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The Second Wave: Japanese FDI to Southeast Asia

*By Malcolm Cook**

EXECUTIVE SUMMARY

- Japan has long been the largest national source of foreign direct investment (FDI) to Southeast Asia and is the largest source for Thailand, Malaysia and Indonesia.

- Southeast Asia is benefitting from what appears to be the early stages of another major wave of Japanese FDI inflows. It is reminiscent of the first major wave which lasted a decade from 1988 to 1997 and helped transform the regional economy.

- In 2013 alone, Southeast Asia's six largest economies received 17.3% of Japan's global FDI outflows, roughly half of the amount received by the United States, two and a half times the amount received by China and eleven times more than India. Since 2009, these Southeast Asian economies have received three-fifths the amount of Japanese FDI as the United States, seven-fifths as much as China and five times more than India.

- Indonesia, Vietnam and Thailand are the greatest beneficiaries of this second wave while Thailand, Malaysia and Singapore were the first wave's largest recipients. The Philippines, despite having Southeast Asia's second largest population base, largely missed the first wave and is doing the same again.

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- Japanese small and medium enterprises could make a much greater contribution to this second wave. Effective home and host country support will be key for these firms to realise their Southeast Asian expansion plans.

- Preliminary figures suggest that this second wave to Southeast Asia consists predominantly of manufacturing sector FDI and not services or mining despite the upsurge in Japanese non-manufacturing FDI globally.

INTRODUCTION: THE FIRST WAVE

It is common knowledge that the first major wave of Japanese FDI to Southeast Asia was central to the region's development success. Supply chains, production networks, export-oriented industrialisation, exchange rate volatility, 'flying geese' and even ASEAN economic integration have all become focal points of the regional economic discussion in part due to the regional effects of the first wave of Japanese investments.[1]

In fact, the effects were nothing short of being transformative for Southeast Asia. Bangkok and Singapore now have two of the largest Japanese expatriate communities in the world, easily outstripping Seoul and Hong Kong. From 1985 to 1990, Japanese FDI increased five-fold to Malaysia, six-fold to Singapore and an incredible 25-fold to Thailand, with Southeast Asia's share of total Japanese FDI outflows roughly doubling in this period.[2] Japanese FDI to the region, centred on the electrical and electronics and the automobile industries, maintained this new and much higher level for a decade. By one bullish estimate, by 1996, a single Japanese multinational, Matsushita, was involved in local operations in Malaysia equal to six percent of that country's GDP.[3]

The first wave's main gravitational pull was global in scope and political in nature. In September 1985, the United States, after five years of significant dollar appreciation, brought together Japan, West Germany, the United Kingdom and France in the Plaza Hotel in New York to strong arm a managed depreciation of the dollar. In response, from 1985 to 1988 the Japanese yen appreciated sharply against the dollar, forcing Japanese firms to rapidly shift production overseas.

Within five years of the Plaza Accord, the share of overseas production by Japanese manufacturing firms had doubled, a growth trend that has yet to subside. In the late 1980s, China and India were not yet open and the currencies of Taiwan and South Korea also experienced wrenching appreciations in the face of American pressure, reducing their attractiveness as alternate production bases to Japan. The most advanced and manufacturing investment-friendly economies of Southeast Asia faced neither restriction.

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[1] For more information on the protagonist role Japanese firms operating in Southeast Asia played in ASEAN-based economic integration efforts, please see Yoshimatsu Hidetaka, "Preferences, Interests and Regional Integration: The Development of the ASEAN Industrial Cooperation Arrangement", *Review of International Political Economy*, 9, no.1 (2002): 123-149.

