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Topics *The effect on exports of Japanese direct investment in Asia*

The relationship between exports and Japanese direct investment in Asia, as seen in the example of the electrical equipment industry, can be characterized by Japanese exports being induced by direct investment in ASEAN4 and driven by the expansion of domestic demand, rather than direct investment, in the case of China.

■ Healthy exports of electrical equipment to Asia

Japanese exports of electrical equipment to Asia have grown steadily since the 1990s. In 2002, exports to ASEAN4 (Thailand, Malaysia, Indonesia, Philippines) were 1.5 trillion yen, an increase of 2.2% from the previous year, accounting for 12.8% of total exports. Exports to China were 1.3 trillion yen, an increase of dramatic 35.1%. The share of total exports was 12.8%, which reached almost the same as those for ASEAN4.

Over 90% of the electrical equipment exports to ASEAN4 and China was capital and intermediate goods in 2002, with Japan playing the role of a provider of goods required for production. The principal recipients of capital and intermediate goods are Japanese owned enterprises operating in both regions. Thus, electrical equipment exports to these regions are affected by direct investment and the production trends of Japanese owned enterprises.

Two main effects of direct investment on exports

Direct investment is known to have export inducement and export substitution effects in the investing country. The export inducement effect refers to an increase in exports from the investing country to the country being invested in, as capital and intermediate goods are provided especially in the early stages of production. The export substitution effect refers to a curb in exports from the investing country as production goes into full swing and finished goods are then produced in the investment receiving country and intermediate goods are able to be supplied locally. Generally speaking, the more time that passes from the start of production, the greater the export substitution effect becomes and the lesser the export inducement effect becomes.

In order to examine which of these two effects is being exerted upon electrical equipment exports to ASEAN4 and China, estimates were made with (a) real GDP, (b) price and (c) direct investment cumulative amount (direct investment) as the explaining variables. Where the elasticity value symbol against direct investment is positive, direct investment is inducing exports (the inducement effect is greater than the substitution effect). Where the symbol is negative, the opposite is true.

＜Estimated results of functions of Japanese exports of electrical equipment to ASEAN4 and China＞

	Income elasticity value	Price elasticity value	Direct investment elasticity value	Adjusted R^2 (Upper) D.W.(Lower)
ASEAN4	1.91 (4.20)*	-0.94 (-4.45)*	0.41 (3.38)*	0.991 1.534
China	3.39 (9.43)*	-0.02 (-0.06)	-0.42 (-4.93)*	0.951 1.428

NB: Estimate formula for export function is as follows.

ln (real value of electrical equipment exports to country/ region)＝ constant

＋ ln (real GDP of country/ region)

＋ ln（Japanese export price index／wholesale price index of country/ region）

＋ ln（Cumulative total of Japanese direct investment in electrical equipment in the country/ region(-2)）

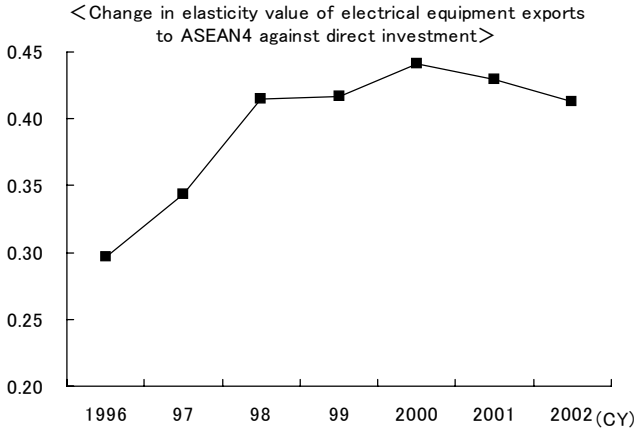
＝Income elasticity value, ＝Price elasticity value, ＝ value of elasticity against direct investment.

Period of estimate: 1982 to 2002. Figures in parentheses are t-values. Asterisk (*) refers to statistical significance at the 1% level.

