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**Japan's New Trade Policy:  
Good or Bad for ASEAN?\***

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## Japan's New Trade Policy: Good or Bad for ASEAN?

### Abstract

Because Japan is a primary investor and trading partner of all the troubled economies, in the midst of the crisis, Japan was called in to help the crisis-stricken countries by opening its market to cheaper imports from South East Asia.

The article analyses the opening to trade of the Japanese economy with the help of a gravity equation on panel data using a Hausman-Taylor estimator. We show that there is no certainty that such a role, that is the opening of Japan, will have positive effects for the ASEAN countries, although no detrimental effects are expected. In the worst case scenario, this move and its impact on ASEAN countries would have neutral effect. This new Japanese policy, if applicable, appears to be not enough to (1) help ASEAN countries emerge from the financial crisis and (2) enable Japan to play the role it could and/or should in the region.

Although many look at this solution – Japan opening its national market -- as the only one, on the contrary, Japanese help has been different and has proved to be very crucial to the ASEAN countries in need. In fact, the case of Malaysia is a good example of how Japan can help to foster the economy. Their experience shows that, next to trade ties, a greater emphasis can be put on a technical and/or other type of co-operation. Within this framework, Japan has helped Malaysia to recover faster from the crisis, without the former having to open wider its market to the latter. However, Japan is also driven by its own interests. Thus, if it wants to play a leading role in furthering ASEAN integration, especially in economic aspects, it will have to consider, soon or later, opening up its market to appear more reliable to its neighbours.

### Résumé

Le Japon est un partenaire commercial et un investisseur important des pays du sud-est asiatique. Pendant la récente crise, de fortes pressions ont été exercées pour qu'il ouvre son marché afin d'aider les économies frappées par la récession.

L'article cherche à étudier les effets d'une ouverture commerciale plus grande du Japon, à l'aide d'un modèle de gravité sur données de panel en utilisant un estimateur de type Hausman-Taylor. L'analyse montre qu'il n'y a aucune certitude concernant un effet bénéfique, pour les pays de l'ASEAN, d'une plus grande ouverture du Japon, même si il semble qu'aucun effet négatif ne puisse en résulter. Dans le scénario le plus défavorable, l'impact sur les pays de l'ASEAN sera neutre. Cette « nouvelle politique japonaise », si elle est appliquée, apparaît toutefois insuffisante pour, d'une part aider les pays de l'ASEAN à sortir d'une crise financière et d'autre part permettre au Japon de jouer dans la région le rôle qu'il souhaite ou devrait jouer.

Bien que de nombreux analystes considèrent cette solution – l'ouverture commerciale du Japon – comme la solution unique, l'aide japonaise s'est avérée plus multiforme et s'est révélée cruciale pour la sortie de crise des pays de l'ASEAN. L'exemple de la Malaisie est à cet égard intéressant. Les relations commerciales peuvent être complétées par diverses formes de coopération. Ainsi, le Japon a permis à la Malaisie de sortir plus rapidement de la crise sans qu'il n'ait été nécessaire qu'il ouvre plus son économie. Cependant, le Japon est bien évidemment guidé par ses propres intérêts, mais, si il veut jouer un rôle leader dans l'approfondissement de l'intégration de l'ASEAN, alors, il devra tôt ou tard, envisager d'ouvrir son économie pour apparaître plus crédible vis à vis de ses partenaires et voisins.

### Key-words

Japan – ASEAN – Malaysia - Gravity equation - Asian crisis – Hausman-Taylor – FDI

### Mots clés

Japon – ASEAN – Malaisie – Modèle de gravité – Crise asiatique – Hausman-Taylor - IDE

## ***Introduction***

Japan is Asia's largest economy by producing two-third of Asia's GDP. Over 40 percent of Japan's exports goes to Asia while almost half of Japan's imports are from Asia. Indeed, Japan's economy is much larger than the rest of Asia combined. By virtue of the fact that the ASEAN economies have different industrial structures and natural resource endowments, it is not surprising that trade dependency is not uniform across sectors throughout ASEAN and that the rapid growth of trade and investment ties in East Asia has been facilitated by the economic diversity of host economies.

ASEAN was established in 1967 by the five founding member nations ; Indonesia, Malaysia, the Philippines, Singapore, and Thailand. The ASEAN membership was extended to Brunei in 1984, Vietnam in 1995, Laos and Myanmar in 1997, and Cambodia in 1998. Most of those countries have been hit from the economic crisis which erupted following speculative attacks on their currencies in July 1997. Then because Japan is a primary investor and trading partner of all the troubled economies, the later look upon Japan as the anchor economy as well as a crisis solution.

The first part of the article will look at the trade relationship between Japan and its partners, more particularly the ASEAN countries. The hypothesis of an unilateral opening up of the Japanese market – considered as Japan's new trade policy - and its outcomes are considered. Does the Japan's new trade policy will lead to trade creation effects. Or does this new policy open the path of trade diversion within ASEAN countries ? We attempt to evaluate the benefits and costs from the perspective of the five founding countries of the ASEAN.

To answer these questions and some related ones, we will make use of a gravity equation of bilateral trade over the period 1962-1996 using panel data techniques. This will allow us, first, to built a normal level of trade, second to compare intra-ASEAN trade and ASEAN trade with Japan. In such an equation, bilateral trade is explained by distance (a proxy for transportation costs), but also by GDP, population, etc. As we will show, intra-ASEAN relationships have been fairly stable while the trade links between Japan and ASEAN countries appear more unsteady. This lead us to say that an opening of the Japanese economy may not necessarily be beneficial for ASEAN countries and indeed may be insufficient for Japan to play the role it want to in the region.

Contrary to the first part, the second part will examine the hypothesis that Japan's past unwillingness to open up its market remains. Under this assumption, we will show why Japan should not be subjected to too many direct attacks for not opening its market to its Asian neighbours as a solution for their recovery. Indeed, Japan has many other ways to help those countries which are not related to trade or investments. In order to illustrate what can be the Japanese relationship with another country and how this can foster and help the recipient country, we will have a closer look at the Malaysian case which provides a very good example.

Japan's presence contributes to Malaysia's economic development especially through its direct investments, while it has been as well a crucial point for the Malaysian faster recovery. Indeed, Japan found its own way of giving a hand to its neighbouring economies. Among others, the main initiative was a financial stimulus package – which is still relevant today and known as the Miyazawa Initiative - aimed at helping battered Asian economies. The amount involved in the financial assistance given by Japan indicates that this country is the single largest source of assistance for crisis-stricken Asia. Thus, maybe, the question should not be only focused on whether Japan's new trade policy is good or bad for the ASEAN integration process. From what will be presented here, one can end up saying that a more appropriated question may be whether there are other ways beside the "outside" request to Japan to open up its market in order to help the ASEAN economies, first as a solution to their recovery from the crisis, and second to enhance their integration. It seems that the answer is yes. Yet, Japan can play a role in the region and in the process of ASEAN integration, not only limited to the trade area.

## ***Part One***

### ***1.1. ASEAN-Japan: The expected effects.***

It is worth noting that the creation of ASEAN was largely motivated by factors not related to trade. The primary goals were to accelerate economic growth and social progress, to promote peace and stability in the region, and to encourage regional co-operation (Melo de, Montenegro and Panagariya 1993). It is only in 1992 that the Framework Agreement on Enhancing Economic Cooperation included the creation of an ASEAN Free Trade Area (AFTA) which should be completed in 2005. Tariff and non-tariff barriers should be eliminated among the members.

We are not focusing our analysis specifically on the ASEAN, even if, with the creation of ASEAN, we should observe trade creation between member countries. What we are interested in, is to look if there is a distinguishing feature between ASEAN countries and Japan regarding trade. Is Japan importing more from ASEAN countries than should normally be observed? Put differently, is there a trade creation between Japan and ASEAN countries? If so, as it can be expected, do we observe trade creation within ASEAN countries? If ASEAN countries trade more among themselves and more with Japan, should we observe a trade diversion with a third bloc of countries ? Finally, if Japan imports more from ASEAN countries does this implies that it imports less from the rest of the world ?

## 1.2. The gravity equation

Gravity equation has several important characteristics. First, it allows to measure directly the impact on trade of the creation of a Preferential Trade Agreement (PTA), or of some specific grouping of countries, by using dummy variables. Second, it allows to built a counterfactual scenario which indicates what would have happened without the creation of the PTA (or without the specific grouping). Third, given the availability of data, panel data techniques can be used to take into account some unobservable heterogeneous phenomena.

In a gravity equation, bilateral trade is explained by the size of the two countries (GDP, population, sometimes area), and on transaction costs (distance, common border) and some factors that may capture the external environment (oil price, real exchange rate). Gravity equation lacks theoretical foundations or more exactly has too much theoretical underpinnings. Gravity equation can be derived either from a Heckscher-Ohlin framework or from a monopolistic structure as proposed by Krugman. Despite this theoretical weakness, the gravity equation has proved to be useful to investigate bilateral trade flows.

