

ILO Asia-Pacific Working Paper Series

How can ASEAN and Japan mutually benefit from ASEAN economic integration?

Hitoshi Sato
October 2014



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Regional Office for Asia and the Pacific

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First published 2014

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Sato, Hitoshi

How can ASEAN and Japan mutually benefit from ASEAN economic integration? / Hitoshi Sato ; ILO Regional Office for Asia and the Pacific. - Bangkok: ILO, 2014
xi, 24 p. (ILO Asia-Pacific working paper series, ISSN: 2227-4405 (web pdf))

ILO Regional Office for Asia and the Pacific

economic integration / regional cooperation / foreign investment / productivity / wages / human resources
development / labour migration / trend / ASEAN countries / Japan

09.05.2

ILO Cataloguing in Publication Data

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Printed in Thailand

Preface

By 2015, the ASEAN Economic Community (AEC), envisioned as a single common market and production base, will become a reality. This will lead to the freer flow of goods, services, investment capital and skilled labour in the region. Tariff and non-tariff barriers will be reduced, which will have implications for intraregional trade and investment. New opportunities for growth and prosperity are likely to emerge, but the challenge is to ensure that growth is inclusive and prosperity is shared.

Ultimately, the success of ASEAN regional integration will depend on how it affects the labour market and therefore how it improves the quality of life of women and men in the region. To prepare for the impact and find the opportunities to seize, the International Labour Organization initiated with the Asian Development Bank a joint study to examine the impact of the AEC on labour. Findings from the series of studies that were initiated are collected in the 2014 publication *ASEAN Community 2015: Managing integration for better jobs and shared prosperity*. That report highlights the challenges and opportunities that will accompany the AEC, including managing labour migration, boosting productivity and wages and improving job quality. The report offers policy recommendations for creating better jobs and ensuring that the benefits of the AEC are equitably shared among different countries and sectors.

The background papers to the joint publication are available as part of the ILO Asia–Pacific Working Paper Series, which is intended to enhance the body of knowledge, stimulate discussion and encourage knowledge sharing and further research for the promotion of decent work in Asia and the Pacific. This paper by Hitoshi Sato examines how ASEAN and Japan can mutually benefit from ASEAN economic integration.

The ILO is devoted to advancing opportunities for women and men to obtain decent and productive work. It aims to promote rights at work, encourage decent employment opportunities, enhance social protection and strengthen dialogue in handling work-related issues. As countries in the Asia and the Pacific region continue to recover from the global economic crisis, the ILO's Decent Work Agenda and the Global Jobs Pact provide critical policy frameworks to strengthen the foundations for a more inclusive and sustainable future.

Yoshiteru Uramoto
Assistant Director-General and
Regional Director for Asia and the Pacific

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Acknowledgements

This paper benefited from very helpful comments and inputs provided by ILO colleagues, including Sukti Dasgupta, Senior Economist and Head of the Regional Economic and Social Analysis Unit, ILO Regional Office for Asia and the Pacific, and Makiko Matsumoto, Specialist on Employment, ILO Decent Work Technical Support Team for East and South-East Asia. Any errors are the sole responsibility of the author.

Abstract

This paper reviews the evolution of the economic and political relationship between Association of Southeast Asian Nations (ASEAN) Member States and Japan since the 1970s and examines how they can mutually benefit ASEAN economic integration. The analysis looks at the perspectives of trade in goods and services, foreign direct investment (FDI) and international labour movements. ASEAN economic integration is highly likely to yield mutual benefits for both ASEAN Member States and Japan through gains from specialization based on comparative advantage and increasing returns to scale and/or geographical agglomerations. In particular, it is expected that the larger ASEAN market will not only attract new Japanese FDI but also urge Japanese multinational enterprises to relocate their affiliates, giving rise to an enhanced agglomeration effect and increases in the new host economy's productivity. To fully realize these gains, appropriate monitoring of the integration progress is important. Some extensions of the ASEAN Economic Community deserve consideration to enhance the effect of integration. They include further liberalization in services trade and FDI, arrangements on government procurement and expansion of the scope of international labour movements.

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The responsibility for opinions expressed in articles, studies and other contributions rests solely with the authors, and publication does not constitute an endorsement by the International Labour Office of the opinions expressed in them, or of any products, processes or geographical designations mentioned.

Acronyms

AEC	ASEAN Economic Community
AFTA	ASEAN Free Trade Area
ASEAN	Association of Southeast Asian Nations
CLMV	Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam
FDI	foreign direct investment
ITA	Information Technology Agreement
MFN	most favoured nation
ODA	official development assistance

1. Introduction and background

It has been 40 years since Japan and the Association of Southeast Asian Nations (ASEAN) Member States initiated their first cooperation (in 1973) – resolving business disputes in the production of synthetic rubber. Since then, Japan and the ASEAN Member States have steadily developed cooperative relationships in both economic and political fields, especially deepening their economic interdependence. Japan has traditionally relied on ASEAN Member States for natural resources and food, whereas countries in the region rely on Japan for various manufactured products. Furthermore, since the late 1980s, Japanese multinational enterprises have developed international production networks throughout Asia, and ASEAN Member States have functioned as a production base for Japanese multinational enterprises.

International production fragmentation has been a global trend for decades, becoming especially important in Asia, which Baldwin (2006) calls “factory Asia”, in which the manufacturing process is fragmented into stages and dispersed around the region. Observers now believe that joining global production networks is crucial for a country’s successful economic development. Thus, ASEAN Member States’ effort to build the ASEAN Economic Community (AEC) by 2015 should be understood from the perspective that economic integration would contribute to enhancing this region’s role and performance in global production networks.

Emphasizing this viewpoint, this paper examines how ASEAN economic integration would affect Japan–ASEAN economic relationships and how Japan and countries of the region can mutually benefit from economic integration. In essence, ASEAN integration seeks to generate a larger integrated market, which provides opportunities to exploit gains from specialization (by increasing returns to scale and agglomeration effects). Reduced trade costs within ASEAN would enhance the division of labour in the region, which would in turn yield not only standard gains from trade but also new production networks that stretch to the Cambodia, the Lao People’s Democratic Republic, Myanmar and Viet Nam (CLMV) countries. Furthermore, a larger unified market and better business environments generated by ASEAN integration likely would attract new foreign direct investment (FDI) flows. Several studies reveal that FDI tends to create “good jobs”, which provide higher earnings and greater productivity externalities in the host countries.¹ Japanese multinational enterprises are expected to fill such a role and contribute to further development of the production networks in ASEAN.

Nevertheless, the gains from economic integration are conditional on its appropriate implementation. Thus the progress of ASEAN integration must be monitored. But even before its launch, the current ASEAN integration plan has at least three flaws: (i) insufficient liberalization in services trade; (ii) lack of rules on government procurement; and (iii) insufficient labour movement freedom. These issues require serious consideration.

¹ For a recent survey, see Javorcik (2012).

2. Japan's historical engagement with ASEAN

Japan and ASEAN Member States have developed cooperative relationships in both political and economic fields since the early 1970s. The first cooperation emerged in 1973 as the Japan–ASEAN Forum on Synthetic Rubber, a business-level dialogue that sought to resolve commercial disputes between ASEAN latex producers and Japanese synthetic rubber firms. At the government level, the announcement of the Fukuda Doctrine in 1977 was the first stepping stone for Japan–ASEAN cooperation.² The Fukuda Doctrine, a backbone set of principles of Japanese foreign policy towards South-East Asian countries, emphasized the importance of Japan's developing cooperative relationships with other governments as equal partners (see the Annex for a chronology of Japan–ASEAN cooperation).³

Japan–ASEAN relationships have deepened through private business trade and investment as well as government support. Indeed, in a development context, private businesses and official development assistance (ODA) are closely intertwined by their mutual complementarity. The Japanese Government has engaged in various assistance activities in ASEAN on the grounds that the development and stability of the region are crucial for Japan's security and prosperity.⁴ Table 1 illustrates that ASEAN has received substantial portions of Japanese ODA over the decades. Although Japan's ODA recently tended to be dispersed geographically, ASEAN has maintained significantly large shares in Asia (Table 1, third column).

