	2001	2002	2003
Export	412,433	422,881	386,271	417,442	480,701	405,155	415,862	469,862
Share*	7.7	7.6	7.1	7.4	7.6	6.6	6.5	n.a.
Import	350,654	340,408	279,316	309,745	381,100	351,098	366,832	381,528
Share*	6.4	6.0	5.0	5.4	5.8	5.5	5.1	n.a.
Balance	61,779	82,474	106,955	107,697	99,601	54,057	79,030	88,335

Notes: \* Share of global exports/imports

Units: US\$ million

Source: JETRO *White Paper on International and Investment*, 2003.

**Table 4.6 Japan's balance of trade by region**

	1996	1997	1998	1999	2000	2001	2002	2003
Total	61,779	82,474	106,955	107,697	99,601	54,057	79,030	88,335
North America	27,534	37,877	49,759	60,184	69,242	56,928	61,027	56,541
EU	13,645	20,621	32,257	31,646	31,527	19,871	17,379	23,104
East Asia	51,527	53,324	30,589	32,902	40,125	15,298	33,567	49,137

Units: US\$ billion

Source: JETRO White Paper on International Trade and Investment, 2003.

**Table 4.7 Japan's exports by selected region**

	Exports				% Share			
	2000	2001	2002	2003	2000	2001	2002	2003
Total	480,701	405,155	415,862	469,862	100.0	100.0	100.0	100.0
North America	150,419	128,313	125,864	122,754	31.3	31.7	30.3	26.1
EU	78,486	64,674	61,115	71,893	16.3	16.0	14.7	15.3
East Asia	190,897	156,625	172,983	210,928	39.7	38.7	41.6	44.9

Units: US\$ billion

Source: JETRO White Paper on International Trade and Investment, various years.

**Table 4.8 Japan's imports by selected region**

	Imports				% Share			
	2000	2001	2002	2003	2000	2001	2002	2003
Total	381,100	351,098	336,832	381,528	100.0	100.0	100.0	100.0
North America	81,268	71,385	64,837	66,213	21.3	20.3	19.2	17.4
EU	46,959	44,804	43,736	48,789	12.3	12.8	13.0	12.8
East Asia	150,772	141,327	139,417	161,790	39.6	40.3	41.4	42.4

Units: US\$ billion

Source: JETRO White papers, various years.

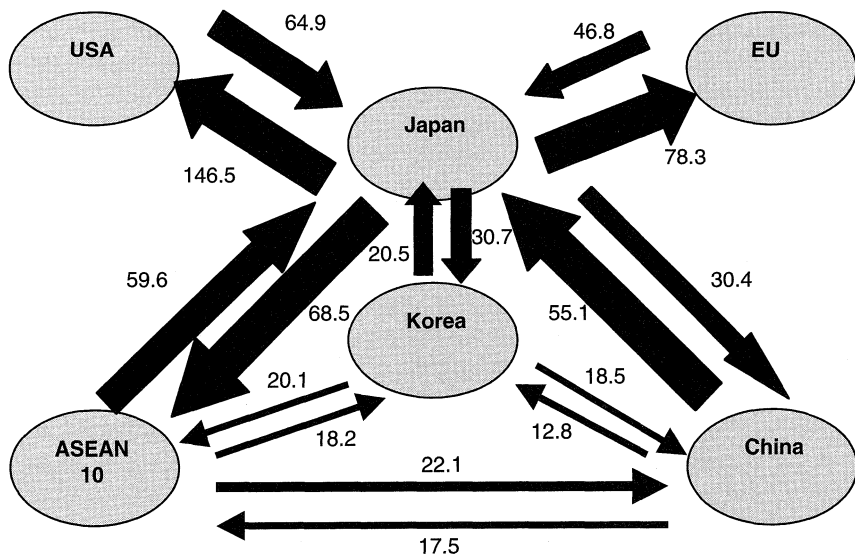
Tables 4.6, 4.7 and 4.8 and Figure 4.9 show the triadic nature and increasing East Asian bias of Japanese trade. In 2000, North America, the EU and East Asia accounted for 31.3, 16.3 and 39.7% respectively of total Japanese exports. By 2003, these percentages stood at 26.1, 15.3 and 44.9 indicating a decline in exports to North America and the EU but an increase to East Asia. Japanese imports from North America, the EU and East Asia stood at 21.3, 12.3 and 39.7 respectively in 2000 moving to 17.4, 12.8 and 42.4% by 2003.

### Japan's trading relationship with East Asia

East Asia, including Japan, now exhibits a level of trade complementarity similar to that previously observed in the then emerging EU and NAFTA regions (METI, 2004). In other words, East Asia is trading and investing more within itself indicating that member economies are already operating in a *de facto* regional economic unit comparable to those observed in Europe and North America.

The AFC had a rapid and negative impact on intra-region/Japan trade and investment yet as conditions in East Asia (to include the Japanese economy) improved from 1999, trade levels moved towards recovery. A review of METI's *White Paper on International Trade* (2000) reveals that the

Figure 4.9 Trade relationships among Japan, ASEAN, China and Korea (USA, EU) (2000)



Notes: Unit US\$ billion  
Source: METI, 2002.

**Table 4.9** Japan's trade balance with East Asian regions/countries

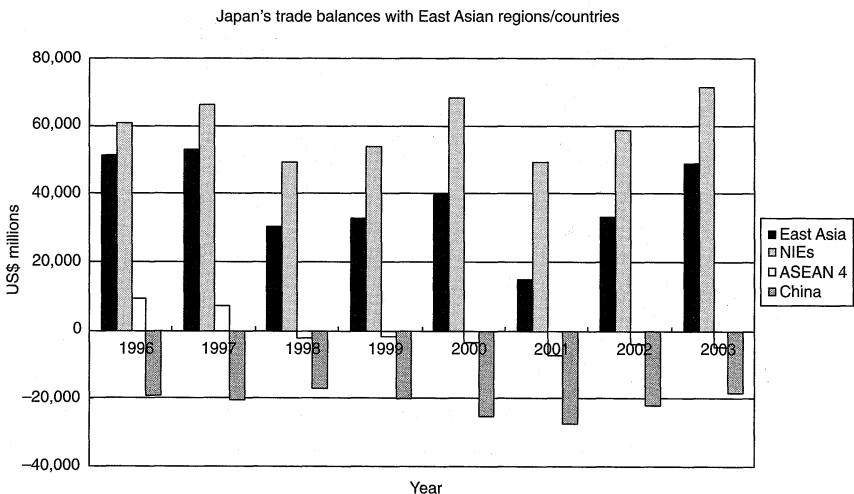
	1996	1997	1998	1999	2000	2001	2002	2003
NIEs	60,785	66,202	49,326	54,032	68,351	49,412	58,889	71,568
ASEAN 4	9,401	7,402	-1,863	-1,586	-3,350	-7,100	-3,497	-4,457
China	-18,660	-20,281	-16,874	-19,544	-24,875	-27,014	-21,826	-17,973

Units: US\$ million

Source: JETRO 2003 White papers, various years.

value of Japanese exports to East Asia had been expanding up to the second quarter of 1997 but that growth slowed throughout the remaining two quarters and became negative from the first quarter of 1998 (see Table 4.9 and Figure 4.10). Exports dropped by between 5 and 10% in each quarter of the following year with this trend only reversed in early 1999 and growth became positive in the third quarter of that year. The bursting of the IT bubble and the 2001 terrorist attacks again impacted negatively on Japan's exports to the region as doubts were raised over the sustainability of the global economy though these have since receded.

Although exports to the ASEAN 4 followed a broadly similar trend the fall was not as severe or as prolonged as that observed for East Asia as a whole. The fall, recovery and growth of exports to East Asian countries mirrored the economic recovery of these countries. Furthermore, there is a

**Figure 4.10** Japan's trade balance with East Asian regions/countries

Source: Calculated from JETRO White Paper on International Trade and Investment, various years.

Table 4.10 Japan's East Asian trade by region and sector

Region/ Country	Sector	Exports			Imports		
		2001	2002	2003	2001	2002	2003
Asian NIEs	Total	87,880	94,277	110,415	38,467	35,387	38,847
	Industrial supplies	23,016	25,388 (26.9)	29,122 (26.4)	9,541	8,418 (23.8)	9,940 (25.6)
	Capital equipment	52,193	55,572 (58.9)	66,122 (59.9)	19,643	18,331 (51.8)	20,280 (52.2)
	Consumer durables	5,540	5,705 (6.1)	6,509 (5.9)	3,647	3,160 (8.9)	3,225 (8.3)
ASEAN 4	Total	54,527	55,641	60,975	54,672	51,563	58,302
	Industrial supplies	11,596	12,482 (22.4)	13,815 (22.7)	22,381	21,143 (41.0)	25,360 (43.5)
	Capital equipment	35,609	35,289 (63.4)	38,026 (62.4)	19,362	17,460 (33.9)	19,512 (33.5)
	Consumer durables	3,609	3,682 (6.6)	4,127 (6.8)	4,383	4,124 (8.0)	4,281 (7.3)
China	Total	31,091	39,866	57,220	58,106	61,692	75,193
	Industrial supplies	11,908	13,897 (34.9)	17,618 (30.8)	9,895	10,057 (16.3)	12,469 (16.6)
	Capital equipment	16,373	21,504 (53.9)	33,481 (58.5)	13,978	17,627 (28.6)	24,328 (32.4)
	Consumer durables	1,308	2,327 (5.8)	3,076 (5.4)	8,203	9,286 (15.1)	11,079 (14.7)

Notes: Figures in parenthesis represent sector share within region.

Units: US\$ million

Source: Compiled from JETRO White paper, 2003.

clear link between production recovery in East Asia and the export of Japanese capital goods reflecting the structure of industrial organisation in East Asia (Urata, 2003). Japanese capital goods (machinery) and components are exported from Japan to East Asian countries and are then used in the manufacture or assembly of finished products. The auto industry in particular, examined in subsequent chapters, exhibits this trade structure. Table 4.10 provides data on the structure of Japan's trade with its East Asian neighbours.

A similar trend is observed for Japanese imports from the region.<sup>13</sup> As conditions in the Japanese economy improved in 1999, exports from East Asia increased and did so faster than those from outside the region. A notable increase was recorded in the importation of office appliances and electronic parts from NIE and ASEAN member economies. Japanese consumption of durable goods also demonstrates a link between Japanese recovery and imports from the region. Imports dipped once again in 2001

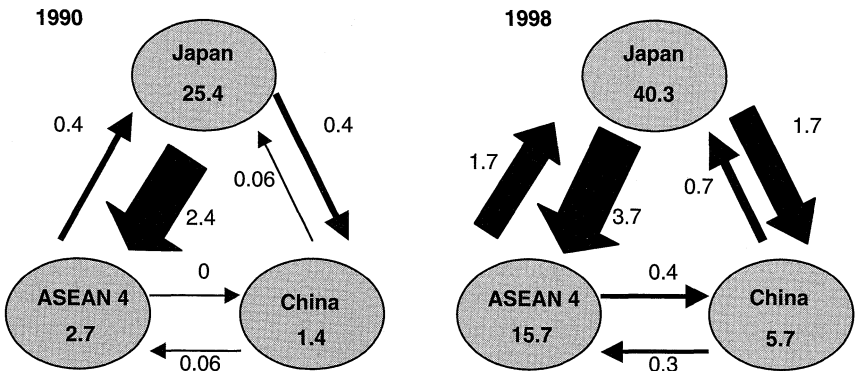
for the same reasons given for the decline in exports above, but have since recovered.

This data suggests that the Japanese and East Asian economies are increasingly interdependent and are economically complementary (Lau, 2003). As East Asian economies recovered from the crisis, Japanese exports to the region grew and, as the Japanese economy grew (albeit weakly) in 1999, East Asia was able to expand exports to Japan. However, it is also clear that the importance of Japan as a trading partner for East Asia declined throughout the 1990s. The share of Japan in East Asia's imports declined from 22% to 16% between 1990 and 2001 while the share of Japan in East Asian exports also declined. East Asia on the other hand has become an increasingly important trading partner for Japan. The region accounted for 34% of Japan's exports in 1990 increasing to 39% in 2001, 32% and 42% of imports in the same period. (Urata, 2003; METI 2004). Urata (2003) draws the conclusion that not only is East Asia expanding more rapidly than Japan but that this expansion or closer economic integration between Japan and East Asia in general, will 'contribute to economic growth for Japan' (Urata, 2003:5). This is a conclusion shared by policy makers in METI and the MOF, as demonstrated in communication of policy positions through various annual white papers, and illustrated by Figure 4.11.

### Intra-Japan/East Asian FDI

The centrality of the AFC in the transformation of the East Asian political economy and on Japan's policy towards the region has been examined above. Earlier sections of this chapter presented an historical overview of

Figure 4.11 Expansion of intermediate trade (machinery parts)



Notes: Unit US\$ billion  
Source: METI, 2002.

Japanese investment in East Asia up to the onset of the AFC and this section seeks to examine trends in Japanese FDI to the region in the post-crisis era.

### **Pre-crisis trends**

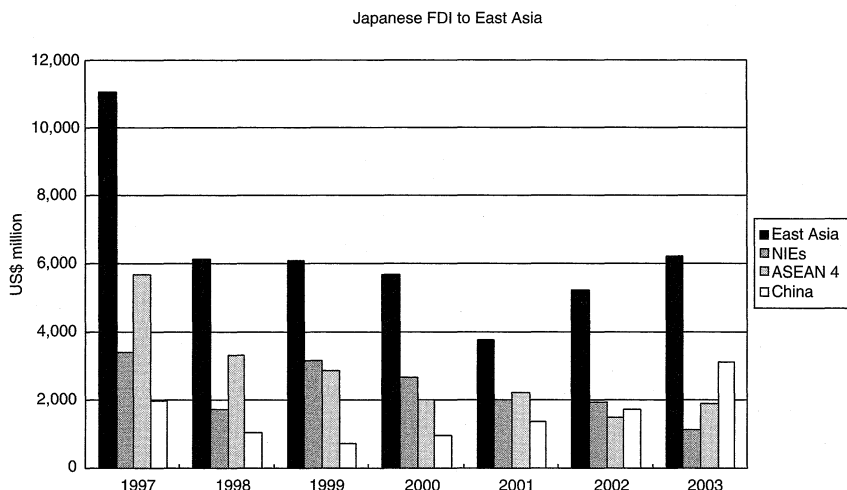
Japanese FDI to East Asia had been increasing up to the crisis, reaching 6.6 trillion yen in 1997, due to yen appreciation in the mid-1990s and the positive global and regional economic situation. In East Asia Japanese corporations continued to relocate their operations away from Japan and to further regionalise production. ASEAN countries for their part attracted further investments due to the steady liberalisation of the investment environment and strong economic growth. More specifically, Japanese FDI became increasingly orientated towards the ASEAN 4, Thailand and Indonesia in particular, at the expense of the NIEs at this time. FDI to China had been increasing since the start of the 1990s but peaked in 1996 and steadily declined until the recent upswing that began in 2000/2001. On the eve of the crisis, then, East Asia was the second largest recipient of Japanese FDI (after the US) and enjoying year on year growth due to a mixture of pull and push factors.

### **Post-crisis trends**

Two opposing forces came into play in the wake of the crisis. First, as the extent of the crisis and resulting instability in the political economy became clear, the risk of undertaking investment in the region substantially increased. Market-orientated investment dried up as markets collapsed, particularly in the automotive sector where firms were left with plummeting sales and idle capacity, and the general investment climate turned negative. The second force, however, was much more benign. Currency devaluations led the way to 'fire sales' of suddenly cheap assets and Japanese investors were able to increase their equity stake in struggling partners as liberalisation packages designed to encourage FDI were hurriedly put in place.

Japanese FDI flows to the region declined year on year until 2001 when levels began to increase once more while remaining well below the levels seen in the pre-crisis period (see Figure 4.12). Within this, the ASEAN 4 economies experienced a particularly dramatic decline with investments falling from US\$5,696 million in 1997 to US\$1,936 million by 2003. Conversely, Japanese FDI into China has been increasing year on year since 2000 overtaking that directed to the ASEAN 4 in 2002 underscoring the growing popularity of China as an investment destination (see below). In 2003, Japanese FDI to East Asia stood at US\$6,233 million, a drop of US\$4,861 million or approximately 44%, with 50% of the total directed to China. These figures should also be viewed in the context of a general decline in total Japanese FDI from US\$53,972 million in 1997 to US\$31,606 in 2001.

Figure 4.12 Japanese FDI to East Asia



Source: JETRO White Paper on International Trade and Investment, various years.

In summary, it is possible to conclude that although the stock of Japanese investments in East Asia remains unsurpassed, post-crisis trends indicate that less FDI is flowing out from Japan in general and that a smaller percentage of this is directed towards East Asia. Japan remains the leading intra-regional investor but its share of FDI directed to East Asia is increasingly accounted for by Chinese investments at the expense of ASEAN 4 economies.

### Regional production networks

As examined in Chapter 2, Japanese business has regionalised production in East Asia through the utilisation of RPNs. Increasing intra-industry trade within these networks contributes to intra-regional trade and thus regional economic interdependence. Indeed, the establishment of RPNs in the auto and electronic sectors throughout ASEAN in particular provided the rationale for numerous intra-industry trade facilitation schemes (BBC, AICO) culminating in the AFTA. RPNs are the result of Japanese FDIs and are also important contributors to deepening regional economic integration.

Japanese trade, investment and production structures have underpinned the economic development of East Asia. In the post-crisis era Japan's role in the deepening of economic interdependence has not significantly diminished but has quantitatively and qualitatively altered. Japan is trading more with the region though the importance of this trade for the rest of the region has declined. Japan is investing less in the region reflecting a global trend, and China is the biggest recipient of this, raising serious challenges

for ASEAN economies that remain in a competitive relationship with China.

### **Responses to the Asian financial crisis – finance**

Japan's initial response to the crisis was largely criticised in ASEAN as being inadequate and uncoordinated. Here was evidence, so the argument went, to reinforce the (mis)conception that Japan is inherently unwilling or unable to take a leading role in its own sphere of influence. Yet as Japan's response has unfolded, it has become increasingly clear that, in fact, there has been a discernible shift in policy and Japan is positioning itself to 'exert considerable covert economic leadership in the region' (Hughes, 2000). It is possible to identify four broad Japanese responses to the crisis that shook East Asia between 1997 and 1998. First and foremost was the immediate financial response that is the subject of this section. Subsequent responses have taken longer to emerge but perhaps have had a greater impact on the transformation of East Asian political economy as discussed in Chapter 3. These are identified as the shift in Japan's basic external economic policy (FTA/EPA strategy), support for the institutionalisation of the East Asian vision of regional economic community (East Asian regionalism) and, less directly attributable, the continued restructuring of the Japanese economy. With the exception of issues concerning domestic restructuring, these secondary responses are discussed elsewhere in this chapter and attention now focuses on Japan's financial initiatives.

#### **The immediate response**

Japan's involvement in dealing with the crisis commenced early when it hosted Thailand and the IMF in Tokyo during negotiations to conclude a financial rescue package for that country (August 1997). In recognition of potential for catastrophe throughout the region, Japan proposed the creation of a multilateral AMF backed with US\$100 billion to deal with the currency crisis at the regional level. This proposal however was unacceptable to the US and the IMF (citing moral hazard and an undermining of the IMF's position), China (wary of Japanese attempts to extend regional influence) and others and was quietly withdrawn later in the year. Japan's acquiescence to IMF conditionalities may be seen in the larger context of political norms *vis-à-vis* the United States (Hook *et al.*, 2001). Yet by 1998, growing resentment of the IMF's handling of the crisis and renewed fears of further shocks to the already fragile Japanese economy led Japan to introduce the New Miyazawa Initiative.

#### **The New Miyazawa Initiative and other measures**

This bilateral initiative made available US\$30 billion to Asian countries for both short-term capital requirements and medium to long-term recovery

and reform (MOF, 2002). The initiative may be seen in terms of Japan's deep financial and commercial involvement in the East Asian regional economy and the feared impact of an East Asian collapse on the domestic economy. It is also speculated that the crisis served as a sharp wake-up jolt for Japanese policy makers who until this point had been preoccupied with Japan's own economic malaise. With the domestic economy stuttering, Japan needed to ensure that the much vaunted export sector remained in good health.

The New Miyazawa Initiative in turn paved the way for the CMI announced at the third APT summit meeting in 2000. This represents a regional strategic response to financial concerns by member states and is largely underwritten by Japan (see Table 4.11). The initiative is a system of bilateral currency swap agreements, complementary to IMF arrangements that could be utilised in the event of future financial crises. Under the agreement Japan commits to lend US dollars and buy local currencies in an attempt to shore up the currency in question against the kind of speculative attacks witnessed in 1997 and 1998.

The New Miyazawa and Chiang Mai Initiatives demonstrate Japan's commitment to, and influence over, the emerging East Asian financial architecture. Moreover, the same rationale informing Japan's basic external economic policy and FTA strategy also pervades its approach to financial matters. That is, fully 50% of funds available through the New Miyazawa Initiative are to be implemented to support corporate debt restructuring, social security provisions and economic stimulation. In other words, in the same way that the FTA strategy aims to go further and deeper than simple trade liberalisation, financial measures are designed with one eye on the

**Table 4.11** Japan's bilateral swap arrangements under the Chiang Mai Initiative

Country	Agreement	Amount*	Currency
China	two-way	3	Yen-RMB
Indonesia	one-way	3	US\$-Rupiah
Malaysia	one-way	1**	US\$-Ringgit
Philippines	one-way	3	US\$-Peso
ROK	one-way	2***	US\$-Won
Singapore	one-way	1	US\$-Singapore \$
Thailand	one-way	3	US\$-Baht & US\$-Yen

Notes: \* US\$ billions

\*\* In addition to US\$2.5 billion swap arrangement under the New Miyazawa Initiative

\*\*\* In addition to US\$5 billion swap arrangement under the New Miyazawa Initiative

Source: Adapted from MOF online database, available at [www.mofa.go.jp](http://www.mofa.go.jp) accessed at various dates.

promotion of the developmental state concept (softens neo-liberal 'market discipline above all else' norm) and the other on regional economic integration (Japan underpinning efforts to stabilise the region).

Japan is further involved in promoting an Asian bond market, the internationalisation of the yen and efforts towards establishing a region-wide mechanism for foreign exchange rate stability (Amyx, 2003; Hook *et al.*, 2001; Kuroda and Kawai, 2003; Yamazawa, 2004).

Japan's financial response to the AFC provides early evidence of the gathering shift in its basic policy stance towards East Asia. The New Miyazawa and Chiang Mai Initiatives allowed Japan to assume a core position in the region's emerging financial architecture. Further efforts proceed in this context and are premised upon slow but sure regional financial integration. Although China was praised for resisting the temptation to devalue the RMB in the wake of the crisis, through the efforts described above, Japan has been able to demonstrate political willingness and financial wherewithal to assume a leadership role in this area.

## **Responses to the Asian financial crisis – institutionalisation of regionalism**

The institutionalisation of regionalism in East Asia was reviewed in Chapter 3 where it was found that the APT process and the subsequent establishment of the EAS framework remains the only structure capable of promoting the *de jure* regionalism envisaged by the EAVG. This section builds upon these findings by reviewing Japan's role in this process; in what way is Japan involved in the institutionalisation of regionalism in East Asia? Is Japan willing and able to assume the leadership role necessary to realise an East Asian Economic Community?

### **Japan's political role in East Asia**

Japan's broader approach to East Asia may be explained, to borrow the language of international relations, in terms of structure, agency and norms (Hook *et al.*, 2001). While acknowledging their inseparability, it is possible to approach Japan's relationship with the region by considering individually the political, economic and security spheres. Japan's economic engagement with the region has been described above and the security sphere is beyond the scope of this paper. It remains therefore to consider certain aspects of Japan's political relationship with the region. This section does not presume a review of the determinants of Japan's international relations but rather focuses on Japan's role in the institutionalisation of regionalism in East Asia. Japan's traditional approach to the region is first considered before an examination of Sino-Japanese leadership rivalry and the APT process.

Japan's domestic malaise throughout the 1990s has been well documented, yet this does not detract from the fact that it remains the world's second largest economy and by far the biggest economic player in East Asia. Japanese ODA and investments in the region in the post-war era laid the foundations for the 'economic miracle' of economic development (World Bank, 1993) and Japanese corporations play critical roles in many East Asian economies, particularly in Southeast Asia, maintaining dominant positions in key industrial sectors such as automobile production. ASEAN member economies are to a greater or lesser degree dependent on Japan for capital and technology and the deepening trade and investment relationship between China and Japan further underlines Japan's importance. As noted above, today's moves towards *de jure* regionalism are rooted in the *de facto* regionalisation of Japanese investment and production in the region to date.

In spite of this economic dominance Japan has shied away from seeking and carving out an overt leadership, or hegemonic, role in the region and has preferred instead a more oblique *modus operandi* based on ODA and 'quiet diplomacy'. When Malaysian Prime Minister Mahathir proposed the Japan centric EAEC in 1991 for instance, Japan deferred to its relationship with the US and the Asia-Pacific vision that this entailed and declined to assume a more politically defined leadership role in East Asia. Yet Japan's promotion of regional economic integration in general and economic partnership agreements (both bilateral and multilateral) in particular represent a 'new and important strand in Japanese policy behaviour' (Gilson, 2004:91) and is one that has emerged in response to the transformation of the region's political economy. In other words, Japan may now be strategically seeking a less ambiguous and institutionalised leadership role.

### **Sino-Japanese leadership rivalry**

The scramble for FTAs in East Asia may clearly be understood on one level as a proxy battle between China and Japan for political leadership of the region. Japan considers itself the lead goose, the big brother, the natural hegemon whereas China for its part considers itself to be returning to its rightful and historic position of economic and political influence as the middle kingdom of East Asia. Japan (and ASEAN) fears a dominant, assertive, and possibly expansionist China while China and Korea view Japan's more active engagement with suspicion borne of unresolved colonial era issues. An East Asian Community of one form or another will only become a reality when both countries are on board and the process is given 'directional leadership'. Japan and China are both alluding to this role through their pursuance of FTAs or EPAs multilaterally with ASEAN.

China was able to score a certain amount of political capital by offering ASEAN an 'early harvest' of liberalisation in agricultural sectors as part of its

FTA proposal. Japan, on the other hand, is constrained by domestic special interest groups who lobby for continued protection in a way that the Chinese leadership is not. Then again, it is clear that ASEAN would stand to gain more from an FTA with Japan's highly complimentary economy than an agreement with China's highly competitive structure. Indeed, individual ASEAN nations have expressed disquiet over the potential impact of the China-ASEAN proposal in general.

In contrast to the centripetal force exerted by the China-ASEAN and Japan-ASEAN FTA/CEP processes, Sino-Japanese relations may also be seen as an obstacle to the realisation of East Asian regionalism in so far that this is premised on the prior establishment of a FTA agreement in Northeast Asia. In short, the establishment of an East Asian economic community is contingent on the establishment of an East Asian FTA. This in turn will only materialise when the final section of the regional FTA structure, a China-Japan or China-Japan-Korea FTA, falls into place. The prospects of a bilateral agreement between the two powers, or one to include Korea are, at the time of writing, slight. Relationships sank to a low in 2005 as anti-Japanese riots erupted in parts of China, the trigger being the approval by the Japanese state of history text books that allegedly gloss over Japan's wartime aggression and actions in China in particular. These riots were merely symptomatic of the continuing deep current of mistrust between the two countries over Japan's past military and imperialist aggression. However, the relationship had been slowly improving until this point. China's accession to the WTO has been supported and welcomed by Japan, the two countries are committed to a peaceful resolution of the North Korean issue, and trade and investment links have never been stronger. Given this, it may be reasonable to assume that the relationship will return to a businesslike if frosty standing in the coming years. This does not suggest, however, that a 'shared directional leadership' structure will emerge in the near future (Terada, 2004). Indeed, both China and Japan will continue their diplomatic engagement with ASEAN first in an attempt to stake out a leadership role before expending greater efforts on improving their own bilateral relationship.

### **Japan and the ASEAN+3 (APT) process**

Japan supported the establishment of the APT process in 1997 and the more recent promotion of the EAS framework. The APT process may be seen as the EAEC in all but name. It is exclusively East Asian in racial not geographic terms as membership is not extended to Australia, New Zealand, the US or Russia. Further contrasting with the APEC framework, APT's rationale is regional economic integration rather than APEC's straightforward trade liberalisation. In recent years APEC seems to have withered as APT has grown and although the Bogor Declaration committed members to removing all

tariffs by 2010 for developed countries and 2020 for developing countries, all the 'action' on this front is seen in the APT and bilateral FTA processes. APEC's inability to tackle the AFC was understandable – it is a forum for trade liberalisation based on open regionalism, not a financial mechanism – but only served to highlight its narrow agenda. While APEC should not be summarily written off, it is increasingly clear that the current focus of attention is on East Asia rather than Asia-Pacific.

Japan's role within this marks a significant departure from previous norms and indicates a further reorientation of Japan's policies towards the region. Within APEC Japan is a large fish in a big bowl<sup>14</sup> but at the same time remains to a certain extent in America's shadow. Within the APT framework, however, Japan assumes a greater weight and importance as seen above. In other words, Japan has a greater potential to secure a leadership role in the APT/EAS process than within APEC. Japan's quiet diplomacy is demonstrated in its willingness to host official and quasi-official conferences,<sup>15</sup> the commemorative ASEAN 10 summit in Tokyo in December 2003 and the support given to the establishment of an APT secretariat.<sup>16</sup>

Economic integration in East Asia is considered by Japan to be a crucial component of domestic growth and for this reason its FTA strategy goes beyond trade liberalisation to include measures promoting deeper or comprehensive economic partnerships. In addition to pursuing economic (financial, trade, investment) measures, Japan also promotes these goals through political or diplomatic means. The reorientation of Japan's policy away from Asia-Pacific and towards East Asia signifies a new direction for Japan and one which will require an unambiguous leadership role. This will be constrained by China, Japan's colonial legacy and domestic resistance but it is clear that Japan is committed to a deeper level of regional economic integration as a precursor of an East Asian community. Japan, then, is deeply involved in the institutionalisation of regionalism and appears willing to play a more clearly defined leadership role while at the same time is constrained in this by domestic and external factors. Even as the underlying and essentially Cold War security structure remains, Japan is perhaps seeking a more autonomous role in its economic and political relationship with East Asia.

### **Responses to the Asian financial crisis – FTA strategy**

As noted above, Japan has adopted a multilayered approach to its external economic policy and of central importance to this is the shift<sup>17</sup> from an exclusively multilateral preference (one track) to one which recognises the growth and relevance of regional and bilateral efforts (multi-track). This section reviews Japan's FTA strategy and the notion of 'economic partnership' before examining a sample of Japan's regional and bilateral efforts in East Asia.

Fundamentally, regional and bilateral FTAs share common aims and objectives with the multilateral approach. There is an underlying assumption, most

**Table 4.12 Japan's current situation regarding FTAs/EPAs in East Asia**

	<b>Overview</b>	<b>Status (as of April 2005)</b>
<b>ASEAN (JACEP)</b> Multilateral	November 2002 Joint Declaration (Japan-ASEAN Summit) FTA in ten years (2012) Talks suspended in 2004	Formal negotiations recommenced April 2005
<b>ASEAN+3</b> Multilateral	East Asian Vision Group report 2001 proposed the establishment of an East Asian FTA East Asian Study Group reported on feasibility at ASEAN+3 Summit 2002	To be further discussed at the 2005 East Asian Summit
<b>Australia</b> Bilateral	JSG initiated 2005 to explore alternative means of strengthening economic partnership	Japanese decision not to pursue FTA with Australia (2005) due to agricultural issues
<b>Chile</b> Bilateral	Intention to establish JSG announced at 2004 APEC conference	JSG initiated January 2005 to study feasibility of FTA
<b>China</b> Bilateral	Talks proposed by China	No movement from Japan
<b>Indonesia</b> Bilateral	Preparatory meeting 2003	Talks planned for 2005
<b>Korea (JKFTA)</b> Bilateral	Government interest since 1998 JSG initiated 2002 Report submitted 2003	Negotiations deadlocked
<b>Malaysia (JMEPA)</b> Bilateral	Proposed in 2002 WG formed and reported in 2003 JSG formed and reported 2003 Negotiations commenced 2004	Aim to conclude basic negotiations by May 2005
<b>Mexico (JMEPA)</b> Bilateral	Negotiations initiated November 2002 Basic agreement reached March 2004	Entered into force April 2005
<b>Philippines (JPEPA)</b> Bilateral	WG initiated 2002 Joint Coordinating team reported 2003 Negotiations commenced 2004 Koizumi/Arroyo statement that agreement had been reached in principle Nov. 2004 Agreement to be finalised (2005)	Final negotiations ongoing (2005)

**Table 4.12** Japan's current situation regarding FTAs/EPAs in East Asia – *continued*

	Overview	Status (as of April 2005)
<b>Singapore</b> (JSEPA) Bilateral	Japan's first FTA	Entered into force November 2002
<b>Taiwan</b> Bilateral	Taiwanese proposals for talks	No movement from Japan
<b>Thailand</b> (JTEPA) Bilateral	WG initiated 2002 WG reported 2003 TF mandated 2003 TF interim report 2003 Negotiations commenced 2004	Negotiations ongoing Latest meeting (5 <sup>th</sup> round) December 2004 Substantial progress on agreement Rice excluded

Notes: WG: Working Group, TF: Task Force, JSG: Joint Study Group

Source: MOFA, 2002a; *Nihon Keizai Shimbun*, various dates.

clearly enunciated as the neo-liberal agenda, that global economic growth is dependent on continual progress towards free trade through liberalisation and deregulation. Regional and bilateral initiatives have gained in popularity for a range of reasons (see Chapter 3) but they remain in essence premised on this assumption; it is simply that in the current climate they are seen as more 'doable'.

In these first few years of the twenty-first century, Japan is actively pursuing a number of regional and bilateral FTAs as presented in Table 4.12. This represents a new direction for Japan and the impact of this policy will reverberate throughout Japan, East Asia and beyond.

As examined above, Japan's FTA strategy is a key component of the multilayered approach to external economic policy. Yet this strategy purports to go beyond 'simple' trade liberalisation and is further driven by political economy considerations. These include domestic restructuring, promotion of economic development in East Asia and the strengthening of Japan's economic and political position in the region, particularly *vis-à-vis* China (see below) (Urata, 2004). With strategy informed by these factors, three criteria are identified that guide decisions on which countries to negotiate with and these are presented in Figure 4.13.

Much then is asked and expected of Japan's FTA strategy. Not only should any FTA be WTO compliant but it should also facilitate developments outside of the traditional trade facilitation remit. This context offers an explanation of why Japan prefers to refer to FTAs as economic partnership agreements and attention now turns to review the distinction in more detail.

Figure 4.13 Japan's criteria for identifying countries/regions with which to pursue EPAs/FTAs

**1. Creation of an international environment beneficial to Japan**

Will the proposed EPA/FTA:

- facilitate efforts towards community building, stability and prosperity in East Asia
- contribute to Japan's economic power and tackle political and diplomatic challenges
- reinforce Japan's position at multilateral negotiations?

**2. Attainment of Japan's economic interests**

Will the proposed EPA/FTA:

- substantially expand trade and investment
- improve the business environment for Japanese companies operating in the country
- harmonise 'economic system' including intellectual property rights
- facilitate the movement of people
- contribute to stable imports of resources
- eliminate economic disadvantages caused by an absence of an EPA/FTA
- promote Japan's structural reforms?

**3. Feasibility of realising an EPA/FTA**

Will the proposed partner:

- have the capacity to implement commitments
- cause trade friction with other partners
- be able to give appropriate consideration to the liberalisation of difficult products?

Source: Adapted from MOFA, 2004.

## Economic Partnership Agreements (EPAs)

'New age' FTAs aim to go beyond 'simple' trade liberalisation and Japan is a particularly keen exponent of comprehensive and flexible economic partnership agreements. Japan's commitment to EPAs stems from a recognition that globalisation necessitates comprehensive and deep economic relationships between economies. This in turn requires going beyond tariff reduction to encourage trade in services, innovation, competition and free flows of information, people and capital (MOFA, 2002a) and partly explains the focus on East Asia as recorded in Table 4.13. Such ambitions are not yet to be realised multilaterally and appear more achievable at the regional level. The EU and to a lesser extent NAFTA stand testament to this.

The EPA with Mexico is an exception to this general rule but may be explained with reference to Mexico's membership of NAFTA and FTA with the EU (2000). Moreover, METI indicated that the absence of a FTA with Mexico exposed Japanese companies to average tariff rates of 16% resulting in Y600 billion of lost export revenue and 30,000 job losses (METI, 2002).

**Table 4.13** Korea's trade with Japan, 1999

Exports	15.86	Textile products, electric machinery, metal products, oil products, machinery
Imports	24.14	Electric machinery, machinery, metal products, precision machinery, chemical products, light industry products
Balance	-8.28	

*Units:* US\$ billion

*Source:* MOFA, 2004: 12.

