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Neighbourhood Revisited: Explaining Japanese Foreign Direct Investment in the BIMSTEC Region

Arindam Banik* and Pradip K Bhaumik†

Abstract

FDI flows are generally believed to be influenced by economic indicators like market size, export intensity, institutions etc. irrespective of the source and the destination countries. This paper looks at Japanese FDI outflows in an alternate approach based on the concepts of neighbourhood and extended neighbourhood. Interestingly, the current literature emphasizes the trade aspect and thus overlooks the investment aspect. Using a database, the study shows that the neighbourhood concepts are widely applicable in different contexts – particularly for Southeast Asia, USA, China, EU and also in the case of the BIMSTEC region. The study finds that there are significant common factors in explaining the FDI inflows in select regions. While a substantial fraction of FDI inflows may be explained by select economic variables, the region-specific factors and the idiosyncratic component also account for a large part of investment inflows in Southeast Asia, USA, Europe, and China. The findings may have strong relevance in explaining present and future Japanese trade and investment flows in the BIMSTEC region.

1. Introduction

For decades, social scientists have been using a modified version of Isaac Newton's Law of Gravitation to predict movement of people, information, and commodities between cities, countries and even continents. The gravity model, as social scientists refer to the modified law of gravitation, takes into account the population size of two places and the distance between them. Since larger places attract people, ideas, and commodities more than smaller and places closer together have a greater attraction, the gravity model incorporates these two features.

The *gravitational* attraction between two continents, countries or regions with geographical proximity, historical relationship, location and roots may explain our neighbourhood model. Such attraction, in turn, can explain certain economic flows such as investment, market access and trade.

This paper is presented in seven sections. After this brief introduction Section 2 traces the evolution of various neighbourhoods that may explain FDI flows while Section 3 elaborates the various neighbourhoods of Japan. Sections 4 and 5 position China and the BIMSTEC region as extended neighbourhoods of Japan. Section 6 reveals the structure of BIMSTEC region's trade and investment and explores the possibilities of Japanese investment in the extended neighbourhood. Section 7 concludes.

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2. The Evolution of the Neighbourhoods

A historical study of global FDI flows suggests FDI has flowed into four distinct neighbourhoods (Banik *et al.* 2004):

1. The original neighbourhood – direct investment of USA in the manufacturing Industry of UK;
2. The intermediate neighbourhood – the formation of the European Common Market;
3. The extension of the intermediate neighbourhood – the changing pattern of FDI flows;
4. The extended neighbourhood – the role of ethnicity when FDI became explorative and brought changes in repetitive and local experimentation with new alternatives in its wake.

Historically, foreign direct investment (FDI) inflow in the *original neighbourhood* was engendered by the technological and economic hegemony acquired by the USA as compared with Western Europe at the end of the Second World War. This stemmed from the fact that the economies of Western Europe had been battered during the war and so there was considerable opportunity for the expansion of US FDI. The United Kingdom emerged as the original neighbourhood and the ‘preferred destination’ for FDI inflow after the World War II for two reasons: (i) the infrastructure and the production capacity of the UK were not damaged or disorganized and (ii) there were sequential flows of foreign investment because of the similarity between the US and the UK firms in terms of product-markets, human resources, production technology, consumer tastes and culture in the most general sense.

Initially, the *intermediate neighbourhood* had market conditions with which US firms were not familiar including differences in language and business practices, lack of similarity in the GDP per capita, finite capital available for foreign expansion and high costs of establishing plant capacity in the intermediate neighbourhood relative to the original neighbourhood. However, FDI inflow into the intermediate neighbourhood improved as the economic conditions became similar to those of the original neighbourhood. As in the case of the original neighbourhood, it was exploitative in nature. Another important factor that influenced FDI inflow into the intermediate neighbourhood was the formation of the common market by the EC-6 that provided extra incentive to establish or expand activities for the US firms. Increased FDI inflow was due to the growth of the intermediate neighbourhood economies relative to the original neighbourhood as well as the increasing homogeneous market conditions in the intermediate neighbourhood. FDI in Germany grew at over 4.3 times the rate of real GDP (1972-1982), compared with 3.3 times recorded by EC-6 as a whole and US multinational firms were treating Germany as original neighbourhood. Finally, one factor that influenced FDI inflow in the intermediate neighbourhood was the process of integration. As the intermediate neighbourhood moved towards a single market, preferred destination became less important. Due to market growth potentials of this neighbourhood, US companies started to diversify their production activities to exploit the advantage of the single market.

FDI inflow in *extension of the intermediate neighbourhood* has been significantly influenced by the globalization of financial markets as well as the realization that FDI can bestow substantial benefits on the host country where domestic management skills and entrepreneurship are embryonic and where there is no other way of organizing large scale manufacturing. Capital inflows to this neighbourhood has also benefited from technological progress that improves the timeliness, accuracy, and analysis of information. Technological innovation and increasing cultural ties between the developing and industrial countries, has increased the range and variety of participants among emerging market countries in recent cross-border capital flows. Similarly, in many developing economies the private sector as well as the share of total capital

flows that go to private borrowers is growing. FDI became increasingly explorative in this neighbourhood.

FDI inflows to both the original and the intermediate neighbourhoods attained their peak by the end of the 1980s. Hence FDI inflows to the *extended neighbourhood* became explorative and brought changes in repetitive and local experimentation with new alternatives in its wake. Similarly, linear approximation of FDI in terms of exploitation became increasingly inaccurate as the neighbourhood was extended. In this case, FDI reduced to identifying some critical variables that would make producer(s) to become competitive in the extended neighbourhood. Put differently, ability to compete started depending on the use of techniques, skills, and organizational forms compared to international levels of cost, quality, flexibility, and delivery. In the extended neighbourhood, the spillover effect of FDI was as much beneficial for the host country as the benefit from the investment.

3. The Neighbourhoods of Japan

For the most part, the growing Japanese involvement in the global economy has taken three broad paths. Each of them, though related, is different from one another. Indeed, it shows the rise of Japan as a key global player in the areas of trade and investment. The first path has involved the trading firms. The *Sogoshosha*¹ have developed global scanning, huge information banks, transportation and logistical networks in order to service Japan's import needs for basic raw materials, food, and energy. These trading firms have been on the vanguard of post-war period and they were responsible to manage Japan's security of supply challenges in part through direct foreign investment in the areas of sourcing energy and raw materials (McMillan 1984; Tsurumi 1976; Young 1979).

The second path involved investment in labour intensive low tech manufacturing in two stages. Starting in the late 1950's and gradually rising till the 1970's, the Japanese have been transferring to countries of Southeast Asia their production sectors where Japan had lost competitiveness to other Asian economies. Textiles, electronic machines and appliances, timber, pulp were the first growth sectors that dominated Japanese FDI, followed in the late 1970's by chemicals, food processing, heavy machines and other manufactures. In most cases, joint venture forms of organization have been the vehicles of FDI and technology transfer (Kojima, 1977). The same investment pattern was continued along the second path in the next stage when the focus shifted to Europe and North America. Once the trading firms had spearheaded the initial export penetration, overseas distribution/warehousing/service branches were established to push imports to the point where full-fledged production became viable. In sectors like colour TV's, zippers, cars, ball bearings and consumer electronics, overseas production was deliberately postponed till some import thresholds were crossed.

The third path involved a conscious, well planned strategy to build capacity in export of capital goods and turnkey projects. Japan has made extensive use of foreign aid linked with infrastructure development and in many of these, major Japanese firms developed overseas turnkey skills that were later used for competitive success in other markets. The three paths complemented each other in helping Japan come from behind and become an economic superpower.