Table 1. Regional distribution of Japan's official development assistance, 1970–2010 (%)

Year	ASEAN	Asia	ASEAN/Asia
1970	38.9	94.4	41.2
1980	36.3	72.8	49.9
1990	34.7	61.7	56.3
2000	33.2	60.1	55.3
2010	26.8	53.1	50.4

Source: MOFA, Japan.

ASEAN Member States have been important suppliers of natural resources and food for Japan. For example, in 2011, Malaysia, Indonesia and Brunei Darussalam together supplied roughly 35 per cent of Japan's total natural gas demand. Thailand provided roughly 60 per cent of Japanese sugar imports (imported sugar satisfies 90 per cent of Japan's sugar demand).⁵ In contrast, ASEAN substantially relied on Japanese manufactured products: approximately 30 per cent of the region's imports of transport equipment originated from Japan during the 2000s. This relationship reflects the classical comparative advantage theory, which is an important aspect of Japan–ASEAN bilateral trade.

² Prime Minister Fukuda revealed principles of Japanese foreign policy towards South-East Asian countries during his tour to the first ASEAN–Japan Summit.

³ The establishment of the ASEAN Cultural Fund in 1978 and the ASEAN–Japan Centre, an international organization located in Tokyo, in 1980 are immediate achievements of the Fukuda Doctrine. The ASEAN–Japan Centre has promoted cooperative ASEAN–Japan activities, from business to cultural exchange.

⁴ This view is expressed in Japan's Official Development Assistance White Paper 2012, available at www.mofa.go.jp/policy/oda/page_000016.html [accessed 24 Sep. 2014].

⁵ These trade figures are for 2011 and come from various sources.

In addition to this classical economic interdependence, Japan and ASEAN Member States have developed another interdependent relationship within the manufacturing sector. To exploit the labour–cost advantage, Japanese firms aggressively increased their FDI in ASEAN Member States in the late 1980s and 1990s. As a result, the region comprises a substantial portion of Japanese multinationals’ global production networks.

The aggressive investment by Japanese multinational enterprises shifted labour-intensive production processes, such as assembly lines, to foreign locations (vertical FDI). This trend was especially remarkable in the Japanese electrical machinery sector.⁶ Splitting production processes and shifting those that are labour-intensive to labour-abundant countries helped reduce the total production costs and increased production scale. Yet, Japanese FDI in ASEAN is mutually beneficial to both host and source countries. For example, Japanese multinational enterprises’ local procurement accounted for 36 per cent of electrical machinery and 30 per cent of transport equipment in 1987 (UNCTAD, 1991). Thus the multinational affiliates in Asia procured substantial portions of intermediate goods and services from the local markets, even at this relatively early stage of Japanese FDI.

The Asian financial crisis that began in 1997 accentuated how economic stability within ASEAN is vital for Japan. The financial crisis not only motivated the establishment of a cooperation framework by ASEAN+3 (the People’s Republic of China, Japan and the Republic of Korea) in 2000 but also encouraged Japan to assume leadership in supporting ASEAN Member States. In fact, during and after the crisis, Japan aggressively assisted ASEAN Member States, producing two new ODA funds: the Japan–ASEAN Solidarity Fund in 1999 and the Japan–ASEAN General Exchange Fund in 2000.

During the 2000s, Japan enhanced its relationships with ASEAN Member States in several respects. In particular, the 2003 ASEAN–Japan Commemorative Summit in Tokyo launched a cooperation package spanning many topics. The cooperation package specifically included a regional economic partnership agreement, which eventually produced the 2008 ASEAN–Japan Comprehensive Economic Partnership.⁷ The Summit highlighted the necessity to reduce the development gap between the older ASEAN Member States and the CLMV countries and declared that Japan and ASEAN would cooperate in global issues, such as counter-terrorism, anti-piracy, environmental protection and infectious disease containment.⁸

Starting with Singapore in 2002, Japan created economic partnership agreements with seven ASEAN Member States in the 2000s (Malaysia in 2006, Thailand in 2007, Indonesia in 2008, Brunei Darussalam in 2008, the Philippines in 2008 and Viet Nam in 2009). As section 4 describes, the extent to which these agreements will generate economic gains for each country is not clear. This uncertainty occurs partly because ASEAN Member States unilaterally reduced most favoured nation tariffs after the conclusion of the agreements. However, it is likely that the agreements have at least encouraged communication between each country and Japan through dialogue models built into the agreements and thus helped to improve business environments.

⁶ For example, in this sector, Japanese affiliates located in Asia generated around 57 per cent of total sales from the Japanese and third-country markets (UNCTAD, 1991).

⁷ When the Partnership began in 2008, it was in force with four ASEAN Member States: Singapore, the Lao People’s Democratic Republic, Myanmar and Viet Nam. It was then in force with Brunei Darussalam, Malaysia, Thailand and Cambodia in 2009 and with the Philippines in 2010; it has yet to be enacted with Indonesia.

⁸ At the Summit, the Japanese Government committed to contributing \$1.5 billion for the Mekong Region Development Project within three years.

Japan's support for the Mekong countries was revised as ASEAN Member States set a goal for establishing the ASEAN Community by 2015.⁹ After the Master Plan on ASEAN Connectivity was announced in 2010, the Japanese Government solidified its political position to support the ASEAN Community.

3. Japan's trade and foreign direct investment with the ASEAN region over the past two decades

3.1 Merchandise trade

Table 2 illustrates the pattern of trade between Japan and the ASEAN region. The first two columns indicate how the value of Japan's total manufacturing exports to the region is divided among 13 manufacturing sectors. Similarly, the third and fourth columns present the sector distribution of Japan's imports from ASEAN Member States. In both 1990 and 2011, Japan's major exports were general machinery, electrical machinery and transportation equipment, whereas exports to Japan were oil and coal products, pulp, paper and wood, and food products. In the general machinery and electrical machinery sectors, the share of exports exceeded that of imports, implying Japan's advantage over ASEAN competitors. It is not surprising that Japan lacks advantage over ASEAN in the oil and coal, pulp, paper and wood, and food product sectors. Japan exports more sophisticated products (such as general machinery) to ASEAN in exchange for natural resources and low-technology products (such as pulp, paper, wood and food).

Table 2. Japan–ASEAN merchandise trade, by sector, 1990 and 2011

	Share of total exports (%)		Share of total imports (%)		Intra-industry trade (Grubel-Lloyd index)	
	1990	2011	1990	2011	1990	2011
Foods	0.8	0.6	11.4	8.2	0.16	0.12
Textile	2.3	1.0	2.2	3.8	0.88	0.41
Pulp, paper and wood	1.9	2.0	15.0	10.1	0.27	0.32
Chemicals	9.4	11.2	2.0	6.9	0.30	0.79
Oil and coal	0.4	4.8	49.1	35.8	0.02	0.23
Stone, clay, glass and concrete products	1.2	1.3	1.8	0.9	0.90	0.86
Iron and steel, nonferrous metals	13.0	20.4	7.8	8.1	0.65	0.59
General machinery	25.8	21.6	3.4	5.5	0.19	0.43
Electrical machinery	21.0	20.8	2.9	10.9	0.20	0.71
Household electric appliances	5.3	1.2	1.3	3.9	0.32	0.46
Precision machinery	1.9	2.9	0.4	1.6	0.27	0.74
Transportation equipment	15.4	10.3	0.1	1.9	0.01	0.33
Miscellaneous goods	1.6	1.7	2.6	2.5	0.88	0.79

Note: Sector distributions of Japan's exports to and imports from ASEAN are shown.
Source: Author's calculation of RIETI-Trade Industry Database (RIETI-TID), 2012.

⁹ *Roadmap for an ASEAN Community 2009–2015* was published in 2009.

At first glance, the trade pattern between Japan and ASEAN does not seem to have substantially changed over the past two decades. General machinery and electric machinery are still Japan's two major exporting sectors, while oil and coal is the primary importing sector. However, certain sophisticated goods sectors have substantially increased in Japan's share of total imports; for example, electrical machinery increased from 2.9 per cent in 1990 to 10.9 per cent in 2011. Chemicals also increased, from 2 per cent in 1990 to 6.9 per cent in 2011. Even in transportation equipment, Japan virtually imported nothing from ASEAN in 1990, but that import share increased to 1.9 per cent in 2011. These changes in Japan's import patterns indicate greater ASEAN industrialization in this time period.