EPAs, then, have strong regionalist and developmental connotations reflecting Japan's continued promotion of the developmental state concept and its broader intentions in East Asia. Focus now turns from policy to practice. Three FTAs/EPAs are briefly reviewed below in an attempt to illustrate both the current status of EPA progress and issues emanating from this.

### **The Japan-Singapore Economic Partnership Agreement (JSEPA)**

Japan and Singapore concluded a series of bilateral negotiations in October 2001 and signed an agreement in January 2002 that brought the JSEPA into force in November of the same year. The JSEPA represents Japan's first foray into bilateral FTAs. The FTA 'plus' components of the EPA include measures for investment liberalisation, investment and business facilitation, visa initiatives, Intellectual Property Rights (IPRs) and a Mutual Recognition Agreement.

Although the quantitative benefits of the agreement may be modest<sup>18</sup> at best, as Japan and Singapore already maintained low tariff regimes, the EPA is seen as a positive development for the following reasons. First, it strengthens existing economic ties between the two economies. Second, it creates new opportunities for business and trade, particularly in the service sectors. Third, it is WTO compliant and consistent with Japanese and Singaporean aims of promoting liberalisation. However, it is perhaps the demonstration effect that is the most important outcome. Singapore, as an economy premised on free trade and one frustrated with the slow progress at the WTO and regionally, was already keen to champion FTAs and had indeed launched negotiations with a number of countries prior to the JSEPA process. Latecomer Japan, on the other hand, has benefited most from the steep learning curve required of the processes of negotiation, consultation, planning and implementation of the agreement. The JSEPA experience has increased its capacity and willingness to handle FTAs and may be seen as a demonstration of political will and commitment to liberalisation, free trade and regional economic integration.

## Japan-Korea Free Trade Agreement (JKFTA)

In contrast to the relatively quick and easy conclusion of the JSEPA, the Japan-Korea FTA is at the time of writing 'dead in the water' (*Nihon Keizai Shinbun*, 21/02/05). The two governments launched a joint research group consisting of members from Japan's Institute of Developing Economies (IDE) and Korea's Korea Institute for International Economy Policy (KIEP) in 1998 which presented findings in 2000. A subsequent series of eight Study Group meetings held throughout 2002 and 2003 culminated in the presentation of findings in 2003 which concluded that the FTA would be mutually beneficial and recommended moving to the negotiation stage. This duly started in December 2003 but after six meetings, no agreement had been reached by the end of 2004.

In spite of the publication of the Study Group's favourable report and subsequent studies (Nakajima, 2005) confirming the beneficial outcome of the agreement (see Table 4.16), the JKFTA represents perhaps the biggest challenge to Japan's FTA strategy. Reluctance to conclude an agreement is evident on both sides. Korea runs a sizable trade deficit with Japan (recorded on Table 4.13) and fears that this would increase with certain sectors (machinery, electrical equipment) hit particularly hard. Japanese reluctance is explained, once again, with reference to agricultural and food products protectionism (see Table 4.15). The Koreans have also cited the

**Table 4.14** Tariff rates between Japan and ROK (%)

Product	Japan	ROK
Agricultural	36.3	51.9
Forestry	4.7	2.3
Fishery	6.8	11.7
Mineral	0.0	2.6
Processed food	42.1	44.8
Textiles and apparel	10.4	8.0
Metal products	2.1	7.3
Motor vehicles	0.0	8.0
Other transport equipment	0.0	2.8
Electronic equipment	0.0	8.0
Other machinery and equipment	0.3	7.9
Other manufacturing products	3.9	7.5

**Table 4.15** Macroeconomic effects (long run) of the JKFTA

	Real GDP (%)	Equivalent variance*	Terms of trade	Trade balance*
Japan	0.02	2,945	0.23	-277
ROK	1.09	3,972	0.06	-301

Notes: \*US\$ million

Based on tariffs presented in Table 4.14 reduced to 0.0%.

Source: Nakajima, 2005: 5.

**Table 4.16** Main areas covered by the JACEP

Liberalisation and facilitation	Trade in goods and services, rules of origin, customs procedures, e-trading, mutual recognition, investment, movement of natural persons, IPR, government procedure, competition
Enhancing economic cooperation	Financial services, ICT, science and technology, human resource development, trade and investment promotion, SMEs, broadcasting, tourism

Source: Adapted from ASEAN Secretariat.

closed nature of Japan's industrial organisation as a point of difficulty. Further political and cultural factors remain and include the legacy of Japanese colonialism, territorial disputes, discrimination by Japan of Japanese of Korean descent and the North Korean issue to name but the most pressing. The faddish popularity of Korean soap operas will not compensate for this.<sup>19</sup>

In summary, a more realistic (and less promising) assessment of the challenges facing Japan's FTA strategy than that presented by the JSEPA is painted by the JKFTA. If Japan is finding difficulty in concluding a bilateral FTA with its closest neighbour (and closest following 'goose'), what likelihood can there be of future meaningful (WTO compliant) agreements with other nations or groups of nations, particularly those at a less advanced stage of development and relying more on access to Japan's protected sectors?

### **Japan-ASEAN Comprehensive Economic Partnership (JACEP)**

Prime Minister Koizumi formally proposed a Japan-ASEAN Comprehensive Economic Partnership in early 2002 and this was followed by the Joint Declaration announced at the November ASEAN Summit meeting of the same year. The declaration drew on a report compiled by the JACEP Expert Group that had been submitted to relevant economic ministers in the preceding September. The declaration calls for the 'implementation of measures for the realisation of the comprehensive economic partnership,

including elements of a possible FTA between Japan and ASEAN, {to be} completed as early as possible within ten years' (ASEAN, 2002).

The summit agreed to establish a committee (AJCCEP) to research relevant issues and to prepare a draft framework for negotiations. This was submitted to the Leaders' Meeting in 2003 and at the 2004 ASEAN Summit agreement was reached that negotiations should commence. The first round of these took place in Tokyo in April 2005. Global Trade Analysis Project (GTAP) model projections suggest that the JACEP would expand trade and promote economic growth amongst member economies, with ASEAN in particular benefiting from enhanced access to Japan's markets. ASEAN exports could expand by US\$20.63 million (over 1999 values) and Japan's GDP could expect to increase by between 1.1 and 2 trillion yen resulting in between 150,000 and 260,000 jobs (MOFA, 2004).

The JACEP is Japan's first regional FTA, although negotiations are underway or have been concluded with core ASEAN 5 members, and represents the central plank of Japan's efforts towards regional economic integration. Moreover, it is officially intended to 'foster the establishment of an East Asian community' (MOFA, 2002a). The relatively long-time frame (ten years) suggests that bilateral EPAs will be utilised as a stepping stone to a regional framework and indeed once (if) EPAs are signed with the majority of ASEAN members, themselves locked into the AFTA, then the jump to a Japan-ASEAN agreement should be relatively straightforward. The JACEP is also seen as a hedge against an over concentration of Japanese business investments in China and as a way to deal with complex rules of origin matters that are not resolved through bilateral FTAs.

The JACEP is thus imbued with significance beyond trade and investment liberalisation and harmonisation. Given that Koizumi's original proposal came hot on the heels of China's offer to ASEAN to create an FTA, the Japanese response must also be viewed in terms of the struggle for, if not hegemony, then pre-eminence in a nascent East Asian economic community. This issue is further explored below.

Japan's policy shift in recent years has resulted in a boom in FTA activity in East Asia. Japan has signed a number of bilateral agreements and is currently working towards a regional agreement with ASEAN member economies. At the same time, considerable and seemingly intractable issues continue to restrain Japan in its negotiations and legitimate doubts exist as to the longevity of this current trend. This is not to dismiss Japan's FTA strategy but any failure to conclude any of the negotiations currently underway will surely question the credibility of its basic economic policy.

### **The rise of China: from threat to opportunity**

Whether or not the rapid growth of the Chinese economy may be seen as a threat or opportunity largely depends on the unit of analysis. While the

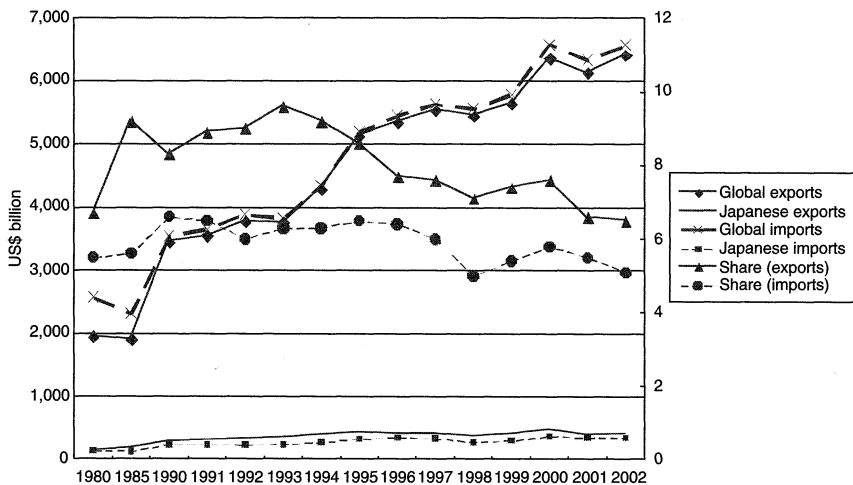
Japan-China trade structure is highly complementary and thus a positive influence on the economic development of both countries, certain sectors of the Japanese economy will undoubtedly lose out to their Chinese counterparts. Japanese consumers may be able to purchase cheap textiles and agricultural products but Japan's strategic position in East Asia is increasingly challenged by an ascendant China.

In general, and notwithstanding a rash of reactive protectionist measures,<sup>20</sup> a consensus has emerged in Japan in recent years that China is more of an opportunity than a threat to the Japanese economy (MOFA, 2002a; World Bank, 2003; *Nihon Keizai Shimbun*, 2003<sup>21</sup>). This section reviews Japan's developing trade and investment relationship with China in addition to examining briefly certain issues in the political economy of the broader relationship between the two nations.

### Japan's global trade

Japan's share of global trade has fluctuated over the past two decades but at 6.5% of exports and 5.1% of imports, returned in 2002 to a level similar to that observed in 1980 before serious yen appreciation and build-up of offshore production (See Figure 4.14). Significant growth in imports following the 1985 Plaza Accord was followed by an equally significant downturn in the mid-1990s as the reality of the collapsed bubble economy took hold. Exports expanded rapidly throughout the 1980s but subsequently followed a downward trend from the early 1990s, with a short rally between 1998 and 2000.

Figure 4.14 Share of Japan's trade in global trade



Source: Compiled from MOF trade statistics.

Japan's major trading partners have remained relatively static over the last two decades reflecting the triadic nature of global trade, yet some movement is observed within this. The USA accounted for a 31.3% share of Japan's exports and a 21.3% share of imports in 2000 declining to 26.1% and 17.4% respectively in 2003. The EU has followed a similar downward trend in exports, from a 16.3% share in 2000 to 15.3% in 2003 but imports rose slightly from 12.3% to 12.8% in the same period (recorded on Table 4.17)

East Asia has expanded its share of Japanese exports from 39.7% to 44.9% while imports from the region also rose from 39.6% to 42.4%. East Asia's growing importance to Japan is examined above in terms of deepening of regional economic interdependence and trade data confirms this trend. The NIEs continue to account for the majority of Japan's exports to East Asia, 52% of the regional total in 2003, while those to the ASEAN 4 have remained constant averaging approximately 18% of the total between 2000 and 2003. China, however, has expanded its share in Japanese exports to the region from just below 16% in 2000 to 27% in 2003.

Imports from the USA, Japan's previously largest trading partner, have fallen year on year from a 19.0% share in 2000 to 15.4% in 2003 while those from the EU have remained steady at between 12 and 13% (see Table 4.18). Within imports from East Asia, which rose from 39.6% in 2002 to 42.4% in 2003, those from the NIEs have dropped from 31% of the total in 2000 to 24% in 2003 while the ASEAN 4's share has also dropped from 32% to 29%. China has increased its share from 37% to 46% in the same period and overtook those from the USA (in value terms) in 2002. Japan's dependency on the Middle East for oil is reflected in the share of imports, 13.3% in 2003, originating from that region. As the Chinese economy continues to grow, the issue of securing energy supplies is likely to assume a prominent position in Japan's relationship with its neighbour (Calder, 1997).

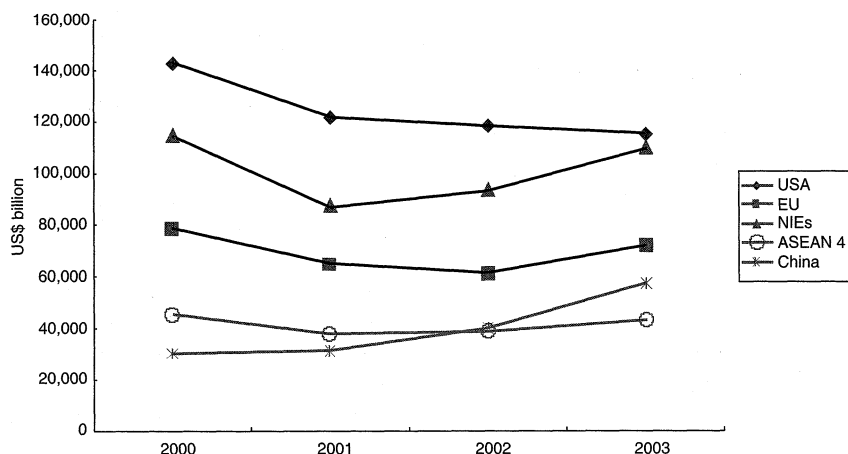
**Table 4.17 Japan's major trading partners – exports**

	2000		2001		2002		2003	
	Value	% share	Value	% share	Value	% share	Value	% share
USA	142,911	29.7	121,712	30.0	118,550	28.5	115,412	24.6
EU	78,486	16.3	64,674	16.0	61,115	14.7	71,893	15.3
Asian NIEs	114,977	23.9	87,879	21.7	94,277	22.7	110,415	23.5
ASEAN 4	45,493	9.5	37,655	9.3	38,841	9.3	43,293	9.2
<b>China</b>	<b>30,428</b>	<b>6.3</b>	<b>31,428</b>	<b>7.7</b>	<b>39,866</b>	<b>9.6</b>	<b>57,219</b>	<b>12.2</b>

Units: US\$ billion

Source: JETRO White Paper on International Trade and Investment, various years.

Figure 4.15 Japan's major trading partners – exports



Source: Nakajima, 2005: 5.

### Japan's trade with China

On the data presented above it is clear that China is assuming a greater role in Japanese trade. Unusually, Japan maintains a persistent deficit in the balance of trade with China, annually averaging approximately US\$17,000 million between 1995 and 2003 (recorded on Table 4.19). However, an examination of the products traded demonstrates the complimentary nature of trade between the two nations as presented in Tables 4.20 and 4.21.

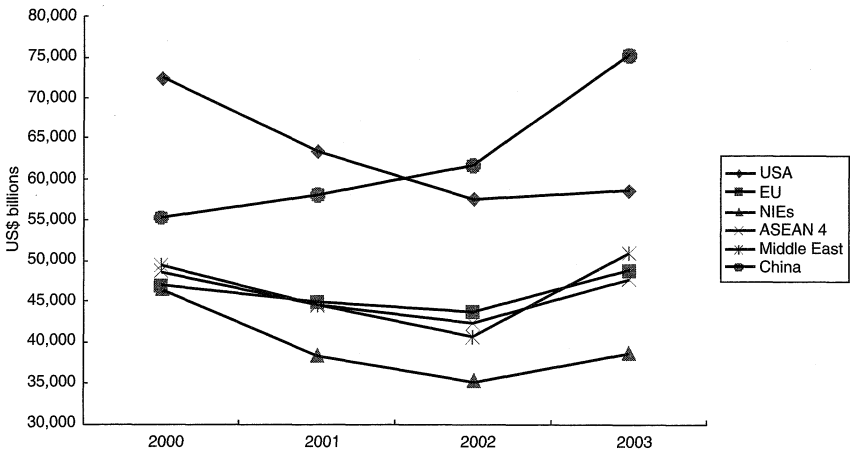
Table 4.18 Japan's major trading partners – imports

	2000		2001		2002		2003	
	Value	% share	Value	% share	Value	% share	Value	% share
USA	72,432	19.0	63,520	18.1	57,634	17.1	58,658	15.4
EU	46,959	12.3	44,804	12.8	43,736	13.0	48,789	12.8
Asian NIEs	46,625	12.2	38,467	11.0	35,387	10.5	38,847	10.2
ASEAN 4	48,843	12.8	44,755	12.7	42,338	12.6	47,751	12.5
Middle East	49,395	13.0	44,581	12.7	40,694	12.1	50,914	13.3
<b>China</b>	<b>55,303</b>	<b>6.3</b>	<b>58,105</b>	<b>7.7</b>	<b>61,692</b>	<b>9.6</b>	<b>75,193</b>	<b>12.2</b>

Units: US\$ billion

Source: JETRO White Paper on International Trade and Investment, various years.

Figure 4.16 Japan's major trading partners – imports



Source: JETRO White Paper on International Trade and Investment, various years.

Exports to China grew by 43.5% in 2003 reaching a record US\$57.2 billion. 58.7% of Japan's exports to China consist of the capital equipment needed to sustain China's industrial boom, namely machinery, and a further 30.8% consists of various industrial supplies (crude materials, mineral fuels, industrial chemicals and metals). The rapid expansion of automobile production in China has added to this increase in trade as Japanese manufacturers expand their operations and capacity. Exports of construction machinery also increased.

Imports from China grew to US\$75,193 million in 2003 up 21.9% on the previous year, which itself was up 6.2% on 2001 figures. Imports of machinery and household equipment grew rapidly in 2003 with computers and other electrical finished products accounting for much of this. It is important to note that reverse exports, particularly in IT products, from Japanese and Taiwanese original equipment manufacture (OEM) suppliers figure prominently in this data.

Japanese trade with China is increasing both quantitatively and qualitatively. Strong demand for capital goods is supported by Japanese multinationals that have relocated production capacity to China and increasing

Table 4.19 Japan's trade deficit with China

	1996	1997	1998	1999	2000	2001	2002	2003
Trade balance	-18,660	-20,281	-16,874	-19,545	-24,876	-27,014	-21,826	-17,974

Unit: US\$ million

Source: JETRO White Paper on International Trade and Investment, various years.

**Table 4.20** Japan's trade with China by sector – exports

Sector	2001		2002		2003		
	Value	Value	YOY % change	Share	Value	YOY % change	Share
<b>Total</b>	<b>31,091</b>	<b>39,866</b>	<b>28.2</b>	<b>100</b>	<b>57,220</b>	<b>43.5</b>	<b>100</b>
<b>Food &amp; direct consumers</b>	<b>165</b>	<b>162</b>	<b>-1.5</b>	<b>0.4</b>	<b>193</b>	<b>19.0</b>	<b>0.3</b>
<b>Industrial supplies</b>	<b>11,908</b>	<b>13,897</b>	<b>16.7</b>	<b>34.9</b>	<b>17,618</b>	<b>26.8</b>	<b>30.8</b>
Crude materials	1,052	1,155	9.7	2.9	1,493	29.3	2.6
Mineral fuels	263	340	29.2	0.9	441	29.4	0.8
Industrial chemicals	3,900	4,916	26.1	12.3	6,540	33.1	11.4
Metals	2,889	3,644	26.2	9.1	4,498	23.5	7.9
Textiles	2,374	2,296	-3.3	5.8	2,652	15.5	4.6
<b>Capital equipment</b>	<b>16,373</b>	<b>21,504</b>	<b>31.3</b>	<b>53.9</b>	<b>33,481</b>	<b>55.7</b>	<b>58.5</b>
Non-electric machinery	6,304	8,343	32.3	20.9	12,758	52.9	22.3
Electric machinery	7,671	10,094	31.6	25.3	15,288	51.5	26.7
Transport equipment	909	1,188	30.7	3.0	2,332	96.3	4.1
<b>Consumer non-durables</b>	<b>222</b>	<b>271</b>	<b>22.1</b>	<b>0.7</b>	<b>360</b>	<b>32.8</b>	<b>0.6</b>
Textiles	136	133	-1.7	0.3	154	15.9	0.3
<b>Consumer durables</b>	<b>1,308</b>	<b>2,327</b>	<b>77.9</b>	<b>5.8</b>	<b>3,076</b>	<b>32.2</b>	<b>5.4</b>
Household equipment	10	14	41.1	0.0	17	20.3	0.0
Domestic electric equipment	51	64	26.6	0.2	97	51.2	0.2
Passenger cars	382	1,184	209.6	3.0	1,444	21.9	2.5
Motorcycles and bicycles	46	50	8.2	0.1	58	15.6	0.1
Toys & musical instruments	377	520	37.9	1.3	723	39.1	1.3
<b>Others</b>	<b>1,115</b>	<b>1,703</b>	<b>52.8</b>	<b>4.3</b>	<b>2,490</b>	<b>46.2</b>	<b>4.4</b>

Unit: US\$ million

Source: JETRO White Paper on International Trade and Investment, various years.

Table 4.21 Japan's trade with China by sector – imports

Sector	2001		2002		2003		
	Value	Value	YOY % change	Share	Value	YOY % change	Share
<b>Total</b>	<b>58,106</b>	<b>61,692</b>	<b>6.2</b>	<b>100.0</b>	<b>75,193</b>	<b>21.9</b>	<b>100.0</b>
<b>Food &amp; direct consumers</b>	<b>6,038</b>	<b>5,932</b>	<b>-1.8</b>	<b>9.6</b>	<b>6,205</b>	<b>4.6</b>	<b>8.3</b>
<b>Industrial supplies</b>	<b>9,895</b>	<b>10,057</b>	<b>1.6</b>	<b>16.3</b>	<b>12,469</b>	<b>24.0</b>	<b>16.6</b>
Crude materials	1,201	1,127	-6.2	1.8	1,245	10.4	1.7
Mineral fuels	2,029	2,023	-0.3	3.3	2,518	24.5	3.4
Industrial chemicals	1,646	1,662	0.9	2.7	2,088	25.7	2.8
Metals	937	958	2.3	1.6	1,568	63.8	2.1
Textiles	1,577	1,575	-0.1	2.6	1,777	12.8	2.4
<b>Capital equipment</b>	<b>13,978</b>	<b>17,627</b>	<b>26.1</b>	<b>28.6</b>	<b>24,328</b>	<b>38.0</b>	<b>32.4</b>
Non-electric machinery	4,620	7,377	59.7	12.0	11,239	52.4	15.0
Electric machinery	7,495	8,221	9.7	13.3	10,353	25.9	13.8
Transport equipment	310	372	20.3	0.6	455	22.1	0.6
<b>Consumer non-durables</b>	<b>18,734</b>	<b>17,610</b>	<b>-6.0</b>	<b>28.5</b>	<b>19,730</b>	<b>12.0</b>	<b>26.2</b>
Textiles	15,338	14,247	-7.1	23.1	16,054	12.7	21.4
<b>Consumer durables</b>	<b>8,203</b>	<b>9,286</b>	<b>13.2</b>	<b>15.1</b>	<b>11,079</b>	<b>19.3</b>	<b>14.7</b>
Household equipment	375	431	15.1	0.7	525	21.7	0.7
Domestic electric equipment	1,918	2,300	19.9	3.7	2,784	21.0	3.7
Passenger cars	1	2	92.9	0.0	3	56.5	0.0
Motorcycles and bicycles	376	478	27.1	0.8	582	21.7	0.8
Toys & musical instruments	2,006	2,153	7.4	3.5	2,457	14.1	3.3
<b>Others</b>	<b>1,257</b>	<b>1,180</b>	<b>-6.2</b>	<b>1.9</b>	<b>1,383</b>	<b>17.2</b>	<b>1.8</b>

Unit: US\$ million

Source: JETRO White Paper on International Trade and Investment, various years.

imports of finished products, IT equipment in particular, are recorded as reverse exports. In spite of the persistent trade deficit, Japan's industrial sector and consumer base benefits from this increased trade. Sluggish domestic demand for automobiles and construction machinery is offset by strong exports of finished products in addition to strong demand for the machinery for manufacture in China. However, the positive nature of this increased Japanese-Chinese trade should not be overstated as imports from China in 2002 accounted for roughly 1% of Japanese GDP and the overall impact of Chinese economic development is limited (MOF, 2002 Committee Report). The challenge for Japan lays not so much in dealing with surging Chinese imports but in its ability to upgrade the domestic industrial structure. Japan at present maintains product differentiation in IT and consumer electronics but as product cycles shorten, competition will become increasingly keen even in those high-end, high-value added sectors where Japan currently retains a competitive advantage.

## **Further trade related issues**

### **FTAs**

As examined above, Japan's basic external trade policy is to pursue a multi-layered approach to trade liberalisation and economic development. The FTA strategy is a key component of this and three China related FTAs warrant attention. The first of these is the political impact of the China-ASEAN FTA proposed by China as part of a comprehensive economic framework agreement in a bold initiative in 2001. It is of no coincidence that Prime Minister Koizumi presented his vision for comprehensive economic relations with ASEAN shortly after China's coup. Even though an agreement between China and ASEAN was signed in 2004<sup>22</sup> and an 'early harvest' programme of agriculture measures was offered unilaterally by China, the agreement essentially remains a paper tiger and will not come into force until 2010, with sensitive issues to be tackled at some undefined point after that. Nevertheless, the agreement caught Japan somewhat off-guard<sup>23</sup> and Japan's promotion of the JACEP is inevitably viewed in the context of Japan and China rivalry and jockeying for leadership in the region.

The establishment of a FTA between Japan and China is so unlikely at the time of writing as to warrant only mention in passing. However, JETRO announced in 2004 the establishment of a joint study group to examine the impact of an agreement and this is due to report in late 2005. Although such an agreement would hold advantages for Japan, politically the possibility of any movement on this front in the near future is remote. A final FTA proposal concerns the establishment of a China-Japan-Korea, or Northeast Asian, FTA. The FTA was proposed by Chinese Prime Minister Zhu Rongji in 2002 and a joint feasibility research project was established

in the same year. At the time of writing, the latest development was that the three heads of state, Premier Wen, Prime Minister Koizumi and President Roh Moo Hyun 'expected to deepen discussions at the academic-level' (MOFA, 2004).

It is probably safe to conclude that, in contrast to the rapid pace of developments at the bilateral level, FTAs between Japan and China, and a wider Northeast Asian FTA will be some time yet in coming. However, as regional economic integration continues apace within East Asia, the rationale to conclude agreements of this nature, or even an East Asian FTA, will become clearer.

### Hollowing out

The surge in Japanese FDI to China has renewed popular fears of a 'hollowing out'<sup>24</sup> of the Japanese economy. However, a more studied approach suggests that the empirical evidence does not support this claim and that the declining share of the manufacturing sector in Japan's GDP may be more correctly attributed to the processes of structural change that constantly motivate economic development (Ramstetter, 2002). Moreover, although it is clearly the case that certain sectors of the Japanese economy are forced to contend with intense competition from Chinese imports; these difficulties are often the result of structural problems within the Japanese economy (Sadao, 2002).

Brief mention should also be made of a number of further issues that are relevant to an examination of the trade and investment relationship between Japan and China. Although China's accession to the WTO was approved in 2001 by the WTO Ministerial Summit, Japanese firms operating in China continue to face a range of difficulties (see Table 4.22), as recorded by the Japan Bank for International Cooperation (JBIC) Survey on FDI (2001).

**Table 4.22 Problems faced by Japanese firms in China**

Issue	%
Legal system*	53.3
Tax system*	42.2
Administrative procedures	34.9
Political and social instability	34.0
Restrictions on equity participation	20.3

Notes: \* response given for a particular aspect of the system, e.g. transparency, instability or complicated nature

Source: JBIC, 2002.

These operational difficulties are in addition to concern over intellectual property rights and copyright infringements, SARS and political friction between Beijing and Tokyo.<sup>25</sup>

### Japan's FDI in China

Japanese FDI in East Asia was examined above. This at first focused on trends in FDI to China in the post-crisis era before considering the motivations of Japanese firms investing in China and other relevant issues. Table 4.23 records Japanese FDI to China between 1990 and 2003.

FDI to China peaked at US\$4,473 million in 1995 then declined year on year until 2000 and has grown each year since then, reaching US\$3,143 million in 2003 (see Figure 4.17). As a percentage of total outflows, FDI to China accounted for 8.8% in 1995, 1.1% in 1999, 11.6% in 2000 and 8.7% in 2003. FDI to China as a percentage of Japan's FDI to East Asia reached 38% in 1995 before falling back to a low 11% in 1999. China's share has been increasing year on year since then and stood at 50% in 2003 reflecting the huge boom in the first years of the twenty-first century and the clear reorientation of investments away from the ASEAN 4 in particular.

### Motivations

What accounts for this swing to China? Since 1995, China has topped the list of the most promising countries for overseas business operations in the JBIC's survey on the overseas business operations of Japanese manufacturing companies (JBIC, 2002). Overwhelmingly, respondents cited the potential for market growth (82.3%) and the inexpensive labour force (74.9%) as the main reasons for this choice. In other words, operations would be based

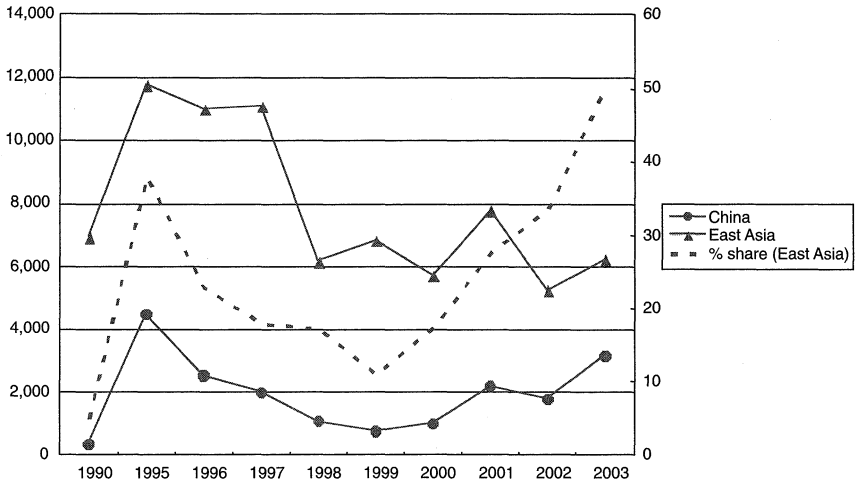
**Table 4.23 Japanese FDI to China**

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total	56,911	50,694	48,019	53,972	40,747	66,694	48,580	38,333	36,858	36,092
China	349	4,473	2,510	1,987	1,065	751	995	2,161	1,766	3,143
% share (world)	0.6	8.8	5.2	3.7	2.6	1.1	11.6	5.6	4.8	8.7
East Asia	6,946	11,763	10,997	11,094	6,169	6,825	5,711	7,786	5,250	6,233
% share (East Asia)	5.0	38.0	22.8	17.9	17.2	11.0	17.4	27.7	33.6	50.4

*Unit:* US\$ million

*Source:* JETRO *White Paper on International Trade and FDI*, various years.

Figure 4.17 Japanese FDI to East Asia and China



Source: JETRO White Paper on International Trade and Investment, various years.

Table 4.24 Japanese FDI to East Asia

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003
East Asia	6,946	11,763	10,997	11,094	6,169	6,825	5,711	7,786	5,250	6,233
China	349	4,473	2,510	1,987	1,065	751	995	2,161	1,766	3,143
NIEs	3,355	3,179	3,539	3,411	1,765	3,198	2,682	2,488	1,961	1,154
ASEAN 4	3,242	4,111	4,948	5,696	3,340	2,876	2,035	2,922	1,523	1,936

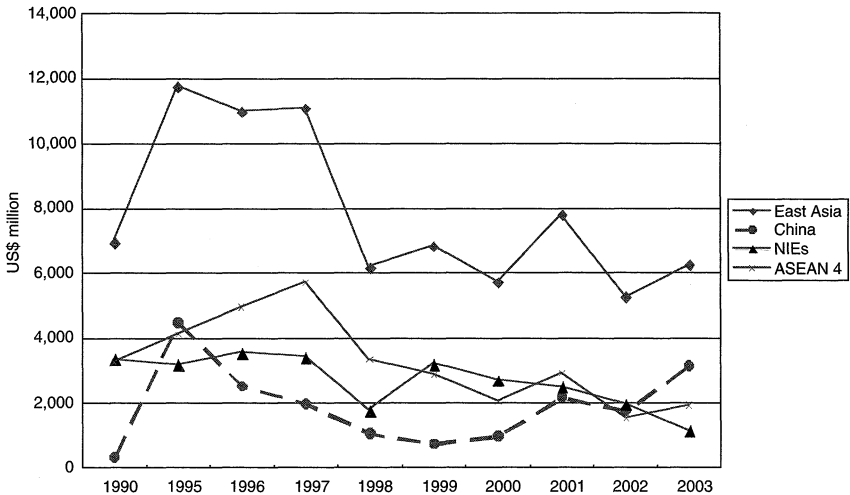
Unit: US\$ million

Source: JETRO White Paper on International Trade and Investment, various years.

on China's comparative advantage in labour costs and market orientated rather than the export orientation that has characterised manufacturing investments in Southeast Asia, the supposedly 'pro-trade' investments identified by Kojima *et al.* The trend of Japanese manufacturing firms locating operations in China is set to continue as 73.9% of respondents to the 2003 survey indicated that they intended to strengthen or expand operations in China, up from 70.1% in 2002. Furthermore, although 61.4% indicated that they had suffered an impact from SARS, 89.0% also responded that this would have no impact on their medium-term business outlook.

The trade and investment relationship between Japan and China continues to deepen although it is important not to overstate the impact of this when put in the context of the overall Japanese economy. The trade structure is complementary with Japanese capital goods exported and consumer

Figure 4.18 Japanese FDI to East Asia



Source: JETRO *White Paper on International Trade and Investment*, various years.

goods, IT equipment in particular, imported and Chinese economic development has had a positive impact on Japan's economy. Prospects for a Japan-China FTA remain remote and current attention remains on the political implications of the China-ASEAN, Japan-ASEAN FTA agreements and proposals. In recent years, Japanese FDI in East Asia has exhibited a strong bias towards China, overtaking those to the ASEAN 4 and the NIEs to account for over half of all FDI in the region. On these two key economic indicators it is clear that the focus of Japanese economic activity in the region continues to shift from Southeast to Northeast Asia; a further key aspect of the transformation of the East Asian political economy.

### Concluding remarks

Japan has played a critical role in the economic development of East Asia in the post-war period. Japanese ODA and FDI have been overwhelmingly targeted at the region and Japan's basic policy stance has been to promote development on the basis of the developmental state concept. Although economic policy has been subservient to political constraints, Japan was able to establish and maintain its position as the region's pre-eminent economic power.

In the post-crisis era of transformation, Japan has demonstrated a greater capacity and willingness to assume a general leadership role and to promote an East Asian vision of regional economic integration. This is demonstrated in its responses to stalled multilateralism (pragmatic, multilayered

trade policy), the AFC (financial initiatives, FTA strategy, promotion of the institutionalisation of regionalism) and by linking regional interdependence with domestic structural reform.

The complementary nature of the Japanese and East Asian economic structure means that East Asian economic development and Japanese economic growth are two sides of the same coin. While an East Asian Economic Community remains firmly in the (distant) future, Japan has an opportunity in this era of regionalism to carve out a central, though not hegemonic, role in East Asia through progressive and pragmatic leadership. In order to achieve this, serious efforts must be made to overcome the difficulties presented by domestic special interest groups representing those sectors of the Japanese economy that would bear the brunt of increasing trade liberalisation. Sidestepping this problem by omitting contentious issues from FTA/EPA negotiations risks undermining this opportunity and would be more detrimental to Japan than to the region as a whole. Japan's leadership ambitions will also be constrained by rivalry with China.

This chapter has briefly reviewed Japan's economic role in and responses to the transformation of the East Asian political economy and represents a further section of the research context. Chapter 5 narrows attention still further from the regional (Chapter 3) and national (Chapter 4) to the corporate.

# 5

## Japanese Foreign Direct Investment in East Asia: The Automotive Sector

Chapter 5 concludes the review of the research context and prepares the ground for the presentation and analysis of empirical data in subsequent chapters. This chapter considers the automotive sector from a global, national and regional perspective. Given the scale and complexity of the automotive sector, these sections do not attempt a business history or comprehensive overview of the myriad issues that may be observed. Rather, the aim is to survey the industries and pertinent trends so as to locate the subsequent presentation of empirical data in the broader, global perspective.

### **Why study the auto industry?**

With the exception of ICT, it is hard to identify any other sector that has had such an impact on modern society as the automotive industry. Its product, the automobile, is one of the most evocative images of modern society. Automobiles have shaped not only our physical landscape (roads, pollution) and societal (commuting, travel) and economic (employment, production, trade) configuration, but also the very means of mass manufacturing and business management (Fordism, Toyotaism).