Japanese society has traditionally been a relatively closed society with a culture distinctly different from that of its geographically proximate neighbours. The neighbourhoods of Japan, therefore, were not built on premises of similarity of language, culture, ethnicity, customer choices, etc. In Japan's case they evolved from necessities like strengthening and securing supplies of critical raw materials, to shifting production bases for their sunset industries where domestic production was becoming non-competitive due to high wage rates, to circumventing non-tariff barriers from growing economic integration like in Europe.

Table 1: Japan's Outward FDI by Country/Region (US\$ million)

	Fiscal Year	1965-1969 (AA)	1970-1974 (AA)	1975-1979 (AA)	1980-1985 (AA)	1986-1991 (AA)	1992-1997 (AA)	1998	(% of total)	1999	(% of total)	2000	(% of total)	2001	(% of total)	2002	(% of total)	2003	(% of total)	2004	(% of total)
	U.S.A.	84	393	964	2,983	20,544	18,550	10,413	(25.26)	22,415	(33.21)	12,349	(25.18)	6,461	(20.01)	8,215	(22.29)	10,577	(29.30)	4,677	(13.16)
	Canada	21	66	74	145	796	669	630	(1.53)	2,477	(3.67)	134	(0.27)	88	(0.27)	234	(0.64)	103	(0.29)	159	(0.45)
Subtotal (North America)		105	458	1,038	3,127	21,340	19,219	11,043	(26.79)	24,892	(36.88)	12,483	(25.46)	6,550	(20.28)	8,449	(22.92)	10,680	(29.59)	4,836	(13.60)
Subtotal (Latin America)		60	398	614	1,676	4,697	4,332	6,522	(15.82)	7,723	(11.44)	5,282	(10.77)	7,715	(23.89)	5,746	(15.59)	5,262	(14.58)	6,371	(17.92)
	Indonesia	32	199	541	755	718	1,797	1,116	(2.71)	959	(1.42)	420	(0.86)	627	(1.94)	529	(1.43)	648	(1.80)	311	(0.88)
	Hong Kong	2	51	133	332	1,307	1,073	639	(1.55)	975	(1.44)	946	(1.93)	348	(1.08)	208	(0.56)	396	(1.10)	639	(1.80)
	Singapore	2	40	115	245	817	1,082	655	(1.59)	1,038	(1.54)	457	(0.93)	1,147	(3.55)	752	(2.04)	322	(0.89)	715	(2.01)
	Malaysia	4	43	51	103	498	697	521	(1.26)	527	(0.78)	232	(0.47)	257	(0.79)	80	(0.22)	463	(1.28)	125	(0.35)
	Korea	3	96	121	97	453	363	304	(0.74)	980	(1.45)	817	(1.67)	563	(1.74)	626	(1.70)	284	(0.79)	845	(2.38)
	China	0	0	3	46	519	2,384	1,076	(2.61)	770	(1.14)	1,008	(2.06)	1,453	(4.50)	1,766	(4.79)	3,143	(8.71)	4,567	(12.85)
	Taiwan	10	23	30	73	396	381	224	(0.54)	287	(0.43)	511	(1.04)	321	(0.99)	375	(1.02)	152	(0.42)	479	(1.35)
	Philippines	4	29	69	59	148	472	381	(0.92)	637	(0.94)	465	(0.95)	791	(2.45)	410	(1.11)	196	(0.54)	317	(0.89)
	Viet Nam				0	0	177	51	(0.12)	99	(0.15)	21	(0.04)	78	(0.24)	60	(0.16)	70	(0.19)	109	(0.31)
	Thailand	9	23	34	66	745	1,078	1,405	(3.41)	837	(1.24)	932	(1.90)	884	(2.74)	504	(1.37)	629	(1.74)	1,184	(3.33)
	Myanmar				0	0	6	2	(0.01)	10	(0.01)	10	(0.02)	-	(0.00)	-	(0.00)	-	(0.00)	-	-
	Bangladesh			0	2	9	16	3	(0.01)	-	-	8	(0.02)	-	-	-	-	-	-	-	-
	Nepal				0	4	3	-	-	-	-	-	-	4	(0.01)	-	-	-	-	-	-
	Bhutan					2	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
	India	1	1	4	9	20	172	259	(0.63)	208	(0.31)	168	(0.34)	145	(0.45)	310	(0.84)	87	(0.24)	97	(0.27)
	Sri Lanka	0	0	1	14	2	67	36	(0.09)	19	(0.03)	11	(0.02)	13	(0.04)	23	(0.06)	-	-	-	-
BIMSTEC Countries		10	24	39	90	782	1,342	1,706	(4.14)	1,074	(1.59)	1,129	(2.30)	1,046	(3.24)	838	(2.27)	716	(1.98)	1,281	(3.60)
Subtotal (Asia)		86	507	1,105	1,803	5,665	9,820	6,682	(16.21)	7,348	(10.89)	6,006	(12.25)	6,639	(20.56)	5,669	(15.38)	6,399	(17.73)	9,388	(26.41)
Subtotal (Mid & Near East)		24	95	264	145	92	346	146	(0.35)	113	(0.17)	19	(0.04)	20	(0.06)	37	(0.10)	17	(0.05)	4	(0.01)
	U.K.	50	251	63	220	3,841	3,109	9,784	(23.73)	11,718	(17.36)	19,176	(39.11)	3,968	(12.29)	4,412	(11.97)	1,785	(4.95)	1,789	(5.03)
	Netherlands	0	18	33	238	2,181	1,759	2,146	(5.20)	10,387	(15.39)	2,764	(5.64)	4,521	(14.00)	3,295	(8.94)	6,869	(19.03)	8,058	(22.67)
Subtotal (Europe)		57	376	342	1,185	9,606	8,066	14,151	(34.32)	25,977	(38.48)	24,485	(49.93)	10,600	(32.82)	15,428	(41.86)	12,623	(34.97)	12,963	(36.47)
Subtotal (Africa)		14	46	199	344	534	378	454	(1.10)	520	(0.77)	56	(0.12)	218	(0.68)	194	(0.53)	105	(0.29)	115	(0.32)
	Australia	17	87	242	315	2,499	1,733	1,403	(3.40)	890	(1.32)	546	(1.11)	521	(1.61)	1,273	(3.45)	927	(2.57)	1,845	(5.19)
Subtotal (Oceania)		30	118	266	361	2,856	1,941	2,229	(5.41)	929	(1.38)	703	(1.43)	554	(1.72)	1,335	(3.62)	1,006	(2.79)	1,869	(5.26)
TOTAL		377	1,998	3,828	8,641	44,790	44,101	41,228	(100.00)	67,502	(100.00)	49,034	(100.00)	32,297	(100.00)	36,858	(100.00)	36,092	(100.00)	35,548	(100.00)

Notes: AA stands for annual average. 1. "0" indicates an amount of less than one million US dollars; "-" indicates no investment recorded during the corresponding period; Blank columns indicate "not applicable". 2. Figures for FY1994 and before were released in US dollars. From FY1995 onwards, figures were first released in Japanese yen and converted to US dollars using Bank of Japan average inter-bank rates for the applicable period.

Sources: Prepared by JETRO from Ministry of Finance (MOF) statistics for Japan's inward and outward FDI, MOF Policy Research Institute Monthly Finance Review, and Bank of Japan foreign exchange rates.

The Intermediate neighbourhood

Historically, Japanese FDI outflow to its intermediate neighbourhood was strongly influenced by two motives, one, to procure raw materials and foodstuff from resource-rich US and Canada, and two, it was necessitated by the Japanese firms' desire to shift production out of Japan to countries with lower comparative costs in land, water, minerals, and chemical feedstock². This is applicable in the case of a number of processed food, chemicals and metals firms. Protectionism was also one of the explanatory factors that determined Japanese expansion into TV, bearing, and electronics manufacturing in the US. This, however, was often complemented by a desire for technological and market learning on the part of the investing firm. For example, Sony's San Diego plant for colour TV production has been of utmost importance to the firm not only as an outlet for its products, but also the technological laboratory from which to acquire new ideas and the latest technologies. In the process, it was an opportunity to introduce new products after experiments. More strikingly, the move to local production in the high labour cost economy was encouraged by automation in the wake of sharp increase in wage rate³.