To take in account the effects of PTA, some dummies are in general included into the equation. A first wave of studies (see for instance Aitken 1973) introduced one dummy capturing the effects of the creation of a PTA on intra-bloc trade. This dummy takes the value 1 if both countries belong to the PTA and 0 otherwise. These studies were able to measure trade creation and trade diversion within the PTA. A second wave of studies (Bayoumi-Eichengreen 1995, Frankel 1997) introduced a second dummy which captures trade between member countries and non-member countries. This dummy takes the value 1 if one country belongs to the PTA and 0 otherwise. With these two dummies one can see if there is trade a creation, that is the intra-trade is increasing whereas the extra-trade is unaffected. It can also be seen if a trade creation within the PTA happened at the expense of a trade diversion with the rest of the world.

As Soloaga and Winters (1999) have pointed out, it is very important to distinguish between imports and exports flows: «...these dummies for extra-bloc trade covered both imports and exports they were capturing diversionary consequences on flows in both directions». Thus in this paper the focus will be not on total trade but on import flows.

The gravity equation explains trade flows between a country *i* (importer) and a country *j* (exporter). Writing the equation in logarithms, where *t* means time, we obtain:

$$\log M_{ijt} = \mathbf{a}_0 + \mathbf{a}_1 \log Y_{it} + \mathbf{a}_2 \log Y_{jt} + \mathbf{a}_3 \log P_{it} + \mathbf{a}_4 \log P_{jt} \\ + \mathbf{a}_5 \log D_{ij} + \mathbf{a}_6 L_{ij} + \mathbf{a}_7 \log P_t + \mathbf{a}_8 T + \mathbf{u}_{ij} + \mathbf{e}_{ijt}$$

Where:

$M_{ijt}$  is the value of imports of country  $i$  from country  $j$  at time  $t$

$Y_{nt}$  is the Gross Domestic Product of country  $n$  at time  $t$ ;  $n=i,j$

$P_{nt}$  is the total population of country  $n$  at time  $t$

$D_{ij}$  is the distance between the two countries. Points for measuring distance are commonly taken at the capital city or at the main economic centre if it is different. For instance, in Brazil, São Paulo is preferred to Brasilia. Distance is chosen as a proxy for transportation costs which should increase with the distance between two countries.

$L_{ij}$  is a dummy that takes the value 1 if countries  $i$  and  $j$  are sharing a land border and 0 otherwise

$P_t$  is the real oil price at time  $t$

$T$  is a trend

To these variables that define a «normal» trade<sup>1</sup> between countries we will add dummy variables that will capture specific links between blocs of countries.

A dummy ASEAN will catch the relations among ASEAN countries that is ASEAN members being the importer and the exporter.

A dummy ASEAN-JAPAN will take into account the links between ASEAN and JAPAN, with the importer being Japan and the exporter being ASEAN. If as expected ASEAN countries trade more among themselves, can they still export more to Japan?

A dummy ASEAN-ROW, where ROW means the rest of the world and does not include neither Japan nor ASEAN countries, will capture the trade relations between ASEAN and the rest of the world. The importer will be ROW and the exporter ASEAN

A dummy JAPAN-ROW, where Japan is the importer and ROW the exporter will tell us if Japan imports more from the rest of the world.

$\nu_{ij}$  is a specific effect for each couple of countries.

$\varepsilon_{ijt}$  is a log-normally distributed error term.

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<sup>1</sup> Regarding trade within the Asian region, an important determinant may be FDI's. Unfortunately, this variable is not available for so many countries as included in the sample.

### **1.3. The econometric approach**

The equations have been estimated using panel data techniques. A specific bilateral effect has been introduced to take into account for unobservable characteristics between two partner countries as for instance: cultural affinities, historical links. These effects in cross sections are partly captured by the dummies measuring PTA (or group of countries) and are therefore an important source of bias. In fact, panel data techniques are preferable to cross section relations as they can in a certain degree eliminate these potential sources of bias.

To take into account an unobservable heterogeneity two methods are available. In the absence of correlation between specific effects and the explanatory variables random effects are preferable because they are convergent and efficient. On the reverse, when the explanatory variables are correlated with the specific effects only fixed effects are convergent. However, a fixed effects equation with specific bilateral effects would eliminate the variables such as distance or land border that do not present intra-individual variability.

A technique that combine random effects and a correction for a plausible correlation of the specific effects with the explanatory variables has to be used. Such a technique has been developed by Hausman and Taylor (1981) and will be used here to estimate all the equations. The variables which exclude intra-individual variability will not disappear from the estimated equations. This method has yet been used in a gravity equation by Brun, Guillaumont and Melo de (1999). We make the hypothesis that distance, land border, regional dummies, population, oil price are exogenous, that is uncorrelated with the specific effects. The endogenous variable is GDP, that is correlated with the specific effects. As the Hausman-Taylor approach is a TSLS technique we need to use instrumental variables. Following Hausman and Taylor, instruments variables are:

For the exogenous variables that posses an intra-individual variability (population, oil price): the intra-individual mean of these variables and the difference between the variable and its intra-individual mean.

For the exogenous variables without intra-individual variability (distance, land border): the variables themselves without transformations.

For the endogenous variables with intra-individual variability (GDP): the difference between the variable and its intra-individual mean.

A Hausman test is applied to each equation which tell us if a TSLS procedure (Hausman-Taylor) is preferred to a Quasi-Generalised Least Square (QGLS) estimator (Random effect model). Under the null of no correlation between the specific effects and the explanatory variables, both methods are convergent but only QGLS are efficient. Under the alternative of a correlation between the specific

effects and the explanatory variables, only the TSLS procedure is convergent. A high value of the statistic, which follows a Chi-square, means a rejection of the null.

Data are taken from UN-COMTRADE database for the period 1962-1996. No country was a priori eliminated, so the data include developed countries as well as developing ones. The dependent variable also includes oil and is deflated by a world price index of imports taken from International Financial Statistics (IFS) of the IMF. Data for distance are taken from a CD-ROM of the company CVN. Oil price is taken from IFS. All remaining variables are taken from the World Development indicators CD-ROM of the World Bank.

To evaluate the links between Japan and ASEAN concerning trade, it seems important to have the longer time span as possible. It allows to discriminate different time periods where some changes occurred within the functioning of the ASEAN or in the international environment. In this respect, we distinguish 4 main periods. The first period covers 1962-1966 and shows the nature of the links among ASEAN countries before the creation of the bloc, as well as the links of the future ASEAN countries with Japan. The second period is 1967-1976 it reviews the beginning of the ASEAN until the adoption of the Preferential Trading Arrangement. The third period covers 1977-1984, where 1985 has been marked by the Plaza Agreement. The last period is 1985-1996 and is concerned with ASEAN after the Plaza Agreement. This period is split into two sub-periods: 1985-1991 and 1992-1996, 1990's being considered as difficult years for Japan and 1992 being the year of the AFTA adoption.

#### **1.4. The results**

Table 1 presents the estimated coefficients and the t-tests for the four periods. As usual in gravity equation, the GDP (importer and exporter), the populations and the distance appear to be always significant, the only exception is for the population of the exporter country in the first period which is non significant. Trade increases with the level of GDP of the exporter and importer, decreases with the size of the population and with the distance between the two partner countries.

The variable measuring proximity through common land border appears to be always significant and to play positively on the level of trade. Oil prices in all but the first period is a factor that affected negatively trade with the highest coefficient for the period 1977-1984 which was marked by the second oil price shock. The trend is negative and significant in the last three periods.

All the variables of the first part of the table 1 from the intercept to trend define a normal level of trade,. The remaining dummies tell us if the blocs considered trade more or less than this normal level. As all the variables are in log, in order to get the percentage of change of a dummy variable, we just need to calculate  $(\exp(\text{dummy coefficient})-1)\times 100$ . For instance the percentage of change of the dummy ASEAN-ROW for the third period is:  $(\exp(0.57)-1)\times 100 = 77\%$ . That is, these countries trade 77 % more than is expected with the gravity model.



From these dummies, we can see that ASEAN countries always trade more than is expected via the gravity equation. This is true even before the creation of the ASEAN. For all the periods the coefficient is quite high, meaning that, at least ASEAN countries trade among themselves four times more than is expected via the gravity equation. But we should keep in mind that it does not mean that ASEAN increases trade fourfold. We can note that the coefficient has decreased for the period 1977-1984 compared to 1967-1976. What may surprise is the fact that the coefficient for the first period is so high. This may be due to the fact that Singapore serves as an entrepôt both for Malaysia and Indonesia. Despite this last element, there is a special link among ASEAN countries.