Sources: Ministry of Finance, 'Trade Statistics' and 'Inward Direct Investment and Foreign Direct Investment'; Bank of Japan 'Price

■ Direct investment inducing exports in ASEAN4

In the case of ASEAN4, the symbol for the value of elasticity for direct investment is positive,



Note:The elasticity value was calculated with 1982 as the starting point and each year as the end point.
Source: As for Table

indicating that direct investment is inducing exports. Moreover, the value of elasticity rose between ’96 and ’98 and has maintained that high level since.

In ASEAN4, given the accumulation of related industries due to direct investment by Japanese companies since the ‘60s, it would be no surprise if increased local supply had led to the substitution of exports and a weakening of the export inducement effect. However, the export inducement effect is not only still greater than the export substitution effect, it is actually increasing.

A primary reason for this is that Japanese companies produced high-value-added products in their ASEAN4 factories. In addition, from 2000 onward, Japanese companies accelerated the shift of production from Japan to ASEAN4 as part of their business restructuring. This movement created a demand for more advanced parts and materials which could not be supplied locally in a short period. The effect was to increase the dependence on goods from Japan.

In the future, it is believed that the substitution effect will gradually grow stronger while the inducement effect declines. Once business restructuring is completed and production under the new strategies gets fully underway, it is expected that companies will then strive to procure intermediate goods locally, in order to boost international competitiveness.

■ Export substitution effect strong in China

The investment environment in China has been changed significantly in the last ten years. The Chinese government‘s announcement that it would encourage foreign direct investment in 1992 and China’s accession to WTO increased investment from overseas. In these reasons, it still may be early to estimate the effects of direct investment in China, but similar estimates to the ones performed for ASEAN4 were made.

As can be seen from the table above, the symbol for the value of elasticity for direct investment is negative and the estimates showed that the export substitution effect is greater than the export inducement effect. This would appear to be due to the fact that, as Japanese companies’ production in China is still at an early stage, the substitution of finished products has been more pronounced than any increase in exports of intermediate goods. The percentage of the value of Japan’s electrical equipment exports to China accounted for by finished products (audio, visual, and telecommunications equipment) fell significantly from 49% in 1990 to just 7% in 2002. The fact that exports to China are increasing though the value of elasticity for direct investment is negative is due largely to the effect of the income factor.

In the future, it is believed that the export inducement effect of direct investment will show a net improvement, due to the following two factors. First, Japanese companies that have invested in China after China’s WTO accession will start up local production in the near future. This will induce intermediate goods from Japan. Second, as products manufactured in China will shift to higher added value ones, the demand for intermediate goods from Japan will increase. Factors on both sides of the supply and demand equation, such as increases in income and fiercer competition among foreign and local companies, will mean a rapid shift to producing high added value products in China.

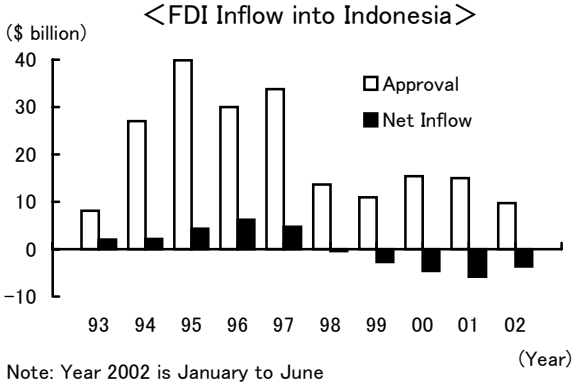
Compared with the long history of investment in ASEAN4, Japanese companies’ investment in China has really just gotten started. Looking ahead, as production in China gets into full swing, the correlation between direct investments and exports to China is expected to become much closer. However, China is different from ASEAN4 in the following two factors: its industrial base is very well provided for, and competition among enterprises is very tough. In these reasons, it is highly possible that China’s ability to provide capital and intermediate goods will develop rapidly. In order for Japan to enjoy the economic effects of direct investment in China as increased exports, Japanese products will need to be ever more sophisticated and differentiated from their Chinese counterparts. (Minako Mori)

Indonesia *Foreign Direct investment still sluggish*

■ Foreign direct investment in Indonesia still slow

Foreign direct investment in Indonesia for 2002 was worth $9.75 billion on approval basis, 35.2% down from the previous year. The rapid increase in investments in the IT field led foreign direct investments to reach $15.4 billion in 2000 and $15.1 billion in 2001, but the downward trend began to pick up speed from the beginning of 2002.

