

**Legacies of Change:  
The Transformative Role of Japan's  
Official Development Assistance in its  
Economic Partnership with Southeast Asia**

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## **ABSTRACT**

This paper provides a broad overview of Japan's foreign aid (ODA) to Southeast Asian countries from its inception until 2006, with data through 2004. Japan has been by far the largest bilateral donor to Southeast Asia. Between 1969 and 2004, 65 percent was in concessionary yen loans, 20 percent in technical assistance and 15 percent in untied grants; the amount and type of aid has depended up on the recipient's size and level of development. This aid has been an integral, synergistic component of Japan's burgeoning trade with and foreign direct investment in Southeast Asia. Due to domestic budgetary problems, Japan ODA to Southeast Asia peaked in 1999; however successful development in many Southeast Asian countries has meant their trade with, foreign direct investment from, and financial flows with Japan have become much more important in that development process. Despite many problems and difficulties, the huge amount of Japanese ODA and its synergies with trade and FDI have served both Japan and Southeast Asia well, and political relations are good and deeply embedded.

Japan's relationship with Southeast Asia has evolved dramatically throughout the postwar era. In the 1950s, memories of Japan's wartime aggression led Southeast Asian states to view Japan suspiciously. Most reluctantly concluded peace treaties with Japan only in response to US pressure and promises of Japanese economic reparations. Political relations were strained and economic ones were extremely limited despite the complementarity between resource poor Japan and resource rich Southeast Asia.

Today, Japan is the largest provider of economic aid to Southeast Asia and its largest source of foreign direct investment. Japanese economic engagement has played an important role in the region's economic development. The legacy of these comprehensive economic interactions is a wholesale turnaround in Southeast Asian political relations with Japan. Southeast Asian views Japan as a good neighbor and an important participant in ASEAN activities.

### **The Pivotal Role of Japanese Government Official Development Assistance**

This chapter provides an overview of the evolution of Japanese Official Development Assistance (ODA) to Southeast Asia, which encompasses the 10 ASEAN members and, now, in a very small way East Timor.

Japan's foreign aid to Southeast Asia has been, and is, an integral, synergistic component of Japan's overall economic relationship with the region. The successful economic development and growth of both Japan and Southeast Asian nations has meant that, over time, trade and Japanese business investment in the area have burgeoned, so aid has come to play a more modest role. Despite many problems and inefficiencies, Japan's aid program has been quite successful, not only in straight-forward economic development terms, but in broader terms as well, meeting the interests both of Japan and of Southeast Asia.

In the first part of the chapter, I consider Japan's ODA policy and its evolution, the major Japanese players, ODA flows to Southeast Asia, and aid's synergies with the economic relationships. I then document the dramatic expansion of Japanese foreign direct investment (FDI) to Southeast Asia, and note ASEAN's role. I adopt as my lens what I deem the Japanese government and business perspectives to have been.

## **The Goals and Objectives of, and Major Players Behind, Japan's ODA Policy**

The goal of ODA is economic development in recipient countries. This is considered the best way to reduce poverty. As put forth in Japan's 2003 charter and its previous ODA charter, aid should facilitate trade, as well as foreign (Japanese) direct investment in the recipient.<sup>1</sup> As countries develop, the composition of ODA should shift from grants to untied loans on preferential terms, while technical assistance persists. ODA should be channeled first to physical infrastructure projects and next to human and institutional capacity building. ODA should support the effective self-help programs of the recipient countries; the recipients should have their own, appropriate development strategies.

Japan is not only the largest official aid provider to Southeast Asia, it is also the major foreign business player. Japan's influence in the region thus is strong. While humanitarian concerns are real, Japanese foreign policy objectives toward Southeast Asia always have been quite straight-forward: to promote Japan's own economic interests directly and indirectly through promoting the economic development of the region's economies; to develop and expand political influence through peaceful and cooperative measures; and to secure important energy, mineral, and land-produced resource supplies by imports.

It is fundamentally a market- and business-driven economic foreign policy. As such, it inevitably has become more complex, and more micro (company- and industry- specific) as Japanese firms have invested more in the countries.

The Japanese government has used its aid programs for Southeast Asia effectively in promoting its broader foreign policy objectives. Do not misunderstand: Japan's governmental policies go substantially beyond narrow, selfish, economic self-interest. They are broad, often enlightened, with a definite humanitarian element, as evidenced by Japan's quick and substantial response to the tsunami in December 2004. Japan immediately provided \$500 million in grant aid, dispatched medical teams, and sent Self Defense Forces and other disaster relief teams to afflicted areas. In the longer run it deployed country ODA for reconstruction and helped the establishment of a tsunami early warning system.

## The Major Japanese Players

The major Japanese players in Japan's aid and economic relations with Southeast Asia - government bureaucracies and private businesses - engage in close, synergistic cooperation. ODA administration involves the Cabinet Office, 10 Ministries, and 2 government agencies.<sup>2</sup> The Ministry of Foreign Affairs has overall responsibility for the ODA program; naturally it focuses on diplomatic relations. METI (The Ministry of Economy, Trade and Industry) plays a lead role in economic policy toward the Southeast Asian countries and their umbrella organization, ASEAN.