An examination of the intra-industry trade further clarifies that indication. The last two columns in Table 2 present each sector's degree of intra-industry trade in 1990 and 2011 by the standard Grubel–Lloyd index, which approaches 1 as intra-industry trade becomes dominant.¹⁰ Several sectors in which Japan has a comparative advantage over ASEAN Member States exhibit substantial increases in intra-industry trade: for example, the index increased from 0.20 to 0.71 in electrical machinery; in chemicals and precision machinery, it increased from 0.30 to 0.79 and from 0.27 to 0.74, respectively. For the merchandise sector as a whole, the index increased from 0.24 in 1990 to 0.48 in 2011 (not reported in Table 2).¹¹

The structural changes in Japan–ASEAN bilateral trade also can be observed in trade by production stage. Table 3 breaks down the merchandise trade into five categories: primary goods, processed goods, and parts and components are intermediate inputs, whereas consumption and capital goods are final goods.¹² The first two columns present the distribution of Japan's exports to ASEAN in 1990 and 2011. More than 60 per cent of Japan's exports to ASEAN were intermediate goods (processed goods, and parts and components) in 1990. This trend increased in 2011: More than 70 per cent of exports were categorized as intermediate goods. In contrast, primary goods comprised a substantial portion of ASEAN's exports to Japan in 1990.¹³ However, the share of primary goods declined, and that of parts and components increased from 4 per cent to approximately 13 per cent in 2011. In addition, capital goods, which accounted for less than 3 per cent in 1990, increased to approximately 8 per cent. By expanding the export of parts and components and capital goods, ASEAN's exports to Japan have become diversified in the production-stage classification over the past two decades.

¹⁰ The standard Grubel–Lloyd index is given by:

$$1 - \frac{|EX_{ijk} - IM_{ijk}|}{EX_{ijk} + IM_{ijk}},$$

where EX_{ijk} and IM_{ijk} are country i 's exports to country j and country i 's imports from country j in sector k , respectively. The index approaches 1 when intra-industry trade prevails in the sector.

¹¹ The sector average of the Grubel–Lloyd index is given by the following formula:

$$\sum_k \frac{2 \times \min\{EX_{ijk}, IM_{ijk}\}}{\sum_k EX_{ijk} + \sum_k IM_{ijk}}.$$

¹² The product categories depend on RIETI–Trade Industry Database (RIETI–TID)'s definition, which in turn uses the Broad Economic Categories (BEC) codes. For details, refer to www.rieti-tid.com. Processed goods comprise BEC codes 121, 22, and 32. Parts and components comprise BEC codes 42 and 53.

¹³ Processed goods had the largest shares in both 1990 and 2011, but that occurred because oil and coal products belonged to this category.

Table 3. Bilateral merchandise exports, by production stage, 1990 and 2011 (%)

Production stage	Japan		ASEAN	
	1990	2011	1990	2011
Primary goods	0.3	0.5	30.4	18.9
Processed goods	33.1	38.3	47.1	42.6
Parts and Components	27.6	35.2	4.1	12.5
Consumption goods	10.0	5.4	15.4	18.1
Capital goods	29.0	20.5	2.9	7.8

Note: Production stage in RIETI-TID is based on the Broad Economic Categories (BEC) classification.
Source: Author's calculation of RIETI-TID (RIETI-Trade Industry Database), 2012

Thus, the characteristics of the Japan–ASEAN merchandise trade are twofold. First, trade based on the classical comparative advantage theory still carries substantial weight. ASEAN's supply of natural resources and food has been particularly important for the Japanese economy. Second, however, intra-industry trade in the sectors where Japan has comparative advantage over ASEAN has increased over the past two decades, which implies that gains from specialization arising from increasing returns to scale and agglomeration effects have become more important for Japan and ASEAN. Additionally, Japan–ASEAN trade reflects the increasing importance of production fragmentation between Japan and ASEAN Member States.

3.2 Trade in services

As is commonly known, statistics for services trade are not as well organized as those for the trade in goods, partly because services are less visible than goods and their transactions are more complex. The classification of services trade by the General Agreement on Trade in Services (GATS) uses the following four supply modes of services trade: direct cross-border trade in services (Mode 1), movement of the customer to the country of the provider (Mode 2), sales of services through an offshore affiliate (Mode 3) and temporary movement of natural persons to provide services (Mode 4). The balance of payment statistics cover Modes 1, 2 and 4.¹⁴ Mode 3 is included in the statistics of foreign affiliates' sales.

Table 4 reports the distribution of bilateral services trade between Japan and ASEAN, based on the Japanese balance of payment statistics. Although the table is not free from the caveats cited previously, two interesting changes are evident between 1996 and 2011.¹⁵ First, the share of other business services exported from Japan grew, from 31 per cent to 42 per cent. This category includes production services, such as trade-related services. Thus, the increase appears to reflect that Japanese multinational enterprises developed production networks within ASEAN during the 2000s. Second, the proportion of royalties and license fees in Japanese services imports increased markedly, from 1 per cent to 14 per cent. The same category in Japanese exports also increased, from roughly 14 per cent to 18 per cent. This data suggest that technology transactions between Japan and ASEAN have become bidirectional in parallel with the evolution of production networks through Japanese FDI.

¹⁴ Another difficulty with services-trade statistics is data availability. It is much harder for governments to track international transactions in services than in goods trade because they are less "visible".

¹⁵ As an example of insufficient data collection in services trade, Japan's balance of payment statistics for services transactions classify sectors and countries only after 1996.

Table 4. Japan–ASEAN bilateral services trade, by sector, 1996 and 2011 (%)

	Export		Import	
	1996	2011	1996	2011
Transportation	27.3	30.5	26.1	21.6
Travel	28.8	1.0	3.5	3.8
Communication	2.2	1.0	1.4	0.3
Construction	12.8	7.9	21.8	12.8
Insurance, finance	1.8	1.5	2.0	1.0
Information	0.9	1.4	0.8	0.4
Royalties	0.9	13.6	13.7	18.0
Other business	25.4	25.6	30.6	42.0

Source: Authour's calculation of the balance of payment statistics, BOJ.

3.3 Foreign direct investment

Japanese FDI in the ASEAN region heavily increased during the late 1980s, especially after the 1985 Plaza Accord, which caused sharp real appreciation in the Japanese yen. While Japanese multinational enterprises increased their FDI in industrialized countries, such as the United States, to penetrate the markets without trade conflicts (horizontal FDI for tariff jumping), they also began to shift labour-intensive goods and production processes, such as assembly, to industrialized countries, including the newly industrialized economies and the ASEAN Member States, to exploit inexpensive labour costs (vertical FDI). Indonesia, Malaysia, the Philippines and Thailand (ASEAN-4) were the most popular FDI destinations at that time.¹⁶

In the early 1990s, China replaced ASEAN as the most popular destination for Japanese FDI. But then, the FDI boom towards China and the ASEAN-4 plunged from the impact of the 1997 Asian financial crisis. Japanese FDI in China revived after 2000, particularly during the period immediately after China's accession to the World Trade Organization. However, the revival of Japanese FDI in ASEAN did not occur on the same scale as it did in China.