Viewed by sector, figures for 2002 show that investment in the service sector accounted for 62% of the total, while investment in manufacturing industries such as chemicals, pharmaceuticals, and paper and pulp, which had hitherto been leaders, dropped to 33%. Though investment in the service sector expanded due to the implementation of investment promotion measures, such as allowing 100% foreign capital investment in the distribution sector, the unfreezing of large scale projects and the speeding up of investment approval procedures, investment in the manufacturing industry continues to wilt.



Note: Year 2002 is January to June
Sources: BKPM, Bank Indonesia

This drop in the amount of approved investment in 2002 is not limited to Indonesia but can be seen throughout ASEAN (Association of South East Asian Nations). Common causes include (1) the gradual drying up of money coming into the developing countries in the wake of the September 11 terrorist attack in the US, and (2) increased competition with China in trying to attract foreign direct investments. In addition, existing investors have already been pulling out of Indonesia, one by one, and when the withdrawn investments are subtracted from the received investments, the result is the only negative net direct investment figure in ASEAN. In 2002, some 10 Japanese affiliated companies and 40 Korean affiliated companies withdrew. More recently, at the end of March, Sony Corp. closed its 100% owned Sony Electronics Indonesia and withdrew from production in that country.

■ Improvements in investment environment a matter of urgency

As part of the reason for this slowing in foreign direct investment in Indonesia, social and political instability, rampant bribery and corruption, and the lack of progress in structural reform may be considered issues peculiar to Indonesia. A degree of social and political stability has been achieved gradually since the inauguration of the Megawati administration, but the terrorist bombing in Bali in October, 2002, threw the country's problems once more into sharp relief and resulted in a significant loss of confidence in Indonesia internationally. Indonesia is troubled not only by radical Islamic groups but also by disputes with local independence movements. The escalation in attempts to overthrow the Megawati government, triggered by the announcement early in 2003 of price hikes for public utilities, is part of the situation. Also, corruption, collusion and nepotism (KKN) persist within the government, and judicial and structural reform continues to languish. Companies that have withdrawn from Indonesia cite the underdevelopment of supporting industries, prevailing bribery among customs and tax authorities, and the lack of proper legal systems in support of investment and labor issues as major reasons.

The social and political instability described, as well as the bribery and corruption, are structural problems and the government is under pressure to make further improvements in the investment environment. In February, the Megawati administration declared 2003 'Investment Year' and announced a range of measures designed to improve the investment environment, such as expanding and improving preferential tax treatment for foreign companies, speeding up approval procedures, etc. It is considered that the first step for the Indonesian government to take towards investment recovery is swiftly implementing the 'New Investment Law', pending since 2002, and thus restoring international confidence.

(Tatsuro Bando)

Philippines *Amendments to Anti-Money Laundering Act signed into law*

■ Background to Anti-Money Laundering Act amendments

In June, 2000, the Philippines was included in a list of non-cooperative countries and territories (NCCTs), drawn up by the Financial Action Task Force on Money Laundering (FATF), an intergovernmental body under OECD. One of the major reasons for this was that, under the Bank Secrecy Law, the central bank's powers of supervision over the banks were severely limited. In September, 2001, the Anti-Money Laundering Act was passed and the Philippines narrowly escaped FATF sanctions before the end-of-September deadline. However, the country was not removed from the list of NCCTs. The fact that requirements to report suspicious transactions were limited to transactions over 4 million pesos and that a court order was required in order for the Anti-Money Laundering Commission (AMLC) to conduct investigations of bank accounts was seen as effectively hindering the implementation of the Anti-Money Laundering Act.

There are currently only 10 countries still on the list of NCCTs, which once numbered over 20. FATF demanded that the Philippines (a) amend the amount threshold restricting the reporting of suspicious transactions, (b) strengthen rights to investigate accounts, (c) clarify the central bank's powers of supervision related to money laundering, and (d) make the law retroactive to cover accounts opened prior to the enactment of the law. FATF set a deadline of March 15th, 2003, for the completion of these measures. Failure to comply by the deadline would result in restrictions on international financial transactions, and other sanctions. There was considerable worry that such sanctions would prevent Philippinos working overseas from sending money home and would interfere with trade transactions and the international transactions of local banks, resulting in severe consequences for the economy.