On financial issues, the Ministry of Finance is the key player. JBIC – the Japan Bank for International Cooperation, an uneasy merger of the Export-Import Bank of Japan and the Overseas Economic Cooperation Fund – is the major implementing institution for government loan aid programs. JICA, the Japan International Cooperation Agency, provides technical assistance. This includes designing and setting the Japanese company-friendly specific technical requirements for recipient-country ODA project proposals. Bureaucratic infighting is substantial. Administratively this system inevitably is weak, but politically it may be essential to harness the wide range of potential business interests, as well as those of relevant government bureaucracies. In 2006, as part of its financial and budgetary reforms, the Japanese government is transferring the foreign aid loan program from JBIC to JICA.

Major business players provide the fundamental underpinning for this good, expanding economic set of relationships. Historically the most important have been the major general trading companies (*sogo shosa*). They funded the development of raw materials that their domestic clients needed, and they developed export markets for Japanese goods. They have always been an incredible source of economic intelligence, collecting information and guidance on markets, suppliers of particular products of interest to Japanese importers, export prospects, and Japanese foreign direct investment opportunities. While designed primarily for business clients, this information was shared with the government bureaucracy.

Since the mid-1980s, a great number of Japanese companies, large and small, have directly invested in all the ASEAN countries, in a quite diverse range of activities, especially the automobile and electronics industries, as well as other manufacturing. The large investing

firms in particular, given their economic and political power within Japan, are now important economic policy players.

Major Japanese banks have sustained and, indeed, increased their lending and related activities in Southeast Asia, despite their withdrawal from the United States and other markets. Their immense non-performing loan difficulties are now resolved, and they have consolidated into the three megabank financial groups, Mitsubishi UFJ, Mizuho, and Sumitomo Mitsui. They are a main source of finance for the subsidiaries, joint ventures, and affiliates of their Japanese clients investing in Southeast Asia. Despite the 1997-98 financial crisis, the Southeast Asian financial operations of Japanese banks have generally been profitable.

### **The Growth and Evolution of Japan's ODA Policy**

Japan's aid program has grown and evolved significantly over the past half century. It began in October 1954 when Japan both joined the Colombo Plan for Cooperative Economic and Social Development in Asia and the Pacific, and established its first reparations agreement, with Burma, as an integral element of its postwar peace treaty. Reparations and peace treaties were then rapidly signed with the Philippines, Indonesia, and the Republic of Vietnam (South Vietnam). Quasi-reparations grant aid and technology cooperation agreements were made with Cambodia, Laos, Thailand, Malaysia, and Singapore.

Ishikawa (2005) stresses the importance of Japan's basic aid philosophy: ODA pragmatically focuses on economic development as the way to overcome poverty and bring about social change; aid should be requested by recipient countries in the form of specific projects, but otherwise with only limited conditionalities. He stresses that the genesis of these policies lies in the way in which initial reparations payments were made, with a salient Japanese sense of remorse.

Initially, Japan's economic relationship with Southeast Asia was small and relatively simple. Japan imported essential natural resources and materials, and paid with exports of machinery and equipment, much of it financed by reparations and consumer manufactured goods. Over time the economic relationship has become far larger for both sides, and much more multidimensional and complex.

The Japanese government divides the evolution of its ODA program into four periods:<sup>3</sup>

- 1954-76 Development of aid programs and systems.
- 1977-92 Major expansion to become the world's largest donor.
- 1992-2002 Period of first ODA Charter, which was designed to clarify Japan's aid philosophies and goals as the world's largest donor.
- 2003 Period of second ODA Charter, which was revised in the context of reduced funding commitments.

Taking a broader approach to the evolution of ASEAN–Japanese cooperation, Akrasanee and Prasert stress the importance of the Fukuda Doctrine, the 1977 economic diplomacy policy statement enunciated by Japanese Prime Minister Takeo Fukuda.<sup>4</sup> They divide ASEAN-Japan cooperation into four eras primarily defined by external global shocks:

- 1945-69 Postwar rehabilitation and normalization, with establishment of ASEAN in 1967.
- 1970-84 The oil crises, Fukuda Doctrine (1977), trade frictions, and dramatic aid expansion.
- 1985-96 The 1985 Plaza Accord, end of the Cold War, and major growth of Japanese foreign direct investment (FDI) in Southeast Asia.
- 1997- The 1997-98 Asian financial crisis, the 1998 New Miyazawa Initiative of \$30 billion in economic recovery aid for ASEAN countries, and Japan's focus on regional free trade agreements and an East Asian Community in which ASEAN countries play a significant role.