**Table 1: Gravity Model Estimates - Panel Data Techniques**

Dependent variable: total bilateral imports				
Explanatory Variables	1962-66	1967-76	1977-84	1985-96
Intercept	-4.78 (1.58)	-12.7 (48.1)	-13.6 (29.4)	-15.4 (50.2)
GDP importer	1.23 (8.01)	1.19 (22.4)	0.98 (18.5)	1.38 (27.0)
GDP exporter	0.83 (7.50)	1.18 (25.4)	1.28 (19.0)	1.59 (45.8)
Population importer	-0.44 (2.41)	-0.38 (6.81)	-0.09 (1.95)	-0.37 (8.58)
Population exporter	0.05 (0.51)	-0.26 (5.81)	-0.31 (5.20)	-0.53 (16.3)
Distance	-0.78 (29.6)	-1.08 (66.1)	-1.25 (79.4)	-1.11 (82.5)
Common land border	1.16 (7.30)	0.98 (12.6)	0.51 (6.54)	0.97 (13.6)
Oil price	-3.46 (1.63)	-0.07 (2.92)	-0.12 (3.72)	-0.05 (1.97)
Trend	-0.05 (1.56)	-0.03 (7.86)	-0.04 (10.5)	-0.01 (5.68)
ASEAN	2.34 (7.65)	1.81 (14.3)	1.61 (15.0)	1.77 (24.2)
ASEAN-JAPAN	1.21 (5.01)	1.49 (8.00)	1.78 (8.33)	0.31 (1.65)
ASEAN-ROW	-0.19 (1.15)	0.28 (4.44)	0.57 (10.4)	0.86 (21.8)
JAPAN-ROW	-0.90 (4.05)	-0.17 (1.21)	0.14 (0.93)	-1.04 (7.10)
Number of observations	17158	55502	58637	102730
F-test	714	1995	2510	4304
R-squared	0.41	0.43	0.48	0.44
Hausman test	17.0	90.0	48.1	638

t-tests are between brackets.

On the reverse, if Japan imports more from ASEAN in the first three periods (1962-1966, 1967-1976, 1977-1984), it does so either by importing less from the rest of the world (first period) or by having a «normal» trade with the rest of the world (period 2 and 3). For the last period (1985-1996), Japan imports less from the rest of the world than expected and has a «normal» trade with ASEAN.

When we look at the link between Japan and ASEAN, the coefficients appear high and significant between 1962 and 1984, and of increasing magnitude. However, for the last period however the coefficient shrinks steadily and is almost non significant, that is we cannot distinguish it from zero. This marks an important change in the trade relationships between Japan and ASEAN: Japan does not seem to import more from ASEAN than is expected via the gravity equation. This may be in part attributable to the crisis which hit Japan in the 1990's.

The fact that ASEAN countries trade more among themselves and for the first three periods (1962-1966, 1967-1976, 1977-1984) more with Japan, has not been made at the expense of trade with the rest of the world. Except for the first period where the coefficient is non significant, the coefficient shows a positive sign, and, is increasing and significant for the last three periods indicating that ASEAN countries export also more than is expected to the rest of the world.

Table 2 discriminates the rest of the world between OECD countries (which do not include Japan) and NON-OECD countries (which do not include ASEAN). It appears that for ASEAN, except for the first period (1962-1966), exports are superior to the norm as well as with OECD countries as with NON-OECD ones. With the later, the coefficient is increasing while with the former, the coefficient is smaller for the last period compared to the third period. In short, for ASEAN countries there is no marked difference for its exports to OECD and NON-OECD countries.

Concerning Japan, the reverse seems true. Japan imports less than expected with other OECD countries whatever the period we look at. With NON-OECD countries, there is no clear pattern as Japan imports less than expected for the first and last period (1962-1966 and 1985-1996), more than expected for the third period (1977-1984) and imports in accordance with the norm in the second period (1967-1976). In the case of Japan, one reason may be the existence of a trade diversion as ASEAN countries export more and more technological products which are competing with products exported by OECD countries. There is a trade-off: if Japan imports more from ASEAN it imports less from other OECD countries.

**Table 2: Gravity Model Estimates - Panel Data Techniques**

Dependent variable: total bilateral imports				
Explanatory Variables	1962-66	1967-76	1977-84	1985-96
Intercept	-4.80 (1.58)	-12.7 (46.7)	-13.5 (28.9)	-15.4 (50.2)
GDP importer	1.23 (7.91)	1.18 (21.5)	0.97 (18.3)	1.37 (26.7)
GDP exporter	0.83 (7.49)	1.19 (25.5)	1.28 (19.0)	1.59 (45.7)
Population importer	-0.44 (2.39)	-0.37 (6.50)	-0.09 (1.93)	-0.36 (8.41)
Population exporter	0.06 (0.53)	-0.26 (5.89)	-0.31 (5.20)	-0.53 (16.3)
Distance	-0.78 (29.8)	-1.08 (66.2)	-1.25 (79.4)	-1.12 (82.8)
Common land border	1.16 (7.30)	0.97 (12.5)	0.51 (6.55)	0.97 (13.5)
Oil price	-3.45 (1.62)	-0.07 (2.91)	-0.12 (3.71)	-0.05 (1.96)
Trend	-0.05 (1.54)	-0.03 (7.79)	-0.04 (10.4)	-0.01 (5.57)
ASEAN	2.34 (7.64)	1.80 (14.2)	1.61 (8.79)	1.76 (24.2)
ASEAN-JAPAN	1.21 (4.96)	1.52 (7.99)	1.80 (8.33)	0.33 (1.77)
ASEAN-OECD	-0.06 (0.21)	0.45 (3.71)	1.30 (12.5)	0.78 (8.23)
ASEAN-NON OECD	-0.30 (1.34)	0.21 (2.62)	0.32 (4.04)	0.89 (13.8)
JAPAN-OECD	-1.39 (4.55)	-1.44 (9.70)	-1.01 (4.88)	-2.35 (13.6)
JAPAN-NON OECD	-0.73 (2.76)	0.22 (1.35)	0.42 (2.57)	-0.76 (5.02)
Number of observations	17158	55502	58637	102730
F-test	641	1930	2630	4931
R-squared	0.41	0.43	0.48	0.44
Hausman test	17.0	89.0	48.9	638

t-tests are between brackets.

Table 3 separates the last period in two sub-periods: 1985-1991 and 1992-1996. This allows us to observe a sharp deterioration of the link between ASEAN countries and Japan from the first sub-period to the second one where Japan imports no more than the normal level from ASEAN countries.

ASEAN exports more to the rest of the world and the coefficient is increasing, but this increase seems to be directed more toward NON-OECD countries. Japan imports less from the rest of the world and in absolute value the coefficient is increasing. On their side, NON-OECD countries seem to be more affected.

**Table 3: Gravity Model Estimates - Panel Data Techniques**

Dependent variable: total bilateral imports				
Explanatory Variables	1985-91	1992-96	1985-91	1992-96
Intercept	-13.2 (30.0)	-12.2 (14.2)	-13.2 (30.0)	-12.2 (14.1)
GDP importer	1.23 (18.1)	1.63 (13.5)	1.23 (17.9)	1.64 (13.4)
GDP exporter	1.33 (21.4)	0.39 (3.11)	1.33 (21.4)	0.39 (3.11)
Population importer	-0.29 (4.98)	-0.66 (6.38)	-0.29 (4.92)	-0.67 (6.37)
Population exporter	-0.32 (5.64)	0.61 (5.40)	-0.32 (5.67)	0.61 (5.41)
Distance	-1.21 (71.9)	-1.10 (52.2)	-1.21 (72.0)	-1.10 (52.3)
Common land border	0.63 (7.55)	1.41 (14.9)	0.63 (7.52)	1.42 (14.9)
Oil price	-0.05 (1.76)	-0.44 (4.84)	-0.05 (1.76)	-0.44 (4.85)
Trend	-0.01 (3.77)	0.03 (4.61)	-0.01 (3.73)	0.03 (4.60)
ASEAN	1.69 (18.5)	2.42 (13.6)	1.69 (18.5)	2.42 (13.4)
ASEAN-JAPAN	0.82 (4.45)	0.25 (0.65)	0.83 (3.48)	0.24 (0.61)
ASEAN-ROW	0.83 (16.5)	1.42 (17.8)		
JAPAN-ROW	-0.53 (2.78)	-2.03 (6.30)		
ASEAN-OECD			1.00 (8.00)	0.93 (4.12)
ASEAN-NON OECD			0.76 (8.89)	1.59 (12.4)
JAPAN-OECD			-1.41 (5.89)	0.04 (0.09)
JAPAN-NON OECD			-0.33 (1.65)	-2.40 (7.14)
Number of observations	54817	47913	54817	47913
F-test	2515	2237	2863	2358
R-squared	0.49	0.40	0.49	0.40
Hausman test	65371	13973	65371	13973

t-tests are between brackets.

### **1.5. Conclusions for the ASEAN-Japan trade relationship**

The trade relationship between ASEAN countries and Japan seemed to be strong until 1991. For the period 1992-1996 there is a clear break as Japan does not import more from ASEAN than what is expected via the gravity equation. So what could have happened if Japan decided to open up its economy?

First ASEAN seems rather strong enough – in terms of intra-trade - to cope with an opening Japan. Even if intra-ASEAN trade happens to be not so important, the intra-ASEAN coefficient is so high that

it would probably remain positive, showing that ASEAN countries form a real bloc. With the setting up of the AFTA, links among ASEAN members would be strengthened and could ease to face with a new Japan trade policy.