The intermediate neighbourhood was also influenced by historical factors such as 'preferred destination' outside Asia. Since the late 1970's, the United States has emerged as the largest host country of Japanese investment, although South East Asia is the largest area (27.2 per cent), down from a third at the beginning of the decade. Since then and because of Plaza Accord (yen appreciation) Japanese automobile, electrical, electronics and steel companies built large-scale manufacturing plants in North America and Europe, and established a worldwide network of production, sales and financing (Tejima 1992).

Extension of the Intermediate Neighbourhood

FDI inflow in the intermediate neighbourhood was strongly influenced by economic conditions, notwithstanding the opportunities for higher growth in this neighbourhood. Initially, the intermediate neighbourhood had market conditions with which Japanese firms were not familiar. Other factors included differences in language and business practices, lack of similarity in the GDP per capita, finite capital available for foreign expansion and high costs of establishing plant capacity in the intermediate neighbourhood. It was the case that Japanese firms preferred to exploit markets with which the net start-up costs were low as opposed to new market with potential growth and opportunity to maximize profit (Dunning 1993).

With economic development the Asian economies have been becoming significant partners of Japanese trade. Interestingly, the economies are more important as source regions rather than as destination regions. However, the share of imports of the total imports has dropped in the case of Indonesia. This would be a reflection of the structural changes in Japanese imports, in which the share of oil and raw materials has declined after the oil crisis of the 1970s. Indonesia now is no longer a special partner of Japanese trade (Kawasaki 2002).

It is useful to mention here that Japanese firms are one of the largest investors in Asia partly due to their traditional concentration in the manufacturing sector. It is thus likely that their strategies have had important implications for regional FDI flows and other related factors such as production networks, trade pattern and economic growth in Asia. Besides, Japanese outward FDI has shown a strong correlation with the upward movement of the yen-dollar exchange rate after the Plaza Accord in late 1985 (Wong and Adams 2002). Consequently, two factors may have contributed to the significant rise of Japanese FDI outflows in both North America and Asian NIEs. In North America, the real estate and finance sectors were considered as ideal sectors for investment and in case of Asian NIEs, cost minimization against the backdrop of the rapid yen appreciation and labour shortages due to demographic changes that motivated Japanese manufacturing firms to establish production networks in Asia – first in the Asian NIEs (notably Singapore and Taiwan RoC) and in the second wave in ASEAN 4. Note that about 70

per cent of Japanese FDI went to North America and Europe. In 1993, direct investment in the manufacturing sector constituted more than half of Japanese FDI outflows to Asia. The 'China factor' is one of the contributory factors that reveal this trend.

Since 1998, Japanese FDI outflows have displayed a declining trend partly due to the sharp depreciation of the yen against the dollar in early 1997 and also due to the weakness of the Japanese economy. Around this time, the trade and investment that was flooding China for years had grown stronger while a few Asian economies, North America and Europe started to experience an exodus of their manufacturing.

The increase in investments in the finance and insurance industry, on the other hand, came primarily from investment in tax havens, such as the Cayman Islands, the Republic of Panama, the British Virgin Islands, and the Bahamas. These are also the major destinations for Japanese FDI. In 2003, for example, the Cayman Islands came in third after USA and the UK, and the Republic of Panama was in tenth place.

Finally, one factor that influenced FDI inflow in the intermediate neighbourhood was the process of integration. As the intermediate neighbourhood moved towards single market, preferred destination became less important. Due to market growth potentials of this neighbourhood, Japanese companies started to diversify their production activities to exploit the advantage of the single market.

As regards Latin America, the region's investment environment deteriorated in recent time. Yet, the number of investments by Japanese companies registered a double-digit growth. This is particularly relevant in industries such as automobiles, machineries, trade and finance and insurance. The prospect of regional integration may be the driving factor behind the increased investments in the automobile sector. This has attracted a number of automotive assembly manufacturers and their supplies to this region. The major Japanese carmakers that gained a foothold in Latin America, in the midst of economic downturn, have come to position their production facilities in the region also as the export base for North America and European nations that have free trade agreements with the region.

Extended Neighbourhood

The end of the twentieth-century witnessed the peak of Japanese FDI outflows to the intermediate and the extension of the intermediate neighbourhoods. While technological developments have made the physical location of a firm more and more redundant, greater economic integration mandates a production network or at least a foothold in each such integrated region. The Central and Eastern European economies (CEE) in particular are now able to attract huge flows of Japanese investment thanks to its excellent mix of low labour cost and decent productivity. FDI in the extended neighbourhood is largely explorative and brings in its wake repetitive sequences of investments with local experimentation. With more and more countries opening their boundaries for both trade and investment flows, FDI now helps the investment in host countries become internationally competitive in cost, quality, flexibility and delivery.

4. China and the Extended Neighbourhood of Japan

It can be argued that during the first half of the twentieth century China was a proto-colony; certainly a major part of the expansion of foreign investment in China after World War I was the result of Japanese colonialist policies in Manchuria and the treaty ports.

In 1978, after nearly 30 years of largely self-imposed isolation, China finally seemed ready to rejoin the world economy. In the domestic front, the need for economic adjustment was felt due to a variety of reasons. For example, the per capita GNP had grown since 1957 at an average

annual rate of 2.5 – 3.0 per cent, well below the average for China's neighbouring countries such as Japan and South Korea. Likewise, total factor productivity of the Chinese industry had either been stagnant or actually declined since 1957 (Kamath 1990). By 1978, Deng Xiao-ping was emerging as post-Mao China's paramount leader. At the Third Plenum of the Chinese Communist Party's Eleventh Central Committee on December 1978, Deng successfully put economic reforms at the top of Beijing's agenda. Perhaps most importantly, he gained support for sharply reversing the Maoist policy that had explicitly rejected on nationalistic and ideological grounds relying on capital inflows from capitalist countries. A policy of "open door" (*Kaifang Zhenze*) was formally adopted by the Central Committee due to the growing importance of foreign capital and advanced technologies to China's own drive for modernization.

In general terms, Japan's Asia-bound investments have been manufacturing sector-oriented. For example, Japan's FDI directed towards Asia in 2004 amounted to US\$ 9,388 million of which manufacturing sector investments accounted for 69 per cent. By country, China has been by far the largest destination of Japanese FDI in the region (Table 1). This figure is far ahead of Thailand, the second largest destination in Asia in 2004.

The 'China shift' of Japanese manufacturers' production facilities is evident in the share of manufacturing sector investments in 2004. Of the manufacturing sector, the automobile sector stood out most in value, replacing the electrical industry that had enjoyed an overwhelming share till then. The automobile sector was followed by the electrical, chemical, machinery, and metal industries, in this order (Kitamura 2004). As the Chinese economy and industries are bound to increase their presence in the Asian region, Japanese manufacturing companies would not be able to restructure their Asian business strategies without taking into account the Chinese factor.

At the current status, the two economies are strikingly complementary, with Japan hogging the sophisticated end of the electronics, engineering and automobile industries and China occupying the cheaper end. However, competition from South Korea for Japan's top companies is much stiffer than that from China: Samsung in electronics, POSCO in steel, Hyundai in cars and ships have all given Japanese firms more pause for thought than have Chinese companies so far. That helps to explain why Chinese competition has not yet shocked Japan into economic reform. Quite evidently, China is not as big a concern for high-tech Japan as it is, say, for mid-tech Italy (The Economist 2005).