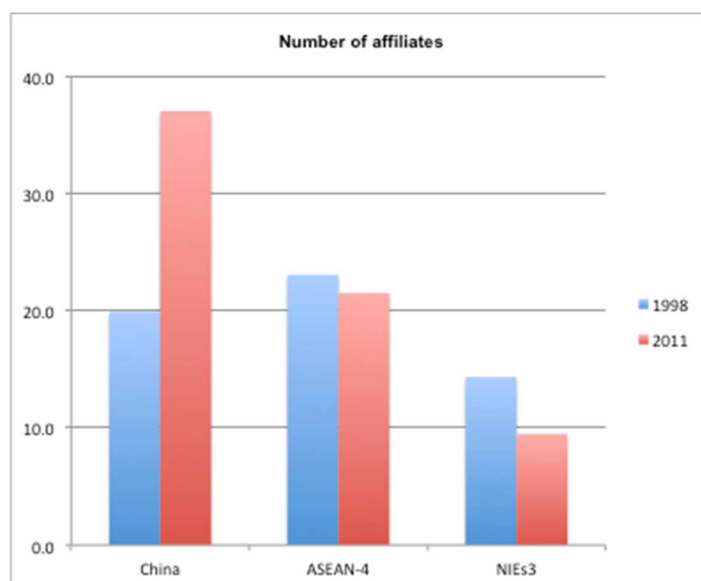
Figures 1A and 1B depict these trends in the regional distribution of Japanese FDI in the manufacturing sector.¹⁷ In 1998, the ASEAN-4 was the most important destination among three Asian destinations (ASEAN-4, the three newly industrialized economies (or NIE3) of the Republic of Korea, Singapore and Taiwan (China) as well as China) in terms of both the number of foreign affiliates and their sales. Japanese foreign affiliates in ASEAN-4 accounted for approximately 23 per cent of the total foreign affiliates, which was the largest regional share in Asia (panel A). However, in 2011, China was the most popular destination, although ASEAN-4 slightly increased its share relative to that in 1998, with a similar tendency in foreign affiliates' sales (panel B). The sales share of Japan's foreign affiliates in ASEAN-4 increased, from approximately 11 per cent in

¹⁶ ASEAN-4 includes Indonesia, Malaysia, the Philippines and Thailand. Asian newly industrialized economies represent Hong Kong (China), the Republic of Korea, Singapore and Taiwan (China).

¹⁷ The data are obtained from the Survey of Overseas Business Activities, a firm-level survey conducted by the Japanese Ministry of Economy, Trade and Industry (METI). This survey includes Japanese firms that own or have previously owned overseas subsidiaries. Overseas subsidiaries are defined as foreign affiliates in which Japanese firms have invested capital of 10 per cent or more or as foreign firms in which Japanese foreign affiliates have invested capital of 50 per cent or more. The choice of sample years, 1998 and 2011, reflects data availability. China includes foreign affiliates established in Hong Kong (China). For this study, NIEs 3 includes three countries/regions but not Hong Kong (China).

1998 to 19 per cent in 2011. The growth in China was much faster, though, where the sales share increased more significantly, from approximately 7 per cent in 1998 to 24 per cent in 2011.

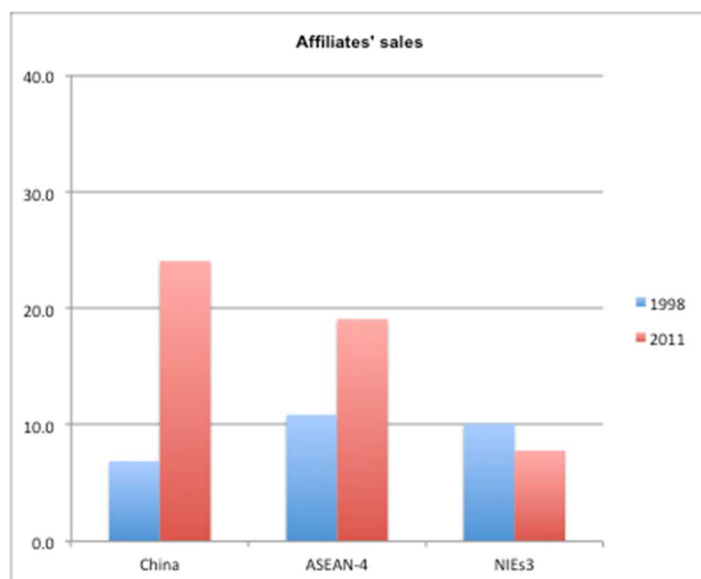
Figure 1A. Distribution of FDI, 1998 and 2011



Note: NIEs3 = The three newly industrialized economies of the Republic of Korea, Singapore and Taiwan (China).

Source: Author's calculation of Survey of Overseas Business Activity, METI.

Figure 1B. Distribution of FDI, 1998 and 2011



Note: NIEs3 = The three newly industrialized economies of the Republic of Korea, Singapore and Taiwan (China).

Source: Author's calculation of Survey of Overseas Business Activity, METI.

Table 5 presents the sector distribution of Japanese FDI in ASEAN affiliates' sales.¹⁸ In 1998, the largest sector was electrical machinery, accounting for approximately 50 per cent of affiliates' sales in that region; transportation equipment followed, at approximately 16 per cent. The FDI sales distribution in ASEAN was skewed towards electrical machinery relative to the distribution in all regions. This distribution dramatically changed during the 2000s: In 2011, transportation equipment occupied the greatest share, at approximately 52 per cent, with electrical machinery following, at roughly 18 per cent. This structural change in the FDI sales distribution reflects changes in Japanese industrial competitiveness. The increasing transportation equipment share and the decline in the share of electrical machinery represent a general trend observable in other regions (the columns for all regions in Table 5). Note that the influence of such a Japanese FDI structural change in the 2000s can be observed in changes in Japan–ASEAN bilateral trade. In Table 2, Japan's export share of transportation equipment declined, from 15 per cent to 10 per cent, indicating production localization through FDI in transportation equipment.¹⁹

Table 5. Distribution of FDI sales, by sector, 1998 and 2011 (%)

	ASEAN-4		All regions	
	1998	2011	1998	2011
Foods	2.3	1.8	2.4	3.0
Textiles	4.7	1.4	2.4	1.0
Pulp, paper and wood	0.7	0.5	1.0	0.7
Chemicals	9.1	7.3	8.2	10.0
Oil and coal	0.1	0.2	0.5	1.2
Stone, clay, glass and concrete products	n.a.	1.0	n.a.	1.3
Iron and steel, nonferrous metals	6.7	8.0	4.4	5.5
General machinery	3.1	5.4	7.5	8.0
Electrical machinery	48.9	18.3	34.3	18.5
Transportation equipment	16.4	51.8	31.9	44.2
Miscellaneous goods	6.3	4.3	7.4	6.6

Source: Author's calculation of Survey of Overseas Business Activity, METI.

As mentioned in section 2, Japanese multinational enterprises' affiliates in Asia purchased considerable portions of intermediate inputs from local markets, even at the relatively early stage of Japanese FDI (the late 1980s). Table 6 shows the evolution of local production networks since the 1990s. The numbers are remarkable: The share of local procurement increased, from about 30 per cent in 1996 to 40 per cent in 2010 in electrical machinery while it increased from about 47 per cent in 1996 to 72 per cent in 2010 in transport equipment.²⁰

¹⁸ ASEAN-4 is used here because the data for ASEAN-10 in 1998 was not available.

¹⁹ Japan's import share in transportation equipment increased from 0.9 per cent to 2.9 per cent. These data are consistent with anecdotal evidence that Nissan and Honda in Thailand began shipping their products to Japan during the 2000s.

²⁰ Not surprisingly, local procurement is much greater in transport equipment than electrical machinery. The difference is attributable to the fact that transportation costs for intermediate inputs in transport equipment are higher than those in electrical equipment.

Table 6. Local procurements, by Japanese multinational enterprise affiliates in Asia, select years (%)

Year	Electrical machinery	Transport equipment
1996	29.9	46.7
2000	32.2	51.0
2005	38.5	66.5
2010	40.2	72.0

Source: White Paper on International Economy and Trade 2012, METI.

4. Impact of ASEAN integration on ASEAN–Japan economic and political relationships

4.1 Trade and foreign direct investment

Established in 1992, the ASEAN Free Trade Area (AFTA) is a core of the ASEAN Economic Community (AEC). Because AFTA is a preferential trade arrangement, it is not free from the usual concerns that special interest groups will distort tariff reductions so that trade diversion might outweigh trade creation and that the reduction in external tariffs would stall. However, it is highly unlikely that these concerns regarding AFTA are legitimate for the following reasons. First, from its outset, AFTA covered a broad range of products, and tariff reductions were substantial, even though the reduction schedule varied among member countries and occasionally altered. In fact, except for the CLMV countries that joined AFTA in 1995, AFTA members had eliminated tariffs for virtually all products by 2010.