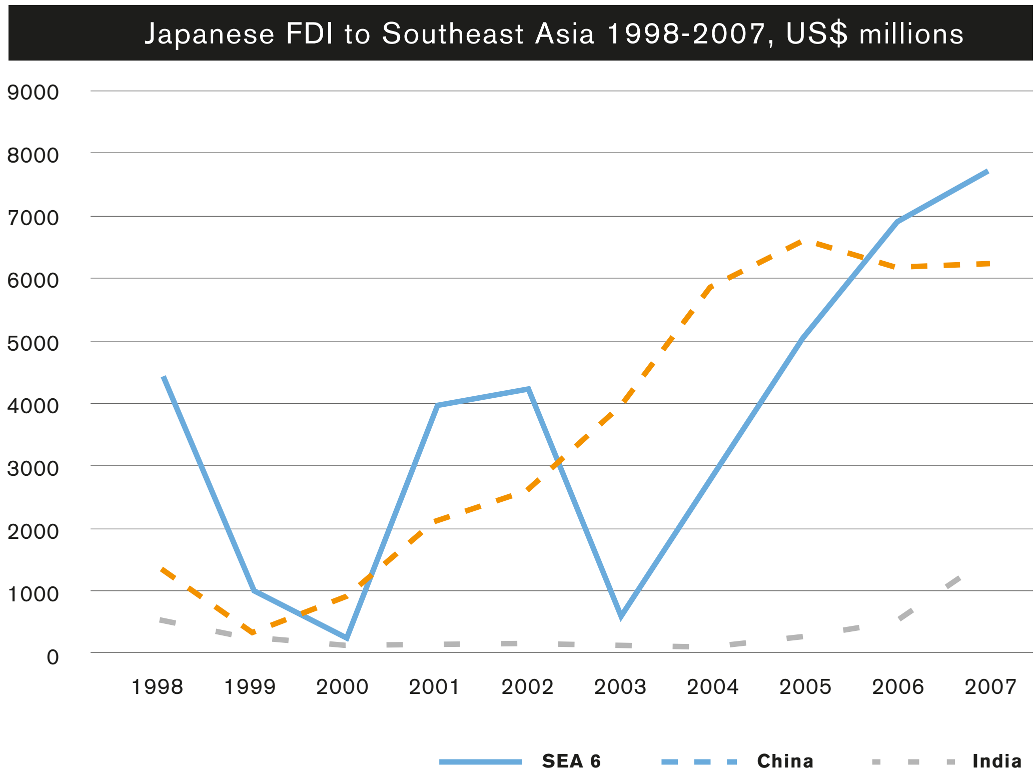
[2] J. Thomas Linblad, *Foreign Investment in Southeast Asia in the Twentieth Century* (New York: St Martin's Press, 1998), p. 143; Higuchi Hiroyasu and Yuhanis Kamil, "Japanese Direct Foreign Investment in Southeast Asia", in *Towards an Economically Resilient Southeast Asia* (Kuala Lumpur: ISIS, 1991), p. 179.

[3] Philippe F. Delhaise, *Asia in Crisis: The Implosion of the Banking and Finance Systems* (Singapore: John Wiley & Sons, 1998), p. 145.

Subsiding

Asian economic and political factors weakened Southeast Asia's pull on Japanese foreign direct investment from 1998 to 2008. The 1997-1998 Asian financial crisis' exchange rate volatility and increased political risk saw a sharp drop off in Japanese FDI to Southeast Asia during this period.[4] When China joined the WTO in 2001, it boosted this huge neighbour's attractiveness as a site for overseas Japanese production and for foreign sales.[5] By 2003, the number of Japanese overseas affiliates in China, for the first time, overtook the number in Southeast Asia.[6] The first wave of Japanese FDI to Southeast Asia crested in 1997 and then subsided.

Chart 1: Japanese FDI to Asia 1998-2007, US$ millions (balance of payments basis, net and flow)[7]



Source: Japan External Trade Organization statistics http://www.jetro.go.jp/en/reports/statistics/