In February, amendments to the Anti-Money Laundering Law were approved but there was opposition from some parliamentarians committed to protecting the Bank Secrecy Law and the content of the amendments did not satisfy the FATF demands. In early March, a team of negotiators, comprising FATF specialists, etc., visited the Philippines and, after many discussions, the final amendments were at last enacted. Principally, the amendments provide for (a) the threshold for suspicious transactions that can be investigated to be lowered to 500,000 pesos, (b) the requirement of a court order for AMLC to freeze bank accounts (with some exceptions) and the strengthening of the central bank's right to investigate accounts, and (c) the deletion of a clause that prohibited retroactive application of the revised law and the leaving of judgments on retroactivity to the courts.

■ Future prospects

The enactment of the revised law allowed the Philippines to escape sanctions and caused the business community to heave a sigh of relief. It is this sense of relief that has been one of the biggest factors in the mid March recovery of the exchange rate, which had been falling steadily since the beginning of the year. However, the Philippines has not been removed from the list of NCCTs. FATF has set effective implementation of the revised law as a condition for removal from the list. The list is reviewed every year in June and it is expected that it will take the Philippines one or two years to be removed.

The latest round of events leaves the impression that there is still a sense of opacity with regard to the Philippines' financial systems, and this is undermining foreign investors' confidence in the country. It is vitally important for the Philippines that the revised law be implemented steadily and that the country be removed from the list of NCCTs. AMLC is currently working on a set of rules for the implementation of the revised law, but more energy will need to be put into their efforts.

NCCTs list

1. Cook Islands
2. Egypt
3. Guatemala
4. Indonesia
5. Myanmar
6. Nauru
7. Nigeria
8. Philippines
9. St. Vincent and Grenadine
10. Ukraine

Source: FATF

(Satoshi Shimizu)

Vietnam *Supporting software infrastructure provision*

■ Investment protection agreement concluded

When the Vietnamese Prime Minister, Phan Van Khai, visited Japan recently, agreement was reached on the concluding of an investment protection agreement, with the agreement expected to be inked within the year. The agreement is part of the 'Initiative for Japan-ASEAN Comprehensive Economic Partnership', which aims to strengthen economic links in a wide range of fields, including investment, science and technology, tourism, etc., and is seen as a preparatory step towards the formation of free trade agreements (FTA) in the future.

If the investment protection agreement is signed, it will confer national treatment and most favored nation treatment upon investing Japanese companies. National treatment will entitle Japanese companies to the same treatment as Vietnamese companies, while most favored nation treatment will ensure that Japanese companies do not lose out, in terms of treatment and conditions, against companies from countries such as the US, which have already signed trade agreements with Vietnam. Foreign companies in Vietnam are the target of a great many restrictions, based on the Foreign Investment Law, and this has prevented many foreign companies from entering the Vietnamese market. The investment protection agreement will do away with this kind of hindrance.

■ The gap between government and private sector

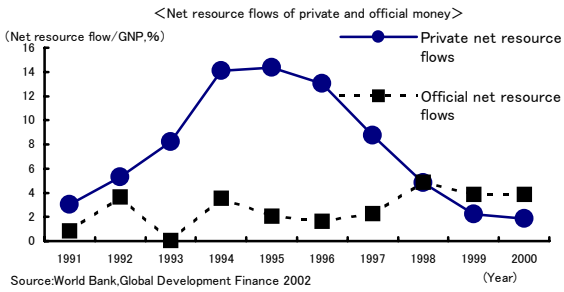
When the Prime Minister visited Japan, his entourage included many businessmen and the visit proved to be a joint government and business sector investment attraction mission. This was the first such mission of this size, hinting also at the size of Vietnam's expectations.

The fact that the Japanese government, while drastically reducing the size of its ODA budget, has maintained its assistance to Vietnam at the same level as the previous year is a clear indication of how important the government views Vietnam. In advance of the mission, the two governments agreed upon yen loans totaling 79.33 billion yen, to be granted for the purposes of developing roads, power stations and other infrastructure, in support of socio-economic development and the development of a market economy.