Second, AFTA countries often unilaterally reduced most favoured nation (MFN) tariffs after AFTA was enacted.²¹ Empirical studies support the view that AFTA did not constrain the reduction in external tariffs (see Calvo-Pardo, Freund and Ornelas, 2009). Third and similar to the second reason, most ASEAN Member States (Indonesia, Malaysia, the Philippines, Singapore and Thailand) joined the Information Technology Agreement (ITA) in 1997, which is another example of MFN tariff reduction. The ITA, enacted in 1997 as one of several World Trade Organization agreements executed after the Uruguay Round, eliminated tariffs on a broad range of IT products by 2000 on a most favoured nation basis, such as telecommunication equipment and computers. Ornelas (2005) and others formally demonstrated that countries participating in the free trade area were incentivized to reduce external tariffs after its formation. Thus, AFTA countries' unilaterally reducing MFN tariffs and joining the ITA can be interpreted as reasonable responses after preferential tariff reductions by AFTA.

Based on the previous analysis, it appears that the emerging economic integration in the goods trade is having no negative effect on external tariffs. But what about the effects of the emergence of an integrated goods market in the region on ASEAN–Japan trade?

²¹ For example, applied MFN tariff rates were occasionally even lower than AFTA's preferential rates for some products during AFTA's tariff reduction. For a theoretical explanation of countries' incentive to reduce external tariffs after forming free trade areas, see Ornelas, (2005).

Standard trade economics provides good guidance. There are two major explanations for international trade: comparative advantage and gains from specialization stemming from increasing returns to scale or geographical agglomeration. Trade based on comparative advantage results from differences in technology, factor endowments (including natural resources), institutions and other influences. The trade data in section 3 suggest that trade between ASEAN and Japan is still largely explained by comparative advantage: Japanese exports in machinery industries in exchange for ASEAN natural resources and food. Given that tariff reductions within ASEAN Member States stimulate external-tariff reductions, economic integration would accentuate trade on the basis of comparative advantage and increase trade volumes with Japan.

The more important effects of economic integration on ASEAN–Japan trade probably will arise from intra-industry specialization because of a larger ASEAN market. The standard trade theory indicates that a larger market size increases the total varieties of products available to consumers and producers. Given scale economy at the firm level, a larger market enables firms to expand their operation and reduce production costs (Krugman, 1979). It is known that decreases in trade costs, such as tariff reductions in ASEAN, have encouraged industry agglomeration within ASEAN. Such agglomeration will probably generate gains from specialization (resulting from increasing returns to scale and/or agglomeration externalities) and increases in industry competitiveness. ASEAN integration thus is expected to further increase intra-industry trade with Japan.

As discussed in section 3, Japanese FDI is concentrated on transportation equipment and electrical machinery (Table 5). ASEAN Member States' tariff reductions (both AFTA and MFN tariffs) have thus far motivated Japanese multinational enterprises to relocate their affiliates within this region, which accelerated industry concentration. An example of this phenomenon is the automobile and related industries in Thailand. ASEAN integration is expected to strengthen the tendency of geographical agglomeration and division of labour within ASEAN.

Additionally, ASEAN integration will probably stimulate new Japanese FDI. Recent FDI statistics suggest a resurgence of Japanese FDI in ASEAN, partly attributable to business environments in China having recently worsened and Japanese multinational enterprises' needs for risk diversification having increased.²² The findings from a survey of Japanese multinational enterprises indicate that in addition to the recent strained relationship between Japan and China, increases in wages and less transparent and unstable regulations are two major disadvantages of the Chinese economy. The survey also revealed that Japanese multinational enterprises regard the ASEAN region as an important alternative to China as an FDI destination.²³ If ASEAN integration can improve business environments, the region will probably attract further FDI from Japan.

²² The balance of payment statistics in 2013 reported that Japanese FDI in ASEAN recorded ¥2,333 trillion (about \$23 trillion), while in China (including Hong Kong (China)) it was ¥1,014 trillion (about \$10 trillion).

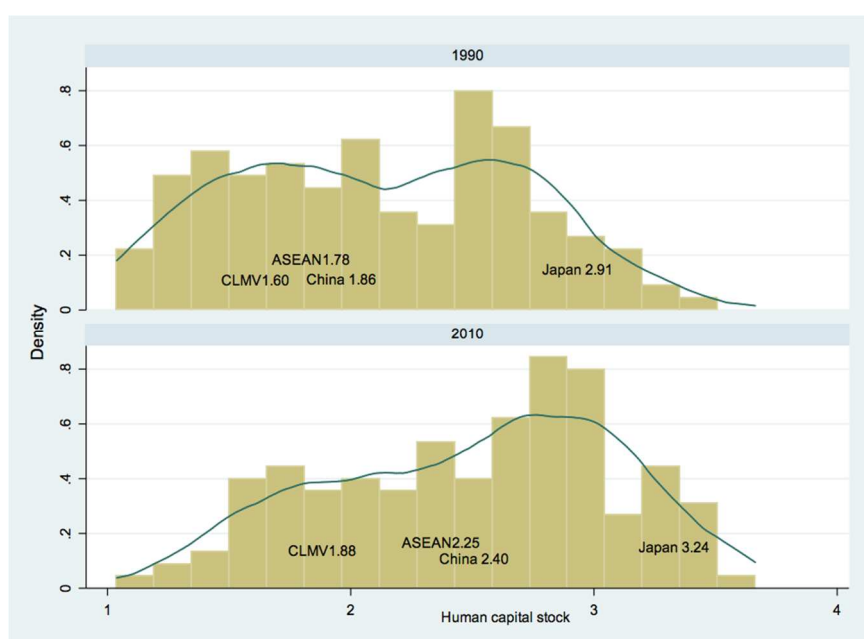
²³ A study group that included the author conducted this survey on business environments in China in 2013. The survey counts about 360 respondents that have manufacturing affiliates in China as of 2012. As is expected, the majority firms listed inexpensive labor costs and increasing demands for their products as the major attractiveness of China. Interestingly, the most considerable attractiveness was a large number of downstream firms to which Japanese multinationals sell their products. Another interesting observation from the survey is that about 55 per cent of Japanese multinationals answered that they would not alter China's share in their worldwide production. Almost the same number of respondents answered that either they would decrease the production share in China or increase it. A preliminary summary of the survey is available from the author.

4.2 Structural transformation and emerging industries

It is not easy to predict how ASEAN integration might influence the industry structure from the perspective of the Japan–ASEAN economic relationship. Employing a multisector computable general equilibrium model, Urata and Kiyota (2003) simulated the impact of an East Asian-wide free trade area on trade patterns in East Asia and found that the creation of such an agreement did not greatly change trade patterns across the countries examined.²⁴ However, the standard trade theory is, again, instructive. On one hand, certain conditions, such as a comparative advantage arising from factor endowments (such as natural resources) will not change noticeably; energy-related products (such as oil and coal) and food products will continue to be important exports to Japan. On the other hand, certain factor endowments are changeable.

Figure 2 depicts the human capital distributions across countries in 1990 and 2010.²⁵ The two panels suggest that developing countries tended to accumulate human capital during those two decades, leading to the rightward-skewed distribution in 2010 relative to that in 1990. However, the CLMV countries appear to lag behind the older ASEAN Member States in human capital accumulation: While the older countries increased their human capital stock by 0.47 per cent, the CLMV countries did so by only 0.28 per cent. This finding implies that ASEAN integration may trigger two changes. First, an integrated ASEAN will become less skill abundant, stimulating increasing exports of unskilled labour-intensive products to Japan. As Table 2 illustrates, for example, the export share of textiles in ASEAN's total exports increased from 1990 to 2011.

Figure 2. Changes in human capital, 1990 and 2010



Note: CLMV: Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam

Source: Author's calculation of Barro and Lee (2012).

Second, the older ASEAN Member States will lose competitiveness in the unskilled labour-intensive sectors. In fact, in the automobile industry, the production supply chains organized in Bangkok and its neighbouring

²⁴ They used the Global Trade Analysis Project (GTAP) model developed by Hertel (1997). In their exercise, an East Asia free trade area includes ASEAN-4 plus Viet Nam, the newly industrialized economies, China and Japan.