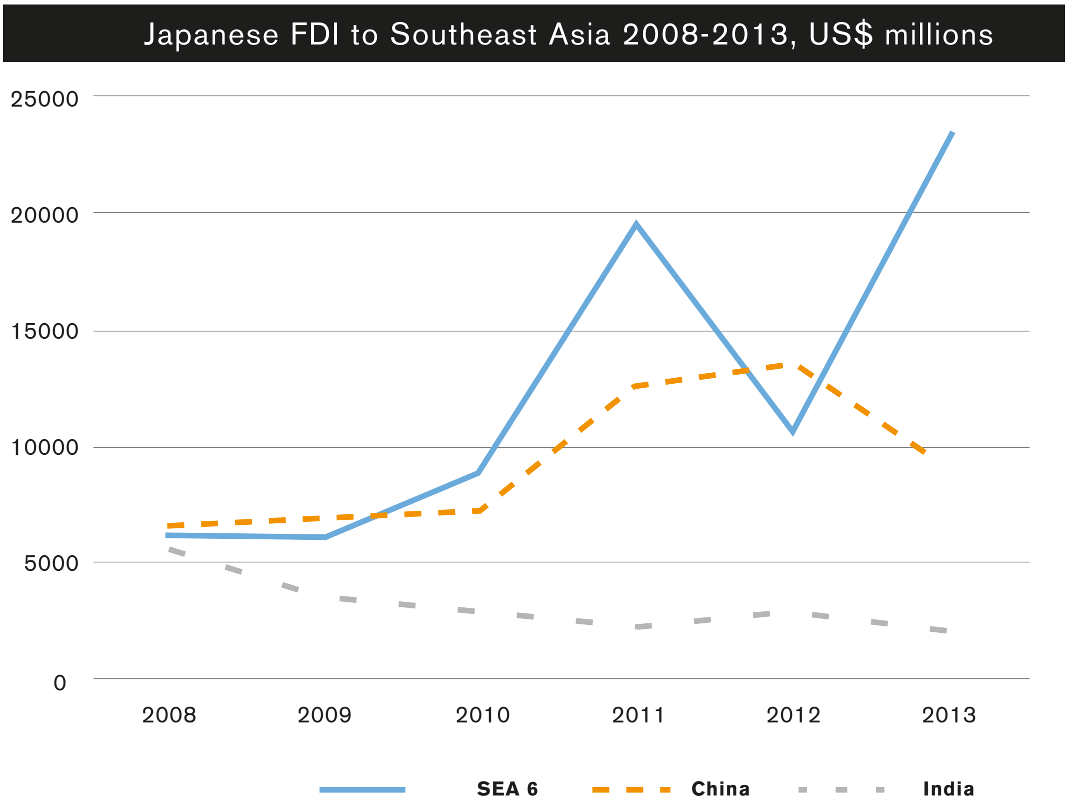
[4] Willem Thorbecke and Nimesh Salike, "Understanding Foreign Direct Investment in East Asia", *ADBI Working Paper* No. 290 (Tokyo: Asian Development Bank Institute, 2011), p. 1.

[5] Thorbecke and Salike, "Understanding Foreign Direct Investment in East Asia", p. 8.

[6] *Survey Report on Overseas Business Operations by Japanese Manufacturing Companies* (Tokyo: Japan Bank for International Cooperation, 2012), p. 4.

[7] The SEA 6 are Indonesia, the Philippines, Vietnam, Thailand, Malaysia and Singapore. For more detailed statistics on Japanese FDI flows from 1998 to 2013, please see the statistical annex at the end. I would like to thank Reema Bhagwan Jagtiani and Callista Hang, hard-working ISEAS Research Associates, for developing these graphs.

Chart 2 Japanese FDI to Asia 2008-2013, US$ millions (balance of payments basis, net and flow)



Source: Japan External Trade Organization statistics http://www.jetro.go.jp/en/reports/statistics/8

Chart 2 shows what appears to be a second wave of Japanese FDI into Southeast Asia that began building five to seven years ago and has significantly swelled since 2010. Surveys of Japanese corporations' FDI plans closely correlate with these figures with only minor time lags between expressed plans for expansion in Southeast Asia and increased Japanese FDI outflows to the region.[9] The most recent of these surveys show an increasing Japanese corporate appetite for greater FDI flows to a larger number of Southeast Asian economies strongly suggesting that this wave may be far from cresting.

[8] The dip in FDI to the region in 2012 can be partially due to the significant disruptions caused by the serious flooding in late 2011 in Thailand and the delays this caused to normal business operations and planning there.

[9] Increasingly FDI figures understate the real investment impact of these Japanese corporate decisions. In Southeast Asia, many Japanese firms have regional headquarters in Singapore and Thailand and fund direct investments in Southeast Asia from these nodes even when the final investment decision is taken in Japan.