Meanwhile, private sector activity is very dull, almost symbolic of the slump in direct investment. Approved Japanese investments in Vietnam in 2002 numbered 42, worth $89.9 million, lagging quite far behind Korea (No. 1 with 137 investments worth $247.82 million) and Taiwan (No. 2 with 173 investments worth $246.98 million).

■ ODA in support of software

The flow of private sector funds into ASEAN overall has been gradually drying up and the trend has been particularly noticeable in Vietnam. In 1995, incoming private sector funding accounted for 14.4% of GNP and this figure fell to 1.9% by 2000. Public funding, meanwhile, increased from 2.0% to 3.9% over the same period and surpassed private sector funding in 1998.



In general, it is not unusual for public funding to have greater weight in developing countries. However, the general pattern in east Asia has tended to be that the inflow of public funding acts as a primer for foreign direct investment and other private sector funding.

In order for Vietnam to be able to follow the east Asian pattern of economic development, ODA needs to be focused not only on infrastructure but also on institution infrastructure and other types of software support, which contribute to improvements in the private enterprise business environment. In addition to an investment protection agreement with Japan, Vietnam has to address a host of issues, including the implementation of institutions aimed at enabling WTO accession. It is often the case that, if there is insufficient progress with reforms in a country that depends heavily on public funding, economic development lags behind. Japan needs to bear this fact in mind when implementing ODA programs.

(Yuji Miura)

India *Fiscal 2003 budget proposal against backdrop of worsening fiscal situation*

■ Worsening fiscal situation

The budget proposal for FY 2003 (April, 2003 to March, 2004) was presented to Parliament on February 28. However, the revised budget for FY 2002, on which the proposal was based, suffered particularly from poor tax and other revenues and the fiscal situation continues to worsen.

The fiscal deficit for FY 2002 has increased from the original budget of 1 trillion, 355 billion rupees (approx. 3 trillion, 370 billion yen) to 1 trillion, 455 billion rupees, and the ratio of deficit to nominal GDP is expected to rise from the original target of 5.3% to 5.9%.

The main reason for this expansion in the deficit has been the failure to generate revenue. Due to poor taxation revenues and the failure to meet target revenues from the sale of government shares in state-owned enterprises, revenues were down 63 billion rupees, compared to the original budget. Because of the fall in revenues from income taxes, corporate taxes and commodity taxes, tax revenues fell below the original budget by 88 billion rupees. Disunity within the ruling party has prevented the privatization of state-owned enterprises from going according to plan, and revenue from sales of government shares was only 33.6 billion rupees, considerably lower than the original budget of 120 billion rupees. The government has increased its borrowing in order to make up for the lack of revenue, surpassing the original budget of 1 trillion, 189 billion rupees. As a result, interest payments now account for 28.6% of expenditure. Fears are that, from FY 2003 on, as borrowing grows, the burden of interest payments will also grow.

<Fiscal Budget of the Central Government>

(Billion Rupees)

	FY2001 (Actual)	FY2002 (Original)	FY2002 (Revised)	FY2003
Receipts	3,644	4,103	4,040	4,388
Revenue Receipts	2,126	2,451	2,369	2,539
Tax Revenue	1,424	1,730	1,642	1,842
Non-Tax Revenue	702	721	728	698
Capital Receipt	1,519	1,652	1,671	1,849
Recoveries of Loans	151	177	183	180
Other Receipts	50	120	34	132
Borrowings and Others	1,317	1,355	1,455	1,536
Expenditure	3,644	4,103	4,040	4,388
Revenue Expenditures	3,016	3,405	3,416	3,662
Interest Payments	1,073	1,174	1,157	1,232
Subsidies	305	398	446	499
Defense Expenditure	400	436	411	443
Capital Expenditure	608	698	624	726
Fiscal Deficit	1,410	1,355	1,455	1,536
Fiscal Deficit/GDP(%)	6.1	5.3	5.9	5.6