5. The BIMSTEC and the Extended Neighbourhood of Japan

The BIMSTEC region has distinct locational advantages such as lower costs of labour and natural resources⁴ and some countries in the region also have large markets. Historically, the countries in the region have followed different economic policies resulting in different FDI patterns. In India for example, the main sectoral and industrial recipients of FDI are fuels, telecommunications, automobiles, financial services, machineries. The key players are USA, UK, Germany, NRIs, Japan, Mauritius and South Korea. The manufacturing and automobile sectors are the major thrust sectors for Japanese investors in India. In Thailand, key players are the USA, Japan, Korea and Singapore and they are involved in manufacturing and other related activities (Table 2). The major players in Myanmar are France, Japan, Malaysia, Thailand and the USA and the sectors are manufacturing, oil & gas, hotels and tourism.

Of late, the BIMSTEC economies have by and large been pursuing liberal foreign investment policies with limited restrictions on FDI. Some of these restrictions include: administrative foreign exchange control; land acquisition and reservation of certain sectors for local operations. A few economies have a very weak capital goods sector due to non-availability of high-tech and high value-added activities. In general, the BIMSTEC economies are classified as natural resource based or service oriented or a combination of both.

Table 2: BIMSTEC: Sectoral and Industrial Recipients and Sources of FDI Inflows

Country	Main Sectoral and Industrial Recipients of FDI	Main Sources of FDI	Japanese investment in sectors
Bangladesh	Textile, Services ,Agro-based industry, Chemicals, Glass & Ceramic, Engineering	European Union, USA, Japan, South Korea, Singapore, Malaysia	Manufacturing
Bhutan	-	-	-
India	Fuels, Telecommunications, Electrical equipments, Financial services, Food processing industries, Automobiles, Machineries	USA, UK, Germany, NRIs, Japan, Mauritius, South Korea	Manufacturing, Automobile
Myanmar	Manufacturing, Oil & Gas, Hotels & Tourism	France, Japan, Malaysia, Singapore, Thailand, UK, USA	Manufacturing
Nepal	Hydro power, mineral exploitation, Chemicals, Tourism, Food and beverages	India, Japan, USA, China, South Korea, France, Hong Kong, UK, Thailand	Manufacturing
Sri Lanka	Manufacturing	Japan, European Union, USA, India, Singapore	Manufacturing
Thailand	Manufacturing, Services	USA, Japan, Korea, Singapore	Manufacturing

Note: - not available

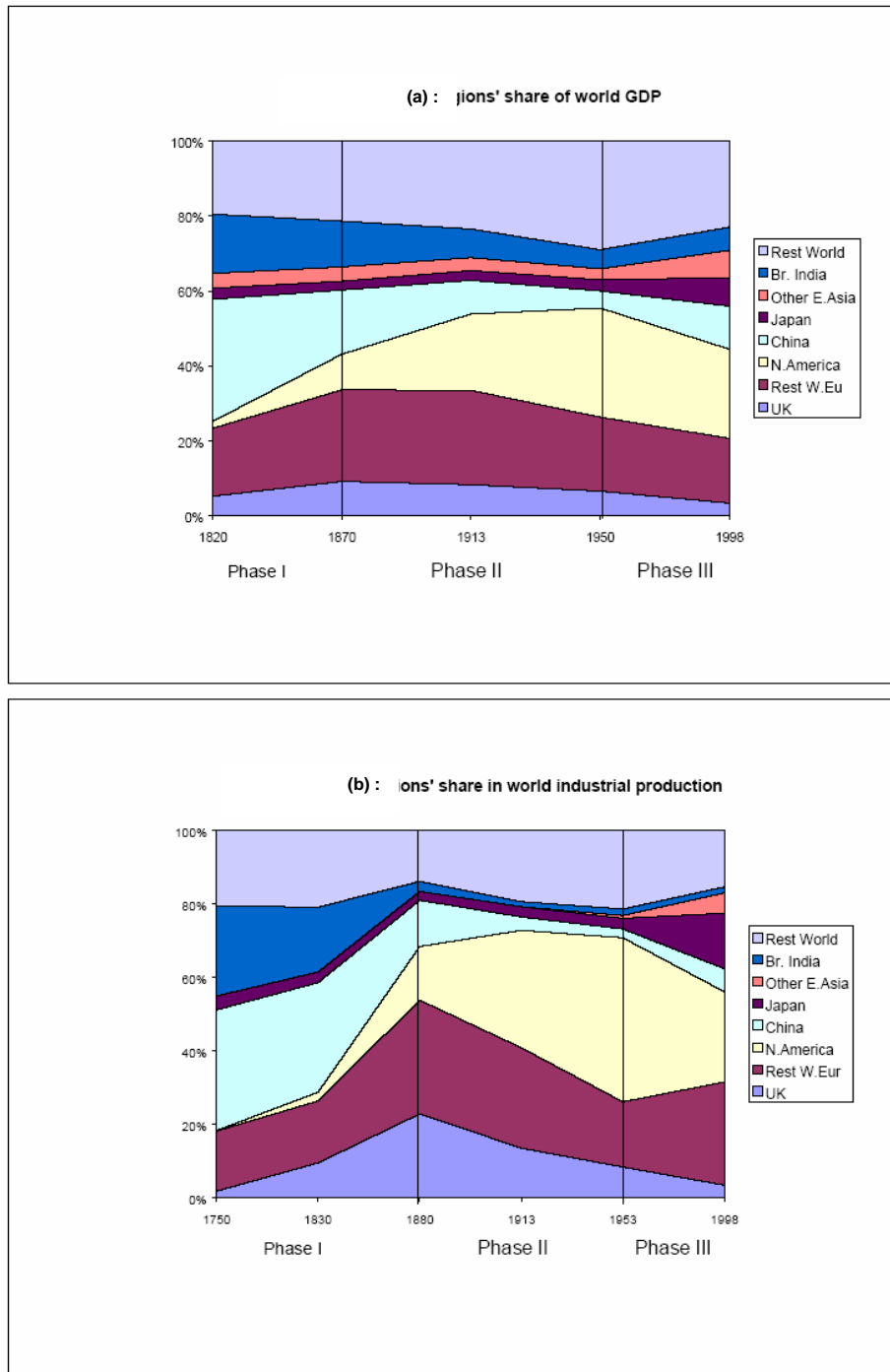
Sources: Japan External Trade Organization, Japanese Trade in 2004, Tokyo, June 2005; and UNCTAD, World Investment Report 2004, New York and Geneva, 2004.

The region has potential for both high-tech and manufacturing industries. The proposed Free Trade Area (FTA) – will encompass some five countries in the region, creating a market with a population of approximately 1.32 billion and a GDP of some US \$ 1015732 million in 2005 (IMF, 2005). The economies, (a few of which are very small) may play an important role by providing fiscal incentives to foreign investors (with particular reference to Japanese investors) in the areas of services and manufacturing. The decision is strategic since it will help the Japanese investors to explore markets in the region and then use the low cost resources to compete in the developed economies. Private investors are more interested in financing projects in the region due to the large internal market and huge resources – particularly in Myanmar. Given the intra-country synergies, economies of scale are sometimes difficult to attain in small economies such as Sri Lanka, Bhutan and Nepal. However, the region can follow the models laid down by countries such as Canada or Ireland that have built their industries on accommodation to the United States. In this context there may be bright prospects of establishing strong Japan-BIMST-EC trade and investment relationships considering BIMST-EC as an extended neighbourhood of Japan. The immediate need of the region is to have resources for capacity building in the areas of infrastructure, communication and transport.