Different causes

The strongest gravitational pull propelling this second wave are the decisions by a larger number of Japanese firms to move a greater share of their total production (and sales) outside Japan. If intentions are turned into operational reality, soon the share of Japanese manufacturing firms' overseas production to total production may, for the first time, overtake the share of overseas sales to total sales.[10]

The primary factor behind these individual corporate decisions to move more production overseas are Japanese firms' divergent projections for market growth in and outside Japan. Every year since 2009, less than a third of Japanese companies surveyed expressed plans to expand domestic operations in the medium term (next three years). Every year since 2010, over 80% of these same firms have plans to expand overseas operations. In 2012 and 2013, significantly more automobile firms planned to scale back or withdraw from domestic production than to increase domestic production.

The dominant reason given by firms for this lacklustre view of domestic production was "domestic market contraction." For firms planning to scale back domestic production, Japan's aging workforce also was not an insignificant concern. Japan's demographic decline is a significant push factor for Japanese FDI. The present size and future growth of emerging markets (and the United States) is a key pull factor and determinant of where Japanese FDI goes when it leaves Japan.[11] While emerging market growth only accounted for 16.9% of total global growth from 1980 to 1990, estimates suggest it will account for 61.6% of global growth from 2010 to 2018.[12]

At the beginning of the first wave, China did not loom as an imminent threat to Southeast Asian economies' ability to attract Japanese FDI. When this wave began to subside, regional perceptions of the FDI displacement to China threat peaked in the aftermath of the Asian Financial Crisis. China largely evaded this crisis and, in the immediate aftermath, it did appear that Japanese FDI was being rerouted.[13] As indicated in Chart 1, from 2000 to 2005, China received more FDI from Japan than Southeast Asia in four of the six years and India experienced a moderate upsurge in Japanese interest.

The tide has turned and Southeast Asian economies are benefitting from corporate Japan's growing concern over the overconcentration of overseas production in China (two-thirds of firms surveyed in 2013 with overseas operations had operations

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[10] *Survey Report on Overseas Business Operations by Japanese Manufacturing Companies*, (Tokyo: Japan Bank for International Cooperation, 2013), p. 4.

[11] Information taken from the JBIC annual surveys for the last three years.

[12] *Global Trade and Investment Report* (Tokyo: Japan External Trade Organization, 2013), p. 2.

13 It is well accepted among trade and investment economists that study this question that the rapid increase in FDI into China has not come at the cost of Southeast Asia. See Zhang Z. and Ow C.H. "Trade Interdependence and Foreign Direct Investment between ASEAN and China", *World Development* 24, no. 1 (1996): 155-170; and Tilak Abeysinghe and Lu Ding, "China as an Economic Powerhouse: Implications on its Neighbors", *China Economic Review*, 14 (2003): 164-185.

in China) and a continued reluctance towards India despite its recognised market potential.[14] Since 2011, Japanese firms' medium-term view of the Chinese and Indian economies as future locations for production and sales have softened after years of being far and away the two most favoured. In 2013, for the first time since the Japan Bank of International Cooperation started asking this question in the mid-1990s, China lost its top ranking, falling to fourth place. A majority of the 280 responding firms did not even identify China as a promising market. India's hold on second place continued to weaken.[15]

Human resource constraints are the largest concern for Japanese companies when it comes to China with rising labour costs identified by 77% of firms as a significant problem.[16] Second order constraints include electricity prices and problems with property rights protection. Political tensions between Japan and China do not appear to be a major factor, particularly for the Japanese firms with the least favourable views of the medium term prospects for the Chinese market. About 30% of the 533 firms surveyed that do business in China have already transferred operations out of China or are considering it.[17] Underdeveloped infrastructure is the top issue weighed against FDI to India and the comparatively low profitability ratio for Japanese investments in India does not help matters. The much greater increase in Japanese FDI flows to Southeast Asia than to China and India over the last four years reflects a shift of Japanese corporate interest away from China and India back to Southeast Asia.

Different locations

The focus of Japanese FDI interest in Southeast Asia also has shifted. Indonesia, like the Philippines, largely missed the first wave of Japanese foreign direct investment. Yet, in 2013 Japanese firms saw Indonesia as the most favourable overseas market in the medium term in the world with particular interest from the automobile industry. Indonesia has experienced the most significant surge among the six largest Southeast Asian economies in Japanese FDI since 2010. Only stalwarts Thailand and Singapore have received more inflows during this period.