These two approaches are not in conflict. While in practice most of Japan's foreign aid went to Southeast Asia, it is not surprising that Japanese policymakers focused on conceptualizing ODA in global terms with an objective of becoming a major player as an aid donor. Akransee and Prasert quite appropriately focus on the ASEAN side of the economic

relationship, and do so more comprehensively, going beyond ODA to consider cooperation in trade and foreign direct investment.

### **Japan Becomes the World's and ASEAN's Largest ODA Donor**

Overall, Japanese ODA net disbursements were the largest in the world between 1991 and 2000. They peaked in dollar terms in 1995 and in yen terms in 2000, despite increasing government budget difficulties in the 1990s. Since then, Japan has reduced ODA considerably in absolute amount and as a share of GDP (from 0.28% in 2000 to 0.19% in 2004), a trend that persists in 2006. Still, Japan continues second only to the United States as a global aid donor in absolute terms.<sup>5</sup> Moreover, Japan's new aid outflows are understated, since ODA recipient loan repayments in effect are available for new Japanese ODA loans while the ODA budget is based on net disbursements.

Most of Japan's ODA is bilateral, and Japan has long made Southeast Asia the major destination of its bilateral ODA, separate from its multilateral funding through the Asian Development Bank and the World Bank. To quote the *Japan 2005 ODA White Paper*, "Approximately 30% of Japan's bilateral ODA is provided to the ASEAN countries and approximately 60% of the bilateral ODA that the ASEAN countries receive is from Japan".<sup>6</sup> Japan has devoted more of its bilateral ODA to Southeast Asia than to any other developing world region, ranging from 22% to 37% of global total net disbursement between 1993 and 2002.<sup>7</sup>

Japan has been by far the largest bilateral donor to Southeast Asian countries. Globally, including Southeast Asia, slightly more than half of Japan's ODA is in concessionary yen loans (low interest rate, long repayment terms). About a third of Japan's ODA for Southeast Asia has been in the form of technical assistance, and the rest is grant aid, which goes predominantly to the poorest countries. Over time, as countries develop, the ODA shifts from grants to loans, while technical cooperation remains a relatively constant share. With successful development, countries are supposed to graduate out of ODA, as have Brunei and Singapore.

As Japan's national interests have evolved, so too has its geographic distribution of ODA. Thus, ODA disbursements to Southeast Asia in 1993 amounted to \$2,440 million,



29.9% of Japan's total aid. The ratio, and after 1995 the amounts, decreased gradually to 21.4% in 1997. Following the Asian financial crisis the amounts and the ratios jumped sharply, peaking at \$3,921 million and 37.3% of total ODA in 1999, before declining rather substantially by 2002 to \$1,754 million, 26.1% of Japan's significantly lower total bilateral ODA of \$6,726 million. On the standard net disbursement basis, Japan's ODA to Southeast Asia in 2004 was only \$907 million, 15.2% of Japan's global ODA of \$5,954. Table 1 provides data for 2004 on Japanese total ODA by country. However, as Table 1 indicates, gross disbursements are much larger, but Indonesia, Malaysia, Thailand and apparently Vietnam made huge repayments of earlier ODA loans, thereby sharply reducing net disbursements. For Indonesia and Thailand, loan repayments exceeded new ODA loans.

Table 1. Japan's ODA Net Disbursements, 2004  
(million dollars, U.S.)

Country/ Territory	ODA					
	Grants			Loan assistance		Total
	Grant aid	Technical cooperation	Total	Gross	Net	
<b>Southeast Asia</b>	200.65	478.53	679.18	4,311.77	227.74	906.92
(ASEAN)	194.59	474.71	669.29	4,311.72	227.74	897.04
Brunei Darussalam	-	0.34	0.34	0.00	0.00	0.34
Cambodia	38.27	40.75	79.02	7.35	7.35	86.37
Indonesia	25.47	105.96	131.43	1,730.11	-449.97	-318.54
Laos	34.75	30.27	65.01	6.72	6.72	71.73
Malaysia	0.03	45.77	45.80	878.55	210.70	256.50
Myanmar	8.41	18.41	26.81	3.57	0.00	26.81
Philippines	42.17	74.60	116.77	107.96	94.61	211.38
Singapore	-	2.70	2.70	7.07	0.00	2.70
Thailand	5.68	72.04	77.71	499.77	-133.30	-55.59
Vietnam	39.81	83.89	123.69	889.72	491.64	615.33
East Timor	6.06	3.82	9.88	0.00	0.00	9.88

Calendar year:

Source: <http://web-japan.org/stat/stats/23ODA32.html> (8/15/2006)

Note: Loan assistance is net of repayments. Gross loan assistance estimates are derived from JBIC Annual Report, 2005, pp.100-101. As such, there may be some data inconsistencies.

Table 2. Japan's Total ODA Net Disbursements, 1969-2004  
(million dollars, U.S.)