Declining shipping costs augmented with developments such as new information and communications technologies (ICT), reduction in transit times associated with air travel (and air freight) and the development of containerization bringing both faster port handling and faster ocean shipping continued to be strong drivers of globalization. Hummels and Yi (2001) find that the cost of an extra day's travel is (for imports as a whole) around 0.3 per cent of the

value shipped. For manufacturing sectors, the number goes up to 0.5 per cent that are around 30 times larger than the interest charge on the value of goods (Crafts and Venables 2001).

Figure1



Source: Hummels, et al (2001)

The above arguments strongly validate the geographical approach of trade and development in the region. If we add the member countries to the Krugman-Venables (Krugman and Venables 1995) story of Figure 1, the approach predicts that during phase III convergence will not be

uniform, but instead take the form of countries, in sequence, making a relatively rapid transit from the 'poor club' to the 'rich club'.

India enjoys a special position in the region due to its historical, ethnic and emotional relationships. It may be possible to develop strong economic linkages leveraging on these old relationships. The Indian economy has many complementarities vis-à-vis the region and Japan and these could be used synergistically to result in a win-win situation for all. On the other hand, there are many areas, covering primary, secondary and tertiary sectors of the economy where India has done exceedingly well and there is scope for developing economic linkages based on the same.

India has excelled in the area of computer software and has evolved as an Information Technology hub for the world market. In recent times, 60 per cent of the total output of the IT sector is exported; another quarter of the output produced is shared between the parent multinational corporations (MNCs) and their Indian affiliates. On the other hand, 60 per cent of the output produced by the MNCs in all other sectors is sold in the local market providing a stronger argument that the size of the Indian domestic market will continue to play a significant role in attracting FDI (UNCTAD 2004).

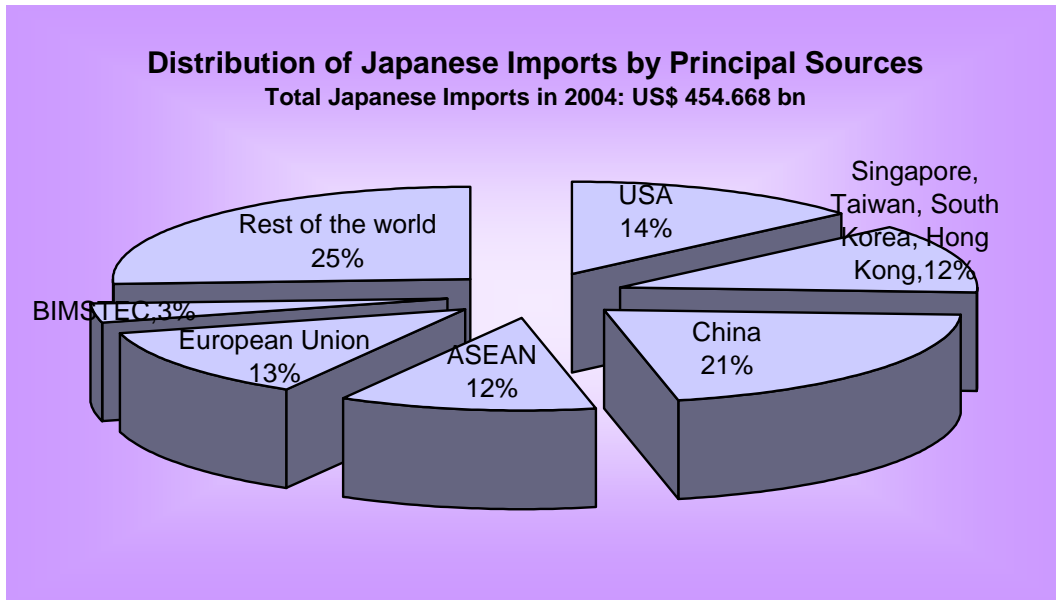
The region has encouraged foreign investment into infrastructure but the demand for infrastructure services is still not being met. This has been blamed on skewed investments in terms of concentration in consumer durable sectors (where it is quick-yielding and withdrawal is easy) as opposed to infrastructure (investment is of long-term nature and the amount of investment needed is very high). For example in the context of India, India's per capita electricity consumption is very low – 526 kilowatt hours/year, as compared to 1,247 for China. Over the past decade, electricity generation has grown at a compound annual rate of 5.5 per cent, but demand has grown even faster. Peak demand exceeded supply by 11.3 per cent in 1998 and by 12.1 per cent in the last financial year (ending this March) (The Economist 2005b). Thus the region as a whole and India in particular seems to have neglected the basic infrastructure such as railroad, power, road, and water management. On the whole, the emphasis on modernizing its basic infrastructure has been rather mild, whereas this could have been the priority in order to generate employment in both rural and urban areas. But opportunities exist due to the vast natural resources available in the BIMST-EC countries to put in a common focus of development.

6. Structure of BIMSTEC Trade and Investment

The intra-regional imports and exports, as percentages of total imports and exports, have remained low in the BIMSTEC region. Table 3 shows the picture in this context.

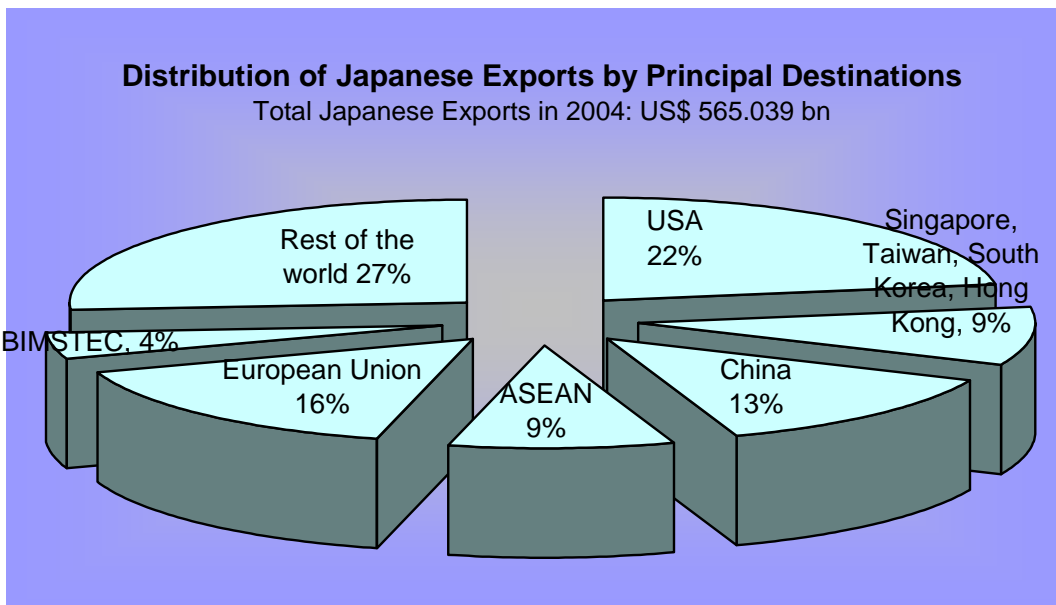
Besides petroleum the six most important groups of export products in nominal terms are garments, agriculture products, software, agro-based preparations, building cement, and iron and steel. Other significant items include bakery products, refined flour, clothing, paints and soaps. The diversified nature of these products suggests an emerging capability. On the other extreme Figures 2 and 3 extract the distribution of Japanese imports by principal sources and exports by principal destinations in 2004.

Figure 2



Note: BIMSTEC data includes Thailand and Myanmar; ASEAN data excludes Thailand and Myanmar
Source: Japan External Trade Organization, Japanese Trade in 2004, Tokyo, June 2005.

Figure 3



Note: BIMSTEC data includes Thailand and Myanmar; ASEAN data excludes Thailand and Myanmar
Source: Japan External Trade Organization, Japanese Trade in 2004, Tokyo, June 2005.