²⁵ Using average school years for people older than 25, from Barro and Lee (2013); human capital is calculated using the method proposed by Hall and Jones (1999).

areas already have begun stretching to border regions in surrounding countries, such as Cambodia and the Lao People's Democratic Republic. Plants in those two countries lead in labour-intensive production processes, whereas those in Thailand have shifted to capital-intensive (or more skilled labour-intensive) processes. With the support of transportation infrastructure development in the Mekong region, this trend will increase. Reduced trade costs stemming from ASEAN integration will accentuate the current industrial agglomeration.

A similar international division of labour within ASEAN is occurring in electrical machinery. For example, after first attracting Japanese multinational enterprises in the late 1980s, Malaysia formed electrical industry clusters. But multinational enterprises, including those in Japan, have begun to shift labour-intensive electrical products manufacturing from Malaysia to Viet Nam and the Philippines. The Malaysian government is now working to attract FDI for more sophisticated electrical products and thus seeking product upgrading.

With integration, services trade will increase its importance in two respects. First, production services will increase with the further evolution of international production networks in Asia. ASEAN integration will probably expand production networks by reducing transportation and border-transaction costs. Additionally, if the AEC can promote liberalization in services trade in this region and can concomitantly improve regional production services, the international production networks between Japan and ASEAN would be enhanced, leading to total productivity gains.²⁶ Second, if ASEAN Member States' economic development progresses further, the demand for consumption services, such as travel, education and finance, would also increase. For example, Japan relaxed tourist visa requirements for five ASEAN Member States in 2013.²⁷ Although it is too early to evaluate the effects of this particular liberalization policy, increases in the trade volume of services are expected.

4.3 Productivity and wages

Prior studies suggest several mechanisms by which trade liberalization increases productivity. First, import competition arising from tariff reductions stimulates domestic producers to improve their X-efficiency. For example, Hay (2001) empirically examined the effects of the 1990 Brazilian trade liberalization on the total factor productivity and found both large productivity gains and large decreases in market shares and profits among Brazilian firms. Second, trade liberalization enables firms to access less expensive but higher-quality imported inputs (Coe, Helpman and Hoffmaister, 1997; Feenstra et al., 1999). Recently, using Indonesian plant-level data, Amiti and Konings (2007) looked at the effects of tariff reduction on final goods and intermediate inputs simultaneously and found that tariff reductions on intermediate inputs generated much greater productivity gains than those on final goods. Third, recent trade literature referring to a diverse range of enterprises emphasized that trade liberalization improves sector productivity by reallocating inputs from unproductive firms to productive firms (Melitz, 2003). Using Chilean plant-level data, Pavcnik (2002) empirically demonstrated that the reallocation of input resources from less efficient plants to more efficient plants was an important channel of productivity improvement. Fourth, trade liberalization encourages firms to adopt new technologies. Bustos (2011) examined Argentinian exporting firms and found that increases in firm

²⁶ Personal contact between customers and clients is essential in many services, and geographical proximity between suppliers and markets is key. Thus, trade in services tends to arise through FDI or natural persons' travels across borders. The AEC can potentially improve the efficiency of services provision by promoting non-discrimination, domestic regulatory reforms and natural person movements (by mutual recognition agreements).

²⁷ The five ASEAN Member States are Indonesia, Malaysia, the Philippines, Thailand and Viet Nam. This policy was implemented in July 2013.

revenue caused by the Mercado Común del Sur (Common Market of the South) encouraged them to upgrade their technology. These four mechanisms can be relevant to ASEAN integration.

The impact of international trade on wages is a classical topic in the international trade literature. The Heckscher–Ohlin theory predicts that trade liberalization increases the relative returns to abundant factors, which are generally unskilled labour for developing countries (the Stolper–Samuelson theorem). However, observers acknowledge that once the Heckscher–Ohlin model is extended, the prediction of factor rewards becomes more complex. For example, in a Heckscher–Ohlin model with three types of countries – high-, middle- and low-income – the impact of trade liberalization on skill premium (relative wage of skilled to unskilled workers) is ambiguous for the middle-income countries.²⁸ Alternatively, if technological catch-up by a developing country is allowed in a two-country Heckscher–Ohlin model, with a continuum of final goods, the skill premium rises in both the industrialized and developing countries (Zhu and Trefler, 2005). Although Japan is a skilled worker-abundant economy relative to ASEAN Member States, the latter have great diversity in skilled and unskilled labour endowments. Thus, the existing studies suggest that careful attention to changes in labour demand and supply is needed when examining the impact of trade liberalization on wages.

Recent empirical studies carefully dealt with such complexity and validated the Stolper–Samuelson theorem. For example, Chiquiar (2008) examined changes in skill premium in Mexico caused by the North American Free Trade Agreement, exploiting regional wage variations. He found that regions with a larger export volume to international markets (such as regions close to the Mexico–United States border) exhibited a relative increase in wages and a decrease in skill premium, as predicted by the Stolper–Samuelson theorem. Amiti and Cameron (2012) studied the impact of tariff reductions in Indonesia on skill premium by using plant-level data. They found that reducing tariffs on production inputs decreased the skill premium within firms that imported their intermediate inputs because they are skill-intensive, and the tariff reduction regarding such products decreases the relative demand for skilled workers.

Based on the premise that multinational enterprises possess superior proprietary assets, such as technology, managerial skills and brands, it has been argued that inward FDI contributes to host countries' productivity. First, multinational enterprises might improve the productivity of acquired local firms by introducing their superior proprietary assets. Second, the entry of multinational enterprise affiliates is likely to force the least productive indigenous firms to exit, leading to improvements of sector productivity. This channel is very similar to the one in which trade liberalization might encourage productive firms' expansion and unproductive firms' contraction (and exits). Third, multinational enterprise affiliates might create technology spillovers to indigenous firms. Such spillovers might arise because: (i) rival indigenous firms might improve their X-efficiency (competition effects); (ii) indigenous firms might learn from the multinational affiliates through observation or establishing business relations (demonstration effects); or (iii) local workers who were trained and increased their job skills at multinational affiliates might move to local firms (labour turnover effects).

Expecting these FDI effects on productivity, developing countries, including ASEAN Member States, have offered special incentives to foreign firms, such as tax incentives, tariff reductions and subsidies for infrastructure, to lure increased FDI. Based on the idea that local participation with multinational enterprises might facilitate spillovers from the affiliates, governments often impose restrictions on foreign ownership.

²⁸ More rigorously, the present study discusses a Heckscher–Ohlin model with multiple cones.

The empirical studies on host countries' productivity gains from FDI, however, have provided mixed results. Using Italian firm data and dealing with the self-selection problem, Benfratello and Sembenelli (2006) found that foreign ownership had not affected affiliates' productivity.²⁹ In contrast, Arnold and Javorcik (2009) revealed that changes in ownership from domestic to foreign significantly improved Indonesian manufacturing plant productivity. They concluded that such productivity improvement came from restructuring because acquired plants tended to increase their investment in machinery and equipment, employment, wages and output. These studies thus suggest that the productivity transfer from multinational enterprises to their foreign affiliates may depend on specific situations, such as the gap between the investment country and the recipient country.

As for FDI spillovers on productivity, Aitken and Harrison (1999) examined Venezuelan manufacturing plants and found that foreign equity participation was positively correlated with plant productivity only for small plants and that inward FDI negatively affected local plants' productivity. More recent literature focuses on identifying channels of FDI spillovers. Blalock and Gertler (2008), for instance, asserted that multinationals operating in emerging markets have an incentive to transfer technology to raise local suppliers' productivity; the authors empirically demonstrated that Indonesian plants that supplied foreign entrants exhibited productivity gains.

The literature on FDI spillovers often identifies positive effects in industries other than those in which foreign affiliates operate (see Bwalya, 2006 for Zambian firms). In particular, a backward link is an important channel through which spillovers occur (see Javorcik, 2004 for Lithuanian firms; Liu, 2008 for Chinese firms; Machikita and Ueki, 2012 for ASEAN firms). In addition, some recent studies highlighted labour turnover as a conduit for FDI spillovers, using matched employer–employee data (see Balsvik, 2011 for Norwegian manufacturing plants and Poole, 2013 for Brazilian plants). Although Balsvik found that workers with multinational enterprise experience contributed 20 per cent more to the productivity of their plant than workers without such experience, Poole found that FDI spillover through worker turnover was pronounced among skilled workers.