Country/ Territory	ODA				
	Grants			Loan assistance	Total
	Grant aid	Technical cooperation	Total	Net	
<b>Southeast Asia</b>	8301.19	10164.99	18468.29	33356.4	51403.53
(ASEAN)	8261.61	10141.6	18405.32	33356.4	51340.56
Brunei Darussalam	-	44.02	44.02	-0.06	43.96
Cambodia	760.54	338.61	1099.16	24.2	1123.35
Indonesia	1503.32	2780.22	4283.54	15301.51	19585.05
Laos	805.01	359.68	1164.69	23.23	1187.92
Malaysia	80.04	1282.5	1362.54	830.42	2192.96
Myanmar	1295.18	298.59	1593.77	1310.9	2904.67
Philippines	2087.5	1720.21	3807.71	6692.59	10500.3
Singapore	24.64	253.11	277.75	-10.66	266.99
Thailand	914.27	2298.18	3212.45	5255.18	8467.63
Viet Nam	791.11	765.58	1559.69	3929.09	5067.82
East Timor	39.58	23.39	62.97	-	62.97

Calendar year

Source: OECD/DAC Online ([http://stats.oecd.org/wbos/default.aspx?DatasetCode=ODA\\_RECIPIENT](http://stats.oecd.org/wbos/default.aspx?DatasetCode=ODA_RECIPIENT))

Note: Loan assistance is net of repayments.

As Table 2 shows, of the 10 Southeast Asian ASEAN members and East Timor, all but Brunei and Singapore have received significant ODA. Japan is by far the largest single donor to each of the countries, providing more than half of total ODA in every one but Cambodia, where the share is 45%. The amount and type of aid depends on the recipient's size and level of development. The largest ODA recipients have been Indonesia, Vietnam, the Philippines, and Thailand. Relative to their populations, Cambodia and Laos are large recipients, and their ODA is overwhelmingly in the form of grants.

Since the loan data in Table 2 are the cumulation of net annual flows between 1969 and 2004, they understate the gross loan flows since loans are eventually paid back. The process varies considerably by recipient country. For example, from 1969 on, net loan aid to Indonesia was always greater than grant aid until 2004, when Indonesia made a major repayment, as shown in Table 1. Loans to Indonesia were particularly large throughout the 1990s. In contrast, Malaysia increasingly paid back loans on a net basis from 1993 until the onslaught of the Asian financial crisis in 1997. Net loan aid to the Philippines was larger than the grants throughout, and peaked in the early 1990s. Similarly, net loan aid to Thailand has been larger than grants throughout the period, particularly in the latter half of the 1990s; Thailand then suddenly made a huge repayment in 2003 (\$1,079 million). On the other hand, net loan aid to Vietnam did not really begin until the 1990s and has been larger than grant aid ever since 1998.

Japanese preferential loan aid, as well as grants, are in yen. This has created costly repayment burdens for ODA loan recipients despite the very easy loan terms, since the yen has appreciated significantly against the dollar and other currencies since 1971; and the dollar has appreciated against the local currencies of almost all Southeast Asian countries. The exchange rate was 360 yen to the dollar until 1971. It rose steadily, to an annual average of 226 in 1980, 141 in 1990, and a short – lived peak of 81 in August 1995. It then declined to a low of 146 in August 1998. It once again appreciated to a 105 – 110 range. Subsequently the rate has moved up again to the 130s, down again in the 105 range in early 2005, then to the 115 – 120 range to mid-2006. Yen volatility and concerns about future yen appreciation served as an incentive for ODA borrowers to pay loans back when their foreign exchange reserve position improved. The ODA loan repayments in 2003 and 2004 probably reflected

both the successful economic and balance of payments performance of some ODA loan recipients and fear the yen might strengthen once again.

A similar trend in repayments over time is illustrated in Table 3, which provides country data on the two ODA loan programs administered by the Japan Bank for International Cooperation (JBIC). (Note that these data are in yen, unlike Tables 1 and 2 which are in dollars.) The International Financial Operations program (IFO) provides export and import loans and direct investment loans and guarantees for Japanese firms; Overseas Economic Cooperation Operations (OEEO) essentially provides ODA loans to recipient governments, plus a small amount of private-sector investment finance, mainly to Indonesia.<sup>8</sup> The small amounts actually disbursed relative to cumulative commitments reflect the substantial repayment of these long-term loans over time. As Table 1 shows, new ODA loans continue to be very substantial: \$4,312 million to Southeast Asia in 2004, with Indonesia continuing to be by far the largest loan recipient, followed by Vietnam, Malaysia and Thailand.

Table 3. JBIC ODA Total Cumulated Loan Commitments and Outstanding Balances  
 March 31, 2005  
 (billions of yen)

	Cumulated Commitments		Outstanding Balances	
	IFO	OEEO	IFO	OEEO
Cambodia		12.9		3.9
Indonesia	4,609.1	4,082.3	1,178.3	2,299.5
Laos		16.8		5.0
Malaysia	1,163.7	935.0	345.4	236.3
Myanmar	61.3	410.0	18.1	273.5
The Philippines	1,436.4	2,006.3	321.0	998.5
Singapore	599.5	9.4	76.9	4.8
Thailand	2,359.8	1,994.6	333.7	792.1
Viet Nam	125.4	995.0	59.4	449.0
Others	229.4	0.4		
Total SE Asia	10,584.6	10,462.5	2,332.8	5,062.6

Notes: The exchange rate on March 31, 2005 was 107.55 yen/dollar.