The automobile industry is also one of the world's leading globalisers though this belies an increasingly regional dimension in production and trade. From its modest beginnings just over a century ago, auto production has emerged as the world's largest manufacturing industry, and now acts as a bellwether for both national and global economies. Indeed, quarterly production and sales figures are analysed with as much intensity as movements in interest rates and are utilised as indicators of consumer sentiment, another critical feature of the capitalist market economy. The automotive industry in the US, for instance, is estimated to account for 5% of private sector employment, 5.6% (US\$243 billion) of private sector compensation and 3.7% of GDP (AAM, 2001).

For a nation to be able to produce an automobile it must first attain a considerable level of technical and industrial competence in a range of

fields. Indeed, the wealth creation effect of the industry has 'profound importance for the industrial development of a country' (Keller, 1997:3). This is particularly so in East Asia. Aside from the economic impact of actual production, the sales and servicing of the vehicle, the oil industry, banking and insurance sectors, a host of other economic actors are dependent on the industry making it 'one of the largest and most important industrial segments in the developed world' (Maxton and Wormald, 1995:78). The share of automotive products in total global trade amounted to 9.9% of imports and exports, and 13.3% of total manufactures (WTO, 2004).

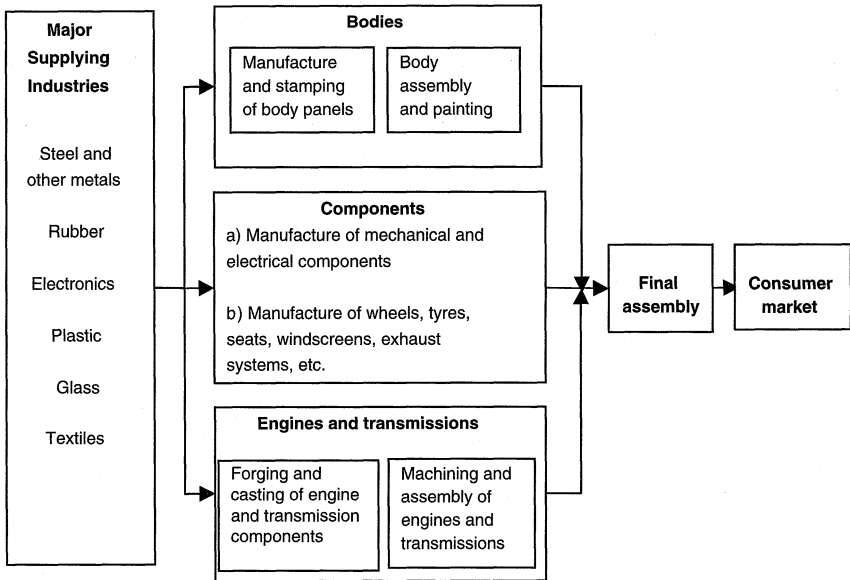
## **Modes of production**

The manufacture of automobiles is one of the most complex processes in modern manufacturing. The finished product is assembled by a relatively small number of firms though this represents only the final stage of production. Automobiles are estimated to require over 20,000 separate components and this has led to the development of a huge supporting industry in the design and manufacture of auto parts. We can therefore distinguish between assemblers<sup>1</sup> (of the final product) and suppliers (of components).

Historically, the industry has moved through three distinct periods of organisational structure: craft production, mass production and decentralisation with coordinated control, and lean production and networking (Wibbelink and Heng, 2000). The initial stage of craft production in Europe and the US soon gave way to a highly centralised and hierarchical form of assembly line-based mass production pioneered by Ford. Fordism, as this mode became known, 'proved to be a more suitable form for incorporating related innovations, developing knowledge and techniques' (Wibbelink and Heng, 2000:12) and led to the transformation of the industry at a time of great social and economic development in industrialised and industrialising economies. Fordism remained the dominant production paradigm for many years but was soon augmented by the managerial and organisational advancements developed by Sloan at General Motors. A key characteristic being the integral production line that allowed for a range of price differentiated autos, in contrast to Ford's Model-T that famously came in any colour so long as it was black, and the creation of managerial divisions coordinated by a central corporate headquarters.

Fordist production represented the global norm in automotive sector industrial organisation throughout much of the twentieth century, yet by the 1960s a new structure began to emerge in Japan. The post-war reconstruction of Japan's industrial base provided an opportunity for the infusion of both new technology and new thinking. The work of statistician W.E. Deming<sup>2</sup> in particular, with its stress on 'quality control', revolutionised Japanese production. During Japan's boom years, Toyota combined

Figure 5.1 The organisation of production



Source: Dicken, 2003: 356.

aspects of Fordist production, Deming's ideas and a nascent concept of human resource management to develop the Toyota Production System, more commonly referred to as 'just-in-time' (JIT) production. JIT or 'lean production' (Womack *et al.*, 1990) is defined as a fundamental rethinking of the production system that shifts attention from 'push' to 'pull'. Simply put, whereas the Fordist model *pushed* materials through the manufacturing process, lean production *pulls*. 'The change involved in going from mass to lean production is...more evolutionary and less revolutionary...more dependent on organisational behaviour than on methods of engineering and technocracy' (Maxton and Wormald, 1995:71).

Lean production has proved to be far more responsive to market demand than alternative structures and has drastically reduced the amount of capital tied up in inventory. A further feature of lean production is its reliance on subcontracting over vertical integration. Where Fordism required in-house production of the majority of components necessary to assemble the car, Japanese manufacturers utilised subcontractors. In order to overcome the challenges that this presented with quality, suppliers were organised into *keiretsu* groupings, accommodating operational and managerial guidance from dispatched executives in return for long-term contracts. Such hierarchical relationships between assembler and the various tiers of suppliers are based less on price and more on performance.

Figure 5.2 Characteristics of Fordist and Lean production

Characteristic	Fordist production (US origins)	Lean production (Japanese origins)
Technology	Complex, but rigid, single purpose machinery using standardised components. Heavy time and cost penalties involved in switching to new products.	Highly flexible. Modular. Relatively easy to switch to new products.
Labour	Very narrowly skilled professional workers design products but production itself performed by unskilled/semiskilled 'interchangeable' workers. Each performs a simple, repetitive task.	Multiskilled, polyvalent workers operating in teams. Several manufacturing, maintenance and repair responsibilities.
Supplier relations	Distant, both geographically and functionally. Large, 'Just-in-case' inventories.	Very close. Tiered system of subcontractors. 'Just-in-time' delivery systems encourage close geographic proximity.
Production volume	Extremely high.	Extremely high.
Product variety	Narrow with only minor modifications.	Increasingly wide range of differentiated products.

Source: Adapted from Jaffee, 2001 and Dicken, 2003.

Indeed lean production, in conjunction with other variables, has underpinned the stunning success of Japanese auto manufacturers since the 1970s. In belated response, US and European manufacturers initiated a period of drastic restructuring throughout the 1980s and 1990s that has resulted in the emergence of a modern, flexible and networked production process operating on a global scale. Lean and networked production also reflects the centrality of the consumer and, together with the implementation of ICT, has led to a drastic shortening of the product cycle (from design to production and market feedback). This phenomenon is not limited to the automobile industry and a similar though more pronounced phenomenon may be observed in the electrical and electronic sectors.

In terms of how production is organised throughout the global automobile industry in the twenty-first century, it is possible to conclude that Western firms have emulated Japanese techniques and that lean production networks are ubiquitous. Differences, of course, exist; relationships with suppliers for example have been shown to vary for American (reliance on price and market discipline) and Japanese (long-term, close relationships) manufacturers (Charoenporn, 2001). The assembler/supplier (tier one) relationship is crucial in facilitating the flexibility in automobile production demanded by local and regional markets. Emerging trends (see below) suggest that the industry could be entering a further distinct stage based on the utilisation of new technology. Attention now turns from production to industry composition. In other words, who the main players are in today's global market.

## Corporate organisation

The industry is dominated by a small number of multinationals with global players as illustrated by Table 5.1. Although a number of independent and/or niche players exist, yet the six leading manufacturers account for 76% of global production (Autopolis). Nationalism still pervades the industry and the capacity to maintain mass production of automobiles is still regarded as a source of national pride. The demise of the indigenous auto industry in the UK<sup>3</sup> has been seen both as representative of the country's relative decline over the past few decades and, conversely, as evidence of a welcome shift from a manufacturing to knowledge-based economy.

**Table 5.1 Top ten vehicle manufacturers by volume and turnover, FY 1998**

Group	Unit Sold 1998 (m)	Rank	Turnover (US\$ billions)	Rank	Brands
GM	8.1	1	126	1	Bedford, Buick, Cadillac, Chevrolet, GMC, Holden, Hummer, Isuzu, Oldsmobile, Opel, Pontiac, Saab, Saturn, Subaru, Suzuki, Vauxhall
Ford	6.8	2	119	2	Aston Martin, Ford, Jaguar, Land Rover, Lincoln, Volvo, Mazda, Mercury
Toyota	5.2	3	109	4	Lexus, Daihatsu, Toyota
Volkswagen	4.6	4	62	5	Audi, Bentley, Bugatti, Lamborghini, Rolls Royce (to 2003), Seat, Skoda, Volkswagen
Daimler Chrysler	4.5	5	111	3	Chrysler, Dodge, Jeep, Maybach, MCC, Mercedes
Nissan <sup>1</sup>	2.5	6	58	6	Infiniti, Nissan
Honda <sup>2</sup>	2.3	7	45	7	Acura, Honda
PSA Peugeot-Citroën	2.3	7	29	10	Citroën, Peugeot
Renault <sup>1</sup>	2.1	9	35	8	Alpine, Renault
Mitsubishi	1.6	10	32	9	Mitsubishi

Notes: <sup>1</sup> Figures are previous to Renault purchasing a 36.8% stake in Nissan

<sup>2</sup> Figures are for 31/03/1998 to 31/03/1999

Source: [www.autoindustry.co.uk](http://www.autoindustry.co.uk), accessed 27/11/2003.

Table 5.2 Growth of automobile production by major countries

	1960		1989		2000	
	Production (000 units)	World share (%)	Production (000 units)	World share (%)	Production (000 units)	World share (%)
USA	6,675	51.4	6,823	19.2	5,636	14.2
Europe	5,902	45.4	13,267	37.4	13,882	35.1
Japan	165	1.3	9,052	25.5	8,100	20.5
Korea	NA	NA	872	2.5	2,361	6.0

Source: Adapted from Dicken, 2003: 358.

Reflecting the triadic nature of the industry, American, Japanese and European (notably German and French) manufacturers dominate the industry. Such national distinctions though are becoming increasingly difficult to define in the face of continuing consolidation (see below). Additionally, automakers operate production facilities on a global basis, often with high rates of localisation making a clear definition of what constitutes a European or Japanese car somewhat difficult. It is useful therefore to concentrate on the geography of production as presented in Table 5.2.

The growth of the Japanese auto industry since the 1960s has been one of the most remarkable trends and is documented in greater detail below. Although Table 5.2 indicates that the percentage of cars produced in Japan has declined somewhat in recent years this is largely due to the relocation

Table 5.3 Passenger vehicles by region (excluding commercial vehicles)

	1997	1998	1999	2000	2001	2002
North America	8,122	8,027	8,256	8,372	7,155	7,346
South America	1,890	1,493	1,345	1,650	1,722	1,671
Europe	13,451	14,522	14,835	14,779	14,939	14,815
Other Europe	2,329	2,410	2,479	2,628	2,435	2,497
Japan	8,494	8,056	8,102	8,359	8,118	8,619
South Korea	2,133	1,625	2,362	2,602	2,471	2,651
Other Asia and Oceania	2,034	1,793	2,086	2,825	2,899	3,413
<b>Total</b>	<b>38,453</b>	<b>37,926</b>	<b>39,465</b>	<b>41,215</b>	<b>39,739</b>	<b>41,012</b>

Note: '000 units

Source: International Organisation of Motor Vehicle Manufacturers, available at <http://www.oica.net/>.

overseas of production plant through FDI. In fact, it is expected that Japanese manufacturers will produce more cars overseas than domestically in the near future. Perhaps more striking is the declining share of autos produced in the US, falling from 51.4% of world share in 1960 to 14.2% in 2000. The emergence of Korean producers in the 1980s is also noteworthy as they grew to account for approximately 6% of world share in 2000.

Approximately 58 million motor vehicles<sup>4</sup> were produced in 2002 as shown in Table 5.3 and the industry is set to expand in the foreseeable future though it is clear that this is highly dependent on the economic cycle and consumer demand. For most consumers, a car is the second most expensive purchase after a house and while there are moves towards more affordable products in the developing world, Tata's \$2,000 car for instance,<sup>5</sup> sales remain linked closely to economic vitality. Furthermore, whereas the mature markets of Europe, North America and Japan, support mainly replacement sales, in other regions of the world, notably Southeast Asia and China, potential growth (new sales) underpins strategy.

**Table 5.4** Leading exporters and importers of automotive products, 2003

	Exports *	Share of world exports **	Imports *	Share of world imports**	Balance *
European Union	371.11	51.3	312.66	42.6	58.45
NAFTA	156.33	21.7	250.47	34.1	-94.14
Japan	102.73	14.2	11.3	1.5	91.43

Notes: \*US\$ billion

\*\* Percentage

Source: Compiled from WTO (2004) International Trade Statistics.

**Table 5.5** Major regional flows in world exports of automotive products, 2003

	Value *		Annual percentage change	
	2003	1995-00	2002	2003
Intra-western Europe	270.6	3	10	21
Intra-North American	94.8	7	6	2
Asia to North America	60.4	7	14	-1
Western Europe to North America	40.8	10	25	13
Intra-Asia	32.4	-2	21	37

Notes: \*US\$ billion

Source: Compiled from WTO (2004) International Trade Statistics.

The triadic structure of production also underscores trade flows (see Table 5.5). Both the European Union and Japan, the two largest producers of automobiles, enjoy considerable surpluses in automotive products while the US, as the core of NAFTA, suffers an equally sizable deficit, just under US\$1 billion in 2003. Approximately 75% of automobile trade in Europe and North America is intraregional in nature, whereas the opposite is true of Asia, highlighting the fact that Asia's (excluding Japan's) market for automobiles remains small. Table 5.4 also notes the relatively small scale of imports observed in Japan. The strength of regional markets and the need for producers to modify products to satisfy local requirements/tastes suggests that the auto industry is more regionalised than globalised.

## **Trends**

Attention now turns to consider a number of trends and issues in the industry.

### **Consolidation**

In recent years, the automotive sector has undergone considerable merger and acquisition (M&A) activity. Although large scale activity has slowed recently (2003) further consolidation cannot be discounted. Daimler Chrysler's relationship with Mitsubishi and the feasibility of an independent Proton for example, are live issues that may result in further consolidation. M&A activity among assemblers boomed between 1996 and 2002 and has recently filtered down to tier one suppliers. Activity in this sector amounted to 61% and 45% of the aggregate value and number of deals for the entire automotive sector, respectively, in 2003 (PWC, 2004). In addition to formal mergers, there has been an increasing trend towards strategic alliances particularly with reference to the development of new technologies such as fuel cells and component sourcing (Dicken, 2003:366). Table 5.1 (above) records the connectedness of global firms.

### **Overcapacity**

Table 5.6 records capacity utilisation rates in the industry as of 2000. In spite of consolidation, the global automobile industry suffers from overcapacity. This situation is exacerbated by the fact that the majority of production facilities are based in mature and cyclical markets with low growth potential. There are areas that invite optimism; East Asia and China in particular, but the rush to initiate or expand production facilities in that country suggests that, even with China's double digit growth rates, the result will be a further and unwarranted increase in global capacity (*The Economist*, 2004). Such misalignment between supply and demand

**Table 5.6 Capacity utilisation and production by region in, 2000**

	Vehicle assembly capacity (m units)	Vehicle output (m units)	Utilisation (%)
NAFTA	19.85	17.17	86.0
Western Europe	20.25	16.57	81.0
Southern and Eastern Asia	24.60	16.30	66.0
Latin America	4.50	2.08	46.0
Central and Eastern Europe and Middle East	5.20	3.45	66.0
Others	1.80	1.15	63.0
<b>World Total</b>	<b>76.20</b>	<b>56.72</b>	<b>72.0</b>

Source: Reinaud, 2001.

adds to deflationary pressures and acute competition. Recent analysis suggests a number of reasons why the industry finds itself in this predicament: unrealistic forecasts of market growth, a need to generate a better return on investment leading to the pursuit of scale economies (greater production capacity), and economic and political barriers to exit (investment in plant, labour, political sensitivity in certain countries) (Autofacts, 2003). This suggests that the industry will enter a phase of rationalisation and already some evidence may be found for this in the East Asian experience of Japanese manufacturers (see below).

### **Technology**

'As we enter the auto industry's second century, we see powerful signs of change that could foretell the next dominant production paradigm. Central to all these changes is the Internet, which is already transforming how information is used and how coordination is managed in this most complex of industries' (IMVP, 2004).

A further trend affecting the auto industry is the utilisation of new technology, most notably alternative energy systems and e-commerce. The cost of developing fuel cells and hybrid engines is considerable and has led to a number of strategic alliances between leading manufacturers including GM and Toyota. The auto industry has also rushed to embrace new technology in IT. E-commerce is set to revolutionise supply chains and hubs, and empower consumers to participate in the production process whereas 'Telematics', that is the concept of regarding the vehicle as an IT/Telecom platform, encourages the development of new relationships between assembler and electronics supplier. Toyota, for example, has adopted Microsoft technology for its vehicle-based information services (*Nihon Keizai Shimbun*, 2003).

The automobile industry continues to exert a huge impact on our modern, capitalist society. Lean and networked production typifies automobile manufacturing which is increasingly driven by short-term, limited run formats dictated by local or regional consumers. Although considered to be a classic example of a globalised and globalising industry, recent movements suggest a more regional focus. Plagued by overcapacity it is likely that further consolidation may accompany a period of rationalisation. It is within this context that attention now turns to consider the Japanese automobile industry.

## **The Japanese automotive industry**

### **Development**

Although the auto industry in Japan can trace its roots back to 1902 (Shimokawa, 1994), any meaningful production of automobiles by domestic firms only emerged in the 1930s. Until this time the market was limited and dominated by imports and domestically produced foreign brands, notably Ford and GM. Yet by 1940, as a consequence of the deteriorating political situation, foreign competitors had withdrawn completely. This development and concomitant implementation of promotion and protection policies by the government encouraged the emergence of the recently established Nissan (1933), Toyota (1936) and forerunners of today's Mitsubishi, Isuzu and Hino. Given the demands of a wartime economy, production inevitably focused on military procurement at the expense of autos to satisfy private demand.

In the immediate post-war period the SCAP administration<sup>6</sup> permitted limited production of commercial vehicles (trucks) but production of passenger cars only recommenced in 1952, roughly coinciding with Japan's quantitative recovery from the war. Subsequently, domestic producers enjoyed strong demand as the economy entered a period of prolonged expansion. This phenomenal growth is reflected in production figures; total production of cars in 1952 amounted to 4,837 but this had risen to 249,508 only a decade later, an increase of approximately 5000% (Japan Automobile Manufacturers Association (JAMA)). Pre-war manufacturers were joined once again by a reformed Mitsubishi<sup>7</sup> and a host of new entrants including Daihatsu, Honda and the forerunner of Mazda.

This was the golden era of industrial policy and MITI exerted considerable efforts to 'guide' the development (rationalisation) of the auto industry. These were mostly resisted, although Prince was merged with Nissan. Perhaps of greater significance was the liberalisation of capital movements in 1965 that permitted access to foreign capital. By the late 1960s, Nissan (including Prince and Fuji) and Toyota (Hino, Daihatsu) dominated the domestic industry while smaller manufacturers, including Mitsubishi, Isuzu and Mazda forged links with foreign (mainly US) firms. Honda's independence remained, as it does today, an exception to this trend.

The first oil shock (1973) slowed to more modest levels Japan's economic growth but also proved to be an opportunity for overseas expansion. In a new,

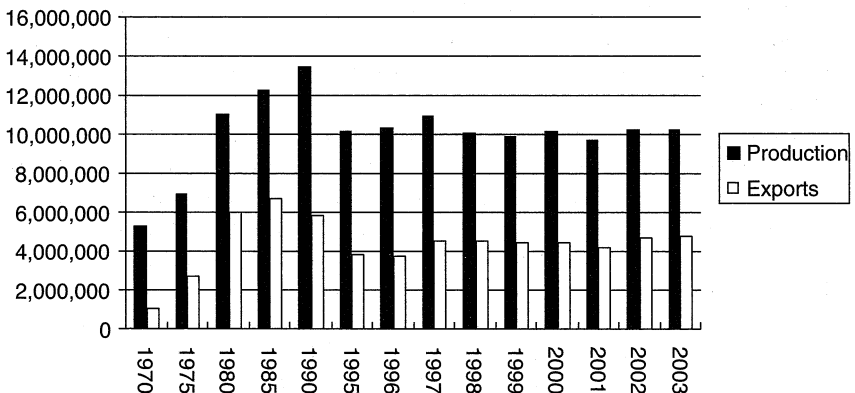
environmentally conscious era governed by high oil costs, Japanese manufacturers of small and efficient cars with growing reputations for quality and reliability found themselves ideally positioned for global growth. By 1977, 51% of domestic automobile production was exported overseas, predominantly to the key markets of North America and Europe. The second oil shock (1979) served to underline this trend and as the American 'big three'<sup>8</sup> and their European counterparts floundered, the remarkable penetration of these markets by Japanese firms inevitably led to trade friction. By 1981, the Japanese government acted to diffuse the situation by negotiating voluntary export restraints (VERs) with Japanese assemblers. The rapid appreciation of the yen following the Plaza Accord (see above), and rising domestic costs created a further rationale for the overseas relocation of production facilities and this trend has continued to the present day as recorded in Table 5.3.

The collapse of the bubble economy in Japan in the early 1990s, or more specifically the collapse in consumption, and renewed yen appreciation led to further pressure on assemblers to reduce costs. Falling profits in the early 1990s led in turn to serve pressure on *keiretsu* group affiliates and the numerous SMEs upon which the *keiretsu* structure exists (Ikeda, 1998). Yet cost and efficiency led restructuring throughout the 1990s coupled with overseas expansion and investment in new technology appears now to be paying handsome dividends. With some notable exceptions, Japanese auto manufacturers are enjoying record levels of production, sales and profit.

### Overseas expansion

The Japanese auto industry is firmly established throughout the global triad and developing world (South America, Africa). Chapters 2 and 3 reviewed the fundamental factors driving global Japanese FDI and documented how investment strategy is geographically contingent. In terms of the global

Figure 5.3 Total domestic production and exports, selected years



Source: Compiled from JAMA statistical database.

triad, the focus of this dissertation is on East Asia yet it is also expedient here to review briefly the activities of Japanese automakers in the key markets of North America and Europe. The East Asian experience receives more in-depth coverage in the following section.

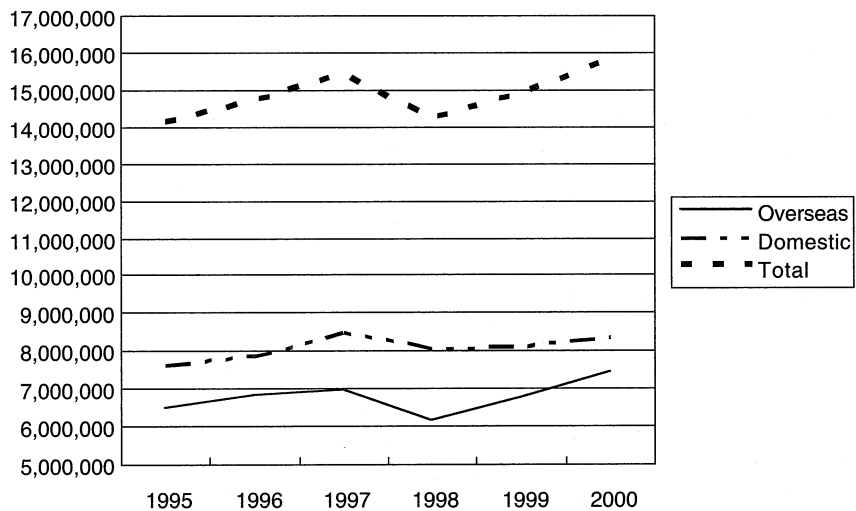
Total production and (domestic) sales of automobiles peaked in 1990 at 13.5 million and 7.5 million units respectively and it is unlikely that these figures will be surpassed in the foreseeable future (see Table 5.7). Demand

**Table 5.7 Total overseas and domestic production, 1994–2002**

	Overseas	Domestic	Total
1994	5,908,054	7,802,037	13,710,091
1995	6,498,938	7,610,533	14,109,471
1996	6,837,626	7,863,763	14,701,389
1997	6,951,657	8,491,440	15,443,097
1998	6,155,846	8,055,763	14,211,609
1999	6,784,007	8,100,769	14,884,776
2000	7,420,881	8,363,485	15,784,366
2001	6,894,547	8,117,563	15,012,110
2002	7,627,186	8,618,348	16,245,534

Source: Compiled from JAMA statistical database.

*Figure 5.4 Overseas and domestic production*

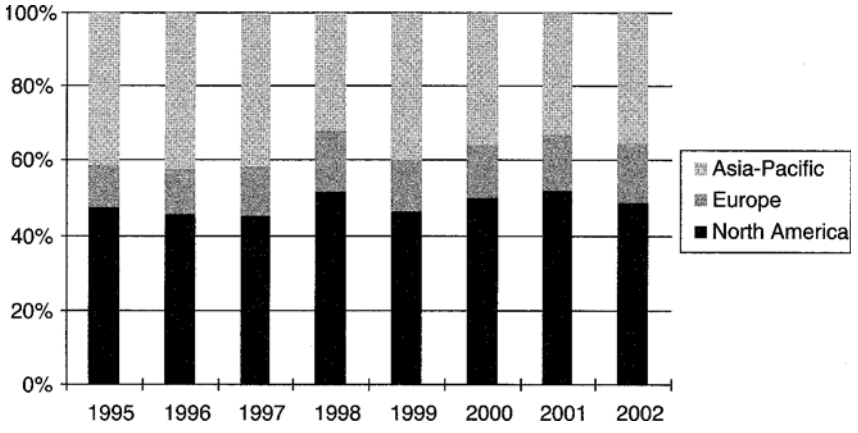


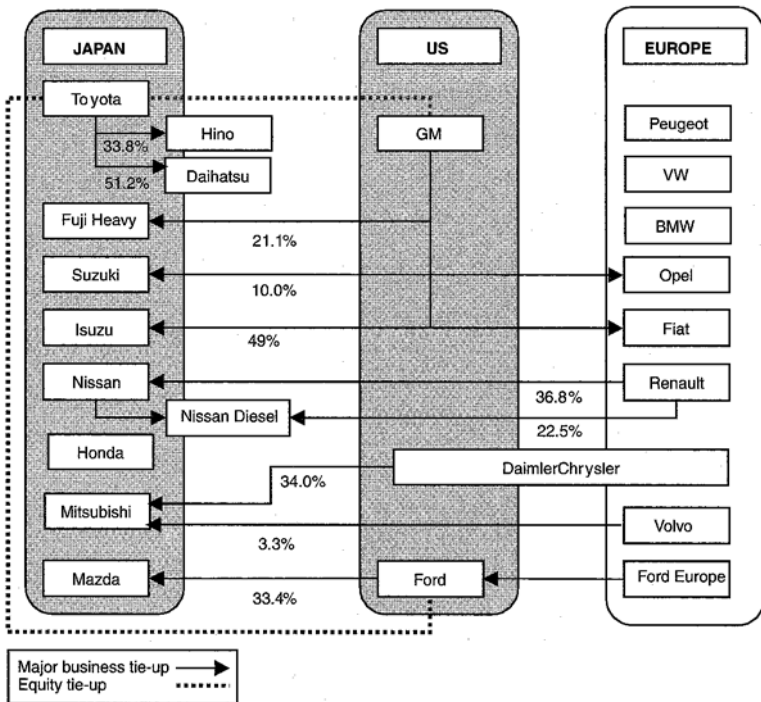
Source: Compiled from JAMA statistical database.

Table 5.8 Overseas and domestic production, 1995-2002

	1995	1996	1997	1998	1999	2000	2001	2002
North America	2,924,482	2,969,660	2,973,822	2,975,537	3,247,225	3,548,228	3,393,889	3,536,703
Europe	684,829	782,381	851,087	953,351	977,059	1,004,873	999,147	1,177,157
Asia-Pacific	2,558,391	2,780,856	2,770,743	1,878,706	2,777,601	2,556,494	2,164,894	2,582,533

Source: FOURIN, various dates. Available at <http://www.fourin.com/jp/index.html>.





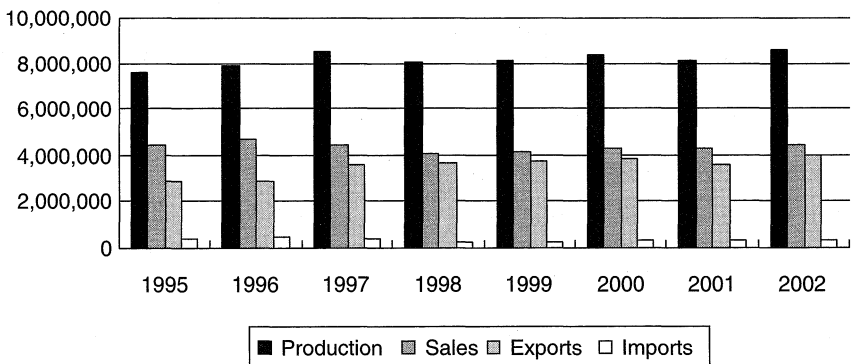
for over 48% of total domestic production, and 53% of exports in 2003. Occupying the second rank are Honda, Mitsubishi, Mazda and Suzuki, together accounting for a further 38% and 37% of total production and exports respectively (JAMA). A third rank is occupied by producers of small or compact models (Daihatsu, Subaru, Isuzu) and two further truck and/or bus manufacturers (Hino, Nissan Diesel).

Clearly, the domestic structure has not experienced consolidation of the scale observed overseas although a number of relationships exist between domestic and foreign companies as recorded in Figure 5.6. Domestically, Toyota includes both Daihatsu and Hino in its group and Nissan has similar relationships with Nissan Diesel and Hino. Tie-ups with foreign firms include Ford's stake in Mazda, Mitsubishi with Chrysler, now Daimler Chrysler, General Motors with Suzuki and Isuzu and Nissan with Renault (see below). Honda is notable for retaining its independence though this has not precluded the company from participating in technical alliances.

### Keiretsu style division of labour

A key characteristic of the industry in Japan is the vertically organised division of labour that relies upon subcontractors for parts and components to a far greater extent than Western firms. In the classic structure, suppliers are into a pyramid of three tiers centred on the assembler. Toyota's supplier network is estimated to have over 10,000 members and is a classic example of the genre. The nature of the close relationship between assembler and supplier has been reported elsewhere (Ito, 1992; Shimokawa, 1994) and although the basic form remains certain pressures have emerged since the mid-1990s to challenge it. These can be summarised as sluggish demand, competition from within and abroad, increased offshore production by

Figure 5.7 The domestic market (cars)



Source: Compiled from JAMA statistical database.

assemblers and, most notably, foreign investment installed management seeking release from *keiretsu* type relationships.<sup>9</sup> Consequently, the supplier industry has experienced severe restructuring (Ikeda, 1998) and currently is in a period of transition (Haak, 2004). A result of this has been a shake-out of the industry, a move to concentrate on higher-value added and increasing offshore production, notably in China (*Nihon Keizai Shimbun*, 2004). Nevertheless, the pyramid structure remains a useful metaphor for industrial organisation in Japan.

### **Foreign investment (inward)**

As noted above, the Japanese auto industry has by and large avoided the consolidation that M&As activity has facilitated elsewhere. However, in recent years a number of high profile tie-ups have occurred between foreign and Japanese assemblers. Renault's effective take over of Nissan (2000) and Daimler Chrysler's assistance to the ailing Mitsubishi Motor Corporation (2001) have had implications far beyond the auto industry. The stunning success of Nissan's CEO, Carlos Ghosn, in turning Nissan around in short order has raised serious issues for the model of Japanese business management in general and has challenged the assumption that Japanese auto-makers have little if anything to learn from their foreign counterparts. With a more inviting investment environment promoted by a government that regards inward FDI as key to promoting structural reform, it is anticipated that this trend will continue.

The automotive industry in Japan is at an interesting conjuncture. The mature domestic market remains depressed and manufacturers have been forced to look overseas for increased sales. Domestic production has not returned to the levels seen in the early 1990s and is unlikely to do so as overseas production steadily increases. The traditional *keiretsu* style structure has been shaken by global competition and foreign investment and component suppliers can no longer be complacent about securing orders from traditional partners. However, the major assemblers appear bullish and have reported record profits in successive recent years on the back of overseas growth and (in no small measure) currency fluctuations. Armed with this overview, attention now turns to consider the role and position of the Japanese automotive industry in Southeast Asia.

### **The Japanese auto industry in Southeast Asia**

This final sector builds upon the overview of the global and Japanese auto industries already presented and narrows the focus to consider the position of Japanese automakers in ASEAN. After a brief statement on regionalism in East Asia, the development of the auto industry in the ASEAN 4<sup>10</sup> and relevant developments in trade and investment policy are reviewed. A final section explores the role and position of Japanese firms in the region, drawing attention to key themes that inform the research process as

presented in Chapter 6. Before we consider the position of Japanese auto manufacturers in East Asia, it is pertinent at this point to clarify once more our terms of reference. Although it is convenient to conceptualise global production, trade and investment in terms of the global triad, with regards to East Asia this suggests a degree of regional coherence and structure that is not yet warranted. Given the formal, legal status of the EU and NAFTA it is reasonable to view these entities as regionally integrated markets yet East Asia remains a diverse collection of independent, national markets.<sup>11</sup> This is certainly the case in the automotive sector for Japan, Korea and China yet increasingly less so for ASEAN, with the caveat of Malaysia noted below.

The deepening of regional economic relations within ASEAN is a key theme of this dissertation and one that informs the research presented in subsequent chapters. It is important to note here that through the implementation of trade and investment facilitating polices, such as AFTA and the AIA, ASEAN has the potential to coalesce and form the basis of an East Asian regional identity as suggested by the global triad concept. The implications of this for the auto and electronics sectors are considerable and are covered below. Attention here, however, is focused on the activities of Japanese auto manufacturers in East Asia or, more specifically, in ASEAN and the Thai market in particular.

In spite of the fragmented nature of the auto market, East Asia is regarded as having very strong growth potential (see Table 5.10). Demand for automobiles is expected to increase in line with rising standards of living, particularly in China. To a certain extent this promising projection is tempered by the fact that the buyer base in East Asia remains limited and

**Table 5.10 Asian vehicle demand projections**

Country	1999	2005	2010
Japan	4,133	4,705	4,792
Korea	703	823	1,095
China	611	1,444	2,402
India	482	874	1,284
Thailand	67	233	494
Taiwan	296	382	426
Malaysia	240	386	580
Indonesia	11	97	170
Philippines	27	115	264
Pakistan	45	64	73
Australia	548	595	693
Others	71	95	116
Grand Total	7,232	9,814	12,389

*Source:* Standard and Poor, 2000.

diffusion rates low but, all things being equal, the market is set to expand both quantitatively (new demand) and qualitatively (higher specification models) in coming years. As investigated below, Thailand is emerging as the *de facto* regional automotive hub for Southeast Asia and exports, both intra and interregional, account for an increasing percentage of production. Japanese makers are maintaining, consolidating and extending their presence while US and European makers, attracted by projected growth are also targeting the region through new investments. China continues to enjoy both high levels of investment and market growth.

## **ASEAN**

The financial crisis had a serious and negative impact on auto production and sales in the region. Production slumped while sales dropped by 70% in ASEAN 4 markets in the first six months of 1998. Yet by 2002 automobile production in the ASEAN 4 had reached 1.4 million units, almost matching pre-crisis levels, and the region had to some extent transformed itself into a major export base. Concomitant liberalisation and promotion of trade and investment facilitating policies have also played a role in radically transforming the regional market. Over time, ASEAN economies have moved from important substitution policies through liberalisation and deregulation to promotion, yet this general trend belies considerable differences at the national level. Thailand and Malaysia in particular warrant attention due to the markedly different strategies employed to develop the automotive sector and the role of Japanese firms within this.

A number of initiatives have emerged from ASEAN in recognition of the fragmented nature of the market and of a need to facilitate economies of scale for auto (and other) manufacturers and associated component suppliers. The Brand to Brand Complementation scheme (BBC) implemented in 1988 was designed to facilitate reciprocal tariff reductions for intra-firm transactions between member countries but was poorly designed, subject to national interpretation and largely unattractive to producers. The scheme was superseded in 1996 by the ASEAN Industry Cooperative Organisation (AICO) parts complementation scheme which attempted to abolish localisation requirements. Under AICO, firms with at least 30% local ownership in member economies were permitted to trade components at reduced tariff rates of between 0 and 5%. AICO may be seen as a precursor to AFTA and has been utilised to varying degrees by Japanese automakers.