Table 3: Intra-BIMSTEC Trade Relationship: 2001

(US\$ million)

(a) Exports

Exports to →	Bangladesh	Bhutan	India	Japan	Myanmar	Nepal	Sri Lanka	Thailand	World
Bangladesh		1.48	60.80	62.00	0.68	1.95	2.02	16.73	5735.60
Bhutan									
India	1087.00	3.00		2011.00	67.00	158.00	547.00	612.00	44434.00
Japan	447.00	7.00	1940.00		187.00	22.00	269.00	11873.00	403383.00
Myanmar	17.92		289.00	93.00			1.14	735.00	2782.00
Nepal	3.77		239.34	10.31			0.01	0.68	613.70
Sri Lanka	10.08		71.99	185.78	0.59	0.33		36.88	4722.40
Thailand	231.00		482.00	9964.00	355.00	30.00	141.00		65112.00

(b) Imports

Imports from →	Bangladesh	Bhutan	India	Japan	Myanmar	Nepal	Sri Lanka	Thailand	World
Bangladesh		5.07	1195.49	720.71	19.72	4.15	7.87	179.69	9010.60
Bhutan									
India	67.00	22.00		2134.00	316.00	262.00	79.00	530.00	51884.00
Japan	115.00		2212.00		102.00	11.00	203.00	10353.00	349056.00
Myanmar	0.74		74.00	205.00			0.65	391.00	2684.00
Nepal	2.14		173.51	23.83			0.37	33.03	907.70
Sri Lanka	2.05		601.48	336.88	1.25	0.01		147.35	5730.80
Thailand	29.00		673.00	13881.00	809.00	1.00	39.00		62057.00

Principal Sources of BIMSTEC imports

BIMSTEC's trade – in particular with Thailand and Japan – has occupied a position of prominence in the Region's external trade. The production structures and trade patterns inherited at independence continue virtually unchanged to the present time. In the Indian context China ranks first followed by United States and UAE as a source for its imports – with Japan being a distant fifth with UK as the fourth largest source for Indian imports (Table 4).

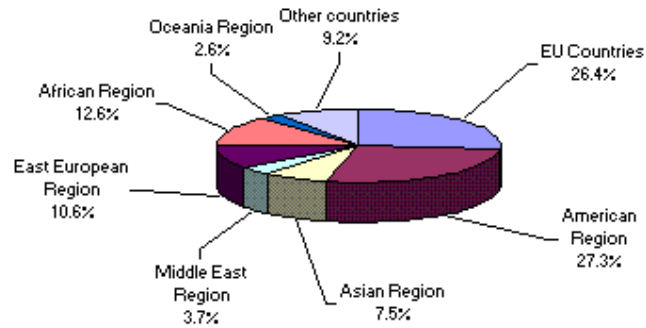
Table 4: Distribution of India's Imports by Principal Sources

(%)

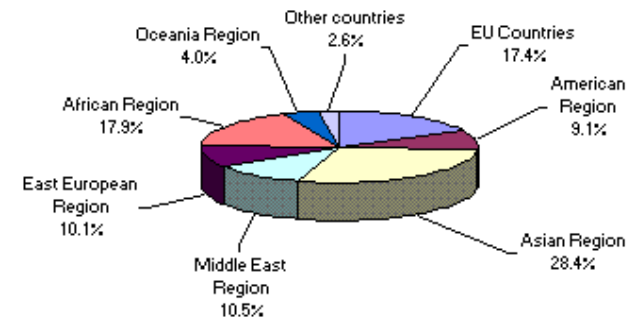
Sources of Imports	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
USA	8.59	7.17	5.68	6.13	7.24	6.44	5.88
UAE	6.94	5.23	6.29	5.58	3.79	4.24	5.43
China	2.59	2.59	2.99	3.96	4.55	5.19	6.30
UK	3.41	2.17	2.12	2.54	2.18	3.39	3.33
Japan	5.82	5.10	3.67	4.17	2.99	3.41	2.81
Myanmar	0.41	0.34	0.36	0.73	0.55	0.52	0.37
Sri Lanka	0.09	0.09	0.09	0.13	0.15	0.25	0.34
Thailand	0.64	0.66	0.63	0.82	0.62	0.78	0.78
Nepal	0.34	0.38	0.46	0.69	0.46	0.37	0.32
Bangladesh	0.15	0.16	0.15	0.11	0.10	0.10	0.05
Bhutan	0.01	0.04	0.04	0.05	0.05	0.07	0.05
BIMST-EC	1.64	1.67	1.73	2.53	1.93	2.09	1.91
Others	71.01	76.07	77.52	75.09	77.32	75.24	74.34
World	100	100	100	100	100	100	100

Source: CMIE, Foreign Trade and Balance of Payments, July, 2005, pp. 270-271.

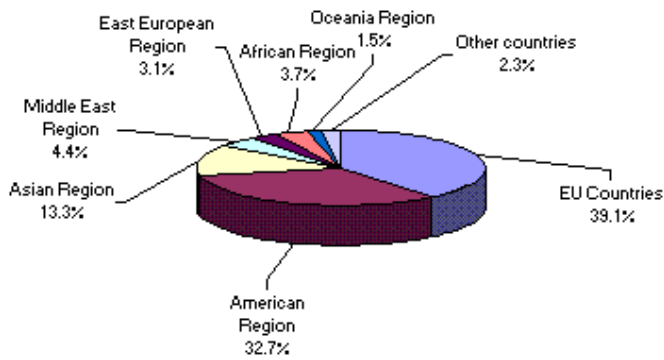
Figure 4: Bangladesh Export by Major Regions



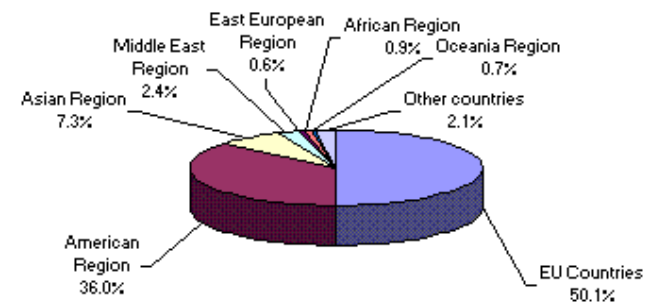
1972-73



1981-82



1990-91



2002-03

Source: http://www.epbbd.com/export/statistics/bangladesh_export_by_major_regions.htm

Table 5: Distribution of India's Total Exports by Principal Destinations

(%)

Destination of Exports	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05
USA	21.67	22.83	20.96	19.43	20.67	18.00	16.74
UAE	5.62	5.66	5.86	5.69	6.31	8.03	8.96
China	1.29	1.47	1.88	2.17	3.75	4.63	5.79
UK	5.59	5.53	5.15	4.93	4.74	4.74	4.47
Japan	4.97	4.59	4.04	3.45	3.54	2.68	2.50
Myanmar	0.09	0.09	0.11	0.14	0.14	0.14	0.14
Sri Lanka	0.09	0.09	0.09	0.13	0.15	0.25	0.34
Thailand	0.97	1.22	1.20	1.44	1.35	1.30	1.08
Nepal	0.37	0.41	0.32	0.49	0.66	1.05	0.92
Bangladesh	3.00	1.73	1.98	2.29	2.23	2.73	2.00
Bhutan	-	-	-	-	-	-	-
BIMST-EC	4.52	3.54	3.7	4.49	4.53	5.47	4.48
Others	56.34	56.38	58.41	62.04	58.76	56.45	57.06
World	100	100	100	100	100	100	100