Second, Japan's opening could be favourable to ASEAN countries, but that is not so sure. If the coefficients of the last period were to remain, an opening of Japan's economy would have no effect on the trade with ASEAN countries. They would continue to trade in accordance with the gravity equation. But one must bear in mind that the years 1992-1996 have been particularly difficult ones for Japan and then do not reflect the normal behaviour of the Japanese economy. In that case, a positive coefficient, as observed for the period 1985-1991, would be more plausible. In that case, a more opened Japan would then be beneficial for ASEAN countries. Maybe ASEAN countries would export more to Japan and less to other OECD countries.

What can be the consequences of the recent crisis for trade in the region? First of all, it may be seen as a temporary shock rather than a permanent one. Even if trade of ASEAN countries has been affected, it may recover quite fast to its previous levels more than one can think and so, even if the crisis had some painful consequences, it could be short-lived as the recovery in the region seems to be well engaged.

What emerges, however, is the fact that if Japan wants to play a greater role in the region, it will not be able to do so, only via a new trade policy. Therefore, this leading role will require a different attitude. Maybe a closer look at the links between Japan and Malaysia could give a good picture of what types of relations are needed, since Japan's new trade policy remains a study hypothesis at the present. This is the object of the next section.

## ***Part Two***

In the midst of the crisis, Japan was called in to help the recovery process by opening its market to cheaper imports from South East Asia. The country is a primary investor and trading partner of all the troubled economies which look upon Japan as the anchor economy. Thus it was widely held that Asia's full recovery was - and still is - dependant on a healthy Japan. But at that time Japan itself was also facing domestic difficulties which did not encourage the government to readily accept the tremendous obligations and pressure to assist the crisis-hit economies in the region by opening up its domestic market.

However, in the process of Asian regionalization, countries should increasingly focus on the less traditional areas in tandem with trade and investments to foster a broader economic integration whether it is based on multilateral or bilateral relationships. Along these lines, Malaysia is an interesting case which provides a very good example of the alternative approaches.

A special relationship between Japan and Malaysia exists since December 1981 when the Prime Minister Dr Mahathir launched the "Look East Policy". At that time, the objective was to promote the industrialisation and modernisation of Malaysia through learning from Japan (and to a lesser extent South Korea), country which had attained high post-war economic growth. It was aimed at popularising Japanese-style management with a particular emphasise given to labour ethics, social consciousness, discipline, and managerial skills.

Since then, although the Look East Policy is no longer as relevant as it used to be in the 1980s, Japan and Malaysia have been witnessing a more encompassing longstanding relationship where Japan has been a strong partner in Malaysia's development over the last three decades.

The relationship has been achieved in a spirit of goodwill and a desire to promote trade and investment, in the belief that smoother trade flows and investment would bring greater friendship and prosperity for both countries. Indeed, Japan-Malaysia relations are diversifying and getting increasingly closer. The partnership in development has extended into all the economic sectors - such as manufacturing, trade, and services - and more recently into multimedia and information technology (IT) development through the Multimedia Super Corridor (MSC).

Indeed, in addition to the static gains coming from a strict trading relationship, the case of Malaysia shows how Japan can play a role in helping to enhance dynamic gains from the strengthened international competitiveness, increased inflow of foreign direct investments (FDI) and learning-by-doing effects through trade and FDI. Overall, Japan's action towards Malaysia during the crisis has been a real critical turning point for the later, and is a lesson for those who have criticised Japan for not having helped the way they wanted it to.

### ***2.1. Japanese-Malaysian trade relations***

Today, Japan is amongst Malaysia's major partners in both regional and global contexts. Such a partnership manifests itself in various forms. A bilateral perspective continues to be renewed as the Japanese commercial presence in Malaysia becomes increasingly significant and important. Briefly what are the Japan's trade relations with Malaysia ? Most of Malaysia's trade deficit with Japan is concentrated in merchandise trade. The first deficit was registered in 1988. Since then, it has expanded for seven years up to 1995 : the years between 1990 and 1996 saw Malaysia's trade with Japan growing at an average rate of 16.2% per annum, with exports to Japan registering average annual increase of 13.6% and imports from Japan increasing at the higher average rate of 18% per annum.

The total trade turnover between the two countries has expanded five-fold in the decade preceding 1997. Japan's export to Malaysia grew nine fold in the same decade due to active export of capital and

intermediate goods through beefed-up investments in Malaysia by Japanese enterprises. Meanwhile, Japan's import from Malaysia advanced three-fold.

The Malaysian's trade deficit started to decrease dramatically in 1996. This decline can be attributed to the slowdown that occurred in the initial export of capital goods through Japanese investments in Malaysia, which have contributed to an expansion of Malaysian exports. In 1996, one year before the crisis, Japan's export to Malaysia stood at US\$1.533 million out of its total export of US\$411.302 million while import from Malaysia stood at US\$11.7 million out of Japan's total import of US\$349.597 million (Bank of Japan). Respectively, in 1997 and 1998, the exports to Malaysia accounted respectively for US\$14.51 million and US\$9.32 million whereas the imports accounted for US\$11.376 million and US\$8.676 million.

Although Japan's share in Malaysia's export has witnessed a decreasing trend, in 1998, Japan was amongst Malaysia's largest trading partner, accounting for 19.67% of Malaysia's import before the United States (19.62%), Singapore (13.55%) and Europe (12.91%) and for 10.50% of its exports after the United States (21.62%), Singapore (16.94%) and Europe (16.42%).

Through the years, trade relations between the two countries have changed greatly in structure. In the past, Malaysia and Japan had comparative advantages in very different industries, the former in crude materials and mineral fuel, and the later in machinery manufactures. In the beginning of the 1980s, timber, gas, crude oil and other raw fuel materials accounted for nearly 90 percent of Malaysia's export to Japan, and manufactured goods accounted for less than 10 percent. In 1997, raw fuel materials account for less than 40 percent, and home electric appliances and machinery, telecommunication and communication equipment, semiconductors, and other machinery and equipment together accounted for about an equal percentage, dominating imports and exports. The share of machinery manufactures as well as other manufactures, rose, thereby is dominating Japan's exports to Malaysia now.

There is a view abroad that Japan follows a policy of restricting and giving priority to domestically - manufactured products. This was true in the 1980s when the import ratio did not exceed 20 percent, which was far below those of other advanced countries. Since then, the ratio has increased : Japan is now importing many of its former mainstay export products. The share of timber, which was one of Malaysia's main exports to Japan, has declined, and processed timber (that is, plywood and furniture), has become Malaysia's main export item. In the area of household electric appliances - such as air-conditioners, radio/cassette players, and colour TVs - Malaysian products account now for 30 to 50 percent of imports of Japan. As such, Malaysia has become ASEAN's top exporter to Japan even if, on the Japan's side, the Malaysian share in Japanese trade remains low as it can be seen from the table 2 in Appendix.

Structurally, one can say that, lately, Japan's trade has been undergoing a major change mainly in its import policy. The typically vertical trade relations between Japan and Malaysia in the beginning of the 1980s have now become horizontal relations witnessing a pattern of greater intra-industrial trade. A similar change in bilateral trade relations can be seen in Japan's trade relations with other Asian countries. This has forced Japan to develop division of labour relations with East Asian countries.

## ***2.2. Japanese Foreign Direct Investment in Malaysia***

### *The Malaysian framework*

Trade conflicts accelerated Japanese direct investment in foreign markets – particularly in the United States and the European Union. The sudden increase in Japanese private direct investment has been driven by the yen appreciation, which, along with land price increases, have caused production costs in Japan to become the highest in the world. Because the competitiveness of many Japanese commodities has weakened, private companies look for production sites in foreign countries. Thus, the Japan's foreign direct investment (FDI) increase can be partly explained by the following push factors. The rapid appreciation of the Japanese yen and the continuing trade friction between Japan and its trading partners which have made it difficult for Japanese firms to continue their export expansion strategy. A number of firms undertook FDI as a part of the globalisation strategy to minimise production costs and to maximise market access. On the pull factor aspect, the recipient countries have been promoting FDI through many incentives policies.

To sustain its development and to foster its economy as an important strategy to expand trade and overseas linkages, Malaysia heavily relies on foreign capital inflows. Its dependence on foreign capital has shifted from official foreign debt finance to private FDI. Within this constraint, Malaysia, as a very pragmatic country, is periodically adjusting some of its pull factors to attract FDI. One of the pull factors which is related to the New Economic Policy (NEP), concerns the Industrial Co-ordination Act of 1975 which stipulated that 30% of the equity and employment in enterprises of a certain size (foreign or domestic) had to be Bumiputera-owned.

In 1985, Malaysia experienced a further blow to its economy, pushing the government to relax its policies on foreign investment in order to attract foreign capital. In fact, the introduction of foreign capital was necessary to stimulate the economy and needed as an incentive policy. Subsequently, the equity policy has been liberalised. Moreover, with the crisis, in 1998, a temporary measure<sup>2</sup> allows foreign companies to have 100 percent ownership under even more relaxed conditions. Expatriate postings have been eased as well. Such deregulation has played a role in attracting Japanese investments. Indeed, this current policy pleases the Japanese who tend to prefer to have their own staff at the head of the company. To them, maintenance and quality control are transferred more

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<sup>2</sup> ending on the 31th of December 2000. An extension of this measure is currently being under study.



effectively when a Japanese rather than a local person holds the position of president or chairman (Kimbara)<sup>3</sup>.