AFTA is the latest and most comprehensive initiative to emerge from ASEAN and is designed to 'eliminate non-tariff measures and quantitative restrictions, harmonise customs valuation and procedures, and develop harmonised standards regulations' (ASEAN Secretariat). Under its terms, all tariffs are reduced to between 0 and 5% under the CEPT programme. Thus, ASEAN may be seen to be working towards the development of a single, integrated regional market. Integration of the auto industry is further

underpinned by the establishment of the ASEAN Auto Industry Integration plan. The implications of these initiatives for Japanese automakers form in part the basis for the investigation of corporate strategy presented in Part III and will be returned to at that point.

### **Malaysia**

Malaysia has attempted development of its auto industry through the promotion of a national car project with assistance from foreign players, originally Mitsubishi and more recently Rover. Integral to this project have been policies designed to maintain a high degree of local content and low foreign penetration. This policy has been relatively successful as national automakers (Proton and Perodua) currently dominate the market. However, there are serious questions as to the viability of these firms when the establishment of AFTA is taken into consideration and a key issue for Malaysia has been whether or not to follow its neighbours and fully implement the AFTA in 2003.<sup>12</sup> Implementation would require Malaysia to lower import duties on Completely Built Ups (CBUs) and components from participating countries and would inevitably lead to an influx of higher quality, though perhaps more expensive, competitors. In late 2004, the Malaysian government under pressure from Thailand and Indonesia (in addition to intensive lobbying by global auto manufacturers) agreed to lower import duties to 20%. However, locally produced cars will continue to enjoy a 50% excise rebate while imported cars will face excise rates of between 90% and 250%.

Malaysia recently lost its lead position in auto production and sales to Thailand, the country fast becoming the 'Detroit of Asia' or at least the 'Detroit of Southeast Asia'. Total vehicle production rose to just under 457,000 units in 2002 of which 371,391 (81%) were produced by Proton and Perodua. Both national automakers are expanding production capacity to contend with projected domestic demand and intra-ASEAN exports. However, Malaysian consumers have been reluctant to purchase new passenger cars in anticipation of AFTA and this has been reflected in declining sales in 2003. This issue figures prominently in Mitsubishi's strategy as discussed in Chapter 7.

**Table 5.11 Malaysia market data**

<b>Malaysia 2003</b>	<b>Units/%</b>
Total sales	<b>404,920</b>
Total production	<b>424,107</b>
2002 to 2003 growth	-6.9%

*Source:* Automotive Resources Asia.

## Thailand

In contrast to Malaysia's protection and promotion of an indigenous or national car project, Thailand has recently pursued policies that promote its aim of becoming a regional hub for the automotive industry. The shift to more liberalised policies<sup>13</sup> suggests that the Thai automotive industry may be described as the most open and progressive in Southeast Asia, albeit with a modest domestic market. A number of measures to promote automotive exports have also been enacted including tax breaks and the establishment of designated export promotion zones (EPZ) designed to significantly reduce bureaucracy. In partnership with Japanese firms, Thailand has notably developed a high quality component manufacturing capability and this is seen as one of the key attractions of the country for firms looking to expand their operations in the region.

Today, Japanese auto manufacturers dominate the Thai market though this has not always been the case. American and, to a lesser extent, European firms held commanding positions in the 1960s and 1970s though they gradually withdrew due to domestic economic difficulties and increasing political uncertainty in the region. As the Thai economy surged in the 1980s<sup>14</sup> demand for autos rapidly increased, greatly benefiting Japanese manufacturers some of whom had maintained a presence in the country since the early 1960s. Local content requirements at this time, and a lack of suitable Thai suppliers, obliged Japanese assemblers to construct their own supplier networks and domestic partners were encouraged to undertake FDI into Thailand. Deregulation in the 1990s has encouraged domestic suppliers to improve efficiency and quality though it remains to be seen whether these will be able to compete with Japanese transplants.

Although locally produced vehicles account for approximately 95% of the market, Japanese makers account for 90% of this. However, as indicated above, the long-standing dominance of Japanese firms in Thailand and elsewhere in the region may be challenged by the arrival of US and European firms. These new arrivals may be able to capitalise on the fact that newly constructed greenfield plants will be planned for the regional and export market, rather than the limited national market orientation of existing Japanese plants. Foreign entrants to Thailand in recent years include Daimler Chrysler and BMW.

Vehicle production in Thailand recovered from the crisis in 2002 and continued with strong growth in 2003, reaching 750,512 units in that year. One of the peculiarities of the Thai market is that the one ton pick-up is more popular than passenger cars (Malaysia) or minivans (Indonesia) and production figures reflect this. Out of a total of 584,951 vehicles produced in 2002, passenger cars accounted for 169,321 (29%) while one ton pick-up production totalled 382,297 (65%). Vehicle exports have also increased from 131,032 units in 1999 to 180,554 in 2002 (FOURIN, 2003), assisted by the devaluation of the Thai baht. Major export markets in 2001 were

**Table 5.12 Thai market data**

Thailand 2003	Units/%
Total sales	533,176
Total production	750,512
2002 to 2003 growth	30.2%

Source: Automotive Resources Asia.

Belgium, Japan and Australia. Reflecting the rise in intraregional trade, major markets for the export of components included Japan and Malaysia.

### Japanese auto manufacturers in ASEAN

Japanese auto manufacturers have increased their presence in East Asia through FDI steadily since the 1960s and now operate throughout the region as shown in Table 5.13. Japanese investments in the region since the 1960s translate into a dominating market position today; Japanese firms account for close to 75% of the Southeast Asian market with higher percentages seen in individual markets, notably Thailand. Due to the historical nature of the market and the particular policies pursued by host economies up to the 1990s, Japanese firms have been forced to develop production networks and supply chains to service individual markets. Toyota, for example, produces Corollas in five separate ASEAN nations resulting in inefficient scale economies. In other words, Japanese manufacturers have been unable to realise substantial economies of scale in East Asia that are enjoyed elsewhere. As these restrictions are lifted through enactment of the AFTA, Japanese firms may face a need to rationalise their production networks. This point informed the research process and is returned to in subsequent chapters.

**Table 5.13 Location and year of establishment of production plant**

	Indonesia	Malaysia	Philippines	Thailand	Vietnam
<b>Honda</b>	1977	1967 2000	1990	1993	–
<b>Nissan</b>	2001	1974	1954 1982	1962 1973	–
<b>Mitsubishi</b>	1972 1973	1983	1963	2003	1994
<b>Toyota</b>	1971	1968	1989	1962	1995

Source: Annual reports, various years.

**Table 5.14 East Asian production by Japanese auto manufacturers, 2002**

	Honda	Mitsubishi	Nissan	Toyota
Thailand	67,348 (3)	105,367 (2)	46,626 (4)	139,983 (1)
Malaysia	6,021 (4)	178,997 (1)	16,173 (3)	28,000 (2)
Indonesia	14,055 (3)	75,110 (2)	3,063 (1)	84,307 (1)
Philippines	12,687 (3)	13,127 (2)	6,588 (4)	21,169 (1)
Vietnam	–	2,289 (2)	–	7,138 (1)
China	59,024 (2)	75,314 (1)	49,884 (3)	19,415 (4)
Taiwan	7,893 (4)	93,973 (1)	56,006 (3)	89,262 (2)

*Notes:* Figures in parenthesis represent position among the four companies in the local market.  
*Source:* FOURIN, 2003: 6.

**Table 5.15 Japanese auto production facilities in ASEAN, 2003**

	Indonesia	Malaysia	Philippines	Thailand	Vietnam	Myanmar
Production Plant	10	9	8	7	7	1

*Notes:* JAMA members.

*Source:* Compiled from JAMA statistical database.

Given the dominance of Japanese makers in both production and sales, it is no surprise that the financial crisis of 1997/8 struck particularly hard. Firms were immediately faced with stagnant local demand, distressed subcontractors and idle capacity. A number of responses to this situation were observed including reorienting production for exports, reducing production through shift cancellation and increased investment in local subcontractors and other joint ventures. The timing was particularly unfortunate as FDI had been increasing rapidly since 1995 in response to the rising yen, though this decreased considerably in 1998. However, production of vehicles (passenger and commercial) by Japanese makers had recovered by 2003 to reach 1.47 million units, exceeding the previous production record observed in 1996 immediately prior to the crisis (JAMA). Recovery in Thailand has come faster than in the other two key ASEAN markets, Malaysia and Indonesia, as Japanese firms increasingly focus on Thailand as a regional base.

This chapter has attempted to bring the research context into finer detail. A review of the structure and nature of global auto manufacturing preceded an account of the structure of and trends within the Japanese industry.

This final section has sought to further define and review a number of key dynamics that form the basis for the investigation into the activities of Japanese automakers presented in Part III. These include the implementation of national and regional policies to liberalise and promote the auto industry and attempts to facilitate an integrated regional market. The implications of liberalisation and integration in ASEAN are a key strand of the research; to what extent have these developments impacted on the strategies employed by Japanese automakers?

## **Part III**

# **Responses to Regionalism in the Automotive Sector**

# 6

## Responses to Regionalism: General Strategy and the Organisation of Production and Management in East Asia

The following three chapters report on how three leading Japanese automotive manufacturers are responding to regionalism in East Asia. As outlined in Chapter 1, data was collated through use of questionnaires and interviews held in Japan and elsewhere in the region with corporate executives. This qualitative data is supported by company and industry statistics where appropriate. Chapter 6 first builds upon the industry level overview found in Chapter 5 with a brief overview of the firms surveyed<sup>1</sup> before offering some comment on the construction and nature of the questions asked. The main body of the chapter then reports these responses for each firm before a final concluding section. Both Chapters 7 and 8 follow a similar format. Taken as a whole these three chapters afford a valuable insight into how key actors in East Asia are reacting to the transformation of the region's political economy as outlined in previous chapters.

### Overview of firms surveyed

#### Toyota

The three automotive makers investigated are representative of the broader group of Japanese firms operating in today's markets. Toyota Motor Corporation (TMC) is Japan's largest automaker and has announced its intention of becoming the world's number one in terms of sales in the medium term.<sup>2</sup> The firm was established in 1933 as a subsidiary of Toyoda Automatic Loom Works, Ltd and developed engines from 1934 onwards. Toyota's production system has become synonymous with the concept of *lean* manufacturing, the benchmark for large scale manufacturing activity.<sup>3</sup> Toyota built a reputation for quality and was well placed to capitalise on changing consumer demands in the key US market in the wake of the 1970s oil shocks. Overseas production facilities have expanded steadily and most notably from the 1980s onwards. In more recent years Toyota has been at the forefront of 'hybrid' technology and was the first manufacturer to mass produce a hybrid model (the Prius) in the late 1990s. Cumulative

hybrid sells exceeded one million units in the second quarter of 2007. Toyota also owns the Lexus (luxury models) brand and Daihatsu (compact models) is a half-owned subsidiary. Fortune global 500 recognised Toyota as the world's eighth largest company in 2006.

### **Mitsubishi**

Mitsubishi Motors Corporation (MMC) emerged from the wider Mitsubishi *keiretsu* in the 1970s but can trace involvement in auto manufacturing back to 1917. In contrast to the other firms surveyed, Mitsubishi has had a longer experience of working with foreign partners including Chrysler from 1971, Hyundai in South Korea and the Proton project in Malaysia. The Chrysler alliance early on afforded Mitsubishi the opportunity to expand into the US market where the company's presence grew throughout the 1980s, with the introduction of the Pajero Sports Utility Vehicle (SUV) model being particularly noteworthy. An IPO in 1988 further supported Mitsubishi's global expansion especially in Southeast Asia (SEA) and confirmed both Mitsubishi Heavy Industries and Chrysler as dominating shareholders. Chrysler subsequently disinvested in Mitsubishi throughout the early 1990s although some cooperation continued.

In more recent years, the company has faced serious difficulties including declining market share, severe cash flow problems, and a collapse in consumer confidence following safety scandals and in 2000 Mitsubishi entered into a strategic alliance with DaimlerChrysler. On paper the synergies between the two firms (DaimlerChrysler's strong position in the US and European markets and Mitsubishi's position in East Asia and technology base) suggested that the alliance made good sense yet by 2004 it was effectively terminated when DaimlerChrysler refused requests for additional investment. This experience serves in stark contrast to that observed in the Nissan-Renault alliance.<sup>4</sup> Subsequently the company has been brought back into the broader Mitsubishi group and is working through a radical revitalisation plan to restore profitability and growth. At the time of writing, Mitsubishi remained the only loss making Japanese automaker.

### **Honda**

Honda is Japan's number three automaker and leading producer of motorcycles and is unique among leading Japanese automakers for its relatively small size, range of product lines, and independence. In contrast to the lineage of Toyota and Mitsubishi, Honda's establishment was due to the consistent efforts of its founder, Soichiro Honda, an engineer and maverick who formally headed the company until 1973. The firm emerged in the post-war period as a manufacturer of motorcycles and later moved into engine development before attempting vehicle production in the early 1960s. Although many of its domestic competitors have forged strategic alliances with other Japanese and foreign firms, Honda has remained

stubbornly independent. This independence has not, however, prevented it from working in partnership with other firms (Rover in the UK, for instance). Today, the company maintains three distinct product lines: motorcycles, automobiles and power products which together mean that Honda is the world's largest manufacturer of internal combustion engines. Innovation has also been a Honda hallmark and the company continues to invest heavily in research and design. Illustrative of this is the development of ASIMO, a human like robot, and aerospace projects.

Perhaps more than any other Japanese auto manufacturer, Honda benefited greatly from the events in the US market in the 1970s (the oil shocks, stricter environmental controls and consumer preferences for smaller, more efficient cars) and established production facilities there in 1982. Further global expansion followed in Europe (UK) and East Asia, where the popularity of its power products and motorcycles afforded initial access into developing economies.

### **General strategy and the organisation of production in East Asia**

This chapter draws on interview and questionnaire responses to three main themes: general strategy, East Asian strategy, and management of operations in East Asia. Firms were asked first to outline their general or underlying global strategies and then to describe how these guided operations in East Asia. The objective of this line of questioning was to establish the degree to which global strategy required adaptation to the particular circumstances of operating in the region. The firms were further interrogated as to what factors would influence strategy in the medium term and also the degree of linkage with extra-regional operations. Finally, firms were invited to describe the management of their operations and to comment on how, and why, this might differ from that observed elsewhere.

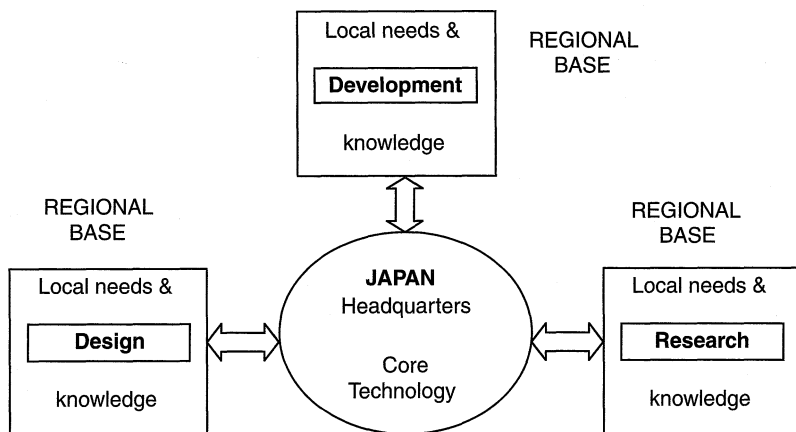
### **General strategy**

#### **Toyota**

Toyota's general strategy was described as *expansionary, regional* and based on the application of *kaizen*. Toyota aims to overtake General Motors (GM), the current number one, to become the largest manufacturer of automobiles in the near term. Quantitatively this equates to a global market share of 15% and production of approximately nine million units by 2010. A central strand of the regional strategy is the International Multi-purpose Vehicles (IMV) project,<sup>5</sup> which has particular relevance to East Asia and is covered in detail below. Regional strategy is further underpinned by objectives in product development and production structure as will be discussed below.

Figure 6.1 demonstrates the regionalisation of product development within Toyota. Central technology will be retained and developed in Japan

Figure 6.1 Toyota's regional product development strategy



Source: Internal Toyota materials obtained at interview, 30/07/03.

while research, design and development of products will be informed by local (regional) needs and knowledge. To this end, R&D facilities have been located in the United States (two), France and Belgium, and more recently (2003) linked centres in Thailand and Australia further underlining the triadic nature of markets and production in the auto industry.

### The IMV project

Launched in 2002 and to some extent in response to the AFC, the IMV project indicates a significant and strategic development. Mirroring general trends among Japanese automakers over the last three decades, global demand for Toyota models was initially met through domestic production and exports. A second phase (1980s onwards) of overseas expansion and localisation followed, though Toyota was a relatively cautious overseas investor at first. This latest phase attempts to move a sizable proportion of Toyota production (500,000 units by 2006, approximately 11% of Toyota's global production at 2002 figures) overseas. ASEAN production bases (Thailand and Indonesia) are central to this strategy. Essentially, the IMV project aims to 'realise global optimal production and supply networks' (Toyota Annual Report, 2003). In other words, Toyota is seeking to capitalise on the trend towards liberalisation, exemplified by AFTA, by rationalising production capacity to realise scale economies and linking global markets. It is suggested that the IMV project could realise cost savings of up to 30%.

It is noteworthy that the project explicitly aims to link production in developing markets (Thailand, The Philippines, South Africa and Argentina) to the 'advanced' market found in Europe. This may be taken as an indi-

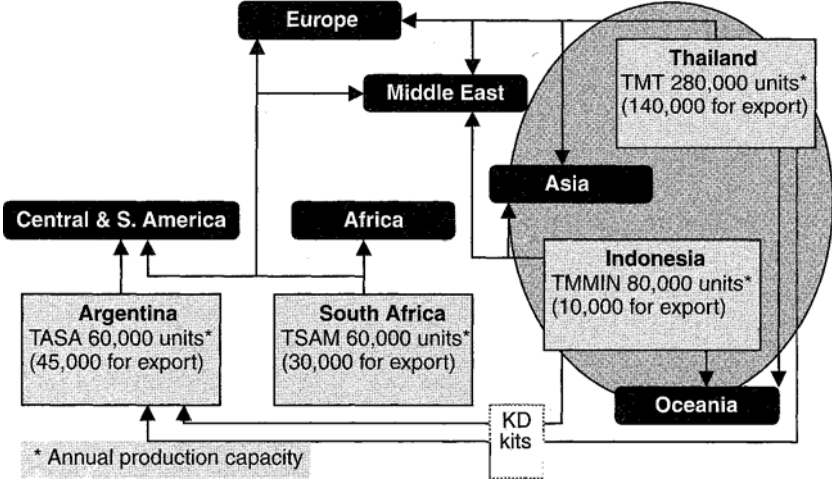


Table 6.1 Main IMV production bases

Country	Affiliate	Production vehicle	Start of production	Annual production	Export destination
Thailand	TMT	Pick-up truck (Hilux VIGO)	August 2004	280,000 units (including 140,000 units for export)	Europe, Asia, Oceania,
		Sport utility vehicle	2005		The Middle East
Indonesia	TMMIN	Minivan	September 2004	80,000 units (including 10,000 units for export)	Asia, the Middle East
South Africa	TSAM	Pick-up truck	2005	60,000 units (including 30,000 units for export)	Europe, Africa, etc.
		Sport utility vehicle	2005		
Argentina	TASA	Pick-up truck	2005	60,000 units (including 45,000 units for export)	Latin America
		Sport utility vehicle	2005		

Notes: Worldwide IMV production including in countries other than the above four is expected to exceed 500,000 units in 2006. TMT: Toyota Motor Thailand Co., Ltd. TMMIN: PT. Toyota Motor Manufacturing Indonesia. TSAM: Toyota South Africa Motors (Pty.) Ltd. TASA: Toyota Argentina S.A.

Source: Toyota promotional material.

the scope of this present paper though reference to the issue here is warranted given the importance of Mitsubishi Motors in East Asia and in the key Thai market in particular.

Looking beyond the immediate survival strategies that the company has been forced to adopt,<sup>9</sup> Mitsubishi's general business strategy is threefold: aggressive *introduction of new models*, pursuance of *strategic tie-ups*, and *rationalisation* in core markets.

*Introduction of new models*: A revamped model line-up is planned for Japan in addition to newly developed global and regional models (Table 6.2). Mitsubishi's financial problems led to a decline in investment in product development (new models) which has led to falling sales of existing (aging) models. As sales are the bottom line in the auto industry, Mitsubishi hopes that the introduction of new models will initiate a virtuous cycle of raising income and greater investment.

*Strategic tie-ups*: Although the relationship with DaimlerChrysler has been truncated, Mitsubishi has sought and continues to seek further strategic tie-ups (though on a limited and relatively small scale) with other manufac-

**Table 6.2 Mitsubishi's new model strategy, 2003**

	2003	2004	2005–2007	Cumulative
Japan	1	2 (1)	11 (6)	14
Europe	3	2 (1)	9 (7)	14
NAFTA	3	4	8 (5)	15
Rest of World	–	2 (2)	10 (5)	12

Notes: Figure in parenthesis denotes common platform with DaimlerChrysler.

Source: Mitsubishi internal documents obtained at interview (28/07/03).

urers. Illustrative of this is OEM supply of cars to Nissan (mini-commercial vehicles, 36,000 units), the Peugeot Citroen Group (SUVs) and negotiations with the China Motor Corp. (Taiwan). By undertaking OEM production for other makers, Mitsubishi is attempting to better utilise production capacity and achieve scale economies.

*Rationalisation:* The third key element of Mitsubishi's strategy is the rationalisation of production and sales networks aimed at cutting excess capacity in Japan, by 20%,<sup>10</sup> the US and elsewhere. The viability of one of the two Australian plants was questioned at interview though at the time of writing, no decision had been taken to disinvest. Perhaps the biggest decision taken by Mitsubishi in this area was to close the Okazaki plant (one of three assembly plants) in Japan<sup>11</sup> and shift production to the Mizushima facility.

## Honda

As examined in Chapter 5, the global auto industry has been undergoing a period of restructuring and a defining feature of the last few years has been the increasing frequency of strategic alliances and mergers. Honda stands in contrast to this trend by fiercely defending its independence and has been able to maintain this through consistently bringing technological innovation<sup>12</sup> to market. Additionally, the motorcycle arm of the company generates a valuable and steady income stream particularly in developing nations such as India, Vietnam and China, and through these operations Honda gains a unique foothold in key markets. The third product line, power products, acts in a similar way by building brand awareness and loyalty. The developing world is often characterised by transition from primary to secondary industries and farmers familiar with Honda pumps, rotavators or outboard motors may be comfortable with the transition to Honda motorcycles, then automobiles.

## Made by Global Honda strategy

Honda's general strategy is underpinned by a basic corporate philosophy that puts stress on developing and marketing innovative and high quality

**Table 6.3 Honda's general strategy**

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**Core elements of Honda's strategy**

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- remain committed to producing close to the customer
  - make efficient use of global resources
  - increase variety of products
  - improve production efficiency
  - increase cost competitiveness
- 

*Source:* Honda promotional material.

products. A second important characteristic is that Honda pursues a policy of producing and developing products in regional markets. This is referred to as 'glocalisation',<sup>13</sup> 'global regions' or 'Made by Global Honda' in Honda material. Honda's general strategy is summarised in Table 6.3.

Innovation has not been restricted to product development and Honda's Global Manufacturing System (GMS) is a crucial component of the *Made by Global Honda* strategy. Toyota's lean production system has set the standard for large-scale manufacturing since the 1970s and Honda's GMS represents a further stage in the development of highly automated, globalised production. GMS is based on the standardisation of production facilities worldwide which allows for greater flexibility in product manufacture. This, coupled with the streamlined platform portfolio (discussed below), means that Honda's ability to adjust production volume, or to introduce new models rapidly, is greatly enhanced. Additionally, investment costs (retooling) are reduced. In an age of shortened product life cycles, such responsiveness and competitiveness are crucial. Honda's general strategy is also expansionary: sales of eleven million motorcycles, 3.4 million automobiles and six million power products, equating to over twenty million customers, were targeted for fiscal year 2004. In fiscal year 2003, Honda achieved global unit sales of eight million motorcycles, 2.8 million automobiles and 4.5 million power products (Honda, 2004:4).

## **East Asian operations**

### **Toyota**

Toyota commenced operations in East Asia in 1964 with a plant in Thailand and expanded its presence throughout the 1980s and 1990s. Most recently significant FDI has been directed to China albeit somewhat belatedly. Japanese automakers play a dominant role in East Asia, China excluded, and within this structure Toyota's position is strongest. Given this dominance an understanding of Toyota's strategies in the region is crucial to any investigation into the East Asian activities of Japanese Multinational Corporations (MNCs).

Three aspects of Toyota's strategy in East Asia may be identified. First, the *rationalisation* of capacity in the region and concomitant development of

Table 6.4 Toyota's East Asian operations

Country	Name	Commenced	Main products	Employees	
China	Tianjin Jinfeng Auto Parts	1997	Steering parts, propeller shafts	400	
	Tianjin Toyota Motor Engine	1998	Engines	730	
	Tianjin Toyota Forging	1998	Forging parts	80	
	Tianjin Fengjin Auto Parts	1998	Continuous velocity joints	270	
	Sichuan Toyota Motor	2000	Coaster, Land Cruiser, Prado	1,150	
	Tianjin FAW Toyota Motor	2002	Vios, Corolla (2004)	888	
	Chang Chun FAW Fengyue Auto	2003	Land Cruiser	245	
	Indonesia	PT. Toyota Motor Manufacturing	1970	Camry, Corolla, Dyna, Soluna, TUV Engines	4,388
		PT. Astra Daihatsu Motor	1992	New small car, Zebra, Taruna, Ceria	1,722
Malaysia	Assembly Services Sdn. Bhd.	1968	Camry, Corolla, Hiace, Hilux, TUV, Vios, Engines	1,652	
Philippines	Toyota Autoparts Philippines	1992	Transmissions, CVJ	718	
	Toyota Motor Philippines Corp.	1989	Camry, Corolla, TUV, Engines	1,242	
Taiwan	Kuozui Motors	1986	Camry, Corona, Corolla, Tercel, TUV, Hiace, Vios	2,826	
Thailand	Siam Toyota Manufacturing	1989	Engines, Propeller shaft	1,266	
	Toyota Auto Body Thailand	1979	Stamped parts	93	
	Toyota Motor Thailand	1964	Camry, Corolla, Hilux, Vios, Wish, Engines	4,360	
Vietnam	Toyota Motor Vietnam	1996	Camry, Corolla, Hiace, Land Cruiser, TUV, Vios	673	

Source: *Toyota and the World*, 2004: 55.

Table 6.5 Production and sales in Asia

Year	Production	Sales
1994	222.7	413.7
1995	259	433
1996	255.1	444.8
1997	246.7	417.9
1998	124.8	229.5
1999	182.1	252.9
2000	248.4	338.9
2001	254.3	342.2
2002	345.7	455
2003	493.1	620.6

Source: *Toyota and the World*, 2004: 54.

Thailand as the regional hub for auto production, second, the *expansion* of market share in key ASEAN markets and third, the *development* of the Chinese market in terms of production and sales.

The IMV project discussed above underpins Toyota's rationalisation efforts in East Asia. IMV production in Thailand and Indonesia builds upon long-term presence in both countries. Toyota initiated production in Thailand in 1964 and has expanded capacity by introducing two further production plants over the years. These now produce the Camry (CKD), Corolla (CKD), Hilux, Soluna Vios (Asian car), Hiace, Land Cruiser, TUV models, diesel engines and other parts. Indonesian operations began in 1970 and now produce Camry, Corolla, Dyna, Soluna, TUV models and petrol engines. Toyota Motor Thailand's (TMT) Gateway plant is now regarded as Toyota's main passenger car production plant in SEA and production capacity currently runs to 300,000 there, more than in any other East Asian country including China. Thailand is also the first ASEAN country to produce a model completely relocated from Japan, in this case the Hilux.

The increasing focus on Thailand as a regional hub (see Table 6.6) and the commencement of the IMV project are largely premised on the implementation of AFTA and the importance of this is considered in detail below.

The second element of Toyota's East Asian strategy, expansion of market share, is being facilitated by the introduction of the so-called 'Asian Cars'. Along with other manufacturers, Toyota has invested in the production of 'localised' regional products. The Vios and the Corolla Altis are Toyota's

**Table 6.6 Toyota's business activities in ASEAN 5 and China**

Indonesia	Malaysia	Philippines	Singapore	Thailand	China
◎○△▲	◎○△▲	◎○△▲	★○	☆◎○△▲◆	☆◎○△▲□

Notes: ★ Headquarters, ☆ R&D centre, ◎ Production sites through FDI, ○ Sales office, △ Parts production site, ▲ Parts export hub, ◆ Vehicle export hub, □ Production site with technical collaboration.

Source: Toyota Annual Reports, various years, FOURIN.

models in this field. Both are built in Thailand and exported to other ASEAN countries, notably Singapore, and Thai exports of the Corolla Altis to Singapore directly replace previous exports of the Japan produced Corolla. The Vios is a development of the Soluna model, a basic saloon, and is only available in ASEAN and China. Both cars are considerably cheaper than comparable models produced in Japan. Through the introduction of these more affordable and localised cars, Toyota hopes to expand market share as the buyer base expands. This is particularly so in Thailand where the one ton pick-up truck remains more popular than standard saloon models. In contemplation of an expanding market, Toyota has been increasing production capacity in recent years in the key markets of Thailand and China.

Toyota is a relative latecomer to the Chinese market but the country now figures strongly in its East Asian strategy and a 10% market share is targeted for 2010. Chinese production of the Coaster and Vios only commenced in 2000 and 2002 respectively. Although Toyota is focusing on Thailand in terms of production, the Thai market is approximately a quarter the size of that observed in China. In pursuit of this, investments into China in recent years have been considerable as recorded in Table 6.8. These investments equate to a total production capacity of 256,500 units in 2002, projected to rise to 345,500 by 2007. Sales in China have been rapid, reaching 98,000 in 2003, a 95% year on year increase.

At the time of interviews in Japan (30/07/04) and Singapore (07/01/04), Toyota retained an optimistic outlook with regards to production and sales

**Table 6.7 Toyota's capacity in 2002 and planned capacity by 2007, selected countries**

	2002	2007 (planned)
10 Asia Pacific	853,000	1,090,000
China	256,500	345,500
Thailand	93,183	320,000

Source: Toyota and the World, 2003 and FOURIN Inc.

**Table 6.8 Toyota's investments in China**

Date	Voting rights	Product
1997	30	Steering parts
1998	50	Engines
1998	90	CVJs, axles, steering columns
1998	100	Forging parts
2000	45	Coaster, Land Cruiser, Prado
2002	50	Vios
	50	Pressed parts
	50	Plastic parts
2003	–	Land Cruiser
2004	90	Stamping dies
2005 (planned)	70	Engines, engine parts
	50	Engines

*Source: Toyota Annual Report, 2004.*

in East Asia. This was largely based on the continued recovery and development of ASEAN markets. The development of production capacity and market share in China and the steady implementation of AFTA were cited as two key factors driving strategy in the region. Additionally, currency fluctuations were identified as an important factor.

## Mitsubishi

In contrast to Mitsubishi's poor performance in Japan and elsewhere, East Asian operations are relatively sound. Mitsubishi is Thailand's leading exporter and a key player in other ASEAN markets. As with other auto-makers, increasing attention has been directed at the Chinese market in the last few years.

Mitsubishi's East Asian strategy (excluding Japan) is based on production in Thailand and China (see Table 6.10). Operations in ASEAN are being consolidated around Thailand as that region's main production centre, and to facilitate this process Mitsubishi reported plans to increase production capacity in Thailand from 126,000 units to 180,000 units by 2005. A stronger focus on Thai operations inevitably suggests the possibility of disinvestment elsewhere in the region and beyond. Symbolic of this greater emphasis on Thailand the local subsidiary, MMC Sittipol, was renamed Mitsubishi Motors (Thailand) Company Ltd. in late 2003; a desire for brand consistency, as Mitsubishi utilises Thai operations for additional exports, was identified as a further rationale for the name change. Recent investments (see below) and announcements pertaining to production organisation suggest that Mitsubishi will aggressively defend its position in ASEAN markets.

Table 6.9 Mitsubishi's East Asian operations

Country	Name	Capitalisation	Stake	Production activities
China	Harbin Dongan Automotive Engine Manufacturing	CNY 500 million	MMC 15.3%, MC 5.7%	Manufacture and sales of engines and transmissions
	Harbin Hatei Motor	CNY 410 million	–	Production and sales of Mirage Dino
	Beijing Jeep Corporation	CNY 1,700 million	–	Production and sales of Pajero, Outlander
	Shenyang Aerospace Mitsubishi Motors Manufacturing	CNY 738 million	MMC 25%, MC 9.3%	Manufacture and sales of engines and transmissions
	South East (Fujian) motor Corporation	USD 91.3million	Taiwan China Motors 50%	Production and sales of Delica and Freeca
	Hunan Changfeng Motor	CNY 323 million	MMC 16.07%	Production and sales of Pajero
Indonesia	MKM	–	MMC 32.3%, MC 32.3%	Manufacture of auto parts
Malaysia	Proton	–	–	Vehicle production
Philippines	Mitsubishi Motors Philippines Corporation Asian	1,640,000,000 Pesos	MMC 51.0%	Lancer, Adventure, L300 Delica, L200 Strada
	Transmission Corporation	350,000,000 Pesos	MMC 84.7%	Manufacture and sales of automotive parts
Taiwan	CMC			Vehicle production
Thailand	Mitsubishi Motors (Thailand) (MMTh)	16,145,000,000 baht	MMC 99.9%	L200 Strada, Lancer
	MMC Engine Co., Ltd.	20,000,000 baht	MMC 99.9%	Engines for Cars
Vietnam	VSM	–	MMC 25.0% MCAH 25.0% Proton 25.0% Local 25.5%	Auto assembly from KD kits

Source: Mitsubishi Facts and Figures, 2004.

Table 6.10 Mitsubishi's operations in ASEAN 5 and China

Indonesia	Malaysia	Philippines	Singapore	Thailand	China
⊙○△▲◆	○△▲□	⊙○△▲◆	○	⊙○△▲◆	⊙○△□

Notes: ★ Headquarters, ☆ R&D centre, ⊙ Production sites through FDI, ○ Sales office, △ Parts production site, ▲ Parts export hub, ◆ Vehicle export hub, □ Production site with technical collaboration.

Source: FOURIN, 2002.

However, one senior executive interviewed in January 2003 was less upbeat about ASEAN operations than the official line presented in the media and indicated that Mitsubishi's overall focus would inevitably be on China. When comparing the two markets (SEA and China), it was emphasised that although SEA markets were growing quantitatively (Thai demand alone expected to reach one million units by 2006) and qualitatively (from pick-up trucks to passenger cars and MPVs), China was already a much larger market and growth there would far outstrip even the most optimistic projections for SEA. It was also suggested that production would be consolidated in China, although the data available at the time of writing and presented here suggests otherwise.

The stated twin-track approach of consolidating production in Thailand and China is further reflected in Mitsubishi's sales strategy for Thailand which is consistent with the general strategy of bringing new products to market. Mitsubishi Thailand referred to its intention to initiate production and marketing of the Grandis (Space Wagon) in 2004, the first overseas production of the model, and the SUV/sedan crossover Outlander in 2003. Mitsubishi pointed to the introduction of these two models as evidence for a shift in focus away from the one ton pick-up truck and towards what Mitsubishi hopes will emerge as a new, discerning customer base.<sup>14</sup> Quantitatively, Mitsubishi is aiming to recover sales in Thailand to 40,000 units in fiscal year 2004/5, representing a 10% market share, and to increase exports to 87,000 CBUs and 21,000 Knock Down (KD) kits. Mitsubishi regards China as a core market and potential regional hub for engine production. To this end, Mitsubishi's presence in the country is expanding at a rapid pace (see below).

In recent years, Mitsubishi's Asian strategy has been developed with reference to the DaimlerChrysler alliance. A key rationale for this was that DaimlerChrysler would benefit from 'greatly expanded access to growth markets in Asia' while a 'great opportunity' was created for Mitsubishi to 'enhance [its] position outside Asia' (*DaimlerChrysler and Mitsubishi Motors to form alliance*. Mitsubishi press release 27/03/00). The effective collapse of the alliance in 2004 has necessitated a major re-evaluation of general strategy but has had less impact in Asia due to the company's traditional strength in the region.

A further characteristic of Mitsubishi's strategy in the region has been its involvement with the Malaysian national car project, the Proton. Without going into fine detail, Mitsubishi became involved in the project in the early 1980s and production of models based on the Lancer commenced in 1985. For Mitsubishi, being involved with the project ensured a ready market for the firm's components, engines in particular, and access to the protected Malaysian market. Yet by 2004 the partnership appeared to have run its course and Mitsubishi Motors entered into negotiations to divest its remaining stake in the project. In some respects Proton has outgrown the need for a supportive parent and the development of the CAMPRO engine and its own platform negate further Mitsubishi involvement. As a result, Mitsubishi was freed to develop its own sales network in the country and Mitsubishi cars will become competitors for the Proton.