IFO = International Financial Operations

OEEO = Overseas Economic Cooperation Operations

Source: JBIC Annual Report 2005, Tables 4, 5, pp.100-101, 106.

### **Aid's Synergies with Business Relations**

Today, Japan's relationships with Southeast Asian countries are based much less on aid and much more on a greatly expanded trade; significant Japanese company direct investment; private financial flows, mainly through Japanese banks; increased technology flows, not only through FDI but by Southeast Asians being educated and trained in Japan; and extensive Japanese tourism. The economics of this are straight-forward. These are private sector activities from which both sides benefit; otherwise they would not take place. The politics, and the business deals at the company level, are more complicated and difficult to discern.

Trade flows, both imports and exports, have always been a fundamental component of Japan's relationships with all of the Southeast Asian economies. As Table 4 indicates, trade has increased tremendously, driven by growth both in Japan and in ASEAN. Trade initially was dominated by Japanese imports of oil and other natural resources and exports of machinery and cheap consumer goods. As all the economies have grown and their economic structures evolved, the composition of trade has evolved according to market opportunities. Now a considerable share of Japanese exports are manufactured goods, both machinery and sophisticated components for assembly, to Japanese subsidiaries and affiliates; in turn those firms are exporting both final products to Japan, and intermediate goods elsewhere as part of the Japanese supply chain production process.

Table 4. Japan Trade with Southeast Asian Countries  
(in millions of dollars)

	Exports			Imports		
	1980	1990	2004	1980	1990	2004
Brunei Darussalam	89	86	108	3263	1278	1892
Cambodia	26	5	80	1	3	100
Indonesia	3476	5052	9075	13230	12744	18652
Laos	13	20	14	6	5	8
Malaysia	2070	5529	12565	3504	5411	14093
Myanmar	215	101	105	77	42	180
Philippines	1692	2510	9598	1964	2149	8243
Singapore	3929	10739	17976	1516	3581	6283
Thailand	1925	9150	20274	1125	4164	14098
Vietnam	114	214	3181	49	597	3858
Subtotal	13549	33406	72976	24735	29974	67407
% of Total Trade	10%	12%	13%	18%	13%	15%

Source: International Monetary Fund, Direction of Trade Statistics 1980, 1990, & 2004

Overall, Japan's economic relationship with Southeast Asia has been, and is, strong, mutually profitable, and very positive, providing political and cultural, as well as economic, benefits to all parties. The overall economic relationship is well-described and documented in the *Ministry of Economy, Trade and Industry 2005 White Paper*, which is interestingly subtitled "Towards a new dimension of economic prosperity in Japan and East Asia." Japanese aid has often financed transport and other infrastructure projects which directly benefit natural resource exports to Japan or FDI activities.

When Japanese official and business policy-makers, and certainly the Japanese public, look at Southeast Asia, they usually see individual Southeast Asian countries, not ASEAN; and some countries are seen far better than others. This is not surprising. Japan's trade and business relations in practice are bilateral, not only with specific countries but, typically, with specific partners. That is the nature of business. Moreover, the focus of Japan's political relations is more on the individual Southeast Asian countries than on ASEAN, though certainly ASEAN has an important broader role in Japan – Southeast Asia relations.

This country-by-country approach as the starting point is natural. After all, Southeast Asia is perhaps the most heterogeneous region in the world. Its 10 countries, 11 with East Timor, have distinctive histories and cultures, languages, and three main religions, including the predominantly Christian Philippines, predominately Buddhist Thailand, Laos and Burma, and predominantly Muslim Indonesia, Brunei and Malaysia.

The economic and political systems are diverse. In all Southeast Asian countries the government plays a major role. Most are relatively export-market oriented; the major exception is Myanmar. They encompass a range of political and institutional heritages and policy regimes – communist states such as Vietnam and Laos; authoritarian states, democratic states, and newly democratic states such as Indonesia.

Differences in population and geographic size are also immense. Four have a population under 6 million – Laos, Singapore, Brunei, and East Timor. In contrast, Indonesia, with 246 million people, is the fourth most populous in the world. Further, natural resource endowments vary considerably – contrast Brunei and Singapore – but most have comparative advantage in some minerals, oil, natural gas, and land-grown products such as palm oil, rubber and timber, as well as foodstuffs



The countries differ widely in level of economic development and hence standards of living. Singapore is an economically advanced economy; by purchasing parity measures, its gross national income per person is \$26,590, only about 10% below Japan (2002 data)<sup>9</sup> In contrast, the estimate for the poorest countries – Myanmar, Cambodia, East Timor, and Laos – is less than \$2,000. By comparison, China is about \$5,500 (though estimates range considerably), which is above the average for all of Southeast Asia and greater than all but four of the countries – Singapore, Brunei Darussalam (14,350, not purchasing power adjusted), Malaysia (\$9,630), and Thailand (\$8,020). This diversity accordingly creates substantial differences in Japan’s political, economic, and business interests. These differences fundamentally determine Japan’s trade and aid flows, as indicated in Tables 1 – 4. In addition, because of its huge size, natural resources, leadership in Asia and among developing countries, and lack of allegiance to a colonial heritage, Indonesia has always been important for Japanese policy makers. Singapore is a special case for business; it is a major entrepôt for Japanese trade, a major location for direct investment, and a regional management hub for Japanese multinationals.