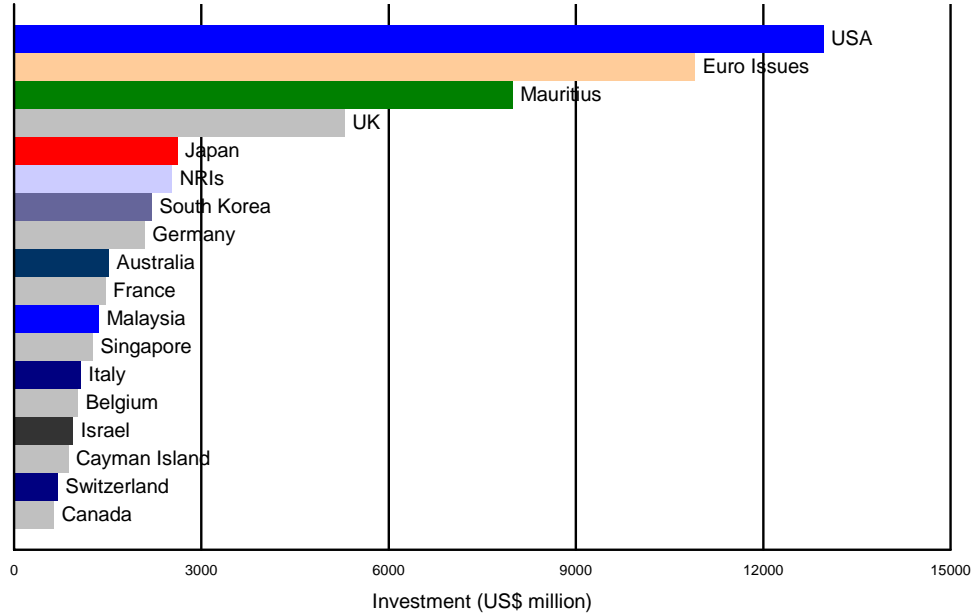
Note: - not available

Source: CMIE, Foreign Trade and Balance of Payments, July, 2005, pp. 130-131.

Figure 5

Sources of FDI in India: 1991-2004

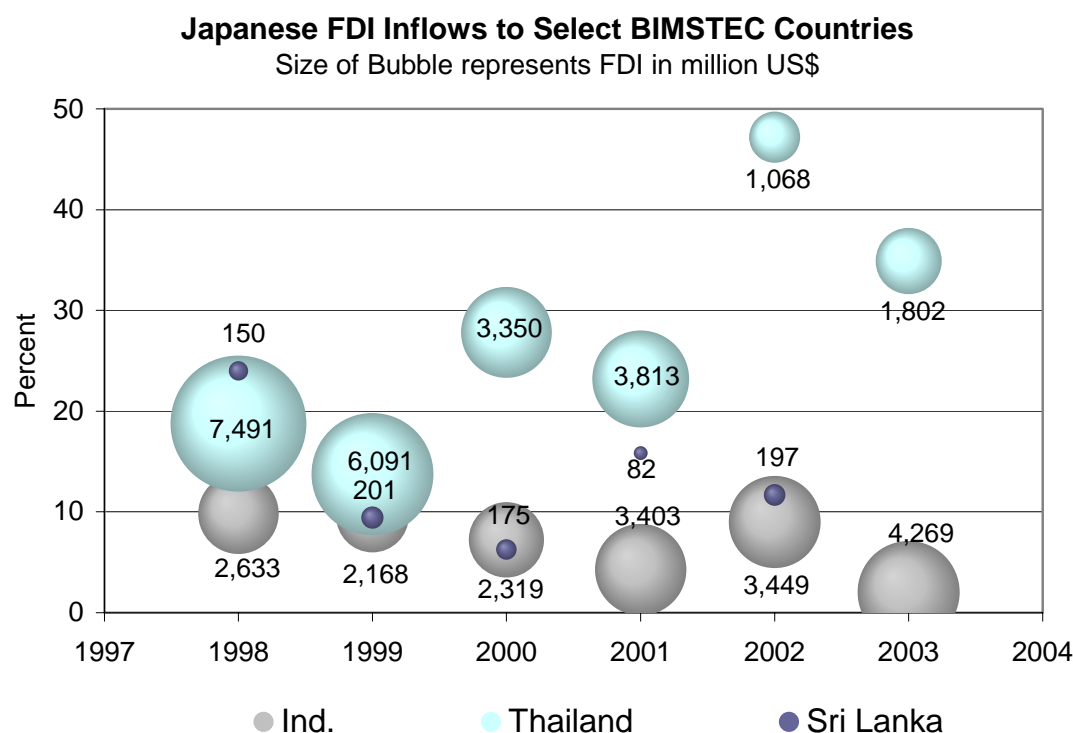
All sources with one per cent of total FDI or higher



Notes: Euro issue represents proposals for Global Depository Receipts (GDRs) and Foreign Currency Convertible Bonds (FCCBs); US\$ 1 = Rs. 45 (July, 2004).

Source: Recomputed from SIA Newsletter, April, 2004, Secretariat for Industrial Assistance, Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India.

Figure 6



Sources: UNCTAD, World Investment Report 2004, New York and Geneva, 2004, pp.367-369.; JETRO, Ministry of Finance, Statistics for Japan's Inward and Outward FDI, Government of Japan.

Destination of Principal Exports of the BIMSTEC Economies

Table 5 shows that though the USA is India's principal export destination, its pre-eminence is gradually weakening and the share of exports to USA has declined from a high of 23 per cent in 1999-2000 to 17 per cent in 2004-05. China, on the other hand has become a major destination of India's export in recent time. Quite interestingly, India's share, as a destination of BIMST-EC exports has been significant. It is still early to infer how strong this rise would be. Figure 4 represents the distribution of Bangladesh exports by major regions over different time periods. The figure highlights the growing dominance of EU and USA as destinations of their exports.

Japanese Foreign Direct Investment (FDI) Flows to the BIMSTEC region

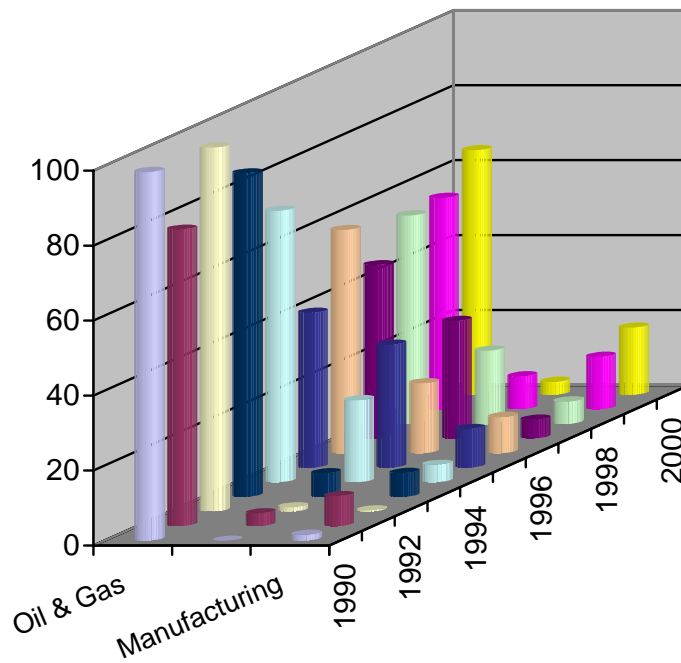
The decline in Official Development Assistance in the 1990s was offset by an increase in private flows to the BIMST-EC region of which FDI was the most significant component compared to the debt flows. In 2004, FDI inflows to countries such as India have been quite high as compared to other member countries (Figure 5). Figure 6 depicts the Japanese FDI inflows to select BIMST-EC countries. The major recipients were Thailand, India and Sri Lanka. For most of the countries the figures do not exhibit a smooth upward trend. The movement is particularly erratic for natural resource-rich countries such as Myanmar and Nepal.