A combination of internal and external factors figure prominently in Mitsubishi's strategic planning. Internally, Mitsubishi must deal with the implementation of the revitalisation plan and aim to return to profitability in the short term; this overriding requirement pervades any subsequent planning. As indicated above, Mitsubishi's plan to aggressively introduce new models in key markets, noticeably Thailand, reflects this necessity. External factors were identified as expanding market demand in ASEAN and China and AFTA implementation. These points will be elaborated on below.

Mitsubishi was early to focus production in Thailand for the export market and remains the largest exporter of vehicles from that country (see Table 6.11). Cumulative exports reached 500,000 units in 2003 with export of the Lancer (to Canada) commencing in 1988 and pick-ups in 1996. The Strada one ton pick-up truck is the leading export model and is produced for sale in over 140 countries.

**Table 6.11 Mitsubishi's Thai production and exports**

<b>Mitsubishi Thailand</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>
Total production	83,857 (2)	92,006 (2)	86,663 (2)	105,307 (2)
Passenger car	6,420 (4)	5,406 (5)	5,741 (5)	2,149 (5)
Commercial vehicle	77,437 (1)	86,600 (1)	80,922 (1)	98,116 (1)
Exports	66,988 (1)	63,541 (1)	60,027 (1)	75,581 (1)
Exports as percentage of total production	80%	70%	69%	72%

*Notes:* Figures in parenthesis denote position in market

*Source:* FOURIN Inc.

## Honda

Honda commenced operations in Asia in 1962 with the manufacture of motorcycles in Taiwan. Manufacture of automobiles, motorcycles and power products now takes place in Thailand, Indonesia, Malaysia, the Philippines, Vietnam, China, Pakistan, India, Australia, and Taiwan (see Table 6.12). Although Honda has not achieved a market share proportionate to its size and relative to its competitors in some Asian markets, it is the region's leading producer of motorcycles and currently enjoys a larger market share of automobiles in China than does Toyota.

Honda's strategy in East Asia (summarised in Table 6.3) was described as an application of general strategy at a regional level. Honda noted that each region has its own particular characteristics and that strategy is organised accordingly. Operations in East Asia are divided between Japan, ASEAN and China and the management of these is considered below. With regards to ASEAN, the intention is to develop the region as a supply and export hub in addition to expanding market share in existing and new markets (including CLMV countries). Strategy in ASEAN is informed by regional trading agreements as examined below.

Honda has undertaken considerable investment in recent years to expand capacity, particularly for export operations, and to gain the maximum benefit from the regional division of labour. The focus of their strategy is thus to utilise this expanded capacity as effectively as possible.

With regards to factors influencing strategy over the coming five years from date of interview, Honda's responses may be summarised in terms of *demand*, *production* and the development of *global platforms*.

### Demand

Rising incomes and changing lifestyle preferences were expected to influence consumer demand for SUVs and MUVs (multi utility vehicles). Additionally, competition was forecast to intensify in the region as more automakers develop their operations and new entrants emerge. In order to deal with this challenge, Honda plans to enhance its interaction with customers through human resource development (training), offering a range of products with high local content (thus at more affordable prices) and promoting the safety aspects of their products. Further liberalisation and revision of tax structures was also expected to influence demand.

**Table 6.12 Summary of East Asian (ASEAN) strategy**

- 
- Integrate with global network (autos, transmissions and components)
  - Relocate model production to new factories on a national basis
  - Develop intra-regional trade under AFTA
-

## Production

Within ASEAN, Honda reported that the focus would be on utilising existing capacity at all its production plants and seeking to expand market share. Auto production in Vietnam (City) is due to commence in 2006 and will utilise AFTA to secure components from other ASEAN production centres. Additionally, Chinese operations were expected to rapidly expand in terms of domestic demand and export production. As covered above, Honda's global strategy has been to create a global network based on the GMS and 'globalisation' and East Asian operations are becoming fully integrated with this.

## Global platforms

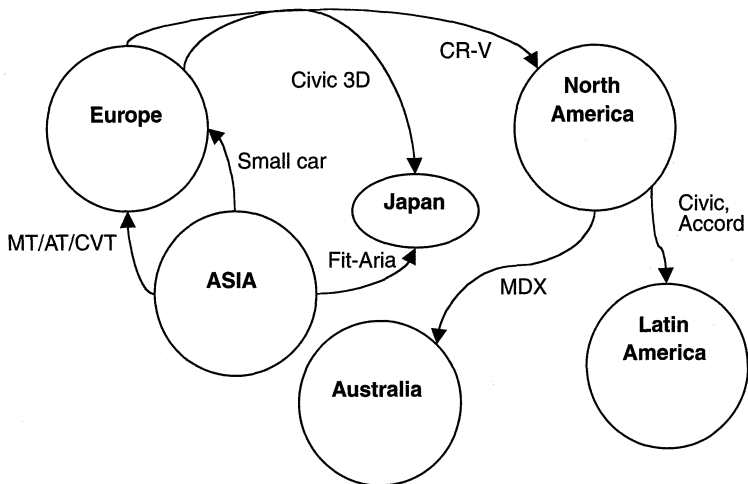
Honda has pursued a strategy of limiting the number of platforms in use and modifying each to local requirements. Honda globally utilises six platforms in contrast to thirteen for Toyota, sixteen at Nissan and Mitsubishi's fourteen. Nissan and Mitsubishi have additionally developed platforms

**Table 6.13 Platform sharing production**

Platform	Country	Model	2002 production	2006 production plan
Small-Max	Japan	Fit	330,877	360,000
	China	Fit-based car	0	50,000
	Thailand	Fit-Aria	0	50,000
	Japan	Civic	79,465	120,000
	Thailand	Civic	20,922	
	Malaysia	Civic	992	50,000
	Philippines	Civic	3,103	
	Indonesia	Civic	n.a.	
Global compact platform	Japan	Stream	76,475	100,000
	Indonesia	Stream	n.a.	40,000
	Japan	CR-V	188,455	200,000
	Taiwan	CR-V	1,131	10,000
	Thailand	CR-V	20,129	50,000
	Indonesia	City	n.a.	0
	Taiwan	City	1,020	0
	Thailand	City	0	0
Accord	Japan	Accord/ Toreno/Viger	124,302	100,000
	Thailand	Accord	6,710	
	Malaysia	Accord	1,015	20,000
	Indonesia	Accord	n.a.	

Source: Compiled from FOURIN, 2003: 29.

Figure 6.3 Global supply network of automobiles



Notes: Excludes exports from Japan MT/AT/CVT: Manual Transmission, Automatic Transmission, Continuously Variable Transmissions.

Source: Based on documents obtained at interview (26/07/03).

with their strategic partners to realise global economies of scale. Models produced in East Asia therefore share common platforms with those produced in Japan and globally (see Table 6.13 and Figure 6.3). Regional operations thus have the potential to become integrated with those elsewhere through the GMS examined above.

Thai produced Fit-Arias are currently exported back to Japan and other models are exported regionally and globally in CBU and CKD form. The expanded transmission plant in the Philippines currently exports approximately 30% of transmission production to the UK.

## Management

### Toyota

Toyota has organised its global operations into seven regions outside Japan: North America, Latin America and Caribbean, Europe, Africa, Middle East and Southwest Asia, Asia and Oceania. Operations in the US are overseen by Toyota Motor North America (TMNA), a wholly owned subsidiary of TMC with a head office in Washington. TMNA is a holding company for Toyota Motor Sales (TMS) and Toyota Motor Manufacturing North America (TMMNA) and also conducts managerial operations including corporate planning and investor relations. A similar arrangement is found in Europe with Toyota Motor Europe (TME), headquartered in Belgium, a wholly

owned subsidiary of TMC. TME is the holding company for Toyota Motor Engineering and Manufacturing Europe (TMEME) and Toyota Motor Marketing Europe.

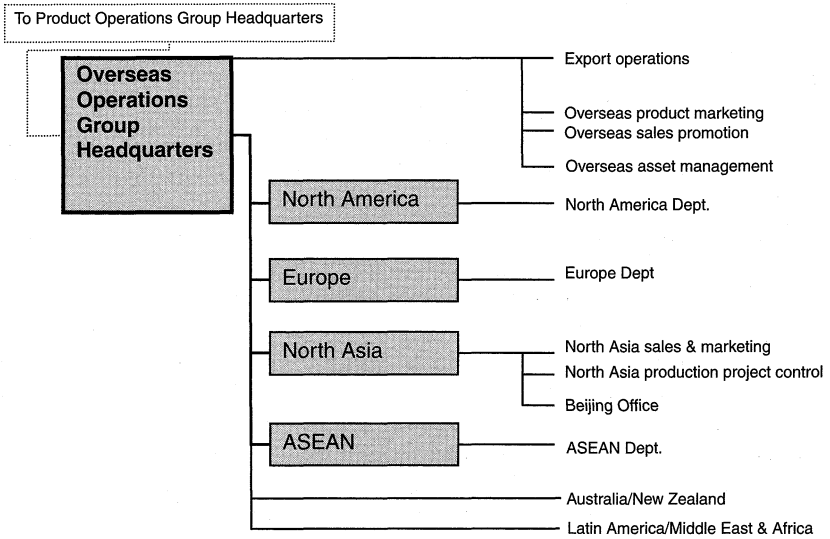
Management in Asia (excluding Japan) was restructured to include China,<sup>15</sup> hitherto a separate entity, in 2001 and is coordinated by Toyota Motor Asia-Pacific (TMAP) which is headquartered in Singapore and 100% owned by TMC. TMAP emerged from Toyota Motor Management Services (TMSS) established in 1990 in recognition of a need for better coordination of activities, parts complementation in particular, in preparation for AFTA implementation. TMSS effectively oversaw production in the ASEAN 4 and thus became a natural entity for the coordination of business activities under AFTA. The key reported objective of TMAP is to manage component procurement to achieve the aim of a 100% localisation rate for ASEAN activities. A second objective is to strengthen sale and marketing capabilities and relevant divisions were established in 2001. In contrast to the more straightforward activities of regional management structures in North America and Europe, Toyota's organisation in East Asia has emerged from an attempt to deal with the complex nature of the regional division of labour. It is anticipated that AFTA will facilitate smoother regional management.

### **Mitsubishi**

Operations in North America are grouped under Mitsubishi Motors North America (Head Office) and Mitsubishi Motors North America (manufacturing) and include MRDA (product design, development and testing), MMSCAN (imports and sales) and MMCA (financing and leasing). A separate entity, MMSC, handles sales in Canada. In Europe, the activities of NedCar in the Netherlands (manufacturing and sales) and Mitsubishi Research and Design Europe (MRDE) are coordinated by a holding company, Mitsubishi Motors Europe (MME) based in the Netherlands. These regional operations are managed respectively by the North American and European offices of the Overseas Operations Group Headquarters<sup>16</sup> based in Tokyo.

Mitsubishi's presence in East Asia includes vehicle manufacturing and/or assembly operations in China (six), Thailand (two), the Philippines (one) and Vietnam (one). Further parts manufacturing plants are located in Indonesia (one) and the Philippines (one). Vehicle production plants also exist in Malaysia (two) but these are related to the Proton project and trucks and will be covered separately below. East Asian operations are centrally managed by the North Asian and ASEAN offices under Group Headquarters but in contrast to the North American and European experience, there are no regional holding companies in either location. The management structure shown in Figure 6.5 was in place in 2004 but was subject to revision under the 2004 (later delayed to 2005) Turnaround Plan.

Figure 6.4 Mitsubishi's overseas management structure, 2004



Source: Mitsubishi materials obtained at interview, 03/02/04.

Figure 6.5 Mitsubishi's revised management structure, 2005

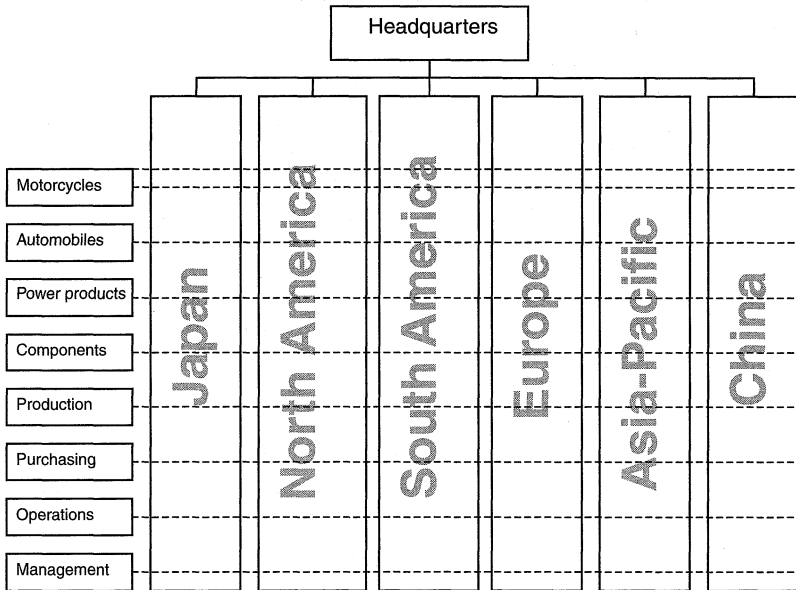
Regional Operations Group HQ (MARKET AXIS)							PX (Product Executive) (MODEL AXIS)
Overseas Operations Group HQ							
	N.A.	Europe	N. Asia	ASEAN	Aus/NZ	S. America M. East	
Development Procurement							Product Operations Group HC Production and Distribution Office Quality Affairs Office
Production Logistics	Responsible for functional optimisation				Responsible for final P/T*		
Quality control							
Sales							

Notes: \* Product launch

Source: Mitsubishi documents obtained at interview.

The above diagram represents the new management structure introduced by the Revitalisation Committee and is intended to clarify authorities and responsibilities, regionally and operationally.

Figure 6.6 Global organisation chart



Source: Honda Annual Report, 2003.

## Honda

Management of Honda's global operations has been organised on a regional basis since the 1990s. With the exception of Japan, each region is headed by a holding company wholly owned by Honda Motor Co., Ltd. (HMC). Honda's global organisation chart is presented in Figure 6.6.

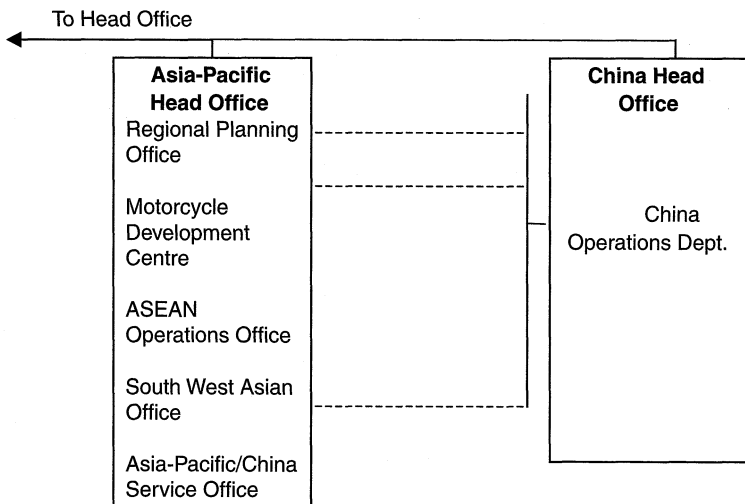
In East Asia, Asian HMC was established in 1996 to coordinate ASEAN operations and is based in Thailand, reflecting that country's dominant position as the largest manufacturing centre in Asia outside Japan. Asian Honda also 'supports and oversees the strategic development and operations of all Honda operations in the region' (Honda Annual Report, 2003). As such, a key aim of Asian Honda as a management structure is to realise regional efficiencies through parts complementation and this office coordinates AICO applications between the ASEAN 4. Principal East Asian subsidiaries are listed in Table 6.14. Asian Honda coordinates all Honda activities across the three main product lines.

The latest addition to the regional structure was established in China in 2004. Honda Motor (China) Investment Co., Ltd. (HMCI) a wholly owned subsidiary plays a similar role to Asian Honda by coordinating strategy and operations throughout China in addition to integrating these operations with the global network. Figure 6.7 shows existing links between the

**Table 6.14 Principal subsidiaries in East Asia**

Country	Company	Activities	Ownership
Thailand	Asian Honda MotorCo., Ltd.	Distribution of Honda products	100%
	Honda Automobile (Thailand) Co., Ltd.	Manufacture and distribution of Honda products	91.4%
	Thai Honda Manufacturing Co., Ltd.	Manufacture of Honda products	60%
	Honda Philippines, Inc.	Manufacture and distribution of Honda products	99.6%
Philippines	Honda Cars Philippines, Inc.	Manufacture and distribution of Honda products	54.2%
Indonesia	P.T. Honda Precision Parts Manufacturing	Manufacture of parts for Honda products	100%
	P.T. Honda Prospect Motor	Manufacture and distribution of Honda products	51.0%
Malaysia	Honda Malaysia Sdn. Bhd.	Manufacture and distribution of Honda products	51.0%
Vietnam	Honda Vietnam Co., Ltd.	Manufacture and distribution of Honda products	70%
China	Honda Automobile (China) Co., Ltd.	Manufacture of Honda products	65%

Source: Honda Annual Reports, various years.

**Figure 6.7 Honda's East Asian operations**

Source: Honda Fact Book, 2002.

Asia-Pacific and China offices and their connection with Head Office (Japan).

## **Summary**

Each of the firms surveyed here are pursuing some form of regional strategy in East Asia that, to greater or lesser degrees, are further being integrated into global networks. These will continue to evolve as firms rationalise existing networks to take advantage of AFTA implementation and begin to consider how their expanding Chinese operations may also link in with those in SEA. Yet there is also evidence to suggest that AFTA implementation may simply recognise and formalise regional networks that have been in place for some time and that its main value may now be more connected with expediting production localisation. This localisation also extends to management and research and design facilities as well as regional products. While both Toyota and Honda continue to regionalise their production operations, Mitsubishi, given the firm's difficult position, is more concerned with rationalisation.

Clearly Thailand has become a central component of East Asian operations for Japanese auto manufacturers and is rapidly approaching the hub status that the government and indigenous industries covet. Already Thailand's gain has meant that other ASEAN countries may have lost out, in terms of attracting and retaining industry, and it remains to be seen what political impact this situation might have on the unfolding regionalist project. It is also clear that Japanese auto manufacturers have, judo-like, seized the opportunities presented by the AFC and that the region as a whole is a net beneficiary of this. Rising exports, deepening localisation and a fundamentally sounder, more consolidated footing for the industry as demonstrated here suggest that both Japanese firms and their host economies are now in a better position from which to face coming challenges. The following chapter now shifts attention somewhat to consider the investment environment.

# 7

## Responses to Regionalism: The East Asian Investment Environment

This chapter builds upon the examination of East Asian strategy, production and management found in Chapter 6 by investigating the nature of the East Asian investment environment as perceived by Japanese auto-makers. Four areas are identified: the AFC, China, investment promotion schemes (namely BBC/AICO and AFTA), and current investment/disinvestment plans. More specifically, questions in these four areas elicited responses on how the crisis had impacted on immediate and more longer-term strategy and also on the position of host governments with regards to inward investment and trade and investment facilitation schemes such as AFTA. Firms were then asked to consider the validity of the assertion that investment in China represented investment lost by ASEAN economies before being invited to comment on new investments in the region and also any planned cases of disinvestment due to a reorganisation of production networks.

### Responses to the Asian Financial Crisis

#### Toyota

Toyota's strategy in the region prior to the AFC was largely dictated by the fragmented nature of the market. Local content requirements in each country necessitated national organisation and resulted in production for, and sales in, limited national markets. Moreover, due to their difficult and limited nature ASEAN-sponsored parts complementation schemes including BBC and AICO were not particularly well utilised.<sup>1</sup> Although the general image of the AFC as a disastrous collapse in output and demand remains valid, the overall impact on Toyota's operations was relatively limited particularly when viewed in a longer-term perspective.

Production in Asia had virtually recovered to 1996 levels by 2001 and had exceeded 1996 levels by 35.5% in 2002 (Table 7.1). However, production in individual ASEAN 4 markets was hit harder and has taken longer to recover (see Table 7.3).

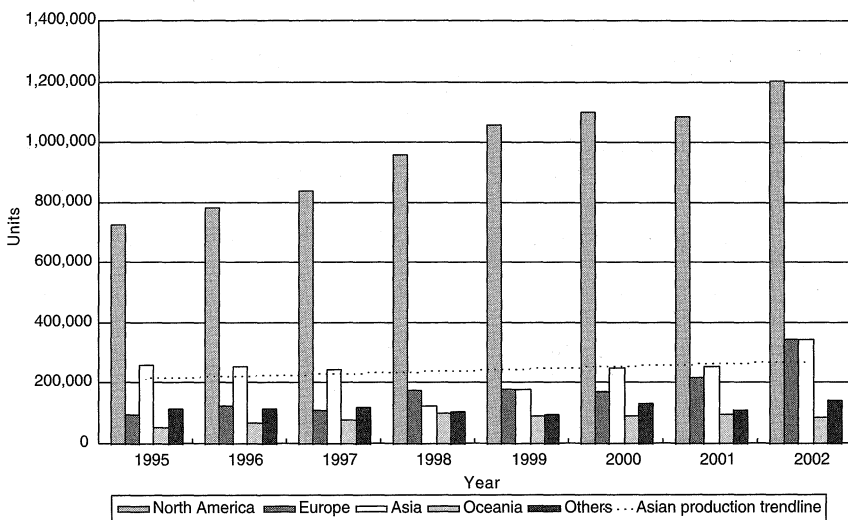
Table 7.1 Toyota's total production, 1995–2002

	Japan	North America	Europe	Asia	Oceania	Others
1995	3,171,300	729,900	95,500	259,000	54,100	114,700
1996	3,410,100	783,000	124,400	255,100	67,600	116,000
1997	3,502,000	838,300	108,800	246,700	77,600	118,800
1998	3,165,800	962,800	175,700	124,800	100,400	103,800
1999	3,118,200	1,061,900	181,500	182,100	91,000	94,600
2000	3,429,200	1,104,000	173,300	248,400	92,400	133,200
2001	3,354,400	1,088,500	217,000	254,300	94,600	108,500
2002	3,485,200	1,205,300	344,600	345,700	86,600	144,900

Asia: Brunei, China, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand, Vietnam.

Source: Toyota Annual Reports, various years.

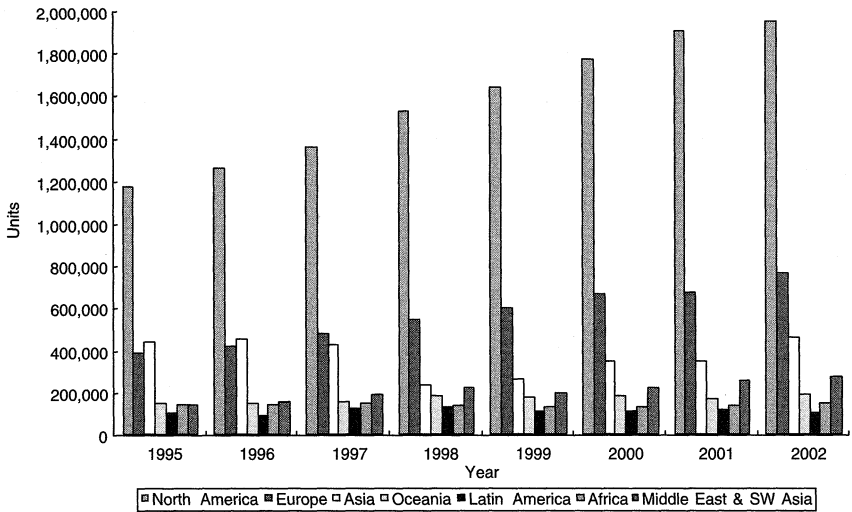
Figure 7.1 Toyota's overseas production, 1995–2002



Source: Toyota Annual Reports, various years.

Sales in Asia decreased from 444,800 units in 1996 to 229,550 in 1998, a decrease of 48% but had recovered to 455,000 units by 2002, representing an increase of 2.3% over 1996. Yet the situation was most severe in ASEAN. Production slumped by 77% between 1996 and 1998 from 290,703 to 66,731 units and had not recovered by 2002, only reaching 273,459 units

Figure 7.2 Toyota's overseas sales, 1995–2002



Source: Toyota Annual Reports, various years.

or still 6% down on figures for 1996. The collapse in sales was more pronounced, dropping by 70% during the crisis years and remaining 10% below pre-crisis levels in 2002 (see Figure 7.2).

The ASEAN 4 accounted for 21.6% of overseas production in 1996 but only 12.7% in 2002 while ASEAN 5 sales in 1996 accounted for 12% of overseas sales but only 7.4% in 2002 as recorded on Table 7.6. During the

Table 7.2 Toyota's Asian and ASEAN 4 production and global share, 1996–2002

	Total overseas production	Asian production	ASEAN 4 production
1996	1,346,000	255,100	290,703 (21.6)
1998	1,467,600	124,800	66,731 (4)
% change 1996–1998	+9%	-51%	-77%
2000	1,751,400	248,400	118,867 (6.8)
2002	2,155,200	345,700	273,459 (12.7)
% Change 1996–2002	+60%	+35.5%	-6%

Notes: Figures in parenthesis represent percentage of total overseas production  
 Source: FOURIN Inc., and author's calculations.

Table 7.3 Toyota's production in ASEAN 4, 1995-2002

	1995	1996	1997*	1998*	1999	2000	2001	2002
Thailand	146,263	149,416 (2)	96,115 (-37)	33,889 (-65)	84,936 (150)	83,145 (2)	90,661 (9)	139,983 (54)
Malaysia	22,333	29,395	29,728	5,558 (-81)	13,966	19,612	22,113	28,000
Indonesia	97,571	75,025	98,350	16,730 (-83)	26,713	89,932	80,486	84,307
Philippines	35,561	36,867	30,977	10,554 (-66)	18,455	18,658	15,873	21,169
ASEAN 4	301,728	290,703	255,170	66,731	120,030	118,867	209,133	273,459

Notes: \* Asian Financial Crisis

Author's calculations

Figures in parenthesis are for year-on-year percentage increase/decrease.

Source: Toyota Annual Reports, various years. FOURIN Inc.

**Table 7.4** Toyota's Asian and ASEAN % sales and global share

	Total overseas sales	Asian sales	ASEAN 5 sales
1996	2,621,800	444,800	314,372 (12)
1998	2,930,000	229,500	93,382 (3)
% change 1996–1998	+11.8%	–48%	–70%
2000	3,382,700	339,300	218,794 (6.5)
2002	3,838,300	455,000	282,761 (7.4)
% change 1996–2002	+46.4%	+2.3%	–10%

Notes: Figures in parenthesis represent percentage of total overseas sales.

Source: FOURIN Inc., and author's calculations.

**Table 7.5** Toyota's sales in selected markets

	1995	1996	1997*	1998*	1999	2000	2001	2002
Asia	433,000	444,800	417,900	229,500	252,900	338,900	342,200	455,000
ASEAN 5	na	314,372	153,523	93,382	146,779	218,794	220,813	282,761
Thailand	na	163,940	107,121	42,661	74,619	71,300	83,514	130,052

Notes: Rounded to nearest hundred

Asia: Brunei, China, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand, Vietnam.

ASEAN 5: Thailand, Malaysia, Philippines, Indonesia, Singapore.

\*Asian Financial Crisis

Source: Toyota *Annual Reports*, various years. FOURIN INC. Inc.

same period, total Asian production increased from 255,100 to 345,700 units though this translates to a decrease in the share of total overseas production from 19% to 16%. In other words, growth in (mainly) Chinese production and sales have helped the region as a whole to recover, while ASEAN's role has been significantly truncated. Although 2004 figures for ASEAN were unavailable at the time of writing, production and sales in Asia had reached 493,100 and 620,600 units respectively indicating continued and sustained growth of the market.

As a result of the AFC, Toyota was faced with three main problems:

- a sudden and acute drop in demand (see Table 7.5)
- overcapacity (see Table 7.3) capacity utilisation dropped to 30% for a period in 1998
- affiliates under severe financial pressure

Toyota responded to these challenges by:

- Suspending production for two months in Thailand. This period was used to retool the production line in accordance with a decision to increase exports as a means of overcoming the problems outlined above.
- Reducing shifts. Toyota consciously made the decision not to close any production plant or to lay off workers but this necessitated drastically reducing shifts.
- Reorientation of production for export. Thailand began exporting the Hilux pick-up to Australia in October 1998, although it is not clear to what extent this was a new development or the accelerated implementation of an existing programme. Exports are also made to Brunei and Singapore (see Table 7.6)
- Injecting new capital into affiliates (2.8 billion baht in Thailand) and other assistance including advance purchasing arrangements and compensation for inventory build-up.
- Agreeing to accept increased numbers for training in Japan and elsewhere.

Although Toyota is the dominant regional producer, it has experienced 'operational difficulties' (interview 30/07/03) in the implementation of parts complementation schemes including BBC and AICO. AFTA implementation was also described as 'patchy' and 'subject to negotiation' (*ibid.*). However, it is clear that there has been a fundamental shift in the policies pursued by ASEAN governments and that Toyota has to some extent based its regional strategy upon this (see Chapters 2 and 3).

Thailand has been the main beneficiary of Toyota's restructuring in Southeast Asia but this has been subject to some negotiation. For instance, Toyota delayed its decision to relocate Hilux production from Japan, the foundation of the IMV project, until Thai authorities made key (favourable) decisions on tax (the Hilux was to be taxed at a higher 4×4 rate rather than the preferential one ton pick-up rate) and dismissed the likelihood of an investigation into allegations of transfer pricing by Japanese MNCs (Automotive Emerging Market, 2002:7) Additionally, Toyota was able to secure certain incentives<sup>2</sup> from the Thai Board of Investment reducing costs by 30%.

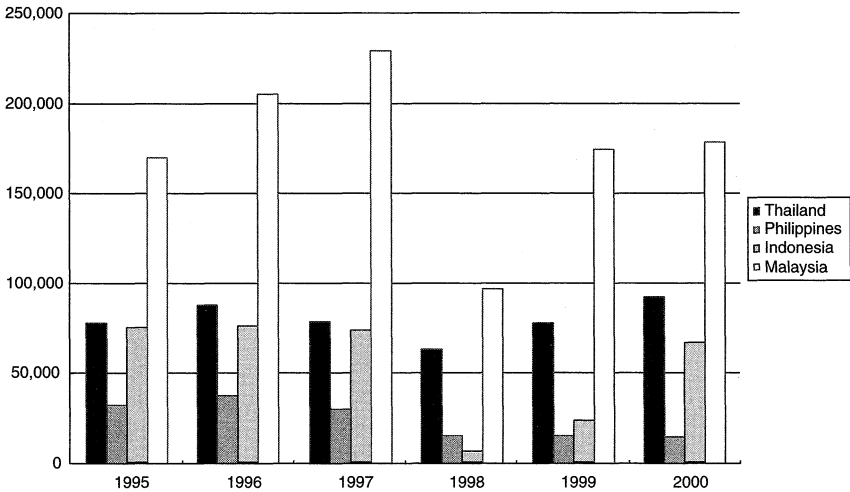
**Table 7.6 Toyota's export of CBUs from Thailand**

	1997	1998	1999	2000	2001	2002
Thailand	1,563	1,819	12,151	16,031	12,028	11,882
YoY % +/-*	na	16	568	32	-24	-1

Notes: \* Author's calculations.

Source: Federation of Thai Industries.

Figure 7.3 Mitsubishi's production in the ASEAN 4, 1995–2000



Notes: Proton production in Malaysia.

Source: Mitsubishi, FOURIN Inc., 2002.

## Mitsubishi

The focus here is on Mitsubishi's reaction to the crisis in Thailand for two reasons. Firstly, once Proton production in Malaysia is stripped out, Thailand is the largest production centre and as noted in the previous section is fast becoming Mitsubishi's regional hub. Secondly, the executives interviewed in Japan and Thailand had particular knowledge of the country. Two key aspects of Mitsubishi's reaction to the crisis are identified: *export-orientated production* and *increased investment*. Figure 7.3 records total production in the ASEAN 4 for reference.

### The shift to exports

The immediate impact of the crisis was to precipitate a collapse in domestic demand. In 1997 domestic sales in Thailand dropped by 53% on the previous year and by a further 55% in 1998 (see Table 7.7 and Figure 7.4).

However, as severe as the collapse in domestic sales was, overall sales remained generally buoyant, if somewhat depressed, throughout the remainder of the decade. As described by Figure 7.4, overall demand was propped up by rapid growth in export sales. This is a key feature of Mitsubishi's reaction to the crisis.

Total production in Thailand reached 87,706 units in the year preceding the crisis but fell away sharply throughout 1997 and 1998 to 62,081 units (as recorded on Table 7.8). By 1999, total production had recovered to 1995 levels and had fully recovered (i.e., exceeding pre-crisis levels) by 2000.

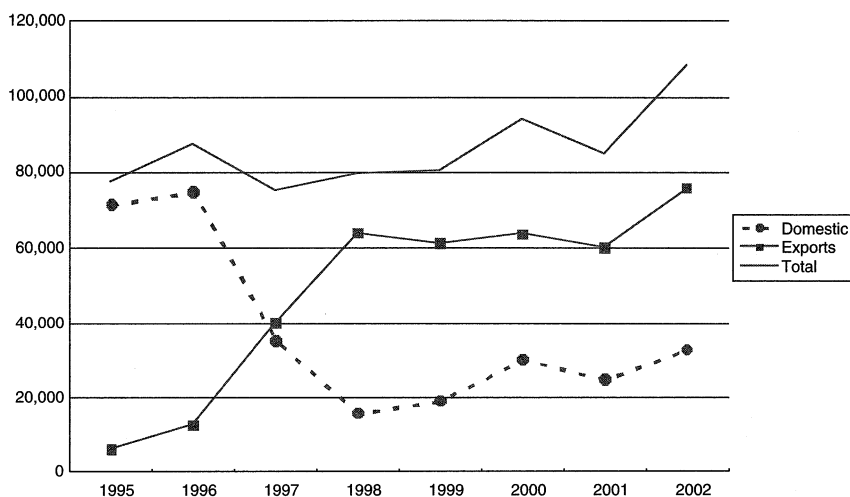
Table 7.7 Mitsubishi's ASEAN 4 sales, 1995–1999

	1995		1996		1997		1998		1999	
	Sales	%	Sales	%	Sales	%	Sales	%	Sales	%
Thailand	71.4	2	74.8	5	35.2	-53	15.8	-55	19.2	22
Philippines	31.7	9	36.5	15	29.6	-19	19.3	-35	15.7	-19
Indonesia	73.7	24	76.3	4	70.1	-8	9	-87	24.4	171
Malaysia	140.6	26	176.1	25	185.2	5	86.5	-53	153.8	78

Notes: Percentages represent year-on-year growth or decline.

Source: Mitsubishi Annual Reports, various years.

Figure 7.4 Mitsubishi's Thai sales, 1995–2002



Source: Mitsubishi Annual Reports, various years.

Within this overall trend, however, the shift from domestic to export-orientated production has been dramatic. 74,483 units were produced for the domestic market in 1996 but as demand collapsed, this fell to just 3,986 in 1999. Even by 2002, domestically-orientated production was only 41% of 1996 levels. On the other hand, exports, which amounted to 13,223 units in 1996 increased to 75,090 by 2002. Exports, therefore, which accounted for 15% of total production in 1996, reached 70% in 2002.

The rapid growth in exports is accounted for by one ton pick-up truck production. Fortunately, the Thai Laemchabang factory had been designated

**Table 7.8 Mitsubishi's Thai production, 1995–2002**

	1995	1996	1997	1998	1999	2000	2001	2002
Domestic	71,962	74,483	36,801	3,986	17,553	28,227	26,870	30,765
Export	5,985	13,223	41,244	58,095	60,304	63,779	59,898	75,090
Total	77,947	87,706	78,045	62,081	77,857	92,006	86,768	105,855

Source: Mitsubishi Annual Reports, various years.

**Table 7.9 Mitsubishi's Thai sales (domestic and export), 1995–2002**

	Model	1995	1996	1997	1998	1999	2000	2001	2002
Domestic	Galant	1,206	946	442	147	15	7	4	1
	Lancer	14,464	19,744	8,803	3,140	4,034	3,696	4,773	7,713
	1T PU	42,890	44,636	23,000	11,286	13,125	24,418	18,759	24,207
	FE/FK/FN	9,758	8,721	2,554	1,075	1,818	1,975	1,205	826
	Delica,	3,108	713	392	192	180	145	129	89
	Pajero								
	Sub-total	71,426	74,760	35,191	15,840	19,172	30,241	24,870	32,836
	Share	12.5	12.7	9.7	11.0	8.8	11.5	8.4	8.0
Exports	Galant	0	0	0	4	0	0	0	0
	Lancer	58	3	3	1,721	3,070	2,416	404	526
	1T PU	6,005	12,547	40,075	59,029	57,692	60,978	59,610	75,040
	FE/FK/FN	0	0	0	2,930	226	146	10	15
	Delica,	0	1	0	117	0	0	0	0
	Pajero								
	Sub-total	6,063	12,551	40,078	63,801	60,988	63,540	60,024	75,581
	Total	77,489	87,311	75,269	79,641	80,160	93,781	84,894	108,417

Notes: No account is given for the small discrepancies in figures between Table 7.8 and 7.9.