### **The Drivers: Growth and FDI**

The fundamental forces driving this expanding Southeast Asia – Japan aid, economic and political relationships – are obvious. Most important was Japanese rapid economic growth until 1990. That made possible the dramatic expansion of Japanese ODA until 2000. In 1964 Japan became the first Asian country to achieve advanced country status under the IMF Article 8; and it joined the OECD. While predominantly a domestic economy in terms of demand because of its huge size, Japan was a prime beneficiary of the liberalizing GATT multilateral trading system. By the late 1970s the Japanese perceived they had caught up with the West. From 1980 Japan began to run global trade and current account surpluses, and by the mid 1980s had become the world’s largest creditor.

In the mid-1980s there was an explosion of Japanese FDI, initially mainly to the United States, but increasingly to Southeast Asia. Japan had lost comparative advantage – competitiveness – in labor-intensive manufacturing; even earlier, it had overcome Southeast Asian import barriers by investing directly. Following the establishment of NAFTA in 1992,

the 1997-98 Asian financial crisis, and the Doha Round debacle in Seattle in 1999, Japan expanded its essentially multilateral, WTO-based trade policy to bilateral FTAs (free trade agreements) or preferential trade arrangements. This gave Southeast Asian countries new importance for Japan; so, too, did the development of ASEAN+3 (China, Japan, South Korea) in the currency and financial policy domains.

Of course the story of this burgeoning economic relationship is not one-sided. As Southeast Asian economies developed and grew – each in its own way and its own pace – they became ever-larger trading partners with Japan. Most adopted the export-oriented development strategies that the Asian newly industrialized economies – Korea, Taiwan, Hong Kong, and Singapore – were so successfully implementing, also taking advantage of the GATT multilateral trading system for manufactured goods. Most overcame domestic anxieties and developed a willingness, and increasingly an eagerness, to accept and indeed attract Japanese and other FDI.

Japanese FDI in Southeast Asia was quite small until the mid-1980s, when it began to increase rapidly. Table 5 provides Ministry of Finance data on Japanese FDI by country since 1951 for three major time periods. The total direct investment flows to Southeast Asia amount to \$83.6 billion, most during the past 15 years. These are reasonable approximations of investment outflows for Japan, even through there are some data difficulties: not all these investments were carried through, and subsequent disinvestments and repatriation of capital have not been subtracted. The current market value of these business investments is substantially higher, perhaps double the recorded outflows.

Table 5: Cumulative Outflows of Japanese Foreign Direct Investment

Fiscal year, million dollars, U.S.

	1951-1980	1981-1990	1991-2004	1951-2004
Brunei	95	14	30	139
Cambodia		1	4	5
Indonesia	4,424	7,116	16,182	27,722
Laos		3		3
Malaysia	650	2,581	7,152	10,383
Myanmar		1	56	57
Philippines	615	965	6,051	7,631
Singapore	936	5,619	11,867	18,422
Thailand	396	4,026	13,353	17,775
Vietnam		6	1,483	1,489
Total	7,116	20,332	56,178	83,626

Annual data for 1991-2004 in 100 million yen were converted into million dollars using the average exchange rate for the fiscal year.

Data are for fiscal years, which end March 31 following the calendar year.

Source: <http://www.mof.go.jp/english/e1c008.htm>

Prior to 1980, FDI in Southeast Asia went primarily to Indonesia, and mainly for natural resource projects to export to Japan. Japan's trading companies have always played an important role. Over time Japanese companies invested increasingly in manufacturing activities, notably in Singapore and Thailand. Japanese FDI has gone overwhelmingly to five countries: Indonesia, Singapore, Thailand, Malaysia and the Philippines. It is indicative of the Japanese government's country-by-country approach that the Ministry of Economy, Trade and Industry refers to Singapore as one of the four Newly Industrialized Economies, and to the others as the ASEAN-4.<sup>10</sup> The large, dynamic increase in FDI beginning in the mid-1980s sharply slowed from 1998, initially due to the Asian financial crisis. While this brought about an initial reduction in Japanese direct investment to Southeast Asia, some diversion began earlier since Japanese FDI to China had already begun to increase significantly prior to the crisis. China was the largest Asian FDI recipient from Japan between 1993 and 1996. From the mid-1990s to 2003 China and Indonesia alternated as first and second largest national recipient globally of Japanese ODA. While Japanese investment in China also declined sharply following the 1997-98 crisis, from 2002 it has increased in amount and share. Japanese FDI in 2004 to China amounted to \$4.6 billion, and to all of Southeast Asia only \$2.8 billion. The decrease in Japanese investment flows to Indonesia, and the increases to Thailand and Singapore have been particularly significant.