*Trends of the Japanese foreign direct investment in Malaysia*

The currency crisis which started in Thailand by the free fall of the Thai baht in July 1997 has castled a dark cloud over East Asian countries. Before the crisis (e.g. 1987-1992), foreign direct investments (FDI) accounted for over 50 percent of overall investments in Malaysia, peaking at 70.8 percent in 1989<sup>4</sup> with Japanese investments being dominant in many sectors of the Malaysian economy.

Japanese investments in Malaysia, after World War II, started in November 1959 when Nozawa Asbestos Cement Company established Marex Industries as a joint venture with a local partner. Japanese investment during the 1960s did not exceed that of 26 investing companies. The first big wave of Japanese investments took place from 1973 to 1976 when about 80 companies, mainly in the integrated circuit industry, were established. During a second wave, from 1982 to 1985, many Japanese construction companies established joint ventures engaged in the construction of buildings, electric power plants, and highways (Kawabe)<sup>5</sup>. Following the severe economic recession which Malaysia faced in 1985, investments by Japanese companies decreased. Subsequent to the yen appreciation of autumn 1985, however, a third wave of Japanese investment in Malaysia has emerged. In 1988, the number of Japanese companies increased drastically.

Japanese statistics show that the flow of Japan's FDI into Malaysia declined sharply in 1992 for the first time since 1985, both in manufacturing and non-manufacturing sectors as a whole. The jump in direct Japanese investment in Malaysia in fiscal year 1996 -from US\$376 million to US\$518 million (Malaysian statistics)- on the other hand, indicate that total approved direct investments by the Japanese manufacturing sector in Malaysia climbed to a record up 120% over 1995. Despite the decline observed in 1992, Japanese FDI still accounts for about 20% of total approved foreign capital investment in the manufacturing sector during the period of 1991-July 1997 with Japan being the second largest investor in Malaysia behind Singapore in 1996 but the largest foreign investor in Malaysian manufacturing.

At the end of 1998, Japanese manufacturing has assets worth 8.1 billion ringgit, accounting for 32.3% of overall foreign assets in Malaysia, especially in general machinery, basic metal, electric machinery and plastic. A survey<sup>6</sup> indicates that no less than 1433 Japanese companies were operating in Malaysia, including 776 manufacturers and 657 non manufacturing firms.

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<sup>3</sup> in Yamashita

<sup>4</sup> according to data of the Statistics Bureau of Malaysia released in 1993.

<sup>5</sup> in Yamashita

<sup>6</sup> JETRO survey in April 1998

However, although Japanese investments in Malaysia are expanding steadily, Malaysia is losing ground every year as Japan's investments destination. This decline is largely due to the economic growth policies implemented in other Asian countries to spur foreign investments, policies which have resulted in a spread of investments mainly into China, India and other countries. A survey by JACTIM<sup>7</sup> in October 1998, confirms this trend. As to which countries are selected in the shifting of operations to other countries, the percentage of companies which replied showed that China, Thailand and India increased over the previous year. The percentage went down regarding Vietnam, Indonesia, the Philippines and Myanmar.

Two other reasons can be mentioned. First, the slowdown of FDI is due to the fact that the major Japanese companies including giants such as Sony Corporation, Matsushita Electric Industrial Co., Hitachi, and Sharp, are already in Malaysia. Second, it is impossible to know how total direct investment has changed because the total also includes loans and reinvested earnings, both of which can be quite large, especially the latter one, for the Japanese companies. But Japan continues to be a leading investor country in Malaysia.

#### *How Japan's foreign direct investment helps Malaysia ?*

Direct investment from Japan played an important role in the transition from import-substitution industrialisation to export oriented industrialisation. Japanese-affiliated companies have definitively helped Malaysia to transform its economy which relied heavily on the export of primary commodities to one of major world exporter of manufactured products, with the aim of the export promotion being to improve the balance of payment.

The Japanese companies' investments have contributed to the Malaysian economic performances. The Japanese investors in Malaysia acted as an economic engine in some cases, taking aggressive steps to undertake local sources for parts and components and to be proactive participants in the Malaysian industrial scheme. The JETRO survey<sup>8</sup> indicates that Japanese firms account for 20% of manufactured shipments, 10% of manufacturing industry employment, and 20% of total Malaysian exports.

However, on the Malaysian side, some issues tend to be frequently brought up regarding FDI. They are : the question of technology transfers (especially with small and medium enterprises) and the promotion of Malaysian staff to higher levels of management in Japanese enterprises as well as the promotion of personnel exchange in economic and cultural areas on an equal footing ; the use of local subcontractors and suppliers ; and one of listing of Japanese enterprises on the Kuala Lumpur Stock Exchange (KLSE). However, paradoxically, Japanese companies do not appear to interact as much as

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<sup>7</sup> Survey on manufacturing by JACTIM, Trade and Investment made in October 1998, sent to 303 member companies of the Manufacturing Subcommittee. 278 companies were engaged in manufacturing. The response rate stood at 52.5% with 159 out of the total.

<sup>8</sup> See above

one would wish with the national Malaysian corporate sector. Most of the needed intermediate goods are imported from Japan by the Japanese firms and the staff are, as much as possible, made of Japanese expatriates. One would also think that having Japanese companies in Malaysia would help it to penetrate the Japanese market through the companies' exports. Indeed, the bulk of exports is not going to Japan. Those exports that go to Japan seem to be taking a downswing every year. This attests to the fact that most of the Japanese companies are treating Malaysia as a production and export base targeted at third country markets<sup>9</sup>.

To end, regarding technology, measured by industry, the electric and electronic industries generally show a high degree of transfer of technology which contrasts with the automobile industry. However, in many cases, it appears that Japanese companies found it necessary to transfer technology only mainly for routine operations.

Within this context, one can wonder why Malaysia still needs and wants to continue to attract Japanese industries if, on a purely trading side, that is between Malaysia and Japan, the presence of FDI does not foster the bilateral ties. Despite all of what has been just said, the contribution of FDI inflows, in fact, can not be denied even at its minimum level. Beside having helped to raise stable financial inflow in the form of non-debt financial resources, the contribution of Japanese-affiliated companies to the process of industrial development in Malaysia can go through different channels. It has raised not only the production levels but also the productivity of many industries, and, with its limits, also helped to bring in production technologies and managerial know-how through the intra-firm transfers.

In the early stages, technology transfer is related to equipment that have already been set up within the affiliated production processes. In latter stages, technology transfer also involves activities such as maintenance, quality control, improvement of production technology or new technology, production management, modification of existing products, development of manufacturing equipment and facilities. In fact, employee training at Japanese joint-venture has considerably promoted those transfers through imports to provide the export industry, training of local personnel and dissemination of information. Japan teaches these stages to local employees whereas the Euro-American companies seem to limit their technology transfer to the stage of operational technology.

In addition, Japanese companies have established networks with Malaysian firms, contributing to the growth of Malaysian firms through the transfer of business resources. The industrialisation through Japanese FDI helped some companies to become stronger and thus enabled them to venture abroad in search of investment opportunities. This phenomenon has created opportunities for Japanese investors to seek out Malaysian companies to explore business partnership in third countries. Japan's FDI contribution includes co-operation through joint government and private projects of the two

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<sup>9</sup> In 1998, 67.4% of the companies exports less than 20% of their production to Japan (JAMECA).

countries for the sake of 'south-south' co-operation which Malaysia aims to promote. Indeed, instituting joint venture projects is one that a host country can choose when making compromises between the conflicting interest of the host country and that of the multinational company. And it is an effective measure by which the host country can reconcile its own ambivalent needs. In short, the development of a wider economic network through the expansion of investment activities has helped to stabilise and to revitalise the Malaysian economy and to contribute to its faster reconstruction, which has struggled with a prolonged recession.

### ***2.3. The Asian crisis, Japan and Malaysia***

Some economists have criticised Japan for its lack of active participation in assisting East Asia when the crisis swept the region. Nevertheless, it can be said that the relation between Japan and Malaysia has its role to play in the Malaysian recovery. The Japanese presence in Malaysia was noteworthy in this role. In parallel, Japan came up with its own aid mechanism, through the New Miyazawa Initiative, showing a manifest indication of Japan's seriousness and commitment to help. On a top, Japan gave a political support to Malaysia.

#### *Japanese companies presence*

The technology transfer which can be put under the broader name of X-efficiency which relates to the optimal organisation of the productive process such as work method, technology transfer, economies of scale, as well as training facilities, has helped the Malaysian industry to cope with the crisis by keeping high tech and competitive productions in an even more competitive market due to the money depreciation of many of its neighbours. Japanese companies also indirectly contribute to the recovery of Malaysia by their export orientations. Those companies are the ones who sustain a strong export production, exports which has been the bulk of the Malaysian economic recovery engine.