Both sets of data are from Mitsubishi sources.

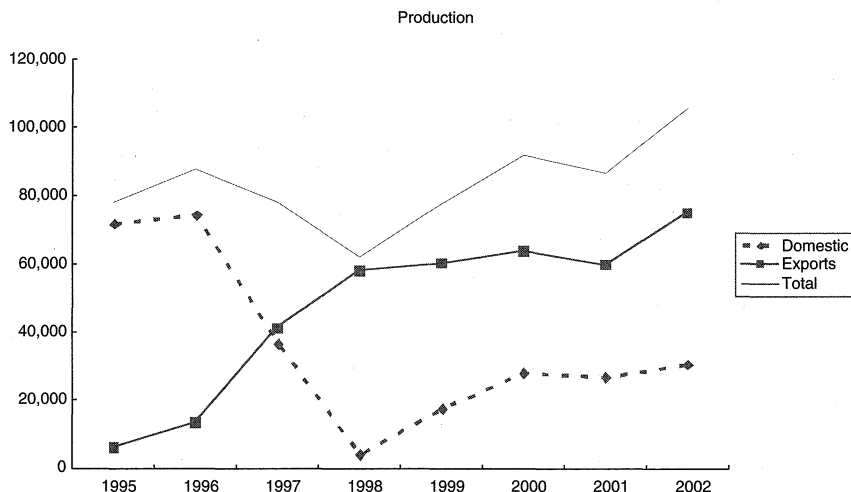
Source: Mitsubishi Annual Reports, various years.

as the global site for production of the Strada (one ton pick-up truck) in 1996 and was thus able to utilise idle capacity as sales of domestic models dropped off. The Strada is now Mitsubishi's leading export model.

### Increased investment

MMC Sittipol faced losses of US\$330 million in Fiscal Year (FY) 1997 which necessitated a bail out from Mitsubishi Motors. Mitsubishi took this opportunity to increase its holdings in the company from 48% to 98%. This came at the expense of the Lee group who had originally been the majority shareholder in the partnership. This change in shareholding allowed Mitsubishi to change the name to Mitsubishi Motors (Thailand) Co., Ltd. in November 2003. This move is reported to have cost Mitsubishi the rela-

Figure 7.5 Mitsubishi's Thai production, 1995–2002



Source: Mitsubishi Annual Reports, various years.

tively modest sum of US\$185 million. Further specific cases of investment in Thailand are reported below. Finally, although Mitsubishi was able to ramp up exports to utilise idle capacity, approximately 1,200 employees were sacked in 1998. However, this action should be seen in the context of global restructuring<sup>3</sup> rather than simply a reaction to the situation in Thailand.

Mitsubishi reported that it is the impact of AFTA rather than the financial crisis that has had most effect on host nation management of inward investment. Apart from Thailand, ASEAN auto producing nations (Malaysia, the Philippines and Indonesia) have been concerned with the question of whether or not indigenous industrial structures can survive. Malaysia's delay in implementing AFTA is the most widely reported manifestation of these concerns but both the Philippines and Indonesia, for varying reasons, have also expressed concerns. Reducing tariffs implies that domestic assemblers and component manufacturers will have to reduce operating costs and raise quality if they are to survive. It is this forced efficiency saving that ASEAN policy makers regard as key to the region's automotive future.

The Philippines introduced the Automotive Exports Program (AEP) in 2003 in an attempt to encourage assemblers to locate CBU production for export in the country. Essentially, the scheme offers a tax credit to assemblers of US\$400 for each CBU exported, although this only applies to exports of 10,000 units per annum.<sup>4</sup> At the time of interview, Mitsubishi had not taken advantage of the scheme but stressed that it would be an

important consideration in future planning. The emerging focus on the Philippines as an export hub for Asian Utility Vehicles (AUVs) suggests that Mitsubishi may utilise the scheme at some point.

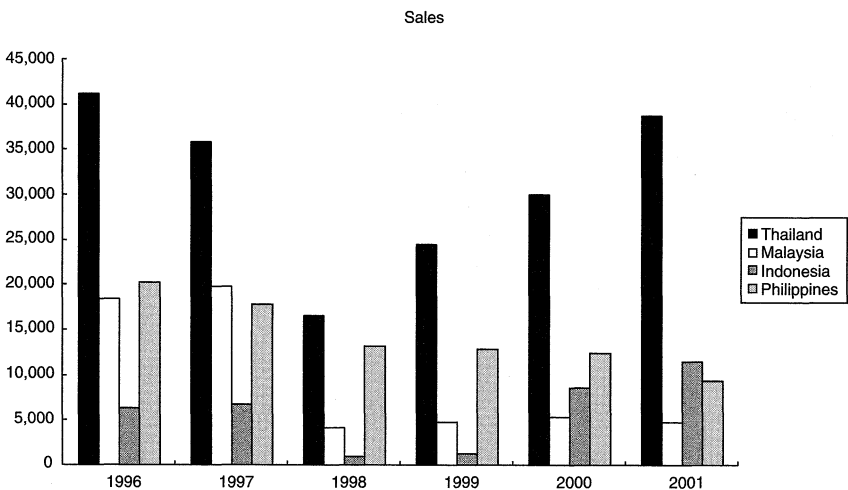
## Honda

As with all automakers, sales of Honda automobiles collapsed in the ASEAN 4 markets during the Asian crisis as recorded in Figure 7.6. Total sales in Thailand fell from 41,285 units in 1996 to 16,559 in 1998 and had not recovered by 2001.<sup>5</sup> With the notable exception of Thailand, sales remained depressed in the remaining markets and progress towards recovery was slow. In addition to the impact of the crisis, Honda found that its market share was decreasing in these markets. It was speculated that the economic downturn discouraged consumers from upgrading vehicles from commercial or semi-commercial vehicles (pick-ups, MUVs) to passenger cars.

Yet, similar to other automakers, the AFC had only a limited impact on Honda's global production output, as illustrated in Figures 7.7 to 7.9, mainly because Asia-Pacific production was relatively modest. This is repeated for sales figures where there was sluggish demand in the domestic market, Japan, was a more important factor than the crisis in explaining depressed overall sales.

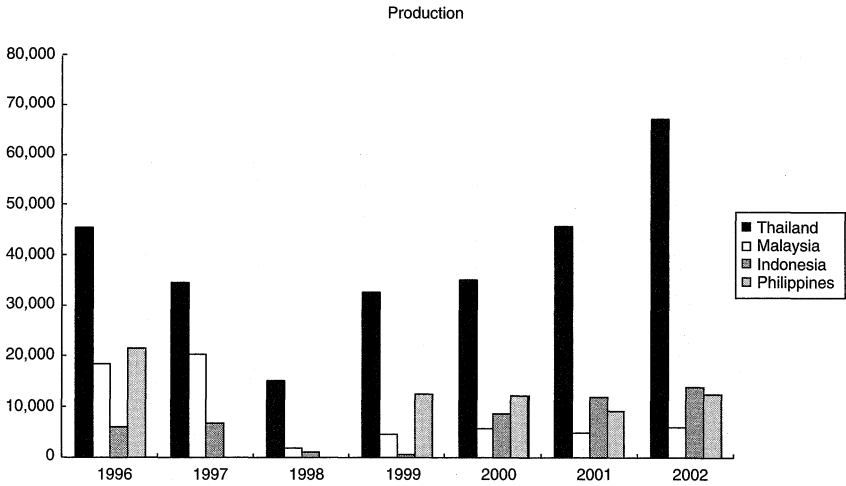
Honda responded to the crisis in two main ways. Firstly, production was refocused to a certain extent on the export market. Honda had commenced exports of the City from Thailand to Singapore and Brunei in July 1997, on

Figure 7.6 Honda's ASEAN 4 sales, 1996–2001



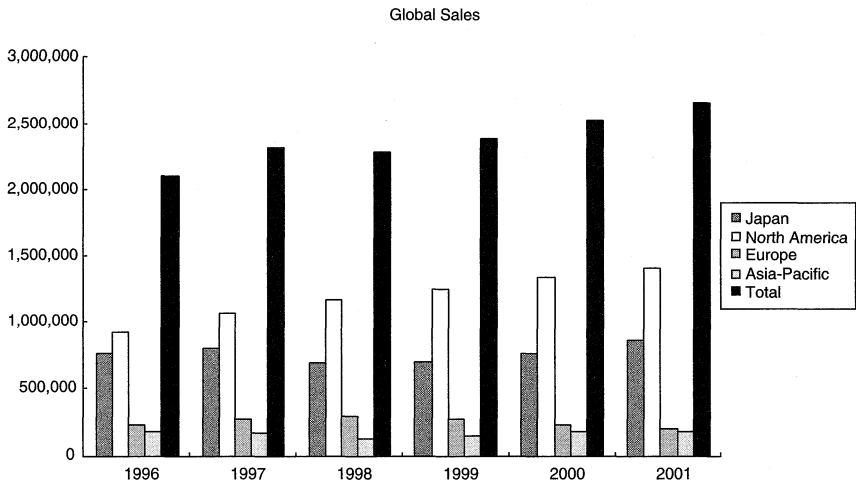
Source: Honda Annual Reports, various years.

Figure 7.7 Honda's ASEAN 4 production, 1996–2002



Source: Honda Annual Reports, various years.

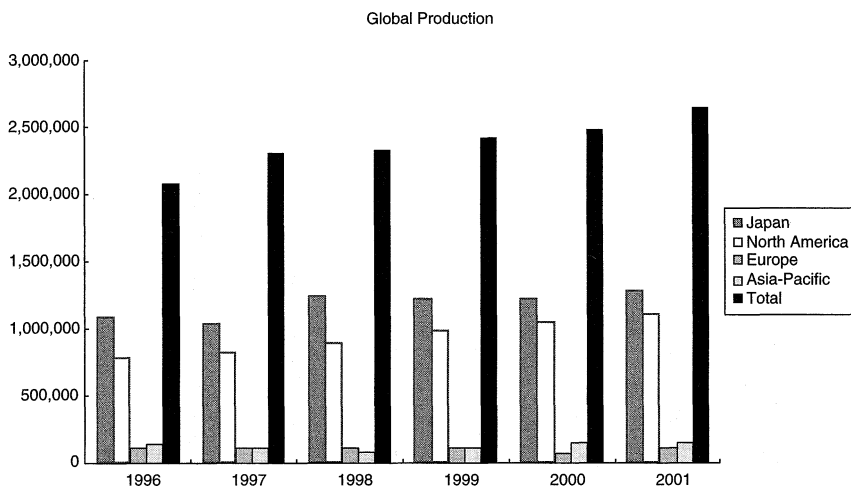
Figure 7.8 Honda's global sales, 1996–2001



Source: Honda Annual Reports, various years.

the eve of the crisis, and this was followed with exports of the Accord to Australia and New Zealand in 1998. Exports of the City to the Gulf states also commenced in 1998 and the Civic to New Zealand in 1999. Thai exports are recorded in Table 7.10.

Figure 7.9 Honda's global production, 1996–2001



Source: Honda Annual Reports, various years.

Secondly, Honda took the opportunity to streamline operations for more efficient and high quality small scale production.<sup>6</sup> Part of this process involved investing in training (sending Thai engineers to Japan) and increasing local content.

In 1997 Honda was perhaps in a better position than most of its competitors to face the challenges of the crisis. This was due to the establishment of Asian Honda in 1996 (headquartered in Thailand) and existing plans to develop Thailand as a regional export hub. In a relatively short time-frame, Honda could thus increase exports and minimise the impact of the crisis.

In response to the question concerning the changing nature of host country attitudes towards inward investment, Honda reported that Thai Board of Investment incentives to promote the auto industry had been somewhat useful for their operations and identified the following specific cases as most relevant:

- Tax exemption on imported machinery
- Local content requirements repealed
- Majority stake in joint ventures allowed
- Reduction in corporate tax

## China

Much has been made of the alleged 'China Threat'. Indeed, this presumption has informed much of the policy debate in the region since before the

Table 7.10 Honda's cumulative export volume from Thailand (baht, millions), 1987-2000

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
	16	153	310	603	1,168	2,298	4,827	9,496	17,102	25,007	34,421	46,123	50,069	75,069

Source: Honda Annual Reports, various years.

onset of the AFC and lies at the heart of ASEAN-led moves towards closer regional economic integration. In contrast to Japan, where in general the debate has moved from China as 'threat' to China as 'opportunity', ASEAN is predominantly concerned with the erosion of its comparative advantages in manufacturing industries. Yet the debate is somewhat different in the automotive sector given the nature and scope of the industry, as reviewed in Chapter 5. The following section records responses to the questions that asked whether investment in China could be seen as investment lost by ASEAN.

### Toyota

As noted above, Toyota is a relative latecomer to the Chinese market and currently has approximately 3% of market share, behind the smaller Honda (5%). Toyota has reported its intention to aggressively increase market share to 10% by 2010 and is employing a number of strategies to facilitate this. Toyota's investments in China have been rapid and substantial, including US\$461 million announced in 2004 to produce the Camry<sup>7</sup> in a new Joint Venture with Guangzhou Auto (Table 7.11). To date, Toyota's main partner has been the FAW group and this diversification may indicate a desire by Toyota to mitigate risk.

Toyota also plans to produce one of its latest designs, the Prius (hybrid), in China and this would be the first overseas production of the model. This contrasts with the production of the Vios, modelled to be more cost attractive for the Asian market, in Thailand and may be explained with reference to the late entry (and therefore new capacity) of Toyota in China and the market's potential.

However, Toyota's general response to the question suggests that there is little or no evidence to support the hypothesis that Toyota's investment in China is investment lost by ASEAN. The rapid expansion of the Chinese market means that there is little spare production capacity and that any further investments will also go to meet future demand. Strategy in China

**Table 7.11** Toyota's recent investments in China

Date	Investment	Partner	Module/part	Market
2004	US\$461 million	Guangzhou Toyota Motor Co., Ltd. (GTMC)	Camry	Domestic
2004	5 billion yen	FAW Toyota Changchun Engine Co., Ltd. (FTCE)	Engine parts	Export to Japan
2004	1.3 billion yen	Toyota FAW (Tainjin) Dies Co., Ltd. (TFTD)	Automotive stamping dies	Domestic

Source: Toyota Annual Reports, various years.

revolves around increasing market share of the rapidly expanding domestic market while strategy in ASEAN revolves around expanding ASEAN market share, exports, and the IMV project. It is possible therefore to conclude that, at the present time, it is not the case that there is a finite pool of resources (auto assemblers are in an expansionary period) and that increased investment in one area necessarily equates to less investment in another. The potential for increased trade between ASEAN and China is discussed below in more detail.

### **Mitsubishi**

Responses to the question indicated that the reality was more complicated than suggested and that investment in China and ASEAN is not a zero sum game as current and planned capacity for the region as a whole continues to expand (see Table 7.12). Although interviewees did not agree with the assumption, there is some speculation as to how far the responses were made in consideration of ASEAN sensitivity. However, as indicated above, actual and potential growth in the Chinese market far outstrips that for ASEAN and to a certain extent it is inevitable that FDI will be reoriented away from ASEAN, with the exception of Thailand, as Mitsubishi develops its operations in China.

One clear example of Chinese investment as ASEAN's loss may be found in the relocation of Pajero SUV production from Thailand to China. Under a joint venture agreement with Beijing Jeep Corporation Ltd., Chinese production of the Pajero SUV began in 2003, with production of the Outlander following in 2004. However, the Thai interviewee explained that rather than signifying a 'loss' for Thailand this was, in fact, more an exercise in refocusing Thai operations on pick-up production for the global market.

In common with most Japanese automakers Mitsubishi has become increasingly interested in China as both market and production site in recent years, both independently and with DaimlerChrysler (see Table 7.13).

Mitsubishi only commenced vehicle production in China in 1999 but by 2002 Chinese operations were producing over 75,000 units annually. Models produced include the Dynamic Family Wagon (Asian strategic model), Freeca, an MPV, a Lancer derivative sedan (saloon), the new

**Table 7.12 Mitsubishi's current and planned production capacity in Asia-Pacific 10**

2002	2003	2004	2005	2006	2007	2008
902,500	1,012,500	1,037,500	1,197,500	1,197,500	1,197,500	1,197,500

*Notes:* Asia Pacific 10 are Korea, China, Taiwan, Thailand, Indonesia, Malaysia, the Philippines, India, Pakistan and Australia.

*Source:* FOURIN Inc., 2004.

**Table 7.13 Mitsubishi's principal operations in China**

Name	Status	Capitalisation	Shareholders	Activities
SEM	JV	US\$ 91.3 million	Taiwan Motor Corp. (50%), local (50%)	Production and sales of Delica, Freeca
HDMC	JV	CNY 500 million	MMC (15%), MC (5%) Local (79%)	Manufacture and sales of engines and transmissions
HHMC	Licensing	CNY 410 million	Harbin Air-Craft (100%) MMC holds no equity	Production and sales of Mirage Dino
SAME	JV	CNY 738 million	MMC (25%), MC (9.3%), local (65.7%)	Manufacture and sales of engines and transmissions
CFA	JV	CNY 323 million	MMC (16%), local (84%)	Production and sales of Pajero
BJC	JV (Daimler Chrysler)	CNY 1,730 million	BAIC (57.6%), DC (42.4%), MMC holds no equity	Production and sales of Pajero Sports, Airtrek (Outlander)
MMS	WOE	–	MMC 100%	Distributor

Source: Mitsubishi Facts and Figures, 2004: 18.

Outlander SUV crossover and the Pajero Sport SUV. These last two models are examples of Mitsubishi's latest developments and by initiating local production Mitsubishi reported that they hope to communicate their commitment to the Chinese market. Moreover, it was noted that local production should allow Mitsubishi to respond quicker to local demands. Furthermore, the decision to produce the latest models in the SUV crossover and standard SUV ranges indicate an expectation that the Chinese market will continue to develop away from simple commercial and saloon models and towards the high-end demand experienced in the advanced markets of Japan, North America and Europe. Mitsubishi sold more than 70,000 units in China in 2002 and expects this to rise to 300,000 in 2007. Given this forecast, Mitsubishi's China orientation is understandable.

### **Honda**

Honda responded that it did not regard this statement as accurate and pointed to the considerable investments made in ASEAN in recent years (see Table 8.6) that have been made in addition to investments in China.

**Table 7.14** Honda's growth in China

	1999	2002	2004
Production	10,008	59,024	214,200
Capacity	50,000	145,000	270,000 ▶ 530,000

*Source: Honda Annual Reports.*

Honda commenced automobile production (Accord) in China in 1999 and operations have grown rapidly in the intervening years yet these operations were not seen as presenting any challenge to those in ASEAN at the time of interview.

Honda now has three production plants in China with a combined capacity of 410,000 units, 50,000 of which are specifically for export (Fit to Europe), producing the Accord, Odyssey (MPV) and CR-V (SUV). Sales from the Guangzhou plant (Honda's largest facility and a joint venture with Dongfeng Motor) reached 117,000 units in FY 2003 making Honda the fourth largest joint-venture automaker in China after VW and GM (just-auto.com 2004:23).

### Investment promotion schemes

A detailed examination of trade facilitating regimes in ASEAN was presented in Chapter 4 where attention was drawn to the BBC and AICO schemes in particular. This section examines the extent to which these schemes have been utilised by the firms investigated.

#### Toyota

Toyota was perhaps the biggest beneficiary of the BBC scheme utilising it to link Malaysia, Thailand and the Philippines<sup>8</sup> yet as noted above (Chapter 4) the scheme was largely ineffective and was replaced in 1996 by the AICO programme. Toyota has also been the most prolific user of AICO and these agreements (27 by February 2003) underpin its current regional strategy (see Table 7.15). The structure of Toyota's AICO based intra-firm production is displayed in Figure 7.10 yet this is not to suggest that all of Toyota's intra-firm trade is covered by AICO agreements and serves to demonstrate the complex and advanced nature of regionalised production.

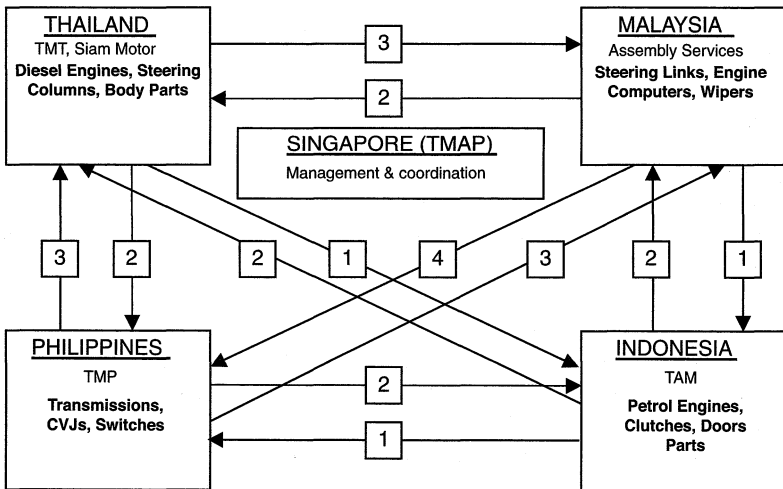
A brief examination of Toyota's AICO use based on the Philippines follows (see also Figure 7.11 below). Toyota had secured AICO agreements to link operations in Thailand, Malaysia and the Philippines for Corolla and Camry production in 2002 and achieved agreement for a further project to link Thailand, Indonesia and the Philippines by 2004. The Thailand-Malaysia-Philippines project approved the imports from Thailand

Table 7.15 Approved AICO applications as of 10/02/03

	Number	% of all AICO automotive approvals
Honda	26	29
Mitsubishi	4	5
Nissan	5	4
<b>Toyota</b>	<b>27</b>	<b>30</b>
	Total	68
Total other Japanese firms including Denso & Yamaha	77	88
Total number of approved applications	101	

Source: Compiled using data from ASEAN Secretariat.

Figure 7.10 Toyota's ASEAN production network under AICO agreements (CKD packs), 2003



Notes: CKD Packs.

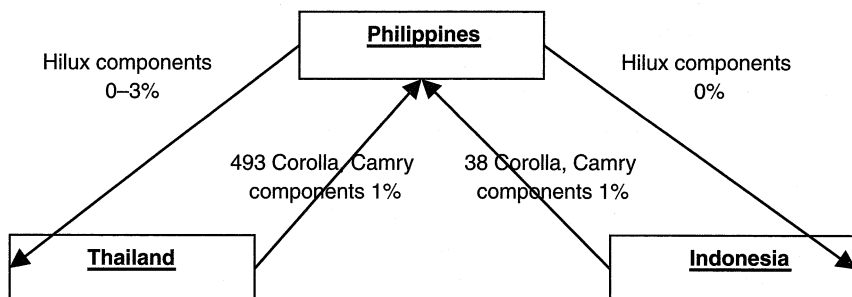
Number in box represents number of approved AICO agreements.

Source: Based on data compiled from ASEAN Secretariat, Toyota.

and Malaysia of OEM components for Corolla and Camry production and exports to Thailand and Malaysia of further Corolla and Camry components.

The second agreement allows for the exchange of Corolla, Camry and Hilux (IMV) components between the Philippines, Thailand and Malaysia. This arrangement provides a slight advantage over previous arrangements

Figure 7.11 Toyota's Philippines-Thailand-Indonesia AICO Agreements



Notes: % = tariff rate.

Source: Compiled using data from TMP.

as CKD packs were subject to a 3% tariff. TMP expected to receive a slight balance of payments surplus under this agreement as exports would reach US\$25.77 million while imports would equate to US\$25.75 million (TMP, 05/2004). The balancing of figures underlines the sensitive nature of AICO agreements coming as they do with an implicit stipulation that export/import values roughly balance.

It is possible to conclude therefore that the BBC and AICO schemes have been central to Toyota's overall strategy to the region and have played a key role in determining investment strategy in particular as they have, more or less successfully, facilitated the regionalisation of production.

The establishment of the AFTA with specific reference to the auto industry was covered above. It is clear that the implementation of the agreement has significant implications for the auto industry in general and Japanese assemblers in particular. All assemblers reported that AFTA was *important* or *very important* to future investment and production strategy. Toyota (*very important*) is taking advantage of AFTA in a number of ways:

- Developing production bases for certain models in each main national market.
- Relocating production of certain models (Hilux) to the region.
- Increasing investment in existing plant.

Toyota in particular expects to benefit from AFTA because of the already regionalised nature of its assembly and component network. It further expects that AFTA implementation will assist with improving quality (through competition) and local content ratios; the stated aim is for 100% localisation for the IMV project.

As the largest producer in the region integration and liberalisation also suggest costs for Toyota in the form of rationalisation of excess capacity

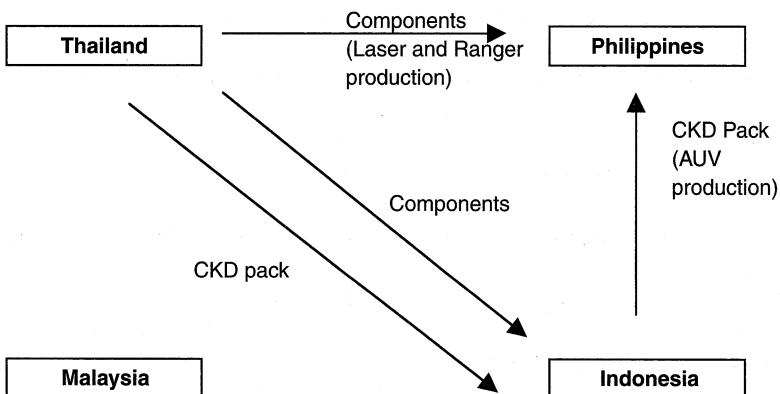
invested in due to prior protectionist policies yet this was not highlighted as a significant issue. Toyota's extensive use of the AICO scheme had already led to a more regionalised and rationalised production network and AFTA is expected to confirm and develop this. The issue of increasing competition from US and European manufacturers and their relative advantage as latecomers was raised and is discussed in more detail in Chapter 6.

### Mitsubishi

Of the four main Japanese auto assemblers, Mitsubishi had the smallest number (4) of approved AICO applications as of 2003 (see Table 7.15). In accounting for this low uptake, interviewees cited difficulties in the implementation of the schemes and the implicit requirement to balance trade between participating countries as key issues. Both the BBC scheme was seen as relatively unimportant. MMC did propose one BBC scheme but did not follow through as their ASEAN production network was not large enough to warrant it. Greater use has been made of AICO as illustrated by Figure 7.12 where Thailand's status as a regional hub is further demonstrated.

Given the unique relationship with the Malaysian national car project, Mitsubishi was able to comment on the importance of AFTA implementation as a manufacturer seeking to rationalise production under AFTA and with an understanding of the need for import protection. On the one hand, Mitsubishi reported that the CEPT/AFTA afforded greater opportunities for rationalisation between Thailand, Indonesia and the Philippines and that, given its multilateral nature (as opposed to AICO's bilateralism), implementation and operation appeared satisfactory and straightforward. Within this, it was clear that Thailand is the main beneficiary and that the

Figure 7.12 Mitsubishi's intra-ASEAN production links under AICO



Source: Compiled using data from Mitsubishi and ASEAN Secretariat.

continuation of production in other countries, Indonesia in particular, was under some doubt. On the other hand, AFTA raises a serious challenge for Proton leading the Malaysian government to delay implementation. Mitsubishi has been redeveloping its sales and distribution network in Malaysia in the wake of the termination of the relationship with Proton and would stand to benefit from access to Malaysia's markets. In particular, exports of CBUs from Thailand could go some way to compensating for the decline of the Proton relationship although market demand for passenger cars and Multi-Person Vehicles (MPVs) contrasts with one ton pick-up truck production.

Mitsubishi also reported that, in addition to the building-up of capacity in Thailand for global export of the one ton pick-ups, the Philippines was becoming a secondary hub for components and AUV production. As noted above, Mitsubishi has indicated investment of approximately P2 billion for the production of a new SUV model in that country. In addition to the benefits of AFTA, Mitsubishi reported that the Philippines export promotion programme had been instrumental in influencing this decision. It is anticipated that up to 200,000 units will be exported to other ASEAN nations, the Middle East, Africa and South America. Strada production in Thailand and AUV production in the Philippines thus demonstrates a further strategy employed by Mitsubishi that rationalises production of key models in specific countries rather than maintaining regionalised production networks.

### **Honda**

In contrast to the reported lack of interest in the BBC scheme, Honda has been a prolific user of the AICO scheme with 26 approvals in place as of February 2003.<sup>9</sup> Consequently, Honda stated that the scheme has been very important to their regional investment and production strategy. An underlying reason for this is the expansion of Honda's regional production network (see below). With new or expanded production plant in Thailand, Malaysia and Indonesia, Honda has invested heavily in the presumed benefits of ASEAN regional economic integration under AICO and its successor, AFTA. An expanded regional production network only makes sense if local sourcing and parts complementation can be made more efficient and intra-company; intra-regional trade facilitated by AICO allows for this. Under the AICO agreement CKD shipments attract a maximum 5% tariff while tariffs for intermediate components average 3%. At these rates, Honda can effectively utilise production plant in all four ASEAN countries and build a complementary production system.

Table 7.16 records Honda's use of the AICO scheme as of March 2002. It is interesting to note that the value of exports between participating countries are roughly in balance. Approximately US\$45 million per year is generated by this trade structure.

**Table 7.16 Honda's AICO approvals by the Philippine Government as of March 2002<sup>10</sup>**

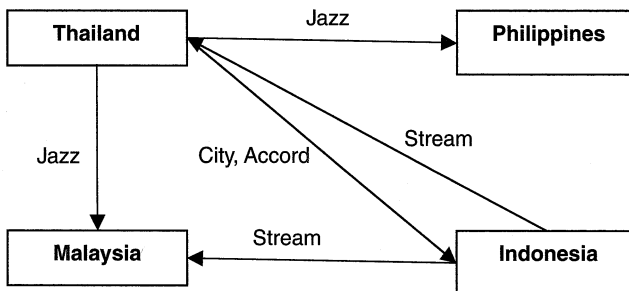
Exporting country	Destination	Value of exports*	Civic	Accord	CR-V
Thailand	Philippines	5,080	✓		✓
		14,900			
Malaysia	Philippines	300	✓	✓	✓
Indonesia	Philippines	2,300	✓	✓	✓
	Thailand	5,300	✓		✓
		15,500			
Philippines	Malaysia	300		✓	✓
	Indonesia	1,800		✓	✓

Notes: \*US\$ 1,000

Source: FOURIN Inc., 2002: 38.

As examined below, the creation of a regional market under AFTA is a key driver of Honda's regional strategy and this is demonstrated by the establishment of production facilities in all four major ASEAN auto producing countries in recent (post-crisis) years. Honda indicated that intra-firm, intra-regional trade facilitated by AICO will continue as not all tariffs will be reduced under AFTA immediately but that it expected AFTA to become the main driving force of liberalisation in the region in the medium term. Honda utilises AFTA to supply Indonesia with the Accord and City models from Thailand, while Thailand imports small numbers of the Stream from Indonesia. The Jazz model is also exported from Thailand to Malaysia and the Philippines, while Indonesia also exports the Stream to Malaysia (see Figure 7.13 below). In the case of the Philippines and Indonesia, these shipments from Thailand replace local production. Malaysia's full accession to AFTA was also welcomed.

Figure 7.13 Honda intra-regional vehicle export under AFTA



Source: Based on data compiled from Honda.

## Investment strategy

Two final questions investigated plans for new investments and any disinvestments in the region. At the time of interviews the firms appeared to be in an expansionary phase and it is interesting to note the development of R&D facilities in the region in particular.

### Toyota

A number of new investments and further investments (or changes in ownership structures) in existing operations were reported. As noted above, Thailand was chosen as the base for Toyota's first overseas R&D centre to be based outside of North America and Europe. The initial investment for this project was announced in 2003 as 2.7 billion Thai baht. Further developments in Thailand include the introduction of new shifts at both Toyota factories to ramp up IMV production and an increase in the number of dealerships from 240 to 310.

Elsewhere in the region assets in Indonesia were reorganised by splitting the manufacturing and marketing units, with Toyota increasing to 95% its stake in the manufacturing arm, PT-Toyota Astra Motor. (*Nihon Keizai Shimbun* February 20, 2003). Toyota further announced plans to invest US\$380 million in Indonesia as part of the reorganisation of vehicle manufacturing and parts production. Toyota announced sizable investments in the Philippines in 2004 to modernise production facilities for the export market and in 2005 for Minivan (IMV) production. Elsewhere in the region ¥620 million investment in a parts testing and procurement centre in Vietnam to source components for domestic and Thai operations was announced in 2004. Toyota denied reports in the *Nihon Keizai Shimbun* (31/01/05) of a plan to introduce a new plant in Thailand to boost production capacity for the IMV project. The newspaper had reported that stronger than projected demand for the Hilux pick-up truck had led to the decision to invest up to US\$485 million.

The breadth and scope of these new investments and rationalisation measures are in accordance with Toyota's overall regional policy as reviewed above. The establishment of the R&D facility in Thailand (and also a sister facility in Australia) is particularly noteworthy as this demonstrates a strong commitment to the development of localised models suitable for not only the immediate East Asian region but also the emerging markets of India and possibly China. In other words, this development may indicate a longer-term vision from Toyota that positions Southeast Asia for export production to late developing markets rather than existing markets in North America, Europe or indeed Japan.

A negative response was received to the question of planned disinvestments. Although considerable excess capacity remains in Toyota's ASEAN operations,<sup>11</sup> it is unlikely that there will be any disinvestment (closures)

given projected demand. However, a certain degree of rationalisation is taking place. Toyota announced plans to merge the two Philippine plants in late 2004 due to poor domestic demand although this action entailed no job losses. One characteristic of Toyota is that they make strenuous efforts to avoid job losses. In Toyota's opinion, announcing redundancies would not be conducive to maintaining a good relationship with the host government; conversely keeping workers employed demonstrates a commitment to the country which is appreciated and creates political capital to be employed at a later date.

### **Mitsubishi**

The general restructuring of Mitsubishi at the time of interviews generated some uncertainty on investment plans. However, it was clear that Asian production and sales were very important to the company at a time of severe difficulty in Japan and elsewhere. The following summarises recent investments in the region.

### **Thailand**

In line with Mitsubishi's plan to develop Thailand as a global production base for the one ton pick-up truck, investments (over a three year period) totalling ¥57 billion were announced in 2003 to develop and produce the next generation in the genre from 2005. More specifically 21 billion baht had been assigned to retool the production line and to add a further paint room<sup>12</sup> at the Laemchabang plant. A significant portion of this investment represented the movement of truck design from Japan to Thailand. This investment is expected to increase capacity from 80,000 to 180,000 units.

### **The Philippines**

P2 billion<sup>13</sup> was invested by Mitsubishi to develop new SUV for global export and the domestic market from 2006. The funds would be utilised for retooling, development and facilities. It was noted that the funding was not contingent on the company revitalisation plan.

### **China**

Under the revitalisation plan, Mitsubishi decided to sell vehicles in China under its own brand and announced in 2004 plans to build a production facility with Hunan Changfeng Motor Company with whom it already has a joint venture. Additionally, Mitsubishi reported its intention to take a stake in South East (Fujian) Motors in late 2004. SEM already produces the Delica and Freeca under licence.

Although strictly outside the geographical scope of this research, the cessation of operations in Australia was raised during the interview. At the time of writing, however, this course had not been pursued but the issue has some relevance to investment strategy in East Asia due to the reasons

behind it. The latest restructuring plan (2005) called for the closure of the Australian engine plant and the downsizing of production capacity. Mitsubishi officials pointed to competition from more cost effective plants in ASEAN, mainly Thailand, in the wake of tariff reductions on CBUs by the Australian government. Interestingly, it was reported that Proton has expressed an interest in acquiring the Australian plant.

In addition to drastic restructuring in Australia, Mitsubishi finally announced cessation of passenger car production in Indonesia in 2005. The Indonesian plant had produced the Dynamic Family Wagon derivative Kuda (minivan) and the Galant (saloon) but in 2003 produced only 7,300 Kuda reflecting sluggish domestic demand. As Indonesia has fully implemented AFTA, Mitsubishi intends to service Indonesian demand for passenger cars from Thai production. Additionally, Mitsubishi's withdrawal from the Proton project has been discussed above.

In summary, Mitsubishi's investment and disinvestment plans for the region largely confirm its stated strategy of promoting Thailand and China as regional hubs. The only exception to this would be the emerging development of Philippine operations. Such rationalisation further illustrates how AFTA implementation is shaping the company's regional strategy.

### **Honda**

In line with its general strategy of global expansion, Honda has announced or undertaken a number of investments in the region in recent years. These investments represent perhaps the most significant programme of expansion by any automaker in the region and reflect Honda's bullish stance on ASEAN's present importance and future potential. Between 2000 and 2004, Honda announced investments in all four main auto producing ASEAN states, in Vietnam and elsewhere in the region (China). The ASEAN investments are very much premised on regional trade liberalisation under AICO and AFTA. Actual and planned capacity is recorded in Table 7.17.