Source: Ministry of Finance

■ Expanding fiscal deficit impeding economic development

The budget proposal for FY 2003 lists among priority issues (a) the elimination of poverty, (b) infrastructure development, (c) strengthening of the fiscal base through reform of the tax system, (d) agricultural development, and (e) improving the competitive strength of the manufacturing industry. The total expenditure is 4 trillion, 388 rupees, which is 8.6% up on the revised budget for FY 2002. However, in addition to poor revenues resulting from poor tax revenues and the slow pace of privatization of state-owned enterprises, factors such as (a) the increased burden of interest payments that accompanies extra borrowing and (b) increased subsidies for the agricultural sector, which is the backbone of the economy, and for the poor, are causes for worry that expenditure for FY 2003 will increase beyond the budget proposal.

If the fiscal deficit grows any larger, funds that ought to have been channeled into priority areas such as infrastructure development and measures to stimulate the high-tech industry will dry up and there is every possibility that this will hinder economic development. Therefore, the government needs to come up with serious measures to reduce the fiscal deficit, and needs to do it quickly.

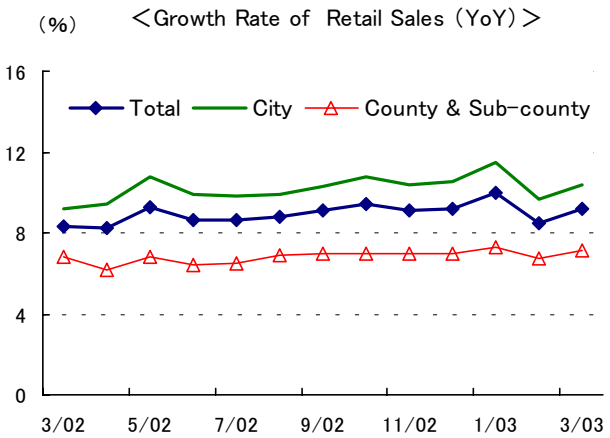
(Hiroshi Imai)

China *Real GDP growth rate 9.9% in 1st quarter*

■ Internal demand continues to grow

China's real GDP grew by 9.9% in the first quarter of 2003, the highest growth since 1997. The high growth rate was supported by increases in fixed assets investments and by greater private consumption of mainly high class goods.

Figures for January to March show that fixed assets investments were up 28%, compared to the same period in the previous year. Positive fiscal policy has helped expand investment in the state-owned sector and private sector investment has also recovered significantly. Viewed by sector, high growth rates were posted by construction investment at 28%, plant and equipment renewal and improvement investments at 37%, and real estate investments at 35%.



Source：National Bureau of Statistics of China

Retail turnover was up 9.2%, compared to the same period in the previous year, slightly up on the figures for the whole year in 2002 (8.7%). The growth in individual consumption was driven by high class goods, such as housing, automobiles, household electrical products, mobile phones, etc. Automobile related sales were up 94% and figures for mobile phones and PCs were up between 50 to 90%. However, individual consumption in rural communities remains poor and provincial and sub-provincial retail figures for January to March grew by only 7.1% (10.4% in urban areas). The consumption gap between urban and rural areas is widening all the time.

Meanwhile, exports were up 33.5% compared to the same period in the previous year, to $86.3 billion and imports up 52% to $57.3 billion, resulting in a trade deficit. Reasons for the big jump in imports include the lowering of customs duties in January, the expanding of the import quota framework, and the rising price of crude oil.

Viewing exports and imports by country/ region, exports to the US were up a massive 32% compared to the same period in the previous year, and those to Europe and Japan were also very robust, up 42% and 24%, respectively. As regards imports, those to the biggest import destination, Japan, were up more than 50% and those to other major import partners were up by 20% or more.

■ Serious economic impact of Iraq war and SARS

For the whole of 2003, as positive fiscal policy has resulted in an expansion of fixed asset investment and a recovery in individual consumption and increased exports on the part of foreign companies and others, real GDP is expected to grow by a high 8%. However, in addition to the increasing global economic uncertainty in the wake of the Iraq war, fears over the SARS virus have already begun to inflict damage upon tourism in China and foreign business with China. Depending upon how the situation develops, a slowdown in economic growth may also be expected.

(Fang Meng)