Out of the companies surveyed by JACTIM 1998, the percentage of companies with an "export ratio of 61% or more" stood at 60.2% (51.7% in the previous survey made in September 1997 over 284 companies of which 153 responded). Of this, 48.6% of the total had an export ratio of "81% or more" up substantially from 35.3% in the previous survey.

Japanese-affiliated companies in Malaysia have a strong export orientation toward North America and other Asian countries. The top five export markets of Japanese-owned companies in Malaysia are the United-States, Singapore, UK, Hong-Kong and Taiwan. However, according to the survey mentioned, the percentage of products to be exported to Singapore shows a decline over the previous year (the majority of companies replied "20% or less"). This can be explained by the result of the Malaysian government policy which tries to minimise export via Singapore and to press for direct export from Malaysia.

*Japan's financial helps*

In the midst of the financial crisis which ran down the Malaysian economy as well as its moral support, no country was willing to offer a financial assistance at favourable rates. While the United States forced stringent and rigid monetary and fiscal policies on countries which received the assistance of the International Monetary Fund - IMF, Japan came up with its own aid mechanisms.

The new Miyazawa Initiative was set in October 1998, by the Finance Minister Kiichi Miyazawa. It unveiled a US\$30 billion financial package -consisted of loan credits, not grants- to assist the battered countries. Under this initiative, the Japanese Ministry of Finance gave to Malaysia's Ministry of Finance and Bank Negara, a US\$2.5 billion (RM9.5 billion) short-term financing facility available, whenever required. The facility is to support credit-extending schemes which promote economic activity such as trade financing, and credit lines for small and medium-sized enterprises.

Japan's financial assistance also included loans amounting to US\$900 million from JEXIM and Official Development Assistance (ODA) and loans from the Overseas Economic Cooperation Fund (OECF) amounting to US\$1 billion. ODA loans, with its favourable interest rates, are normally channelled to projects that target key sectors of the economy such as human resource development, environment, small-medium scale industries and infrastructure. Japan has been providing ODA loans to Malaysia since the late 1960's. However, the appreciation of the Yen in 1994 led to the suspension of further new loan applications. Since the onset of the Asian financial crisis in 1997, Malaysia has been seeking loans from ODA and other Japanese sources to finance its economic recovery process. A further US\$1.1 billion worth of ODA loans are currently being considered for 3 more projects which includes the Port Dickson Phase II project (under the Special Yen Loan Facility to assist economic structural reforms)<sup>10</sup>.

JEXIM has provided a US\$300 million loan for Bank Industri Malaysia Berhad (BIMB) for export financing followed by a three-step loan of US\$200 million to Export-Import Bank of Malaysia (MEXIM). JEXIM has also provided a two-step loan amounting to US\$400 million to Bank Pembangunan dan Infrastruktur Malaysia Berhad (BPIMB) for infrastructural development projects.

Japan had also assisted Malaysia in raising capital for its national economic recovery plan. The Malaysian government was particularly grateful to Japan for such assistance because at the height of the crisis in 1998, Malaysia's sovereign bond ratings were severely downgraded by international credit ratings agency – despite the fact that Malaysia's economic fundamentals were stronger than its neighbouring countries. This made it very expensive for the Malaysian government to raise capital in international financial markets to finance its economic recovery plan.

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<sup>10</sup> See Table of Japan's ODA Loan Assistance to Malaysia in the Appendix.

In fact, Japan's Ministry of Industry and Trade (MITI) assisted Malaysia by backing a significant portion of EuroYen bond issues for a value of US\$560 billion, an arrangement made by Sumitomo Finance International and Nomura International in early 1999. The capital raising exercise in an innovative structured asset backed seven-year bond issue at an attractive coupon rate of 1.2%. Yen 66.6 billion out of the total Yen 74 billion bond issue will be guaranteed through insurance by MITI using for the first time its export credit scheme. International ratings agency, Moody's have given the EuroYen bonds the highest scale rating of triple-A which is higher than Malaysia's and Japan's ratings which at that time were Baa1 and Aa1 respectively. The reason for the top-of-the scale rating is that the ratings agency believes that it is highly unlikely that all three parties will default on the debt.

In May 1999, Japanese Finance Minister Miyazawa announced the mobilisation of the second half of the package devoted to the medium to long-term requirements. The 2 trillions yen package (US\$16-17 billion) will be essentially used to help guarantee sovereign bond issued by Asian governments starting October 1, 1999. In November 1999<sup>11</sup>, the late Prime Minister Obuchi unveiled a US\$500 million "people" focused package –called the Obuchi Plan- a recognition of the central importance of human resources in sustaining economic recovery and aimed at boosting human development in East Asia as well as promoting people exchanges between Japan and other Asian countries.

In fact, all considered, the Japanese assistance to Malaysia to face the crisis has been critical, particularly the short-term financial facility. The extension of its loans also provided a real psychological help to the country while the Prime Minister Mahathir was under siege for criticism of western governments and mass media. Japanese loans are one reason for the growing confidence. Indeed, the answer given to the question to "which country the company would select to make investments in Asia in the future", the 1998 JAMECA survey<sup>12</sup> made just after the launching of the Miyazawa Initiative, confirms one side of this psychological recovery. The 1997 one was conducted immediately after the economic and currency crises had emerged, in August. In 1998, the survey indicates that 42.5% will continue investment and expansion of business in Malaysia, for only 25.3% in 1997. Partial supplementary investment in Malaysia and operation in another country simultaneously get 48.5% of the vote in 1998 compared to 55.5% in 1997. Only 9.2% will choose to shift from Malaysia to another country in 1998, for 19.2% in the previous year. All this shows that in 1997, there were mounting psychological uncertainties but one year later, "anxiety subsided and confidence in Malaysia's investment environment recovered".

Last but not least, Japan gave a strong political support to Malaysia. This support could be perceived especially in two areas. Aside with Mahathir, Eisuke Sakakibara, the then Ministry of Finance<sup>13</sup>, was the main supporter of the creation of an Asian Monetary Fund from its early stage. He also strongly defended Malaysia's capital control measures implemented in September 1998 as a way to deal with

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<sup>11</sup> ASEAN + 3 (Japan, China and South Korea) meeting in Manila

<sup>12</sup> See above

the crisis. Such supports have been particularly critical during the height of the crisis as Malaysia was shunned by the United States and other western countries for its unorthodox approach to resolving the crisis which is going against the IMF-Washington consensus.

#### ***2.4. Japan and ASEAN : is the opening of the Japanese market the only way ?***

The economists should not only focus on the trade aspect when they are talking about how Japan can help the other countries' economy. Japan has helped countries in the past with soft loans. But coming at a time when Japan itself was having great economic difficulties, its financial gestures were indeed munificent. In November 1997, the Japanese economy was rocked by the failure of several financial institutions : the Hokkaido Takushoku Bank, Tokuyu City Bank, and the 100-years old Yamaichi Securities, one of the Japan's "big four" brokerage firm.

As it has been exposed, Malaysia is among the good examples of how, if not by widening its trade, Japan's presence can be a fuel to the domestic economy, as well as a provider of a direct and/or indirect help when time gets darker. Malaysia has been aware of the good use which can be made of the Japanese foreign direct investment as well as financial help, this being even more relevant during the crisis.

##### *The Miyazawa initiative*

Japan has been the world's largest official development assistance (ODA) donor country (1.4 trillion yen in 1998). As it has been seen previously, next to the Japan's ODA, the Miyazawa Initiative has been a crucial cornerstone for the Malaysian recovery. Indeed, this initiative was not only devoted to Malaysia. Beside Malaysia, the main beneficiaries are the other four ASEAN countries – Indonesia, Thailand, the Philippines, Singapore- as well as South Korea, proving that Japan does not make use of an exclusiveness concept. It is having a regional approach when it comes to help and look for partnership. Moreover, to the contrary of IMF or alike institution, Japan left the recipient countries alone to manage their economies as they saw fit.

From the total package of the Miyazawa Initiative, US\$15 billion was made available for medium to long-term financial assistance while the remaining US\$15 billion will be for short term capital needs such as trade financing facilities. Medium to long-term finance assistance was to assist East Asian economies in implementing policies for economic recovery and reforms such as supporting corporate debt restructuring, strengthening the social safety net, stimulating the economy via public work, and alleviating the credit crunch through trade financing and assistance to small and medium sized industries. In March 1999, the ADB approved the establishment of US\$3.06 billion Asian Currency Crisis Support Facility (ACCSF) funded entirely by the Japanese government as part of the Miyazawa initiative.

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<sup>13</sup> an influential figure in Japan's financial circles, better know as Mr Yen

As the region recovers from the Asian financial crisis, the Miyazawa Initiative has entered into its second phase where there is emphasis on the financial markets. Japan plans to mobilise up to Y2trillion of domestic and foreign private sector capital for East Asia through measures such as assistance for fund raising in international financial markets, assistance for investment in Asian private sector enterprises via equity and debt funds, and upgrading and fostering Asian bond markets.