Nevertheless, local participation with multinational enterprises does not necessarily warrant FDI spillovers to local firms. Although local firms that participate in joint ventures with multinational enterprises might access their technology or managerial skills more easily, the multinational enterprises may be discouraged to transfer them to the affiliates out of fear of their proprietary asset eroding. The effect of local participation with multinationals on the degree of FDI spillovers has also been empirically studied. For example, Takii (2005) studied Indonesian plant data and found that the degree of spillovers tended to be small in industries where the presence of majority-foreign or wholly foreign plants is greater. Using Romanian firm-level data, Javorcik and Spatareanu (2008) also found that vertical spillovers were observed among projects with shared domestic and foreign ownership but not with fully owned foreign subsidiaries.

In short, the empirical studies suggest that multinational enterprises may contribute towards improving the productivity of host countries by enhancing the productivity of the acquired firms and the local suppliers from which the affiliates purchase inputs. Labour movements from the affiliates to indigenous firms are another channel for FDI spillovers. However, the empirical studies also suggest that the FDI effects on the host countries' productivity are likely to depend on certain conditions, such as the technological gap between investment countries and host countries and the absorption capacity of local firms and workers. Rigorous

²⁹ It is widely acknowledged that multinational enterprise affiliates on average have higher productivity than local firms. Several empirical studies have reported this tendency. However, for identifying productivity gains by acquired firms, controlling self-selection bias (in which multinational enterprise affiliates might be more productive if multinational enterprises tend to acquire more productive indigenous firms) is important.

empirical studies on the effect of Japanese FDI in ASEAN on recipient countries' productivity are scarce, leaving a gap in needed analysis.

FDI also might affect wages in host countries. It is well established that multinational affiliates pay higher wages on average than domestically owned firms (Lipsey, 2004). Several reasons for this wage premium have been suggested. Fearing technological spillovers, multinational enterprises might offer wage premiums to lower the labour turnovers; multinational enterprises might compensate for their higher labour demand volatility; or multinational enterprises might simply share rent with local workers. Additionally, FDI might raise wages paid by local firms through market-wide improvements in the marginal product of labour. Whether multinational enterprises indeed offer "good jobs" to local workers has an important welfare implication for FDI, especially if inward FDI yields the positive labour market externality in host countries.

Empirical studies on the effect of FDI on wages in host countries also are not decisive. Although many studies find that multinational affiliates pay higher wages than local firms after controlling for worker quality, it could be a situation of self-selection ("cherry-picking" by multinational enterprises). Recent empirical studies that carefully dealt with this possible selection bias found that wage premiums in foreign-owned firms were considerably small (see Almeida, 2007 for Portuguese firms; Heyman, Sjöholm and Tingvall, 2007 for Swedish firms). However, these studies are limited to industrialized countries, and there is a need for more studies using developing country data to assess the labour market outcomes of inward FDI.

As for wage spillovers, empirical studies are even scarcer. Some of the empirical studies on productivity spillovers already cited suggest that wage spillovers is also likely (especially Poole, 2013). The effects of Japanese FDI in ASEAN on wages in host countries have yet to be known. Anecdotal findings suggest that Japanese multinational enterprises might transfer job skills to local workers. For example, when multinational affiliates located in Thailand were damaged by massive flooding in 2011, Japanese multinational enterprises temporarily relocated local employees to their establishments in Japan until the Thai affiliates resumed operations.

Available literature suggests that trade and FDI might improve developing countries' productivity through various channels. Productivity improvements would lead to an increase in real wages on average. But the literature also indicates that the productivity transfer and wage improvement effects of FDI might be conditional. The absorption capacity of local firms and workers could be important for the productivity transfer from multinational enterprises to host countries. As noted, rigorous empirical studies that examined the Japanese FDI effects on the productivity and wages in the recipient countries are scarce. Based on the existing studies, the effects of Japanese FDI in ASEAN seem to have been positive because of the technological gap between Japan and ASEAN and the skewedness of Japanese FDI to machinery products, in which technology is relatively matured and easy to be absorbed by local firms and workers.

Whether local firms' participation increases FDI spillovers is disputable. It is not surprising that regulations on the degree of foreign ownership are unpopular among multinational enterprises, including Japanese

multinational enterprises.³⁰ Such regulations may discourage FDI. Although the AEC has provisions to regulate performance requirements with respect to FDI, its level is not necessarily sufficient.³¹

In terms of wage inequality, it is not immediately clear whether trade liberalization decreases wage skill premium in developing countries. However, recent empirical studies have indicated that careful examination could obtain results consistent with the theory.

4.4 Human resources and skill development

The changes in industrial structure discussed in section 4.2 would substantially influence human capital investment. Integration will heighten the impact of comparative advantage within ASEAN on the regional industrial structure. Such changes, in turn, will affect the regional labour demand. In the past, Japanese multinational enterprises have tended to shift the unskilled labour-intensive products (and production processes) from the older ASEAN Member States to the CLMV countries. Skill upgrading has been observed within the region, partly because the multinational enterprises tend to offer “good jobs” in their host countries.

4.5 Labour migration

Available international migration data indicate that geographical proximity and historical ties, along with cross-country income disparity, may strongly influence patterns of labour migration. Table 7 presents data on bilateral migrant stocks in East Asia (with sending countries in rows and host countries in columns). Japan is not a primary destination of labour emigration from the ASEAN region; in fact, it receives immigrants mainly from China and the Republic of Korea. Consequently, it is unclear how ASEAN economic integration will affect labour migration between Japan and ASEAN.

The Japanese Government encourages skilled foreign workers to stay in Japan, tightly restricting unskilled foreign workers. Given the policy on foreign workers, migrant workers from ASEAN to Japan will probably not increase substantially, even after ASEAN integration. In some areas, Japan and ASEAN Member States already cooperate to encourage migrant workers. For example, Japan formed mutual recognition arrangements for IT technicians with several Asian countries.³² Such arrangements are helpful in reducing information asymmetry between employers and employees and are expected to encourage workers’ international movement. Additionally, some economic partnership agreements between Japan and ASEAN Member States arrange Japan’s acceptance of foreign workers for nursing and certified health care.³³ These agreements ask foreign workers to pass a qualification exam in Japan after working there for a designated period of time. Because of language barriers and other difficulties, passing the exam is more difficult for foreign applicants

³⁰ For example, a brief report publicized in 2011 by Nippon Keidanren, Japan’s largest lobbying group composed of 1,281 companies and 129 industrial associations, claims that performance requirements, including technology transfer and local firms’ participation with multinationals, by recipient countries should be abolished to realize an integrated market in the Asia–Pacific region. The report is available at www.keidanren.or.jp/japanese/policy/2011/110/ [accessed 24 Sep. 2014].

³¹ The AEC will regulate performance requirements, but its level is essentially the same as that for the World Trade Organization (the Agreement on Trade Related Investment Measures).

³² Such countries/regions include China, India, the Philippines, the Republic of Korea, Myanmar, Mongolia, Singapore, Taiwan (China), Thailand and Viet Nam.

³³ These are bilateral free trade agreements (formally called economic partnership agreements) with Indonesia, the Philippines and Viet Nam.

than for indigenous applicants. The Japanese Government offers several supportive measures for foreign applicants, including language-training programmes.³⁴

³⁴ Recently, foreign applicants based on the economic partnership agreements took the qualification exam for care workers for the first time. Their passing rate was roughly 38 per cent, whereas the overall passing rate was 64 per cent (reported in a Japanese Government announcement in March 2012).