The real story of FDI is much more micro than macro: how each Japanese company investing in Southeast Asia succeeds or not, what problems it faces, who its business alliances and relationships are with, and where Japanese ODA fits in. Most Japanese company investments are joint ventures or majority-owned subsidiaries, depending on the legal environment and norms of the host country. Historically, much of the investment has been in trade-related activities, involving Japanese general trading companies, but manufacturing now is the dominant sector, especially vehicles (autos, pick-up trucks, and their parts and components), and electronic goods and components.

Notable examples are the vehicle assembly plants that five Japanese firms have in Thailand, relying on parts produced throughout the region; some vehicles are exported to Japan. Matsushita has long had a major air conditioner production and assembly operation in Malaysia. Intra-Southeast Asian supply chains have become particularly important as trade barriers between ASEAN members have been reduced. Myriads of smaller Japanese

producers have shifted production to Southeast Asia. Many are parts suppliers following large Japanese assemblers, and others seek low-cost labor to produce goods for their distribution networks in Japan.

Since 1989 JBIC has annually carried out a detailed survey of the overseas production activities of Japanese manufacturing firms investing abroad by industry and country. The survey includes questions on evaluations of business preference; plans to increase, maintain, or decrease operations; assessments of risks; and a list of the 10 most-promising country prospects by the four major industry targets of FDI (chemicals, general machinery, electrical equipment and electronics, and automobiles). The 2004 survey appears in *JBICI Review* (2005).

JBIC, through its international financial operations programs, finances Japanese business investments and projects in Southeast Asian countries in a variety of ways. It provides export credits for Japanese company plant exports; co-financing for major electric power and other infrastructure projects; credit enhancement and country-risk reduction for Japanese affiliates in Southeast Asia; and guarantees for Japanese local-affiliate domestic currency bond issues (JBIC 2004, 2005). For example, in order to finance the local currency needs of Japanese subsidiaries and joint ventures in Thailand, in 2005 JBIC raised 3 billion baht (about \$25 million) in a bond issue and lent the proceeds to the three major Japanese banks operating in Thailand so they could make loans to local Japanese-related firms.

While each country and each company poses its own special problems, Japanese FDI in Southeast Asia (and indeed everywhere in the world) faces two important issues. To what degree is the parent company in Japan willing to delegate decision-making, and the attendant transfer of power, to local management from what typically is highly centralized control in Japan? How are local human resources developed, managed, and retained? It seems that, by and large, local blue-collar workers evaluate Japanese management quite highly; they appreciate the work environment and the application of Japanese values of hard work, diligence and on-the-job training. It is more difficult to provide adequate incentives, both financial and in terms of responsibility, for management and technical staff.

## **The Role of ASEAN in Japan's Relations with Southeast Asia**

ASEAN is the umbrella organization which agglomerates, negotiates about, and lobbies for the common economic and political interests of its 10 member states. Over the years ASEAN has played a substantial, contributory role in Japan–Southeast Asia economic relations, especially in the national policy dimensions. ASEAN has served to direct Japan's official development assistance attention to Southeast Asia as a whole. ASEAN has become even more important as Japan has shifted to a Southeast Asian policy of regional cooperation and strategic partnerships with ASEAN and its members.

Its ASEAN Free Trade Agreement (AFTA) has worked towards creating an attractive environment for Japanese companies seeking to achieve economies of scale and create intra-Southeast Asian supply chains, with final assembly in one country utilizing parts produced in other ASEAN countries. An important example is the truck and automobile industry. Parts and components are produced in Japanese subsidiaries or affiliates in Indonesia, Malaysia and the Philippines for assembly in Japanese plants in Thailand. Supply chains have heightened the visibility in Japan of Southeast Asia, and no doubt contributed to the Japanese ongoing decision to focus its ODA on Southeast Asia. ASEAN's efforts to achieve greater regional economic integration of its members have certainly been important in making Japanese FDI more attractive. Moreover, in considering currency and financial cooperation, without ASEAN there cannot be an ASEAN+3, now an important official policy dialogue forum for East Asia.

While Japanese ODA and FDI are driven mainly by conditions in, and relationships with, each member country, not by ASEAN as an organization, Japanese ODA policy is to promote ASEAN economic integration and intra-regional projects such as the Mekong Region Development program.<sup>11</sup> While Japan has been pursuing bilateral FTAs, first with Singapore (2002), then the Philippines, and now Malaysia, Thailand, and Indonesia, it has imitated China in pursuing discussions with the ASEAN secretariat for an ASEAN+1 FTA or similar preferential economic arrangement. However, Japan faces considerable difficulties in pursuing these approaches. Its strong protection of agriculture, forestry and fishing, and health care impede and constrain its FTA negotiations.