### *Japan's agenda*

But, one must be aware that Japan's motives are not purely altruistic. It hopes that by helping its neighbours it can also help itself. Japan has prospered in the main because of countries in the region like Malaysia which, as seen previously, became factories that produced Japanese goods. These countries also became the markets which consumed Japanese products. From this perspective, it is in Japan's greater interest that the countries in the region resolve their economic problems as fast as possible. Both the recovery and the prosperity of the region would undoubtedly spur business for Japanese firms and only enhance the economic prosperity of the nation. The aid package would surely help to reach these aims. In the process of globalisation, the strategy followed by the Japanese government as well as Japanese parent companies should be more exactly called a globalisation approach with a "regionalization" and/or "localisation" strategy in the Asia region.

Within this framework and because Japan has long been eager to assume a larger economic leadership role in the region, the new Miyazawa Initiative is hoped to be a part of what can boost Japan's stature as the region's economic leader as well as giving him a good image (versus the "bad" one carried by the United-States/IMF during the crisis time). The initiative indicates a mix of Japan's increased desire to exert influence on the world stage – Tokyo has been pushing for a permanent seat on the UN Security Council - and frustration on throughout Asia with the West has tried to deal with the Asian hit-economies. Thus the Miyazawa plan can be considered as an attempt to put more control of Asian economies in Asian hands.

Indeed, Japan has two main objectives in providing the aid. One, it hopes the Miyazawa initiative would lead to wider use of the yen. The wider use of the Japanese currency in regional trade would be appreciated. It would mean less dependence on the US dollar. Two, it desires the creation of an Asian Monetary Fund (AMF) which is along the line with the proposals to change the architecture of international finance. As the Philippines financial secretary E. Espiritu said : "Southeast Asian nations would like to see the monetary fund of the US\$30 billion (RM11 billion), becoming a permanent facility as insurance against a recurrence of the region's financial crisis". Thus, on the concept of an AMF, Japan surely can play a leading role in creating such a fund. The main reason is, since the trade tends to be more regional, the region loses disproportionately from trade disruptions caused by currency crisis. Since efforts to liberalise trade are likely to continue (AFTA...), the regional nature of trade within and with ASEAN, is likely to grow further. Therefore the ASEAN countries and the others in the region should try to prevent the spread of these crisis. By smoothing out these fluctuations, institution such as AMF should be able to reduce protectionist tendencies.



*Japan's opening up*

In fact, Japan can even contribute more effectively to the recovery of Asia by allowing access to its market. Indeed, the growing surplus in some balance of payment developing in Asia in as sustainable manner has to be absorbed by the United States and some European countries. As Bank Negara governor, at that time, Ali Abul Hassan Sulaiman<sup>14</sup>, highlighted "while the Miyazawa initiative provides financing for recovery, a more liberal trade and economic regime in Japan would ensure that these funds contribute to long term sustainable growth in Asian economies". Especially if the first objective of making a wider use of the yen is there, this can encourage Japan to expand its trade within the region. However, according to some, it seems that an increase in imports by Japan alone is obviously not going to bring the Asian economies back to their pre-crisis levels, but the contribution is measurable, and highly significant (Dwyer).

But there are various ways by which Japan and ASEAN can enhance their partnership and work towards lessening their economic imbalance relation as well as the risk of another crisis. Further, bilateral and multilateral dialogues including institutional co-operation, active participation in and support for the activities of APEC, WTO, ASEM and the like, should be in the agenda. There is a need for Japan to set up more technical institute in Asia to provide training and re-training programs for Asian workers in order to meet the skill requirements of Japanese manufacturing industries<sup>15</sup>. If this is met, then one can hope it might be easier to get into the Japanese national market.

Japan, through its manufacturing companies, wants to participate in growing Asian market through local production and intra-regional production networks set up by Japanese companies. The growing FDI by Japanese parts suppliers in ASEAN may contribute to development of supporting industries in host countries. In that sense, Japanese FDI in Asia strengthens the complementary relationships between host countries in Asia and Japan within a regionalization strategy.

The deliver relies both on Japan and the recipient/partner countries since possible factors can disturb and slow down the process of regionalization. On the Japanese side they are : accelerated yen appreciation which may very rapidly damage Japanese conventional industries and may bring strong political pressure against enlarged FDI ; the failure to internalise local labour/human resource markets of host countries into Japanese multinational corporations ; and the failure to make their networks open and flexible enough to be acceptable in host countries. On the other hand, possible factors which can disturb the regionalization on the host country side are : the failure to preserve transparent liberalisation strategies of trade and investment ; and the failure to train and educate human resources

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<sup>14</sup> at the Malaysian Japan Economic Association's 21<sup>st</sup> Joint Conference in KL, March 1999

<sup>15</sup> currently, Malaysia is emphasising its policies towards FDI related to R&D purposes. It focuses on attracting the settlement of research centres. One of the reason is to try to reduce the FDI inflows which mainly look at Malaysia as a production centre with relatively cheap labour force this leading now to some increasing immigration problems.

to respond correctly to swift changes of competitive advantages of each country caused by dramatic development of each Asian country. (Sugiyama & Leong, 1998)

ASEAN will increasingly count for Japan. One of the reason it is a crucial allocation partner and ally for globalisation. In the mid to long run, the importance of ASEAN for Japan will grow further, especially since the prospect of WTO regime is not yet very clear neither certain as symbolised by the failure of the Seattle meeting. The market integration based on ASEAN shall get more important in terms of growth for Japan as well as for the Asian countries. Therefore, Japan and ASEAN shall be able to expand their co-operation to more comprehensive and balanced ways, as Malaysia did, in order to regain and sustain the economic dynamism of all those Asian countries.

### ***Conclusion***

In the light of all has been said, Japan's response to the 1997 crisis was, to some extent, decisive to the ASEAN economies. Its financial assistance has been even more remarkable since it was extended by an economy itself in trouble. Including the Obuchi fund, the monetary value of the announced Japanese assistance from July 1997 to November 1999 was approximately US\$79.52 billion of which 85 percent (approx. US\$68 billion) has been already implemented<sup>16</sup>.

Some asserts that Japan is pursuing a political strategy to become the centre of potentially self-sustaining Asian economic system which makes the political economic question of whether Japan has tried to influence its neighbours' trade toward itself a centre one. Even some may point out that the assistance is very much under Japan's interests, one must bear in mind that the recovery of the Japanese economy will ultimately redound to the benefit of the other crisis-affected Asian economies. The crisis and the way ASEAN countries and Japan tried to deal with, highlighted at least one point : the most traditional way of helping, that is a hard-currency financial help, maybe sometime the best solution, at least in the short run. If some were advocating that Japan should open its market, such an action takes time to become effective (government fears, Japanese mentality, ...). Then, also such a demand should be reiterated, its defendants were maybe not aware enough that it was not the best solution for the recovery of the region because it requires longer time. However, the crisis offered an opportunity for Japan to show that despite its unopenness, the country is willing to help its neighbours in need.

But, Japan has no choice than to involve itself deeper with ASEAN. If regional integration could be expected to contain financial crisis, only deep integration can be effective. For this, a leader is needed: Japan can play a role in relation with other willing countries to take the lead in tandem. Once this on the track, and considering that trade agreements such AFTA are getting more effective, Japan shall be more willing to open its market for the sake of the ASEAN countries as well as its own sake. The

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<sup>16</sup> as of July 1999

success and sustainability of opening a market relies partly on the fact that it must be under the will of the concerned country itself rather than being constrained by the others. The late events and the Japanese outcome solutions have proved that Japan has not reached this stage yet.

Seeing the trend taken by the Japanese's trade lately and its rising trend to negotiate bilaterally<sup>17</sup>, it is doubtful that Japan will truly open its market in a short term. However, despite this and from the results presented in the first part of the paper, one can conclude with an optimistic view regarding ASEAN trade and integration. First, if Japan opens its economy, on one side, the trade creation with ASEAN may be weaker than what one may expect. On the other side, the trade diversion, which may result from it, should not be strong enough to disrupt the existing links within the ASEAN block. Second, if this new trade policy of opening never becomes a reality, the existing ASEAN trade performances should not change. It also shall not harm as much as some tend to think the process of ASEAN integration. On the top, whatever happens, the ASEAN countries have seen that Japan is trying to give a positive image of itself in helping its neighbours (versus the United States' one via the criticised IMF-led rescue operations in the region). To some extent, they can rely on Japan in others ways rather than just on trading matter.

Even it shall not given up to reiterate our demand to Japan to be more opened, maybe people shall stop to only beg Japan on this particular subject of trade and start to focus their energy on other requests since Japan seems to be, in that case, if we may say, more open.