Table 7. Bilateral migrant stocks, 2010

	Brunei	Cambodia	Hong Kong (China)	Indonesia	Japan	Republic of Korea	Lao PDR	Malaysia	Myanmar	Philippines	Singapore	Thailand	Emigration total	To East Asia
Brunei	0	0	0	0	0	0	0	8	0	1	0	0	24	37
Cambodia	0	0	0	0	3	3	1	0	0	0	0	50	350	16
China	3	7	2 225	77	614	282	2	126	41	44	498	376	8 345	51
Hong Kong (China)	1	1	0	0	0	0	0	0	0	0	3	0	719	1
Indonesia	7	1	0	0	26	16	0	1 398	0	6	102	1	2 504	62
Japan	0	1	0	0	0	12	0	20	0	8	0	27	771	9
Republic of Korea	0	0	0	0	600	0	0	0	0	2	0	3	2 078	29
Lao PDR	0	1	0	0	3	0	0	0	0	0	0	77	367	22
Malaysia	82	1	0	0	8	1	0	0	0	0	1 061	3	1 481	78
Myanmar	0	0	0	0	7	2	0	17	0	0	0	288	515	61
Philippines	16	1	0	0	205	29	0	277	0	0	0	3	4 276	12
Singapore	3	1	0	0	3	0	0	103	0	0	0	2	297	38
Thailand	13	143	0	0	42	21	1	80	0	0	0	0	811	37
Viet Nam	0	174	0	0	37	45	8	0	0	1	0	22	2 226	13
Immigration total	148	336	2 742	123	2 176	535	19	2 358	89	435	1 967	1 157	215 764	
From East Asia	84	98	84	63	71	77	63	86	46	14	85	74	12	

Note: Figures in to East Asia and from East Asia are percents. Other figures are expressed in thousand. Since detail immigration data are not available for China and Vietnam, these two countries are omitted from the columns.

Source: World Bank, Bilateral Migration and Remittances 2010.

5 Conclusion and policy considerations

If economic integration is achieved as planned, it is highly likely to yield mutual benefits for both Japan and ASEAN Member States. This paper emphasizes that the benefits of ASEAN economic integration can be understood through standard trade economics: gains from specialization, based on comparative advantage and increasing returns to scale and/or geographical agglomerations. At first glance, it is not apparent how Japan can receive comparative advantage-type gains from internal tariff reductions within ASEAN. But two possibilities exist. First, it is theoretically known that internal tariff reductions by free trade agreements incentivize participating countries to reduce external tariffs. The evidence reviewed in this study is consistent with this view: ASEAN Member States often reduce their MFN tariffs unilaterally. Second, Japanese affiliates in ASEAN Member States can directly gain from trade based on comparative advantage. One example is the Japanese affiliates in Thailand that recently began shifting their labour-intensive processes to border regions in neighbouring countries, such as Cambodia.

ASEAN economic integration will enlarge the region's internal market, resulting in gains from increasing returns to scale and agglomerations. The larger ASEAN market will not only promote intra-industry trade with Japan and attract new Japanese FDI but will also urge Japanese multinational enterprises to relocate their affiliates. Such relocations will enhance the agglomeration effect and contribute to increasing the new host economy's productivity.

The gains arising from ASEAN integration, however, will depend on the extent to which "true" integration is achieved. Non-tariff barriers as well as tariffs must be eliminated. Identifying non-tariff barriers is more difficult than targeting tariffs. Although the AEC includes the elimination of non-tariff barriers, the scope of non-tariff barriers is broad, especially for technical barriers and product standards. Thus, appropriate monitoring of the integration progress is important. Additionally, the AEC lacks arrangements on government

procurement. Government purchase of goods and services is a large process, which implies that substantial room for discriminatory treatment will remain even when the AEC achieves a single integrated market.³⁵ In addition to increasing the efficiency of public procurement, non-discriminatory national treatment to suppliers of goods and services will help to increase government transparency.

Another key for successful ASEAN integration is the extent to which countries can attract additional investment from foreign countries, including Japan. FDI tends to create “good jobs” in which workers expect higher pay. From a government’s perspective, the existence of multinational enterprises, the transactions that multinational enterprises bring to indigenous firms and jobs that multinational enterprises offer are expected to improve a host country’s productivity. To increase the attractiveness of ASEAN for multinational enterprises, it is important to promote liberalization in services trade and FDI. In this regard, although the ASEAN Framework Agreement on Services has already started services trade liberalization, its goal is rather limited. Consequently, an extension of the agreement should be considered.

The elimination of regional development gaps is another notable goal of ASEAN integration. Japan has supported narrowing the development gap within ASEAN, especially by helping the Mekong countries through, for example, ODA. If trade costs were zero, country size would not matter for welfare; otherwise, larger countries tend to gain, whereas smaller countries tend to lose because of the home-market effect. Consequently, it is also important for small countries to eliminate trade barriers insofar as possible and increase labour mobility to complement the reduced trade costs. The AEC will liberalize labour movements for skilled labour only. Further expansion of the scope of labour is desirable.

³⁵ In 2011, government procurement represented about 10–30 per cent of GDP in ASEAN, varying by countries (Penn World, Table 8.0). The World Trade Organization (WTO) treaties regulate government procurement by the Agreement on Government Procurement; however, the Agreement is not mandatory for WTO members and only 43, most of them industrialized countries, participate in it. Several preferential trade arrangements, including the North American Free Trade Agreement (NAFTA), have rules on government procurement, such as national treatment. The Japanese Government attempted to introduce rules on government procurement to the economic partnership agreements with ASEAN Member States, but failed, except for the economic partnership agreement with Singapore.

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Annex: Chronology of the Japan–ASEAN relationship

1967	Foundation of ASEAN
1973	Forum on Synthetic Rubber (the first Japan–ASEAN dialogue)
1977	The first ASEAN–Japan Forum, the Fukuda Doctrine
1978	ASEAN Cultural Fund
1981	Establishment of the ASEAN–Japan Center in Tokyo
1984	Brunei Darussalam’s participation in ASEAN
1988	Japan–ASEAN Exchange Projects Fund (Japan–ASEAN Integrated Fund in
1992	2008)
1995	Japan’s participation in UN peacekeeping operations (UNTAC)
1997	Viet Nam joined ASEAN
	Asian financial crisis, ASEAN+3 started (Chiang Mai Initiative in 2000)
1999	Lao People’s Democratic Republic and Myanmar joined ASEAN
	Cambodia joined ASEAN
2000	Japan–ASEAN Solidarity Fund
2002	Japan–ASEAN General Exchange Fund (integrated to JAIF in 2008)
2003	Japan–Singapore Economic Partnership Agreement
	ASEAN–Japan Commemorative Summit in Tokyo, Tokyo Declaration for the
	Dynamic and Enduring ASEAN–Japan Partnership in the New Millennium,
2006	ASEAN–Japan Plan of Action for 2004–2010
	Japan ASEAN Integration Fund
2007	Japan–Malaysia Economic Partnership Agreement
2008	Japan–Thailand Economic Partnership Agreement
	ASEAN–Japan Comprehensive Economic Partnership
	Japan–Indonesia Economic Partnership Agreement
	Japan–Brunei Darussalam Economic Partnership Agreement
	Japan–Philippines Economic Partnership Agreement
2009	Japan–Viet Nam Economic Partnership Agreement
	Mekong–Japan Summit, Roadmap for an ASEAN Community 2009–2015
2010	Master Plan on ASEAN connectivity
2011	ASEAN–Japan Plan of Action 2011–2015
	Bali Declaration for Enhancing ASEAN–Japan Strategic Partnership
2013	40 years of ASEAN–Japan partnership
	Tourist visa requirements are relaxed for five ASEAN Member States

How can ASEAN and Japan mutually benefit from ASEAN economic integration?

This paper reviews the evolution of the economic and political relationship between the Association of Southeast Asian Nations (ASEAN) Member States and Japan since the 1970s, from the perspectives of trade in goods and services, foreign direct investment (FDI) and international labour movements. ASEAN economic integration is likely to yield mutual benefits for both ASEAN Member States and Japan. The larger ASEAN market will not only attract new Japanese FDI but also encourage Japanese multinational enterprises to relocate their affiliates, enhancing the agglomeration effect and productivity in the new host economy's. To fully realize these gains, appropriate monitoring of the integration process is important. Some extensions of the ASEAN Economic Community deserve consideration to enhance the effect of integration. They include further liberalization in services trade and FDI, arrangements on government procurement and expansion of the scope of international labour movements.

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