Even more than Indonesia and the Philippines, Vietnam missed the first wave of Japanese FDI to the region. Only since 2008 has Vietnam become a destination of any real note for Japanese FDI. Now, it is a major recipient, easily overtaking Malaysia as a location for new Japanese FDI. Both Indonesia and Vietnam benefit from low labour costs and strong market potential and see the largest proportion of Japanese

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[14] *Survey on the International Operations of Japanese Firms* (Tokyo: Japan External Trade Organization, 2013), p. 10.

[15] Japan Bank of International Cooperation, 2013, pp. 20-22.

[16] Ibid., p. 28.

[17] Ibid., p. 41.

FDI inflows going into greenfield development among the six largest recipients of Japanese FDI in the region. Vietnam and Indonesia also rank as the second and third most attractive locations for the relocation of Japanese operations from China. Southeast Asian states fill the top five slots for this 'China+1' measure.[18]

Despite deepening political turmoil over the last decade, Thailand remains the favoured Southeast Asian destination for Japanese FDI. In the last three years, Thailand alone has captured one-third of total Japanese FDI flows to the six largest regional economies, almost twice as much as the next largest recipient, Singapore.[19] Thailand is the favoured destination for relocation of Japanese operations from China. The extension of existing operations is the dominant form of new Japanese FDI to Thailand reflecting the benefits for Thailand of its long-standing role as a centre for Japanese production in Asia. Thailand has consistently remained among the four most favourable medium-term markets for Japanese firms and at the top of the list of the most profitable ones.

Japan's demographic decline appears to be having the most significant impact on the production and sales decisions of Japanese small and medium enterprises, the vast majority of the over 300,000 manufacturing firms in Japan. In 2011, less than 1% of Japanese small and medium enterprises possessed an overseas subsidiary.[20] However, from 2008 to 2011, the share of these firms that planned to establish or expand overseas operations increased from 45.1% to 71.4% while the number with no plans for overseas operations fell from 12.2% to 4.2%.[21] Increasing overseas demand and the movement of client companies overseas were the two major pull factors cited by firms planning to enter overseas markets for the first time. These small and medium enterprises nominate local business partner concerns as the most significant bottleneck to overseas expansion and business exhibitions and trade fairs as the most used means to find such partners.[22]

CONCLUSION: LOOKING FORWARD

This second wave of Japanese FDI to Southeast Asia will not be as transformative as the first wave as regional countries are more advanced economically and there are more suppliers of FDI to the region now. If Japanese small and medium enterprises do become a significant new source of FDI to the region, this could provide greater and more diverse technology transfer benefits to host countries. One of the criticisms of the first wave of Japanese FDI, led by large, export-oriented firms building regional

[18] Ibid., p. 41.

[19] Please see the statistical annex at the end for detailed statistics on Japanese FDI inflows to individual Southeast Asian economies from 1998-2013.

[20] JETRO, 2013, p. 10.

[21] *Global Trade and Investment Report*, Tokyo: Japan External Trade Organization, 2012), p. 12.

[22] JETRO, 2013, pp.24-25.

production chains, was the lack of significant and consistent technology transfer.[23]

Yet, the most recent figures are still impressive in size and Japan will likely stay the largest national source of FDI for the region for the foreseeable future. The two major push factors for Japanese FDI into the region Ð Japan's demographic decline and the rising costs of business in China Ð are structural in nature, suggesting that this second wave will not crest and subside soon. Rising per capita incomes, greater spending power and the economy of scale benefits from advancing regional integration are more powerful Southeast Asian pull factors this time around. Japanese investors identify "future growth potential of local market" as the most important source of promise in Indonesia, Vietnam, and Thailand as it is in China, India, Brazil, Mexico and (oddly) Russia.[24]

Host states in the region can enhance pull factors to help ensure this wave's continuation. They can:

- Work with Japanese business and government agencies to provide greater support for Japanese small and medium enterprises seeking to establish or expand overseas. These firms do not have the in-house expertise and host country knowledge of Japan's major firms but face the same domestic market problems. Successful programs will help diversify the sources of Japanese FDI to Southeast Asia and give local small and medium enterprises greater access to Japan.