For Myanmar, Figure 7 shows the sectoral distribution of its FDI inflows during 1990-2000 while Figure 8 depicts the approved and actual FDI by source countries. It appears that Singapore, the UK and Thailand have made the largest commitments to invest in Myanmar. Thailand, however, despite its relatively large commitments, has largely failed to go ahead with

investment projects, only disbursing 17.3 per cent of the committed funds. What is often overlooked is that in terms of actual investment in Myanmar, the most important investors have been the United Kingdom, Singapore, France and the United States.

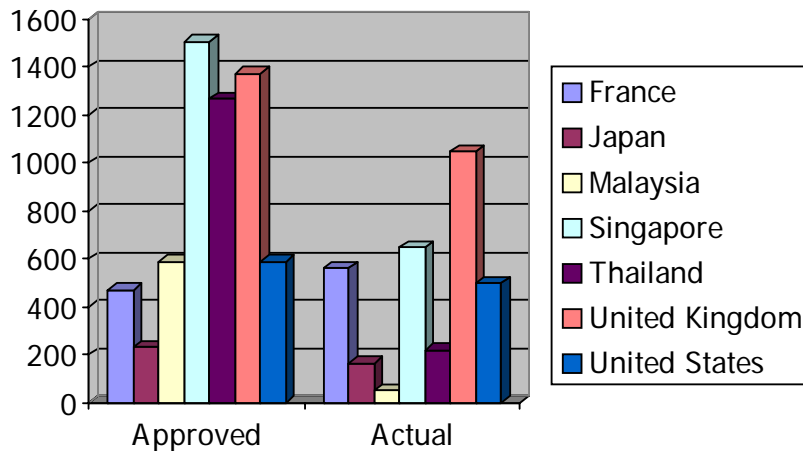
Figure 7

**FDI Inflows to Myanmar (1990-2000)
Sector Actual FDI as % of Total Actual FDI**



Source: http://www.ibiblio.org/obl/docs/fdi_&Garments_industry_in_Burma.htm

Figure 8: Myanmar: Approved and Actual FDI by Country (1990-2000 US\$)



Source: http://www.ibiblio.org/obl/docs/fdi_&Garments_industry_in_Burma.htm

Traditionally, FDI inflows in BIMST-EC have been directed to the primary and tertiary sectors, namely oil and gas, agriculture, forestry and tourism services. However, over time, there have been some inflows to mainly labour intensive, medium to low-technology manufacturing such as garments and data processing activities. The sectoral distribution of FDI inflows has, however, now begun to reflect the international trend with a concentration in the services sector – primarily financial services.

The sources of FDI inflows into the region reflect the historical ties with member states' past and have included the United Kingdom, USA, Japan and ASEAN economies. Probably, after China the Japanese may have this region as their next alternate low cost destination for their investment. The important issues now, though, revolve around risk, stability and incentives.

7. Conclusions

Neighbourhoods are basically mechanisms for risk reduction and as delineated in this paper the dynamics of the environment bring in relevant changes in what could be considered an appropriate neighbourhood for FDI at a given point in time. From a historical perspective, UK was the appropriate original neighbourhood for US FDI just after the World War II – but with rising GDP and evolving common market, the EC-6 countries emerged as the intermediate neighbourhood. Further, with the growth of financial markets, cheaper and faster air travel and developments in information and communication technologies, the risk perception of FDI has undergone significant downward revisions resulting first in the extension of the intermediate neighbourhood and later the extended neighbourhood.

At first sight, the simple neighbourhood model developed from a global and historical perspective may not appear to hold for Japanese FDI – but on closer scrutiny one finds otherwise. It is true that Japan had no original neighbourhood having close linguistic, ethnic and cultural similarity with itself. But its choice of USA and Canada as its intermediate neighbourhood to strengthen and secure the supplies of its critical raw materials has exactly the same motivations. After these exploitative strategies it embarked on the explorative phase with Southeast Asia as its extension of the intermediate neighbourhood which was later expanded to include North America and Europe as the risk perceptions changed with growing domestic wage rates and European economic integration.

As noted by Arndt (2001), one of the innovative features of the current phase of globalization is the fragmentation of production into production networks based on component specialization and intra-product trade. It offers groups of small countries opportunities to make open regionalism work by enhancing their productivity and competitiveness as well as welfare of their nationals. This concept is equally applicable to the BIMSTEC although Arndt justifies it for the ASEAN. As production networks grow in the region, this provides opportunity for Japanese to participate in these networks in their extended neighbourhood with their respective component specializations.

From the Japanese point of view, China's recent rise has changed the situation, and promises to do so even more in future. If any sort of East Asian Community analogous to the European Union emerges, then Japan cannot afford to watch it becoming a platform for Chinese power. Moreover, the case for more regional co-operation of BIMSTEC type and even integration is increasing with the rising interdependence of the region's economies. Thus a better strategy for Japan would be to establish a framework of rules and procedures within which it will have to operate and which will also offer Japan a chance to build alliances with other Asian democracies. The strengthening of the neighbourhoods may have some impact on future Japanese FDI flows to the Asian region.

It is now open to question why some economies have attracted large FDI flows and grown fast (for example East Asia and now China) over the last forty years and others have not. The Latin

American and the Caribbean economies are geographically closer to the highly developed economies. Yet, the regions could not take advantage of this physical proximity. These economies could not become part of the original, intermediate or even extensions of intermediate neighbourhoods perhaps due to the fact that most of the people came from other cultures where neighbourhood was too weak. Perhaps the Japanese may have to learn from this experience.

Notes

- ¹ The Japanese trading company (*sogoshosha*) is a firm that trades a large variety of commodities on a global scale, both in export and import. The *zaibatsu* (hierarchical groups of companies legally separate but linked by close personal, financial and trading relationships. The *zaibatsu* dominated industry and banking from the late nineteenth century through World War II) purchased substantial output directly from small manufacturers even selling products overseas, a task usually too difficult for small firms. The trading companies or *sogoshosha*, such as Mitsui Bussan, Mitsubishi Shoji, Okura, Sumitomo, and Yasuda provided loans to small producers (sometimes indirectly through local merchants and banks) and acquired product. This is because small and medium-sized firms' product contributes the major share of the total Japanese export. Without these traders, many small industries would not have survived. They provided many services such as accounting techniques, foreign exchange procedures, insurance, foreign language skills and other related services. Interestingly, these companies charged high interest rates for loans to small units and purchased their goods at low prices. But overall, the effect of the *sogoshosha*, an institution unique to Japan, was positive, see Yonekawa and Yoshihara 1987.
- ² Examples include soy-sauce firms dependent on US soybeans, steel mini-mill producers dependent on cheap scrap and electric power, textile firms which use large quantities of American cotton and printing ink, and pesticide companies, see Ozawa 1979 pp. 111-121.
- ³ For details see Franko (1983) pp. 70-71.
- ⁴ The idea of setting up a sub-regional co-operation block in the Bay of Bengal basin was first mooted in Bangkok, known as 'Bangkok declaration', by Bangladesh, India, Sri Lanka and Thailand. On June 6 1997, Bangladesh, India, Sri Lanka, Thailand Economic Cooperation (BISTEC) came in force. These countries were chosen because of their proximity and direct access to the Bay of Bengal. The purpose of this regional grouping was to provide trade and technological cooperation among its members in the areas of trade and investment, tourism, transport and communication, technology, energy and fisheries. Later, at the special Ministerial meeting convened in Bangkok on December 22, 1997, with Myanmar entering as a member of the group BIST-EC was renamed as BIMSTEC. At the Ministerial meeting in December 1998, Nepal was added as an observer. By signing the Framework Agreement at the Ministerial meeting held in Phuket (Thailand) in February 2004, BIMSTEC received further momentum in launching of the process of deeper integration in the region (De 2004).

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