### **Thailand**

Significant investment in Thailand boosted capacity there from 55,000 units in 2002 to 120,000 in 2004. Although Honda, along with most other

**Table 7.17** Honda's actual capacity and projected growth in Asia-Pacific 10, 2002–2008

2002	2003	2004	2005	2006	2007	2008
330,000	470,000	620,000	575,000	575,000	575,000	575,000

*Notes:* In vehicles

Asia-Pacific 10: Korea, China, Taiwan, Thailand, Malaysia, Indonesia, Philippines, India, Pakistan and Australia.

*Source:* FOURIN Inc.

producers, had retained excess capacity in the immediate wake of the crisis, market recovery and increasing export sales suggest that this is no longer the case, even with this expansion. Honda's plant in Thailand is one of its biggest and is increasingly geared to export production. A US\$169 million investment for the production of a further model on the compact platform for export to Europe was announced in 2004. This investment reflects the underlying strategy of locating 'world car' production for export in Thailand. Additional investments (317 million baht) have recently been made in human resource development (training) and R&D.

### **Malaysia**

Honda's first production plant in Malaysia was opened in 2002 and investments to expand this were announced in 2003. Approximately US\$98 million was designated to increase capacity to 40,000 units. This move brought Malaysian operations under greater Honda control and away from the pre-existing joint venture which assembled Civic, Accord and City models. Additionally, Honda had invested in bringing new models to market and expanding its dealership network. Part of the rationale for this investment was to improve Honda's market share in the country which is dominated by Proton.

### **Indonesia**

Honda invested US\$30 million to construct a second plant in Indonesia in 2003 taking production capacity in that country to 60,000 units. Automatic transmission production has also been expanded.

### **Philippines**

P770 million was invested by Honda in 2002 to expand production of transmissions taking capacity to 140,000 units for export (projected to generate US\$650 million in sales). Honda also reported that plans have been mooted to develop CBU export production, partly in response to the excise tax rebate scheme. This would, however, be contingent on demand and as excess capacity remains elsewhere, no firm decision had been taken at the time of interview.

### **Vietnam**

Honda has maintained motorcycle producing capacity in Vietnam since 1996 and reported plans worth US\$60 million to extend this existing facility to accommodate automobile assembly (Civic) by 2006. Capacity would be set at 10,000 units and production would utilise a locally assembled engine and components from elsewhere in the region (Thailand and the Philippines).

### **China**

Honda announced plans in 2003 to double capacity by 2004 to 240,000 units in China and to create a further factory with a capacity of 50,000 units for export markets.<sup>14</sup>

Finally, Honda responded that no disinvestments were planned at the time of interview. However it was noted that production of the City had ceased or was planned to cease in Malaysia, Indonesia and the Philippines and would now be centred on Thailand.

## **Summary**

This chapter provides further evidence of both the immediate and negative impact of the AFC and, more importantly, the longer term and much more positive reaction from Japanese auto manufacturers. Toyota, Mitsubishi and Honda all took the opportunity to increase ownership and control of existing investments; initiate new investment projects and reorientate production toward exports. This reorientation is particularly important as it represents a commitment to raise quality standards to a level whereby regionally produced vehicles meet the demands of European and US markets. Moreover firms reported that host governments had made concrete efforts to revamp and make more attractive the investment environment. In other words, we could say that the crisis has further pushed the liberalising agenda and that a more conducive investment environment has emerged as a result.

While a commonality appears to be that investment in China does not represent investment lost by ASEAN it is inevitable, as pointed out by Mitsubishi, that the size, scope and potential of the Chinese market will dominate strategy in East Asia for the foreseeable future. Yet as the evidence presented above indicates, ASEAN economies and Thailand in particular have developed some competitive capabilities (regional markets, for instance) which strengthen their position in this process. Inward investment, then, remains buoyant and the mid-term strategies of firms suggest an optimistic future, at least in the medium term, for the industry in ASEAN.

# 8

## Responses to Regionalism: Regional Production, Trade and Economic Integration

This penultimate chapter records responses to questions in three areas: regionalised production, trade, and regional economic integration. In the initial section the localisation of production and the maintenance of production networks in the region were first considered before attention focused on the impact of China's growth on existing production networks. Finally, firms were asked to comment on the trend of relocating production from Japan to the region (the so-called 'hollowing-out' phenomenon). Trade structures were then examined with particular attention given to the increasing liberalisation of intra-regional trade, exports, the changing structure of host markets, and any instances of 'reverse imports'. The final section elicited responses on broader scenarios for regional economic integration and how specific FTAs might impact on the organisation of production. Within this firms were asked to comment on the validity of a statement suggesting that Japanese auto manufacturers preferred discriminatory regional arrangements as a defensive measure against increasing foreign competition.

### **Regional production: localisation**

Although ASEAN countries still promote the aim of local production they now pursue it through liberalisation and regional economic integration as demonstrated by AFTA. However, whereas in the past automakers struggled to meet local content requirements and were obliged to work closely (transfer technology) with local firms, they now share the aim of localisation in pursuit of cost savings.

#### **Toyota**

Local content requirements in the early 1970s led Toyota to encourage existing suppliers to undertake FDI in ASEAN as local capability, where it existed, did not meet required quality standards. This is of course the point of a local content requirement; foreign assemblers enticed by locational

advantages require concomitant development of supplier networks and this is where technology transfer can take place leading to the development of indigenous capability. Chapter 5 noted that Thailand has moved through perhaps four phases of localisation policies: an initial phase from 1971–1977, a more aggressive period that prohibited the establishment of new assembly plants and banned the import of CBUs between 1978 and 1986, rapid growth and partial liberalisation into the 1990s and, finally, comprehensive liberalisation and the lifting of local content requirements at the turn of the century.

Even though Toyota has been producing cars in Thailand for 40 years, local content rates<sup>1</sup> are variable. Although exact figures were not available at the time of the interviews, media reports in 2002 indicated a 79% localisation rate for pick-up, 74% for the Corolla model, 55% for the Soluna and 49% for the Camry. These generally compare favourably with Toyota operations in other parts of the world: 79% for Camry in Australia, 80% in the UK (European sourcing) and approximately 60% in North America although this is model dependent with higher rates achieved for certain models (Toyota Annual Report, 2003). Localisation of production has been supported in Toyota's case by its policy of 'Thai-nisation', in other words, the localisation of management.

Toyota's stated aim is to achieve 100% localisation in Thailand and throughout ASEAN, a level that appears achievable given that the localisation rate for the Hilux has increased from 60% to 96% since the introduction of the IMV project (Toyota Annual Report, 2004). Achieving 100% localisation within ASEAN under AFTA makes good business sense for Toyota on two fronts: components can be produced (and transported) more cost effectively in low-cost ASEAN countries than in Japan and the need for (expensive and tariff attracting) components sourced from outside the region (Japan) dissipates.

### **Mitsubishi**

As mentioned in Chapter 6, auto producing countries in ASEAN have relaxed local content requirements since the crisis in recognition of the 'cost penalties' that these incurred for assemblers. Mitsubishi echoed statements from Toyota regarding the current situation where localisation is still the aim but now pursued by use of 'carrots' rather than 'sticks'. Further responses to the issue of localisation have been included below.

Mitsubishi confirmed that localisation of production is important to mitigate exchange rate risks and that they have pursued a policy of sourcing locally where possible. Additionally, the trend towards creating regional products, such as the Kuda, is better facilitated where components are sourced locally to reflect local requirements. However, it was also noted that volume is an important factor as investment in new models must be justified by sales volume. In short, low potential sales volume equates to no incentive to develop a localised product. Local content rates for Mitsubishi products vary regionally and by model (see Table 8.1).

**Table 8.1 Mitsubishi's local content rates**

Country/Region	Local content rate
Australia	75–80%
Europe	70%
US	70%
Malaysia (Proton) Thailand	85%
Pick-up truck	50–60%
Passenger car	54%

*Source:* Mitsubishi Facts and Figures, 2004.

Localising production has been retarded in ASEAN by national requirements but it was suggested that Mitsubishi will be able to increase localisation rates regionally under AFTA. That is, a relaxation of local content requirements and virtually tariff free intra-regional trade for components will allow Mitsubishi to consolidate component production based on competitive advantage. This appears to be happening in Thailand, the Philippines and China (engines). In this way, local content rates for certain models, those bound for the regional market in particular, will rise on a regional rather than national basis.

### **Honda**

Honda responded that the overall business environment, while becoming more competitive, was also becoming more liberal particularly in Thailand but that host nations still encouraged the localisation of production in pursuit of indigenous auto sector development. Localisation of production and design is an important characteristic of Honda's general strategy and the company promotes the concept of producing locally for local consumers. Along with Toyota, who launched the Soluna in 1997, and Mitsubishi (Dynamic Family Wagon/Freeca), Honda has developed an 'Asian Car' for regional consumption. The City was launched in Thailand in 1996 and was well received by the market due to its price, which was generally 20% less than the Civic (see Table 8.2). By 2003, the City was exported intra-regionally (Malaysia, Philippines, Indonesia, Taiwan) and to other areas (Middle East). Honda designed the City to be built with a high local content rate (65%+) and to reflect local conditions; Honda removed the heating system for example. Honda notes that localisation of this nature is a valid strategy to reduce component costs and dependence on Japan. The City is also built in China (since 2003) where the local content rate was reported to have reached 80%.

The City is designated to be superseded by the Fit which is already exported to Japan. Localisation rates for this model were higher than for

**Table 8.2 Sales of the Honda City**

Country	2001	2002	2003
China	0	0	16,554
India	9,228	11,816	13,580
Indonesia	2,957	1,606	7,680
Malaysia	728	706	8,123
Philippines	2,480	2,843	3,278
Taiwan	1,524	1,205	0
Thailand	15,415	17,333	28,642

Source: Honda Annual Reports, various years.

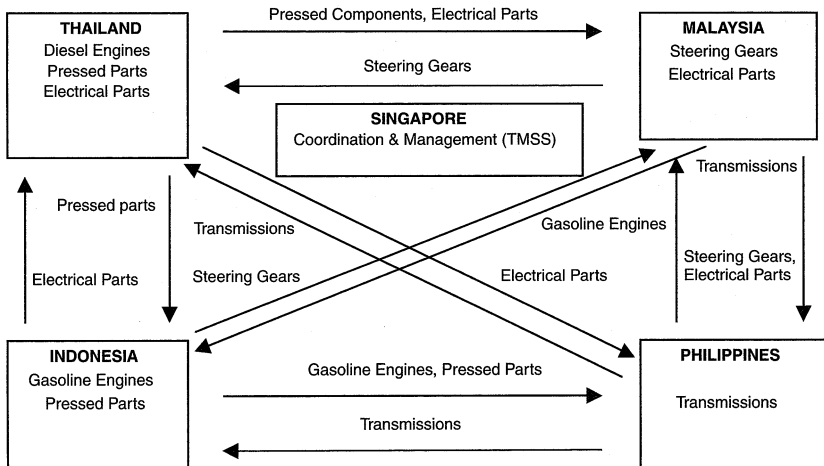
the City but no percentage was offered. It was also suggested that national local content is becoming less of an issue than the regional local content rate. Honda’s strategy in ASEAN would allow it to raise (regional) local content rates close to 100% in the medium term.

**Regional production: production networks**

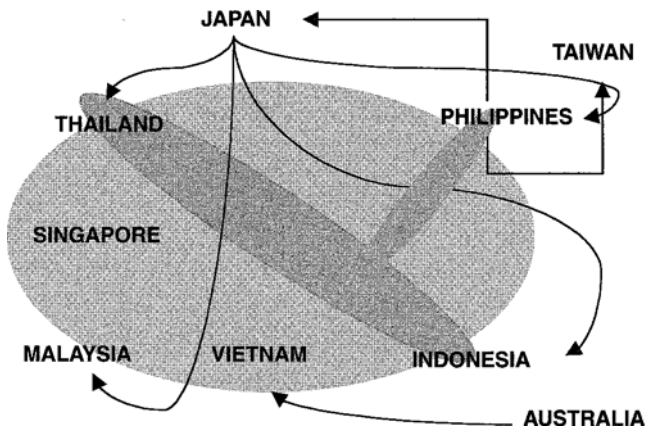
**Toyota**

Toyota’s regional production network is perhaps the most extensive of Japanese automakers in East Asia. As noted above Toyota has 16 manufacturing

Figure 8.1 Toyota’s Asian regional production network, 1993



Source: Petri, 1993: 41.

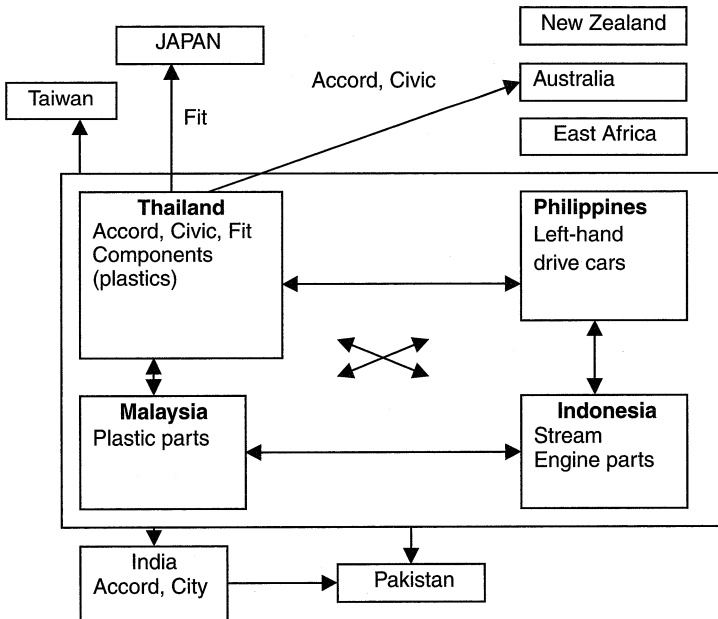


network already reviewed, Mitsubishi has not developed such an extensive regionalised production network. Clear data on intra-regional trade in intermediate components was unavailable at the time of interview although stated localisation rates suggest that the main source of key components continues to be Japan. Given that Mitsubishi appears to be concentrating production in Thailand and, to a lesser extent, the Philippines, it is suggested that intra-company trade under AFTA between these two countries could increase.

**Honda**

Rather than rationalising regional operations around one or two countries, Honda has in recent years expanded its production base among the four main ASEAN auto producing countries. As noted above, this move is supported by significant use of the AICO scheme to increase local sourcing and to make regional parts complementation more efficient. Honda believes that this strategy is consistent with the ‘global regions’ approach and that it will best utilise local characteristics. In other words, Honda will produce in and export from those countries where production is most cost effective for a given component or model. In this way, Thailand’s more advanced automotive industry can best support the production of latest models to

Figure 8.3 Honda’s ASEAN production network, 2004



Source: Compiled from data obtained from Honda.

**Table 8.3 Honda's ASEAN production, 2003 (capacity and model)**

	Thailand	Malaysia	Indonesia	Philippines
Capacity	120	20	15▶40	35
City	●☆◇	○▶X	○▶X	○▶X
Fit series	●☆◇	(○)		
Civic	●	○	○	○
Accord	●☆	○	○▶X	○
CR-V	●	○	○	○
Others		Odyssey	Stream	

*Notes:* Current ▶Planned, ●Production, ○Assembly, ☆Export, ◇R&D, ▶X Cease, (○) under consideration.

*Source:* FOURIN Inc., 2003: 17.

high quality and R&D while Indonesia's skilled labour is able to produce the Stream MPV, the only other production of the model outside of Japan. The Philippines, with its labour cost advantages, has been designated as a hub for component production and export, particularly of transmissions. Additionally, this strategy is based on the global manufacturing system which allows Honda to rapidly reorganise production on demand. Therefore, by investing in a regional production network in ASEAN (see Figure 8.3), Honda is not only well placed for regional growth but also fluctuations in global demand. Table 8.3 records the reorganisation of production in ASEAN as of 2003.

With regards to future development, Honda responded that this would largely depend on market demand and capacity utilisation.

## **Regional production: China**

### **Toyota**

There was little interaction between Chinese and Southeast Asian operations at the time of interview. As noted above, the rapid build-up of capacity in China is to meet present and projected domestic demand though the possibility of linking Guangzhou with ASEAN exists. A further key issue is that of the China-ASEAN FTA and this is considered below.

### **Mitsubishi**

Mitsubishi reported no linkages between China and ASEAN at the time of interview but it was conceded that this was a strong possibility for the future due to China's emergence as a regional hub for engine production. In line with other Japanese automakers, Mitsubishi plans to substantially

increase production capacity in China in anticipation of increasing market demand. Capacity stood at 902,500 units in 2002 with planned investments to increase this by 32.7% to 1,197,500 units in 2008. Further discussion of this point is found below.

### **Honda**

Honda indicated that China will also become an export base for small passenger cars to Asia and Europe. This contrasts with the domestic market orientation generally taken by Honda's competitors. Honda was unable to suggest how China might interact with ASEAN strategy other than to suggest that there was potential for parts complementation between the two entities. It is not yet clear how far Chinese operations will be worked into the global network.

Honda indicated that China is the main focus of expansion in Asia and that projections for production and sales were very positive. Additionally, as there are plans and clear potential for China to develop as an export base, due to its low production costs, it would seem likely that discussions will emerge on the model location in the future.

## **Regional production: relocating production from Japan**

### **Toyota**

As reported above, Toyota is expanding global capacity and envisages a near future where the majority of units are produced overseas. The most significant development with regards to East Asia has been the relocation of Hilux production to Thailand as part of the IMV project. Relocation of specific model production overseas will be dependent on a range of factors including domestic demand and quality. The Hilux was relocated partly because Thailand is a key market for pick-ups but also because demand in Japan had been declining (a general trend across all manufacturers for this type of vehicle) and Thai quality improving.

Toyota's high tech Global Production Center opened in 2003 may also be seen as a strategic move to assist the development of overseas production and future relocation overseas of specific models. The centre focuses on training developed through *kaizen* to promote self-sufficiency of overseas plants.

### **Mitsubishi**

One of the reasons why Mitsubishi was able to deal so successfully with the impact of the crisis in Thailand in 1997/8 was that it had relocated production of the one ton pick-up truck from Japan to Thailand in 1995. This coincided with a full model change and the declining popularity of the pick-up in the Japanese market in general. The Strada (L200 in Thailand) is produced separately for the domestic and export markets at the Lardkabang

**Table 8.4 Mitsubishi's one ton pick-up truck production in Thailand**

	1995	1996*	1997	1998	1999	2000	2001	2002
Domestic	44,056	45,749	19,830	3,496	13,690	23,457	20,379	22,814
Capacity**	54,000							
Export	5,985	13,223	41,244	58,095	60,304	63,779	59,898	75,090
Capacity			60,000					

Notes: \* New model relocated from Japan.

\*\* Figures for 1997. Capacity has since been expanded.

Source: Mitsubishi Annual Reports, various years.

**Table 8.5 Global sales of Thai produced Mitsubishi Strada, 2002**

Japan	Europe	Oceania	C. & S. America	Indonesia	M. East & Africa
n.a.	41,339	6,043	582	547	19,301

Source: Mitsubishi Annual Reports, various years.

No. 1 and Laemchabang No. 2 factories respectively. Mitsubishi was the first Japanese automaker to relocate an entire model to ASEAN in this way in a move that has since been adopted by others. By developing Thailand as the global hub for the pick-up, Mitsubishi was able to maintain its position as Thailand's biggest exporter (Tables 8.4 and 8.5).

In 2004, Mitsubishi began the first overseas production of the Grandis<sup>4</sup> (Space Wagon) model in Thailand for both domestic and export markets.<sup>5</sup> The Grandis is Mitsubishi's latest generation minivan and the decision to produce in Thailand demonstrates both confidence in and commitment to the country.

## Honda

Although Honda has not relocated production of an entire model to East Asia, it has built up component production in the region to a point whereby Thailand is now the largest component producer in Asia outside of Japan. Domestic restructuring and a desire to cut costs led Honda to relocate significant parts production capacity from Japan to lower cost countries including Thailand. More specifically, Thailand produces power train components (engine parts and transmissions) at the Lat Krabang plant which in 2002 had a capacity of 400,000 units. Approximately 50% of this was exported globally.

## Trade related issues: liberalisation

### Toyota

Toyota reported that ASEAN hosts are keen to promote trade liberalisation as demonstrated by the accelerated implementation of AFTA but that concerns remain as to the impact of such moves on indigenous industries. In fact, liberalisation has only occurred fully between Thailand, Indonesia and the Philippines with Malaysia an obvious laggard and substantial import duties remain for CBUs imported from outside of the region.

### Mitsubishi

Interviewees responded that AFTA implementation was clear evidence of more favourable attitudes towards trade liberalisation. However, attention was drawn to the situation regarding extra-regional tariffs, those on CBUs from Japan, which remain subject to national policy and vary throughout the region with Malaysia in particular maintaining high import duties to protect the national car project.

### Honda

Accelerated AFTA implementation was pointed to as the most obvious example of changing attitudes towards trade liberalisation. Honda has been taking full advantage of the scheme and to a certain degree has premised its regional strategy on sustained and deepening liberalisation. Thailand was highlighted as having a progressive and proactive regime. The trend towards FTAs was mentioned as an area of importance and this is considered more fully in the final section of this chapter. In general, Honda concluded that the trade within the region was becoming more liberalised.

Table 8.6 Import duties of ASEAN countries

Import tariff/tax	Indonesia	Malaysia	Philippines	Thailand
CBU	65–80%	140–300%	30%	80%
CKD	10–15%	42%	10%	30%
Excise	40%	65%	15–100%*	38.5–62.6

Notes: \*dependent on engine size.

Source: Compiled from data available at the Thai Automotive Industry website, <http://www.thaiauto.or.th/>.

## Trade related issues: orientation

### Toyota

Pre-crisis production of CBUs was overwhelmingly market-orientated but the severe drop in sales forced a reorientation towards export markets and the IMV project may be seen as a direct response to the drop in regional demand. One aim of the IMV project is to tap into a global market of 140 countries indicating a shift in emphasis from a local to inter-regional orientation. However, Toyota remains bullish on future demand projections in the region and has been investing in production capacity and the development of models specifically suited to the region both in terms of specification and price. It is clear that the implementation of AFTA and recent developments in Toyota's strategy as outlined above suggest that Thailand is fast becoming the *de facto* CBU production hub and thus intra-regional

Table 8.7 Mitsubishi's ASEAN production and sales by model, 2002

Market	Production	Units	Sales	Units	Product origin
Thailand	Lancer	12,076	Lancer	703	Thailand
	Strada	97,589	Strada	24,207	Thailand
			Cedia	7,010	Japan
			Pajero	90	Japan
Philippines	Lancer	1,294	Lancer	1,669	Philippines
	Adventure	7,742	Adventure	7,489	Philippines
	Delica	2,925	Delica	2,615	Philippines
	Strada	1,166	Strada	1,146	Philippines
			Galant	44	Japan
			Delica	49	Japan
Pajero	343	Japan			
Indonesia	Galant	210	Galant	223	Indonesia
	Kuda	9,669	Kuda	10,240	Indonesia
	Lancer	577	Lancer	774	Indonesia
	Colt	15,268	Colt	15,168	Indonesia
	Colt L300	14,700	Colt L300	14,558	Indonesia
Strada			547	Thailand	
Malaysia	Saga Iswara*	46,534	Saga Iswara	46,602	Malaysia
	Satria/Putra*	17,771	Satria/Putra	103,739	Malaysia
	Wira*	88,478	Wira	**	Malaysia
	Waja*	63,726	Waja	57,394	Malaysia
			Perdana	6,711	Japan
			Others	7,030	Japan

Notes: \* Non-Mitsubishi brand vehicles.

\*\* Included in figures for Satria/Putra.

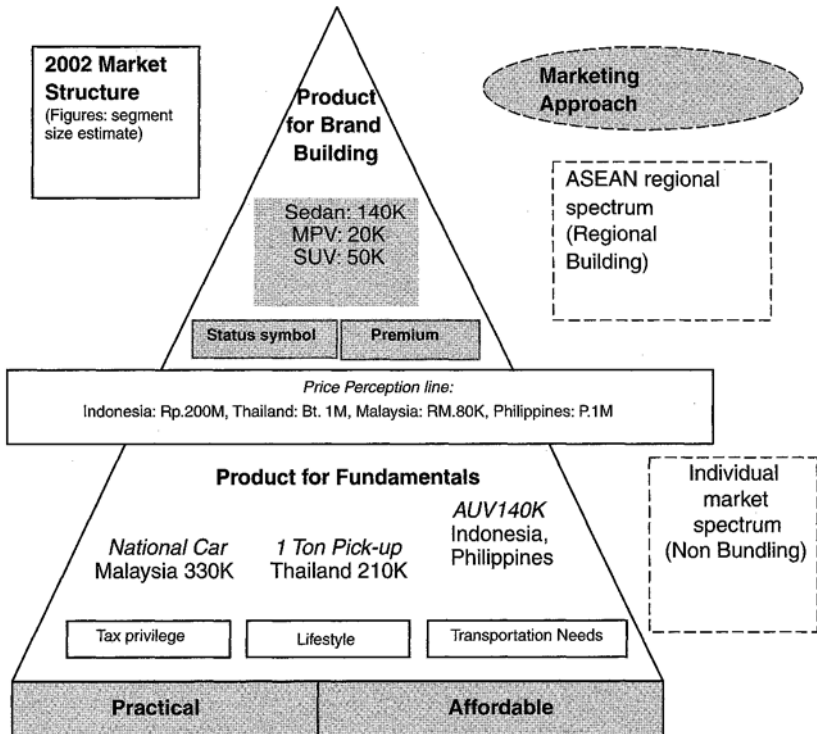
Source: Mitsubishi Facts and Figures, 2004.

trade in CBUs can be expected to increase. Inter-regional exports may also be expected to grow if Toyota can successfully develop ASEAN as a production base for 'localised' models to export to emerging markets (India, Middle East, and Africa).

### Mitsubishi

With the exception of Strada production in Thailand, production is predominantly aimed at host markets as demonstrated in Table 8.7. As of 2004, Mitsubishi was exporting CBUs of the Lancer and Strada models from Thailand to Indonesia and the Philippines. Additionally, Mitsubishi noted the possibility of expanding Thai produced models to Malaysia on full AFTA implementation. Mitsubishi also indicated that as production of the Grandis in Thailand develops, further export opportunities in the region could arise, particularly in Malaysia and Singapore. It was further reported at interview in Singapore that attempts had been made to market the

Figure 8.4 Mitsubishi's ASEAN product market approach



Source: Material obtained at interview (23/01/04).

Thai-built Lancer but that these had not been well received by consumers who cited concerns with quality.

When asked if the orientation of trade had changed significantly in the five years preceding the interview, respondents indicated that there had been no major change in orientation with the exception of increased exports from Thailand. Mitsubishi's regional marketing approach is based around the transformation of national markets as economic growth translates into rising incomes. Figure 8.4 illustrates Mitsubishi's marketing approach based on analysis of markets and models in 2002. The lower half of the pyramid structure records the varying demands of individual ASEAN markets. As noted above, the AUV model is most popular in Indonesia and the Philippines while the one ton pick-up truck continues to lead the Thai market. In Malaysia, demand is strongest for traditional passenger car models. These characteristics reflect consumer choice based upon the twin requirements of practicality and affordability in addition to further considerations around tax privileges (Malaysia), lifestyle and transportation needs. Marketing of these products is conducted on a national basis. A 'price perception line' has been identified for each market over which consumer choice is less influenced by the factors discussed above and more by spending power and status-seeking. Although unit demand is small, these products are more expensive and are freed from national market characteristics. Accordingly, a regional marketing approach can be adopted.

Mitsubishi has stated that the most dramatic growth is expected in the Chinese market and the relocation of the Pajero SUV model reflects the expectation that demand for high-end models will be strong. However, forecasts were generally optimistic for ASEAN growth in the coming years.

## **Honda**

CBU and CKD production was largely aimed at the domestic market before the crisis and, in line with other automakers, Honda has sought to expand exports in recent years. Intra-regional trade in CBUs is still limited and the development of production facilities in each of the four main markets suggests that this will continue to be the case for some models even with AFTA implementation. ASEAN markets are still fragmented to a certain degree in terms of consumer preference. As the one ton pick-up truck is still the dominant model in Thailand, Honda reports that Malaysia, where preference is for family saloons and the overall market is much larger than Thailand, has good potential for expansion. Thai operations already export a significant proportion of production and Indonesia and the Philippines also aspire to be exporting nations. Malaysia, on the other hand, is keen to develop the national car industry as an exporter and has prohibited foreign ventures from exporting. Therefore, Honda responded that the picture is mixed with regards to market orientation but with an emphasis on local and intra-regional trade.

**Table 8.8** Projected demand in ASEAN (passenger cars)

	1999	2005	2010
Thailand	67,000	233,000	494,000
Malaysia	240,000	386,000	580,000
Indonesia	11,000	97,000	170,000
Philippines	27,000	115,000	264,000

Source: Standard and Poor, 2004.

Honda referred to projections that show a steady development of the automobile market in ASEAN in the medium to long term (see Table 8.8). Accordingly, Honda expects that the overall future market orientation will be local and regional.

### Trade related issues: reverse imports

#### Toyota

Toyota is the second largest 'reverse importer'<sup>6</sup> to the Japanese market importing 16,281 units in FY 2003, 48.29% (JAMA) of all passenger cars manufactured overseas by Japanese firms and later imported into Japan. In 2004, Toyota announced plans to export to Japan up to 20,000 units a year of the Avensis model from its UK plant. The Avalon is also exported from the US. To date, these remain the only examples of CBU reverse imports and reflect the quality standards of these plants.

Toyota does not export CBUs from any East Asian production site. However, there has been an increase in the exports of components from affiliates in East Asia, notably from ASEAN as recorded by Table 8.9 although the majority of reverse import components currently originate in Thailand, the Philippines is also emerging as an important production hub.

#### Mitsubishi

The only CBU reverse import indicated was the Strada (one ton pick-up) from Thailand following production relocation from Japan. Imports of this model were limited in number (less than 1,000 units a year) and ceased due to lack of demand in 2000. No data was collected on reverse imports of components.

#### Honda

The Fit 'global compact saloon car' has been exported from Thailand to Japan since late 2002. The model has proved to be very successful and was Japan's top selling car in 2002. The car is produced at the Ayutthaya plant which is the second overseas facility to produce the Fit after the Brazilian

**Table 8.9 Exports to Japan from Toyota affiliates in East Asia**

Exporter	Parts			
Thailand	2 & 5L engines (na) STM	Parts for Cams (91,000) STM	Parts for blocks (45,000) STM	Body parts, resin parts, rubber parts, lamps, etc. (na) TMT
Indonesia	5K engine blocks (6,000) TAM	7K engine blocks (na) TAM		
Philippines	CVJ Assy (na) TAP	Transmission assemblies (na) (commenced 2004) TAP		
China	5A engine parts, blocks, etc (31,000) TTME	Constant velocity universal joint assemblies (na) TFAP	Semi-finished forging for constant velocity joints (na) TTFC	

*Notes:* Figures are for 2002.

na: figures not available.

*Source:* Internal Toyota materials obtained at interview (30/07/03).

subsidiary. There were no plans for further reverse imports from Thailand or elsewhere in ASEAN.

## Regional economic integration scenarios

### Toyota

The JSEPA had no impact on Toyota operations as Singapore is not an auto producing country and already maintains zero import duties on CBUs, although sales are heavily regulated. However, further proposed FTAs, notably with Thailand and the Philippines<sup>7</sup> would have significant implications for their operations. Toyota is adopting a wait and see approach to the issue but does not expect substantial liberalisation to occur rapidly in the event of an agreement being concluded. This view is supported by the

**Table 8.10 Mitsubishi's reverse imports**

1999	2000	2001	2002	2003
977	589	176	1	1

*Source:* JAIA 日本メーカー海外生産車新規登録台数 (Imports by Japanese manufacturers of new cars produced overseas), various years.

Japan-Thailand EPA Task Force who reported in December 2003 that on discussions concerning industrial sector liberalisation the 'Thai side referred to the sensitivities of iron, steel items, *automotives and automotive parts* and petrochemical products' (MOFA, 2003 *Italics added*). Rapid removal of import duties for CBUs and auto parts from Japan into the Thai market for example, would present serious challenges for Thai-based manufacturing and Toyota, as the largest market player (28.1% in 2001), would be affected the most. Therefore the stated wait and see approach will most probably be augmented by lobbying to ensure that any opening of the auto market would be gradual and incremental. Evidence for this may be seen in the central role played by Toyota Chairman, Hiroshi Okuda during the 2004 Keidanren<sup>8</sup> tour of the region to promote bilateral and regional (Japan-ASEAN) FTAs.

The broader implications of the China-ASEAN FTA were considered in Chapter 3 where it was concluded that although a preliminary agreement had been signed in 2004, it is in effect currently something of a paper tiger. However, given the potential gravity of the FTA this is not to suggest that the issue can be exempted from any investigation into present and future corporate strategies in the region. At the time of interviews Toyota was unable to comment on the research question further than to say that it seemed both unlikely and too far distant to warrant consideration at that point. Yet subsequent reports suggest that the recent investment with Guangzhou may have been made with one eye to this very issue and that at some level within Toyota, consideration has been given to 'the possibility of establishing mutually complementary relationships with its production bases in ASEAN countries [and Guangzhou] covering not only trade, such as parts and finished cars, but also R&D' (Hara and Nakanishi, 2004:7). Interviewees were unable to comment on the question of any impact of an APT FTA other than to remark that they were unaware of any internal discussion on the matter and that it would appear to be too remote a possibility to require consideration at this stage.

Toyota has a long history of activity in ASEAN countries and as noted above this led to the development of relatively inefficient production structures based around national markets. The AICO scheme has facilitated the development of a more regional division of labour as examined above and Toyota has been the most active Japanese auto manufacturer in pursuing agreements (27 approvals by February 2003). As noted above the IMV project is essentially based on the utilisation of AICO agreements between Thailand, Indonesia, and the Philippines and Toyota's own figures suggest that these realise a 30% cost saving. Further agreements integrate Malaysia and other ASEAN countries in Camry and Corolla production.

The AICO scheme was intended to facilitate trade between member countries and as such offered an advantage to eligible firms over external (US and EU) competitors. Eligibility required firms to be incorporated in an

ASEAN member country with at least 30% ASEAN equity<sup>9</sup> and for the product to contain no less than 40% local content. Japanese firms, who had spent the previous decades investing in joint ventures with local firms and working to local content requirements, were thus well placed to take advantage of the scheme. It has been suggested therefore that Toyota, along with other Japanese assemblers, retain some ambivalence to the implementation of AFTA as this would degrade the competitive advantages that they have enjoyed over foreign (US and EU) competitors. This would certainly be the case with regards to extra-regional FTAs and Toyota continues to monitor the situation closely.

However, Toyota reported that the changing investment and trade environment is one of many variables considered in the strategic decision-making process and that it fully supports the comprehensive implementation of AFTA. Moreover, the transition from AICO to CEPT effectively removes any remaining tariff costs and this is seen as more beneficial to Toyota's ASEAN production network than previous arrangements. As noted above Toyota is now active in promoting further regional FTAs.

### **Mitsubishi**

Mitsubishi stated that the bilateral FTA with Singapore had no impact on their sales there as import duties were already at zero. One senior executive was sceptical on the further development of Japan+1 FTAs in the region and stated that such moves have no discernible impact on current planning. On the other hand, it is clear that Mitsubishi welcomes the Thailand-Australia FTA (TAFTA) signed in 2003. Under the terms of the agreement, Australia will eliminate tariffs on passenger cars (currently 15%) and reduce tariffs on components to 5% in January 2005 and to zero by 2010. Tariffs on pick-ups, which constitute 85% of Thai exports, will also be eliminated and reports suggest that this could boost exports by up to 30%. Thailand is also obligated to reduce tariffs of 80% on passenger cars with engines of over three litres to zero and those on medium-sized passenger cars from 30 to 0% by 2010. Although the Thai reductions appear considerable it should be recalled that the passenger car market, especially for those with large engines, is limited. Therefore, it would appear that in the automotive sector TAFTA will benefit Mitsubishi as the country's largest exporter.

As noted above Mitsubishi has been increasing its presence in China though there is little evidence of existing linkages between the two entities. Interviewees were unable to comment on the question of any impact from the China-ASEAN FTA other than to suggest that although the agreement had been signed, no clear detail had yet emerged on the implications for the automotive sector.<sup>10</sup> On AFTA, Mitsubishi pointed to the difficulties surrounding the implementation of the agreement, particularly Malaysia's reluctance to fully implement tariff reductions, as evidence to support the notion that a regional agreement such as the APT would be highly ques-

tionable. It was also pointed out that as automobiles are generally the second most expensive purchase made (after housing), liberalisation would have a huge impact on trade balances. Mitsubishi reported that it was not planning for the implementation of such an agreement.