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<sup>17</sup> Japan and Singapore have agreed to start negotiating in January and conclude by the end of 2001

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### ***Appendix A: Japan's ODA Loan Assistance to Malaysia***

Project	Description	Amount (Billion Yen)	Interest (%)
Look East Policy Project	Funds scholarship for students enrolled on 1998 and 1999 to be sent to Japan	14.026	0.75
Beris Dam Construction Project	Funds construction projects of the dam itself and related facilities as well as consultation service	9.737	0.75
Port Dickson Power (Tuanku Jaafar Rehabilitation Project)	Funds construction and consulting service to convert oil burning power plant into combined cycle power plant which is much less harmful to the environment	49.087	0.75 (consulting portion) 1.7 (other portion)
Construction Project of University of Malaysia Sarawak (UNIMAS)	Funds campus construction, equipment procurement, human resource development programme, engineering, project management consultation etc	18.549	0.75 (consulting portion) 1.7 (other portion)
Small and Medium Scale Industries (SMI) Development Fund Programme	Funds manufacturing, agro-based industry and service industry- related financial service to promote their development	16.296	0.75
Higher Education Loan Fund Program II (HELP II)	Funds scholarship for students to be sent to Japan to study engineering science as well as fund procurement of educational equipment and consultation service	5.285	0.75
Pahang-Selangor Raw Water Transfer	Funds engineering service for the water transfer project from Pahang to Selangor	1.093	0.75

*Source: Foreign Ministry Japan, Economic Planning Unit Malaysia in New Straits Times, 7 January 2000*

**Notes:**

Repayment Period (Grace Period)

- General environmental rate: 25 (7) years
- Special for environment and small and medium enterprises: 40 (10) years

Procurement: generally untied.

### **Appendix B: Japan's trade relations with partner regions and economies**

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999 est
<b>Exports (US\$ millions)</b>	<b>130 435</b>	<b>151 500</b>	<b>138 443</b>	<b>146 971</b>	<b>169 748</b>	<b>177 189</b>	<b>210 718</b>	<b>231 330</b>	<b>264 957</b>	<b>274 590</b>	<b>287 664</b>	<b>314 845</b>	<b>339 899</b>	<b>362 602</b>	<b>395 226</b>	<b>443 097</b>	<b>411 302</b>	<b>421 067</b>	<b>387 955</b>	<b>399 109</b>
China share, %	3,92	3,35	2,53	3,35	4,24	7,11	4,72	3,6	3,58	3,09	2,14	2,73	3,52	4,79	4,73	4,95	5,31	5,15	5,2	5,65
Hong Kong share, %	3,67	3,49	3,4	3,6	3,86	3,7	3,42	3,87	4,42	4,18	4,56	5,19	6,11	6,3	6,51	6,27	6,17	6,47	5,79	5,12
Korea share, %	4,13	3,72	3,52	4,09	4,25	4,04	5,01	5,77	5,83	6,01	6,08	6,38	5,23	5,29	6,16	7,06	7,14	6,2	3,97	5,45
Taiwan share, %	3,94	3,56	3,07	3,46	3,52	2,86	3,75	4,95	5,42	5,59	5,37	5,8	6,23	6,12	6,02	6,54	6,32	6,54	6,6	6,76
Indonesia share, %	2,66	2,72	3,07	2,42	1,81	1,24	1,27	1,3	1,15	1,2	1,76	1,78	1,64	1,67	1,94	2,25	2,2	2,42	1,11	1,09
Malaysia share, %	1,59	1,59	1,8	1,89	1,69	1,23	0,82	0,95	1,16	1,5	1,92	2,43	2,39	2,67	3,13	3,79	3,73	3,45	2,4	2,69
Philippines share, %	1,3	1,27	1,3	1,19	0,63	0,53	0,52	0,62	0,66	0,86	0,87	0,85	1,04	1,33	1,49	1,6	2,04	2,06	1,87	2,11
Singapore share, %	3,01	2,94	3,15	3,03	2,71	2,2	2,19	2,62	3,14	3,35	3,73	3,88	3,82	4,6	4,96	5,19	5,06	4,81	3,81	3,87
Thailand share, %	1,48	1,48	1,37	1,71	1,43	1,16	0,97	1,29	1,95	2,48	3,18	3	3,06	3,4	3,72	4,45	4,45	3,47	2,41	2,66
Vietnam share, %	0,09	0,07	0,07	0,08	0,07	0,08	0,09	0,08	0,07	0,06	0,07	0,07	0,13	0,18	0,16	0,21	0,28	0,3	0,34	0,38
Industrial Europe share, %	16,27	15,3	15,31	15,64	13,96	14,13	17,64	19,69	21,02	20,38	21,74	21,68	21,01	17,65	16,4	16,64	16,12	16,46	19,4	18,85
Canada share, %	1,88	2,24	2,06	2,47	2,52	2,57	2,64	2,45	2,43	2,47	2,34	2,31	2,08	1,75	1,49	1,32	1,25	1,45	1,63	1,64
United States share, %	24,46	25,67	26,4	29,49	35,6	37,63	38,88	36,75	34,06	34,22	31,68	29,28	28,45	29,48	30,03	27,54	27,52	28,12	30,86	30,74
Australia share, %	2,61	3,15	3,29	2,91	3,05	3,06	2,5	2,25	2,52	2,83	2,41	2,07	2,08	2,13	2,21	1,83	1,8	1,89	2,07	2,09
New Zealand share, %	0,52	0,6	0,67	0,66	0,68	0,61	0,53	0,49	0,39	0,49	0,42	0,34	0,33	0,35	0,39	0,37	0,41	0,34	0,3	0,37
Other share share, %	15,54	16,33	17,85	24,04	19,98	17,83	15,04	13,33	12,21	11,31	11,73	12,2	12,89	12,3	10,65	9,98	10,22	10,86	12,23	10,57
<b>Imports (US\$ millions)</b>	<b>141 284</b>	<b>142 868</b>	<b>131 566</b>	<b>126 520</b>	<b>136 142</b>	<b>130 561</b>	<b>127 660</b>	<b>150 894</b>	<b>187 460</b>	<b>209 597</b>	<b>235 289</b>	<b>236 612</b>	<b>232 852</b>	<b>241 630</b>	<b>274 181</b>	<b>336 027</b>	<b>349 597</b>	<b>338 646</b>	<b>281 243</b>	<b>289 292</b>
China share, %	3,08	3,7	4,06	4,02	4,37	5	4,49	4,96	5,26	5,29	5,12	6,02	7,29	8,55	10,06	10,69	11,56	12,35	13,18	13,82
Hong Kong share, %	0,41	0,47	0,47	0,53	0,62	0,59	0,85	1,05	1,13	1,05	0,93	0,87	0,88	0,83	0,78	0,81	0,74	0,66	0,62	0,6
Korea share, %	2,15	2,38	2,49	2,69	3,09	3,17	4,18	5,42	6,31	6,17	4,99	5,23	4,98	4,86	4,93	5,16	4,57	4,31	4,32	4,99
Taiwan share, %	1,62	1,77	1,85	2,07	2,35	2,62	3,7	4,77	4,66	4,25	3,62	4,01	4,06	4,01	3,91	4,26	4,28	3,68	3,64	4,09
Indonesia share, %	9,36	9,28	9,09	8,25	8,18	7,81	5,79	5,63	5,12	5,23	5,42	5,4	5,26	5,19	4,7	4,23	4,35	4,31	3,85	4
Malaysia share, %	2,48	2,04	2,28	2,47	3,23	3,33	3,12	3,19	2,53	2,43	2,3	2,73	2,82	3,18	2,99	3,14	3,36	3,36	3,09	3,5
Philippines share, %	1,39	1,2	1,19	1,03	1,04	0,96	0,97	0,91	1,09	0,98	0,91	0,99	0,99	1	0,97	1,04	1,29	1,48	1,57	1,71
Singapore share, %	1,07	1,36	1,38	1,16	1,3	1,23	1,16	1,38	1,25	1,4	1,52	1,44	1,33	1,5	1,69	2,04	2,1	1,73	1,68	1,76
Thailand share, %	0,8	0,74	0,79	0,81	0,76	0,79	1,1	1,2	1,47	1,7	1,77	2,22	2,56	2,7	2,98	3,01	2,94	2,83	2,9	2,91
Vietnam share, %	0,03	0,03	0,03	0,03	0,04	0,05	0,07	0,1	0,1	0,16	0,25	0,28	0,37	0,44	0,49	0,51	0,58	0,64	0,62	0,63
Industrial Europe share, %	7,32	7,98	7,59	8,7	9,52	9,46	14,28	15,02	16,13	16,59	18,12	16,49	16,21	15,26	15,65	16,12	15,54	14,78	15,47	15,47
Canada share, %	3,36	3,11	3,36	3,5	3,62	3,68	3,87	4,05	4,43	4,11	3,64	3,25	3,28	3,37	3,24	3,24	2,9	2,89	2,72	2,62
United States share, %	17,39	17,69	18,38	19,6	19,75	19,99	23,04	21,18	22,55	23,02	22,46	22,67	22,63	23,15	23	22,58	22,85	22,43	24,01	22,1
Australia share, %	4,97	5,18	5,27	5,25	5,35	5,76	5,52	5,28	5,49	5,49	5,25	5,48	5,33	5,07	4,95	4,32	4,07	4,3	4,62	4,19
New Zealand share, %	0,59	0,62	0,65	0,74	0,69	0,7	0,76	0,78	0,88	0,79	0,73	0,77	0,73	0,73	0,75	0,76	0,7	0,69	0,69	0,63
Other share share, %	45,63	44,26	41,14	39,15	36,11	34,86	27,14	25,08	21,6	21,34	22,96	22,14	21,29	20,16	18,89	18,09	18,18	19,54	17,03	17

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