Private-sector, market-driven trade and investment, facilitated by ODA, have brought about great economic integration among the East Asian economies. This will persist and deepen as these economies continue to grow more rapidly than any other region in the world. Even so, how rapidly and how far cooperation among governments in financial and economic policy-making and institution-building develops remains to be seen. In some respects the December 2005 East Asian Summit meeting is indicative of the political difficulties the participants face.<sup>12</sup> “East Asian economic cooperation” today is a politically significant phrase, though its economic substance is not yet clear and uncertainties abound.<sup>13</sup>

### **Conclusion**

There have been cogent, valid criticisms of Japan’s ODA programs in Southeast Asia by both Japanese and Southeast Asian scholars (for example, Kawai and Takagi 2004). These include lack of program coherence, project inefficiencies, lack of post-project evaluations, lack of transparency, lack of coordination with other donors, and corruption in recipient countries. On the other hand, Ishikawa (2005) well makes the case that Japan’s model of ODA to Southeast Asia has been quite good. In a sense, this is the difference between macro and micro perspectives. There have indeed been many problems in Japan’s implementation of its aid program; that certainly is by no means unique to Japan. However, in terms of the overall strategy and effectiveness, Japan’s ODA program overall has made a good, positive contribution to the economic development of Southeast Asia.

In 2003 Japan's Ministry of Foreign Affairs announced a revised ODA charter. In addition to responding to criticisms, this was to address changing international realities, such as the focus on terrorism, conflict, poverty, and environmental issues. More importantly, it was intended to counter the successful domestic pressures to reduce ODA in light of Japan’s ongoing huge budget deficits.<sup>14</sup> Since the late 1990s, many Japanese have been asking: why should Japan’s foreign aid be the largest in the world, even surpassing the United States, when Japan has so many domestic economic and financial problems? The Ministry tried to justify maintaining ODA at the current levels by vigorously promoting ODA reform, with emphasis on transparency, efficiency, and public participation. The stated objective of ODA now is “to contribute to the peace and development of the international community, and

thereby to help ensure Japan's own security and prosperity.”<sup>15</sup> The new appeal to the Japanese public (taxpayers) is an emphasis on the importance of ODA in enhancing Japan's international relations and security.

It is the business community that sustains the government's desire to have a large and significant program. The close synergy between aid and Japanese economic interests is essential to the aid program because it justifies the program's size, nature, and extent. While much earlier on, Japanese companies obtained the bulk of the aid spending, it is now down to about 20% of loans, since loans are not tied to purchases from Japan. (Grants and technical assistance are.) Rather, Japanese businesses benefit from the close linkages at the micro level among aid, trade, and especially FDI in Southeast Asia. Moreover, the Japanese government is attaching increasing, and now significant, importance to the strategic dimensions of the relationship with Southeast Asia.

While the revised charter incorporates changes to specific features and implementation measures, there are major continuities in the underlying strategy for Japan's ODA program and its implementation. The ASEAN countries continue to be the top priority, and ASEAN itself is of some importance. Nonetheless, Japanese ODA net flows to Southeast Asia will continue to decline. The main reason is the stringent expenditure reductions the government has been imposing to solve its still huge budget deficit. The net ODA budget is being reduced 3% annually, though aid loan repayments enable the Japanese bureaucracy to provide somewhat larger gross flows. In addition, as the more advanced Southeast Asia economies continue to develop well, their need for official aid is lessened; they can now borrow in international capital markets. Accordingly, Japan can continue its gradual reallocation of aid to other, less developed countries and regions.

Japan's political and strategic objectives in Southeast Asia have become more complex as its economic and political relationships with China have evolved in recent years. In the 1990s Japan increased its ODA to China, even as Japan responded positively and constructively to the 1997 – 98 Asian financial crisis with more aid to Southeast Asia. Concurrently, Japanese companies began to invest significantly in China, probably also reducing new FDI in Southeast Asia. Japan's recent poor political relationship with China, despite the now immense and beneficial economic relationship, in some respects accentuates its rivalry with China for leadership in Southeast Asia. Japan is substantially reducing its



ODA to China, which will alleviate the need to reduce ODA to Southeast Asia. Probably Japanese multinationals will second-source their supply chains somewhat more in Southeast Asia, in part to reduce the political risk of sourcing in China and in part because production costs in China are rising.

It is difficult to know the degree to which ODA contributed directly and, perhaps more importantly indirectly, to Southeast Asia by enhancing trade, Japanese FDI, technology transfer, and capacity building. In any case, in a strategic sense, from Japan's perspective, its ODA to Southeast Asia has been very successful. The economies of the recipients have grown well. Political relationships are good; and the Japanese government has considerable influence in Southeast Asia, and so do Japanese companies. Despite all the problems and difficulties, the huge amount of Japanese ODA, and its synergies with trade and FDI, have served both Japan and Southeast Asia well.

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