Mitsubishi has had a mixed experience of trade liberalisation. In 1998 the company ceased production in New Zealand after the government pursued a policy of tariff liberalisation. This was expensive for Mitsubishi, costing around US\$15 million, as considerable investments had been made in the country, mainly at the Porirua plant near Wellington. Mitsubishi, along with other Japanese, European and US makers, had been encouraged to establish production facilities (mainly KD) to serve the domestic market by the imposition of tariffs on imports, guaranteeing a small but profitable market. Once these tariffs were repealed, local production became uncompetitive and the market was served better by imports. However, the New Zealand experience may be an extreme example due to the limited size of the domestic market. At the time of writing, the future of Australian operations was under review partly for similar reasons and Mitsubishi's response thus needs to be seen in this context.

## **Honda**

Honda is studying how the TAFTA FTA could be utilised in terms of imports and exports between the two countries. It was remarked that Australia is a mature and saturated market and it was not felt that Honda could expect much expansion in that market. However, it was felt that there was considerable potential with the Thai-India FTA. The motorcycle arm of Honda in particular is looking at expanding trade between the two countries and, as has happened in Vietnam, motorcycles have often been used to gain a foothold in the market. Thailand already exports the Fit to India. It was noted that Japan was engaged in or seeking talks with a number of ASEAN economies regarding FTAs but that each process would require careful consideration. In general, there was some scepticism as to any immediate or even medium-term impact of FTAs on Honda's strategy.

It was suggested that the FTA between ASEAN and China could raise significant issues for the automotive industry in general. Honda intimated that the rising quality and efficiency of the industry in Thailand, combined with emerging policies to promote the 'eco' car, suggest that Thailand would be able to maintain some form of competitive advantage over China although this assessment was not extended to include Indonesia and the Philippines. It was anticipated that any negotiations on auto sector liberalisation would include the main players at an early stage. Honda was unable to comment on any potential impact of the FTA on its own strategy. At the time of interview, Japan-ASEAN EPA talks were relatively recent and there was no clear information on the impact of the proposed FTA on the automotive industry. However, it was noted that Honda has been making

considerable efforts to relocate component production from Japan to the region in pursuit of cost cutting and that the real impact would come on external tariff reduction for CBUs. As these issues had not yet been discussed at the talks, Honda had no further comment to make. Honda reiterated its point of view that the creation of a regional market would be a positive development although they were unable to comment further on the possible impact of an APT FTA.

Honda questioned the validity of the assumption that Japanese automakers preferred discriminatory regional arrangements to secure current status in ASEAN and noted that since the crisis, the number of European and American automakers entering or expanding their operations in ASEAN has risen dramatically. Ford, BMW, Mercedes-Benz, GM and Volvo have all developed production facilities in Thailand in recent years and thus the advantages that Japanese automakers used to have in terms of dominant market share in most countries could no longer be taken for granted. In some ways, Japanese firms were actually disadvantaged by the entry of new competitors who are able to exploit the (Japanese-led) development of the regional auto industry. Honda's strategy to deal with this new competition has been to expand its operations and pursue regional parts complementation.

## **Summary**

This penultimate chapter has examined the changing nature of production and trade in East Asia and has additionally considered how regional economic integration and concomitant trade liberalisation may have an impact on the operations of Japanese auto manufacturers. With regards to regional production networks, the current trend towards liberalisation provides a backdrop against which a number of strategies are employed. Toyota has used full AFTA implementation to maintain its geographical spread but some rationalisation has taken place within this. Mitsubishi, on the other hand, has perhaps been more focused on rationalisation centered on Thailand and the Philippines, while Honda is aggressively expanding operations throughout the region.

Localisation of product, production and management continues apace further signifying a rising 'absorptive capacity' for Thailand and the broader region. The development of a regional market, and the nature of that market, thus emerges as important issue now and for the future. Although existing networks have been based on intra-regional trade in components, the development of intra-regional trade in CBUs is also linked to this issue. Exports of components and to a much lesser degree CBUs to Japan remains a relatively marginal issue and the linking through trade of Chinese operations with those in ASEAN should emerge as an important feature of East Asian operations in the medium term.

Somewhat surprisingly regional economic integration scenarios and FTA activity did not feature as prominently in the responses as was expected. The impression gained is that while some free trade or economic partnership agreements have already been concluded their implementation will take place over a number of years and, based on the AFTA experience, may not be as smooth as originally envisaged. Moreover, the proposed China-Japan FTA was perceived as being so remote as to not warrant consideration. These and other themes are revisited in the following and concluding chapter where the original aims of the study are briefly revisited in light of the analysis presented in these three preceding chapters.

# 9

## Conclusions

As outlined in Chapter 1, this book has sought to examine the ways in which, and extent to, the post-crisis transformation of the East Asian political economy has impacted on the organisation of production in the region. More specifically, the preceding chapters have examined the responses of leading Japanese auto manufacturers to this transformed environment and has sought to examine the relationship between regional production networks, regionalism and regionalisation; earlier identified as the regional nexus. A growing body of literature stresses the importance and validity of a regional perspective on key issues in the international political economy and this book is an attempt to build on this literature by linking regional and national perspectives with a micro-level investigation of *regional* production networks. This, it has been proposed, not only allows us to gain a clearer, richer understanding of the dynamics shaping the contemporary political economy but also reflects the regional, as opposed to global or national, reality of international production.

This concluding chapter first reviews the theoretical and empirical contributions of the thesis in light of the case studies as presented in Chapters 6, 7 and 8. A discussion on Japan's economic relations with East Asia follows and the chapter concludes by highlighting the potential for further research.

### **Theoretical and empirical contributions**

Following a detailed review of the relevant literature in Chapter 2, a modified approach that identifies the complex interaction of state and market, or space and flow, as the central locus of investigation in a regional context was proposed. Accordingly, Chapters 3, 4 and 5 sought to establish the crucial regional context within which firm-level analysis could take place before the micro-level firm analysis presented in Chapters 6, 7 and 8. As such, the theoretical provenance of this study can be traced through to the convergence of the GPN and regionalist literatures as presented by Coe *et al.* (2004) and, more broadly, back to both regionalist and international production traditions, including the Japanese school typified by Kojima.

The approach utilised here is described as modified as the emphasis is on the regional rather than global production network. Additionally, the study is specifically concerned with Japanese production networks rather than those of the generic MNE. Further augmenting this approach is its dynamic nature which draws attention to the changing political economy and the resulting creation of regional locational advantages and sector specific analysis. As such, it is well suited to respond to and cope with the ongoing processes of regionalism and regionalisation. As indicated below, it is anticipated that this approach can yield further contributions to the literature.

The empirical contribution of the study is found in the case studies which reveal the nature of contemporary auto production by Japanese firms in East Asia. The firms surveyed have reacted to regional economic integration in a number of ways and analysis of this affords valuable insights into the regional nexus as described above. Whether Mitsubishi's experience with the Malaysian national car project or Honda's deepening localisation of product design, production and marketing, this study points to the continued relevance of the nation state and of the emerging importance of the (East Asian) regional entity. This study has further found that the hitherto dominant image of the regional production network must be updated to reflect the realities of rationalisation. Methodologically, the case studies have demonstrated the value of face to face semi-structured interviews with relevant executives but also underline the limitations of such research in terms of the nature of response garnered.

Inevitably any interaction between developing nation and multinational firm results in the emergence of asymmetric power relations. Indeed this issue has been identified as of paramount concern in the development literature. Although this study has reported how Thailand has emerged as a regional hub for the auto industry through the liberal trade and investment environment that it has created, this is not to conclude that compliance with the neo-liberal agenda is inevitable or indeed desirable. Clearly, nations need to balance their particular needs and wants with those of the multinational firm and this interaction need not result in a zero-sum game. Cooperation between states at the regional level can facilitate the scale economies necessary for mass manufacturing while still allowing governments to influence the actuality of local investment. Both Thailand and Malaysia, for different reasons, stand in testament to this. The important issue to note is that this complex interaction is captured through the regional nexus approach and, as the model is refined and elaborated, the analytical approach presented here should provide a convenient and effective tool with which to analyse such relationships.

Some consideration should also be given to the implications of this research for policy makers and business practitioners. Perhaps the central issue of importance for policy makers to emerge from the research is that SEA has clear potential to develop further as an important node of

economic activity and as a sizable, more sophisticated consumer market. The numerous investments in capacity made by Japanese automakers as reported in the case studies provide concrete evidence of positive business sentiment by the region's dominant producers for the mid- to long-term. Yet the bullish strategies of firms must translate into opportunity for development through industrial upgrading and for this to occur national and regional 'transformative capacity' must also be developed. AFTA, if fully implemented and if not undermined by concomitant regression in non-tariff barriers, illustrates how national governments can cooperate to create viable and attractive regional markets. With firms beginning to establish regional headquarters and, importantly, research and design facilities, it is now the responsibility of national governments to ensure that the technology, innovation and managerial know-how on offer can be captured and utilised for upgrading the national industrial structure.

In many ways, the regional perspective adopted in this study will already be familiar with business practitioners. Indeed, many of the executives interviewed had explicitly regional remits. However, by looking beyond commercial operations to the broader political economy, business practitioners may be able to perceive how they can strategically respond to the regional dimension presented here. Current and future FTAs will radically alter the business environment, as AFTA has started to do in SEA. While the prospects of an East Asian FTA remain remote, it is remarkable that it is under serious consideration and this should spur a strategic and regional response.

### **Japan and Japanese firms in East Asia**

As explored in Chapter 2, Japan's role in and attitude toward East Asia has been described in terms of the FG paradigm. Certainly, as a broad historical comment, this analogy is useful in our conceptualisation of catch-up development in East Asia and of Japan's role as a semi-hegemon. Further, its visualisation of the internationalisation of the product cycle more or less accurately describes the historic processes of industrial upgrading through the diversification and rationalisation of industry. Yet the regionalisation of Japanese production networks in East Asia appear to negate crucial aspects of the FG paradigm and, more controversially, to support the idea of a neo-dependency of developing economies on Japanese technology and capital. Furthermore, the model's promise of a seamless upgrading of industry capacity through FDI represents a contradiction of Japan's own model of development which, as we have seen, resisted FDI.

The complex nature of the regional nexus as examined in this study suggests that the FG model is unable to competently assess the contemporary reality of international production in East Asia. This is not to devalue the model but to call for recognition of its historical contingency. The original model was both formulated in the 1930s from the point of Japan as the

catch-up economy and Kojima's reformulation of the model provided a valid explanation of the internationalisation of production in East Asia throughout the 1970s and 1980s. It should be of no surprise therefore that today's particular circumstances demand a further re-evaluation of the model. However the realities of twenty first century regionalism may mean that any further reformulation is problematic and that, in effect, the model is superseded by the advances made by GPN analysis, the regionalism literature and, hopefully, by the contribution made by this study.

The regionalisation and rationalisation of production in East Asia may also be seen in terms of 'proactive' globalisation. That is, in contrast to the defensive FDI strategies of Japanese firms reacting to certain sets of dynamics (trade friction, yen appreciation and the 'closed' regionalism of the EU and NAFTA) throughout the 1980s and 1990s, the current era is characterised by investments that seek to capitalise on opportunities for regional dominance, global growth and profitability. Additionally, East Asia is transforming from an attractive place to manufacture automobiles to an attractive market in its own right. Accordingly, Japanese automakers in East Asia still need to maintain strategies for individual countries but these also need reference to broader regional strategies. This is particularly the case in ASEAN where national preferences can be met by regional production. This requires deeper localisation of not only procurement but of management and R&D functions and this is a key policy area for host economies to focus on.

The AFC hit Japanese automakers at a time when many were expanding production capacity in expectation of increased domestic demand. In spite of a number of schemes to promote scale economies within the ASEAN community, production was invariably aimed at national markets and thus the severe downturn in consumer demand resulted in significant difficulties for Japanese automakers. Yet the crisis, and the way in which governments and manufacturers have reacted, may in some ways be seen as a bridge between fragmented national markets operating under the legacy of the statist development ethos to the emergence of a regional (and thus more viable) market and production base.

As Japanese firms have reacted to these events, so has the Japanese establishment. Japan now actively supports and promotes regionalist projects both in an attempt to influence the region's political economy and to promote domestic reform. These issues are beyond the scope of this study but it is clear that Japan remains committed to balancing China's influence in the region even as it recognises the limitations of its own influence in an increasingly integrated economic entity.

### **Suggested research agenda**

As a tentative starting point, this study has shown the value of locating firm-level analysis in a regional, political economy context. To move beyond

this initial survey, a number of avenues for further research are identified. First, as this study has shown, the auto industry is unique among manufacturing industries for its size and complexity and a comparative study with the electronics sector, given that sector's ability to fragment the production process in ways that the auto sector at present cannot, should yield valuable data and insight. Second, the theoretical approach would benefit from an account of national variances in production organisation which would emerge from an investigation into how firms from North America and Europe operate in the region. Moreover, such an investigation would shed light on important aspects of international business culture. Finally, there are compelling grounds for a comparative study of how Japanese firms operate in the other two nodes of global economic activity, North America and Europe.

Finally, a pause for reflection. When one's head is full of competing theories, concepts and cascades of data it is all too easy to forget that the issues discussed here have direct meaning and impact for millions of individuals struggling to free themselves from poverty or seeking a better life for their children. Without abrogating the responsibility to be critical, it is important to recall that Japan and Japanese firms have played a crucial role in the development of East Asia. Recognising this, it is time to move beyond somewhat sterile debates around the construction or not of structures of dependency and to focus instead, and more productively, on how the momentum of development can be maintained and advanced. Development and peace can only be achieved through interdependency and interaction and for these reasons at least the regional economic integration of East Asia is to be encouraged and applauded.

# Appendix

## General Corporate Data

Name	Toyota Motor Corporation					
Head Office	Aichi					
Year established	1937					
Employees (Consolidated)	264,410 (as of March 2004)					
Capitalisation	¥14,006,790 million (as of March 31 <sup>st</sup> 2004)					
Main business areas	Transportation equipment					
Major shareholders (as of March 2002)	Master Trust Bank of Japan, Japan Trustee Savings Bank, Toyota Industries Corp., Nippon Life Insurance Co., Trust and Custody Service Bank.					
Strategic partner	No major business tie-up					
Financial data (yen, millions)	2004	2003	2002			
Sales	17,294,760	16,054,290	15,106,297			
Operating profit	1,666,890	1,363,679	1,123,470			
Pre-tax profits	1,765,793	1,414,003	1,113,524			
Net profit	1,162,098	944,671	615,824			
Interest/Dividend income	55,629	53,280	55,649			
Total assets	22,040,228	20,742,386	19,888,937			
Shareholder equity	8,178,567	7,460,267	7,325,072			
Automobile production (units '000) FY ended March 31 <sup>st</sup>	2004	2003	2002			
Japan	4,284	4,162	4,029			
Overseas	2,229	1,688	2,229			
Total	6,513	5,850	6,258			
Automobile sales (units '000)	2004	2003	2002			
Japan	2,303	2,217	2,217			
North America	2,103	1,982	1,780			
Europe	898	776	727			
Asia	557	462	210			
Other	858	676	609			
Global total	6,719	6,113	5,543			
Principal manufacturing facilities	Japan	North America	South America	Europe	Asia	Others
	12	11	4	7	22	7
R&D facilities	5	3	-	2	1	1
Subsidiaries and affiliates	554 consolidated subsidiaries and 228 affiliated companies					

<b>Name</b>		<b>Mitsubishi Motors Corporation</b>					
Head Office	Tokyo						
Year established	1970						
Employees (consolidated)	43,624 (as of March 2004)						
Capitalisation	¥252,201 million (as of March 2004)						
Main business areas	Transport equipment						
Major shareholders	Mitsubishi Heavy Industries, Mitsubishi Corporation, (as of March 2005) Bank of Tokyo-Mitsubishi, DaimlerChrysler						
Strategic partner	DaimlerChrysler						
<b>Financial data (yen millions)</b>		<b>2004</b>	<b>2003</b>	<b>2002</b>			
Sales		2,122,626	2,519,449	3,884,874			
Operating profit		(128,544)	(96,852)	82,761			
Pre-tax profits		(179,172)	(110,295)	54,344			
Net profit		(474,785)	(215,424)	37,361			
Interest/dividend income		(17,681)	(16,314)	(26,555)			
Total assets		1,589,286	2,029,035	2,425,352			
<b>Automobile production (1,000 units)</b>		<b>2004</b>	<b>2003</b>	<b>2002</b>			
<b>FY ended March 31st</b>							
Japan		n.a.	751,843	766,389			
Overseas		n.a.	785,626	888,473			
Total		n.a.	1,537,469	1,654,862			
<b>Automobile sales (1,000 units)</b>		<b>2004</b>	<b>2003</b>	<b>2002</b>			
Japan		n.a.	358,252	354,269			
Overseas		n.a.	1,168,360	1,216,377			
Total		n.a.	1,526,612	1,570,646			
<b>Principal manufacturing facilities</b>	<b>Japan</b>	<b>North America</b>	<b>South America</b>	<b>Europe</b>	<b>Asia</b>	<b>Others</b>	
	5	2	1	1	14	1	
R&D facilities	4	1	–	1	–	–	

<b>Name</b>		<b>Honda Motor Corporation</b>				
Head Office	Tokyo					
Year established	September 24, 1948					
Employees (consolidated)	131,600					
Capitalisation	n.a.					
Main business areas	Automobile production, motorcycle production, power products					
Major shareholders (as of March 2005)	n.a.					
Strategic partner	-					
<b>Financial data (yen millions)</b>		<b>2004</b>	<b>2003</b>	<b>2002</b>		
Sales		8,162,600	7,971,499	7,362,438		
Operating profit		600,144	724,527	661,202		
Pre-tax profits		641,927	609,755	551,342		
Net profit		464,338	426,662	362,707		
Interest/dividend income		9,299	7,445	n.a.		
Total assets		8,328,768	7,681,291	6,940,795		
<b>Automobile production (1,000 units)</b>		<b>2004</b>	<b>2003</b>	<b>2002</b>		
<b>FY ended March 31st</b>						
Japan		1,242,528	1,170,941			
Overseas		1,939,096	1,797,375			
Total (rounded)		3,181,624	2,968,316			
<b>Automobile sales (1,000)</b>		<b>2004</b>	<b>2003</b>	<b>2002</b>		
Japan		716	849	878		
Overseas		2,267	1,653	1,88		
Total (rounded)		2,983	2,910	2,666		
<b>Principal manufacturing facilities</b>	<b>Japan</b>	<b>North America</b>	<b>South America</b>	<b>Europe</b>	<b>Asia</b>	<b>Others</b>
	5	8	3	4	8	10
R&D facilities	4	1	-	2	1	-

# Notes

## 1 Introduction: East Asia, Regionalism and Foreign Direct Investment

- 1 Gamble and Payne conceive regionalism 'as a state-led or states-led project designed to reorganise a particular regional space along defined economic and political lines' (Gamble and Payne, 1996:2).
- 2 East Asia refers to the following countries: Brunei Darussalam, Cambodia, China, Democratic People's Republic of Korea (DPRK), Hong Kong (SAR), Indonesia, Japan, Laos, Malaysia, Myanmar, the Philippines, Republic of Korea (ROK), Singapore, Taiwan, Thailand, and Vietnam.
- 3 Contemporary is taken here to mean the period from the onset of the financial crisis (1997) to the time of writing (early 2005) although most research was undertaken in 2003 and 2004.
- 4 It should be noted that the terms 'scientific approach' and 'scientific method' are contested terms involving varying ontological and epistemological principles. These issues are considered below while the focus here is more on the particular processes and procedures required of the researcher.
- 5 See in particular page 118 for a full list of suggested best practice.

## 2 Foreign Direct Investment, Regionalism and (Japanese) Production Networks

- 1 This move was derided at the time by many institutions, including the IMF and the popular press but has since gained some recognition as a move which lessened the medium- and longer-term impacts of the crisis.
- 2 See Dunning (1977b) for a full discussion of this point.
- 3 *The international operations of national firms: A study of direct foreign investment*. Submitted 1960.
- 4 Kindleberger identifies four types of market imperfections due to product differentiation (similar product genres with minor distinguishing features including brand name, advertising, certain skills and knowledge, unequal access to resources and production inputs.)
- 5 This approach has been described as the market imperfections paradigm. See Calvert (1981:44).
- 6 More commonly known as 'reverse imports'.
- 7 The eclectic paradigm is presented in full in Dunning (1981) and is also referred to as the OLI paradigm.
- 8 Farrell (2000) notes that, 'The preoccupation with firm-based theories has meant that less consideration has been given to the role of general or country-specific factors.' Farrell here is arguing for a greater balance between 'push' and 'pull' factors. The relationship between the cost of home capital and FDI is cited as an important factor for consideration.
- 9 Akamatsu's work from the 1930s and 1940s received much wider readership after publication in English (1961 and 1962).

- 10 The FG paradigm has been translated from the original Japanese *ganko keitai* literally 'the form of geese'.
- 11 Kojima, a former student of Akamatsu, is widely regarded as the leading proponent of the FG paradigm.
- 12 The Meiji era (1868–1912) marks Japan's rapid transformation from feudal to industrial society.
- 13 Kojima notes that his PROT model of FDI is based on two propositions: 'Proposition 1: Countries gain from trade and maximise their economic welfare when they export comparatively-advantaged goods and import comparatively-disadvantaged goods. Proposition 2: Countries gain even more from expanded trade when superior entrepreneurial endowments are transferred through multinational corporations from the home countries' comparatively-disadvantaged industries in such a way as to improve the efficiency of comparatively-advantaged industries in the host countries and to contract comparatively-disadvantaged industries in the home countries' (Kojima, 1995:110).
- 14 These are circuits of commodity capital (world trade), money capital (portfolio investment) and productive capital (FDI) (Dicken, 2003: 200–202).
- 15 Structuralism essentially posits that to escape dependency on the first-world, third-world countries must remove structural impediments to development through state action (Rapley, 2002).
- 16 This concept is reviewed in greater detail in Chapter 4.
- 17 See in particular Barnett and Mueller, 1974.
- 18 Two previous phases of the international division of labour are identified: the first coinciding with the emergence of capitalism in the sixteenth century was characterised by forcible extraction of primary materials from the periphery, while the second coincided with classical imperialism and the development of international trade between core and periphery (Henderson, 1989:16).
- 19 Scally and Wickramanayake examine the impact of AFTA on Southeast Asian (ASEAN) FDI but conclude that 'the survey results suggest that it might be too early to assess the impact of the AFTA, and that further research be made on this topic when AFTA is fully operational, after 2003' (Scally and Wickramanayake, 2004:61).
- 20 A value chain is defined as 'the full range of activities which are required to bring a product or service from conception, through the different phases of production (involving a combination of physical transformation and the input of various producer services), delivery to final consumers, and final disposal after use' (Kaplinsky and Morris, 2000:4).
- 21 A global commodity chains consist of 'sets of interorganisational networks clustered around one commodity of product, linking households, enterprises, and states to one another within the world economy. These networks are situationally specific, socially constructed, and locally integrated, underscoring the social embeddedness of economic organisation' (Gereffi, 1994:2).
- 22 The differences between GVC and GCC are reviewed in Henderson *et al.*, 2002.
- 23 For a fuller discussion of these aspects, see Kaplinsky and Morris, 2000:25–36, and Gereffi *et al.*, 2005.
- 24 Sturgeon (2000) offers further analysis of the distinctions between value chains and GPNs in the areas of organisational and spatial scales, productive actors and governance style.

### 3 The Transformation of the East Asian Political Economy

- 1 'Entity' is deliberately used here in recognition of the sensitive and politicised nature of alternative nomenclature including 'caucus', 'community' and 'grouping'.
- 2 Standing in contrast to the European experience, cold war flashpoints remain volatile in East Asia. These include the Korean Peninsula and Taiwan.
- 3 The region's internal and external international relations remain broadly as they were in the 1970s notwithstanding greater national democracy (South Korea, Indonesia, the Philippines, Thailand among others) and convergence of economic policy (towards market capitalism).
- 4 Hong Kong, South Korea, Singapore and Taiwan.
- 5 Referring here to the ASEAN 4 (Indonesia, Malaysia, the Philippines and Thailand).
- 6 See Johnson (1982); Amsden (1989); Wade (1990); Aoki *et al.* (1997).
- 7 Defined as 'regional economic integration without discrimination against outsiders' (Garnaut, 1996:1). In practice, this would imply that the elimination of barriers to trade among members of a regional grouping would take place at the same pace as the elimination of barriers towards non-members. Open regionalism is thus consistent with WTO and most favoured nation principles. Additionally, 'one of the most important criteria of open regionalism is the freedom of member countries to liberalize further unilaterally or with non-members on a reciprocal basis' (Das, 2001:32).
- 8 Including the IMF, the World Bank and the G7 (8).
- 9 Eight rounds of negotiations have taken place since 1947; Geneva (1947), Annecy (1949), Torquay (1950–51), Geneva (1955–56), Dillon (1960–61), Kennedy (1963–67), Tokyo (1973–79) and Uruguay (1986–94).
- 10 The Singapore issues relate to investment, competition, government procurement, and trade facilitation.
- 11 This issue will be examined in greater detail with reference to the East Asian experience below.
- 12 No agreement was reached at the Hong Kong talks and despite successive formal and informal gatherings no agreement was in sight as of the end of 2006.
- 13 The tragedy of the Indonesian experience, particularly the treatment of ethnic Chinese, illustrates this point.
- 14 These included enhancing economic cooperation, promoting free trade, accelerating economic growth and promoting open regionalism.
- 15 Full ASEAN summits were held in 1976, 1977, 1987, 1992, 1995, 1998, 2001, 2002, 2003 and 2004 with informal summits held in 1996, 1997, 1999 and 2000 (ASEAN Secretariat).
- 16 These included a human resource development programme, a network of East Asian think-tanks, the East Asian Forum and East Asian Business Council.
- 17 Cambodia, Laos, Myanmar and Vietnam.
- 18 Comprising of Indonesia, Malaysia, the Philippines, Singapore and Thailand.
- 19 The average ASEAN per capita GNP comfortably exceeds that observed in China.

### 4 Japan and the Transformation of the East Asian Political Economy

- 1 Official development aid.
- 2 See also Mulgan, A., 'Japan: A Setting Sun?', *Foreign Affairs*, Vol.79, No.4, July/August 2000, pp. 40–52 and Helweg, D., 'Japan: A Rising Sun?', *Foreign Affairs*, Vol.79, No.4, July/August 2000, pp. 26–39.

- 3 Although the focus here is on economic aspects of the concept, other no less important factors include (inexhaustibly) societal and cultural norms, historical experience and the post-war security structure.
- 4 Japan transferred US\$1.5 billion to ten East and Southeast Asian countries between 1955 and 1965 in 'reparations and economic and technical assistance. The bulk of this money was tied to the purchase of Japanese goods and services' (Pempel, 1997:56).
- 5 Though this position was conceded back to the US in 2001.
- 6 The DAC Peer Review 2004 noted significant revisions to this with greater autonomy afforded to the Japan International Cooperation Agency and the merger of other agencies into the Japan Bank for International Cooperation in 1999 (OECD DAC Peer Review, 2004).
- 7 Japan and the US, contributing the largest share of funds, share equal voting rights in the ADB as these are designated in accordance with capital shares (Matsumoto, 2000).
- 8 Deliberately echoing the wartime Greater East Asian Co-Prosperity Sphere (see Koschmann 1997, 99–103).
- 9 See for example Japan's response to the East Asian Economic Caucus proposal from Malaysian Prime Minister Mahathir in 1990.
- 10 See MOFA, 2002b *Japanese Economy and Structural Reforms*.
- 11 See METI, 2002 in particular.
- 12 'Singapore has so far voiced readiness to scrap all tariffs on imports from Japan. But Tokyo is arguing it wants to maintain tariffs on agricultural and fishery imports. The main farm-related products Japan imports from Singapore are goldfish, tuna and cocoa powder. Although they make up only 4% of the value of imports from Singapore, worth 600 billion yen a year, Japan is trying hard to maintain tariffs on them as lawmakers representing agricultural interests are strongly opposed to their elimination.' (Kyodo News Japan, *Singapore opens 3rd round of negotiations on FTA* 03/09/2001).
- 13 Reverse imports to Japan from Japanese companies operating in East Asia account for approximately 30% of total imports from the region amounting to approximately 25% of total sales of Japanese companies (METI, 2000).
- 14 'APEC has 21 member economies which account for more than a third of the world's population (2.6 billion people), approximately 60% of world GDP (US\$19,254 billion) and about 47% of world trade' (APEC Secretariat).
- 15 For instance, the Towards ASEAN-Japan Comprehensive Economic Partnership International Symposium held in Tokyo July 2003 and hosted by IDE/ JETRO.
- 16 Japan supports a dedicated entity separate from the existing ASEAN secretariat though this proposal has been resisted by others.
- 17 Further underlining this shift, Japan in 2002 established within the Ministry of Foreign Affairs a Headquarters for the Promotion of FTAs and EPAs chaired at Vice-Ministerial level and a Division for FTAs and EPAs in the Ministry's Economic Affairs Bureau that plans and drafts strategy.
- 18 The most visible and quoted benefit was the elimination of Singapore's tariff on beer resulting in a 2.7 fold surge in exports from Japan (METI, 2004).
- 19 The Korean made hit drama *Winter Sonata* led to a mini boom for all things Korean in Japan during 2004.
- 20 Japan invoked safeguards against imports of leeks, shiitake mushrooms and *tatami* mats which rose by 44.9%, 33.1% and 49.6% respectively in volume terms in 2000 (MAFF, 2001).
- 21 'We should not see China's remarkable development as a threat but rather as a chance to stimulate Japan and other countries and also lead to the development

- of Japan and ASEAN.' Prime Minister Koizumi's speech to delegates at the Japan-ASEAN Summit in 2003 reported in the *Nihon Keizai Shimbun* 12/12/ 2003.
- 22 A framework agreement was reached in 2002.
  - 23 Although it has been suggested that this was a direct consequence of Japan's switch to FTA promotion in the region and the Japan-Singapore EPA in particular (REITI, 2003).
  - 24 Defined as, 'a process where the transfer of economic activities to foreign affiliates of multinationals leads to a reduction of economic activities in the home country and more specifically in the home country parents of those multinationals' (Ramstetter, 2002:43).
  - 25 See for example the anti-Japanese demonstrations and riots that swept China in April 2005.

## 5 Japanese Foreign Direct Investment in East Asia: The Automotive Sector

- 1 The terms auto assemblers/manufacturers/makers/producers are used interchangeably throughout.
- 2 W.E. Deming (1900–1993) developed 'fourteen points for management' based on statistical analysis to promote better quality and more efficient industry. He was invited to Japan in the 1950s where his ideas, largely ignored in his native US, found ready acceptance among Japanese business leaders. The annual Deming Prize is still awarded to Japanese corporations that excel in quality control.
- 3 It is interesting to note that although indigenous automakers have all but disappeared, the UK is the fourth largest producer of automobiles in Europe and is home to more global brands than the region's largest producer, Germany.
- 4 Figure includes passenger cars, light commercial vehicles, heavy trucks, buses and coaches.
- 5 'Disclosure of Tata's partnership bid with MG Rover came as Mr Tata made clear that he is pressing ahead with a project to bring to market a "\$2,000 car", which he believes could revolutionise personal transport in India and some other Asian countries.' *Financial Times: Tata seeks deal with MG Rover* in UK March 9 2003.
- 6 Supreme Commander for the Allied Powers, 1945–1952.
- 7 The allies held the *zaibatsu* structure partly responsible for the war and pursued a policy of dissolution underpinned by the purge of wartime leaders and anti-monopoly laws (1947). Mitsubishi had been a key target of this legislation.
- 8 GM, Ford, and Chrysler.
- 9 Carlos Ghosn, the Renault appointed head of Nissan, initiated a revival plan and 'as a result, most of the present suppliers will be eliminated from the suppliers' lists, except the most competitive company that will take all the business. Many of the companies in the Nissan Group will face bankruptcy. This attack on the keiretsu is something that Nissan could never have done alone, however urgent action had become' (OECD, 2000).
- 10 Indonesia, Malaysia, Philippines, Thailand.
- 11 In terms of GDP per head on a PPP basis, East Asian economies include in 2003 high-income economies of Japan (28,000) and Singapore (27,030), middle income Thailand (6,920) and Malaysia (6,640), and developing China (4,690) and Vietnam (2,380).
- 12 In January 2003, ASEAN 6 economies (Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand) reduced tariffs to the 0–5% range for

goods originating in member states. Malaysia negotiated a postponement for auto-related products including CBUs.

- 13 On January 1<sup>st</sup> 2000, Thailand abolished local content requirements and revised the definition of what constitutes Complete Knock Down (CKD) production.
- 14 Thai GDP grew at an average rate of close to 9% between 1985 and 1995.

## 6 Responses to Regionalism: General Strategy and the Organisation of Production and Management in East Asia

- 1 Further corporate data may be found in the appendices.
- 2 Toyota overtook GM to become the world's largest carmaker in terms of volume in early 2007.
- 3 See in particular Liker, Jeffrey (2003), *The Toyota Way*, New York: McGraw-Hill; Womack, James *et al.* (1991), *The Machine That Changed the World: The Story of Lean Production*, New York: Harper Perennial.
- 4 See in particular Froese, Fabian and Goeritz, Leif (2007), 'Integration Management of Western Acquisitions in Japan', *Asian Business and Management*, 6(1): 95–114.
- 5 Innovative International Multi-purpose Vehicles.
- 6 A total of five IMV vehicles are planned including three pick-ups, a minivan and a SUV.
- 7 DC retains its stake in Mitsubishi but this has been reduced to around 13% due to capital infusions from the Mitsubishi group and elsewhere.
- 8 Intense negotiation between Mitsubishi Heavy Industries, the core component of the Mitsubishi group, Mitsubishi Corporation, and the Bank of Tokyo Mitsubishi resulted in the Revitalisation Plan announced in January 2005 and has been criticised as an exercise in 'putting loyalty way ahead of sound economic reasoning' (Bloomberg.com accessed 22/02/05).
- 9 See Mitsubishi Heavy Industries for a detailed report of the 2005 Revitalisation Plan.
- 10 Mitsubishi's Nagoya plant was utilising just 29% of its capacity in 2002.
- 11 Press reports in 2005 indicated that this had been delayed until 2006 or 2007.
- 12 The VTECH engine and fuel cell for instance.
- 13 Honda defines glocalisation as 'activities cultivated on a global scale but rooted in local soil' (Honda promotional material).
- 14 Mitsubishi's regional marketing strategy for ASEAN is considered in greater detail below.
- 15 It was reported that China may receive its own headquarters in the medium term (Interview 30/07/03).
- 16 Separate departments exist for Australia, New Zealand, Latin America, the Middle East and Africa but are not coordinated by regional offices as in the North American, European, North Asian and Asean cases.

## 7 Responses to Regionalism: The East Asian Investment Environment

- 1 AICO was more successfully utilised than BBC due to its more liberal nature.
- 2 Incentives included a corporate tax holiday and tax exemption for imported machinery.

- 3 Mitsubishi announced plans to reduce global staff numbers by 12,000 in 1998.
- 4 The scheme was later modified to include automotive components.
- 5 Sales recovered to 60,774 units only in 2003.
- 6 Honda factories in Thailand received ISO9002 certification in 1998.
- 7 Toyota intends to satisfy local demand for the Camry solely through local production and will eventually terminate exports of the model from Japan.
- 8 'Thailand exported under body and electrical parts, and Malaysia exported parts for fuel tanks, suspension systems, steering link assembly, convenient and accessory equipment, and electrical parts to the Philippines. In turn, both the countries imported manual transmission from the Philippines' (SICCI, 2002:6).
- 9 Toyota, by comparison, had 27 approvals in place.
- 10 The Philippine Government maintains a database of AICO approvals as signed by Executive Order.
- 11 Toyota's production capacity in Thailand was 240,000 units in 2002 with 139,983 units produced equating to a capacity utilisation rate of 58%.
- 12 Painting is the most time consuming aspect of the production line and inadequate facilities will lead to bottlenecks.
- 13 From a total investment fund of P10 billion for the project.
- 14 Exports to Europe of the compact Jazz model commenced in 2005.

## **8 Responses to Regionalism: Regional Production, Trade and Economic Integration**

- 1 It must be recalled however that Toyota sources perhaps 70% of components from locally based Japanese suppliers.
- 2 China, Indonesia, Malaysia, Philippines, Taiwan, Thailand, and Vietnam.
- 3 IMV production (Innova model) in the Philippines is under consideration and has gained Board of Investment approval (2002).
- 4 The Grandis was launched in Japan in 2003.
- 5 Mitsubishi planned to commence exports to the Philippines in 2005.
- 6 Reverse imports are imports from overseas affiliates of that country's own firms.
- 7 Japan and the Philippines announced an agreement in principle on an EPA between the two countries in November 2004. As part of this agreement auto and auto parts tariffs are to be eliminated by 2010.
- 8 Okuda is currently (May 2005) Keidanren Chairman.
- 9 This requirement was waived following the AFC and remained suspended until 31<sup>st</sup> December 2004 (ASEAN Secretariat, 2004).
- 10 Later reports suggest that CBUs will be excluded from the FTA while tariffs on components from ASEAN will be reduced from 30 to 20% (*Bangkok Post*, 12/05/04).

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