- Build on the market opening successes of the 'noodle bowl' of bilateral and regional trade agreements between Southeast Asian states, Japan and other Asian countries that are nodes in Japan's regional production networks. The free trade agreement utilisation rate among Japanese firms is steadily increasing and the ASEAN Free Trade Area and the ASEAN agreements with China and India are among the most utilised third-party trade agreements for Japanese firms operating in the region.[25] Thailand and Singapore's early pursuit of trade agreements with partners beyond Southeast Asia may help explain their continued attractiveness to Japanese FDI.

Further liberalisation through these agreements' regular review mechanisms and a successful end to the recently begun Regional Comprehensive Economic Partnership negotiations between the ten ASEAN member states, Japan, China, India, South Korea, Australia and New Zealand should enhance the volume and duration of this second wave of Japanese FDI to Southeast Asia.

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[23] Mark Z. Taylor, "Dominance through Technology: Is Japan Creating a Yen Bloc in Southeast Asia", *Foreign Affairs*, 74, no. 6 (1995): 14-20.

[24] JBIC, 2013, pp. 25-31.

[25] JETRO, 2013, p. 33.

- Both Vietnam and Indonesia, as the two new beneficiaries, could sustain their attractiveness by improving their hard and soft infrastructure. Both are raised as significant concerns by Japanese firms.

- Asia as a whole has not benefited significantly from the recent upsurge in Japanese non-manufacturing FDI. In 2010, Asia captured over 80% of Japan's total non-manufacturing FDI outflows but less than 20% of total non-manufacturing FDI outflows. These non-manufacturing outflows were roughly twice as large in volume as the manufacturing ones.

- The figures for Southeast Asia were equally lopsided. Southeast Asia received over a third of Japan's total manufacturing FDI outflows in 2010 and only 7% of non-manufacturing ones, with Singapore alone accounting for 46% of the Southeast Asian total for the latter category. Despite the mineral and energy wealth of the Philippines, Indonesia and continental Southeast Asia, the region accounted for less than 2% of Japanese mining-related FDI in 2010. Service and mining sector liberalisation will be key to reverse this regional lacunae.[26]

[26] Figures from a table of Japanese FDI abroad provided to me by a JBIC official in Tokyo in April 2014.

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STATISTICAL ANNEX

Japanese FDI to East Asia 1998-2007, US$ millions (balance of payments basis, net and flow)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
SEA 6	**4440**	**1021**	**202**	**4010**	**4253**	**546**	**2800**	**4986**	**6880**	**7716**
Indonesia	916	199	585	481	307	484	498	1185	744	1030
Philippines	521	591	510	275	1074	114	6	442	369	1045
Vietnam	169	87	39	139	203	230	128	153	467	475
Thailand	1668	-119	593	1594	528	678	1867	2125	1984	2608
Malaysia	445	-332	-4	570	257	-504	163	524	2941	325
Singapore	721	595	-1521	951	1884	-456	138	557	375	2233
China	1301	360	934	2158	2622	3980	5863	6575	6196	6218
India	460	261	175	150	146	124	139	266	512	1506
USA	6013	7140	14121	7031	7441	10691	7559	12126	9297	15672
World	24627	22266	31534	38495	32039	28767	30962	45461	50165	74650

Source: Japan External Trade Organization statistics http://www.jetro.go.jp/en/reports/statistics/

Japanese FDI to Southeast Asia 2008-2013, US$ millions (balance of payments basis, net and flow)

	2008	2009	2010	2011	2012	2013
SEA 6	**6230**	**6175**	**8903**	**19555**	**10532**	**23399**
Indonesia	731	483	490	3611	3810	3907
Philippines	705	809	514	1019	731	1242
Vietnam	1098	563	748	1859	2570	3266
Thailand	2016	1632	2248	7133	547*	10174
Malaysia	591	616	1058	1441	1308	1265
Singapore	1089	2881	3845	4492	1566	3545
China	6496	6899	7252	12649	13479	9104
India	5551	3664	2864	2321	2802	2155
USA	44674	10660	9193	14730	31974	43703
World	130801	74650	57223	108808	122355	135049

Source: Japan External Trade Organization statistics http://www.jetro.go.jp/en/reports/statistics/
** The very low FDI figure for Thailand in 2012 may be partially due to the significant disruptions caused by the serious flooding in late 2011 and the delays this caused to normal business operations and planning.*