Foreign Direct Investment in Japan's Foreign Policy: A Comparative Study of India and Indonesia

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CERTIFICATE

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TO

MY DEAREST

APPACHAN & AMMACHI

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ABBREVIATIONS

ADB	Asian Development Bank
APEC	Asia-Pacific Economic Cooperation
ARF	ASEAN Regional Forum.
ASEAN	Association of Southeast Asian Nations
EOI	Export-Oriented Industrialisation
EU	European Union
FDI	Foreign Direct Investment
FERA	Foreign Exchange Regulation Act
FIPB	Foreign Investment Promotion Board
GATT	General Agreement on Tariffs and Trade
GNP	Grows National Product
HMT	Hindustan Machine Tools
IDP	Investment Development Path
IMF	International Monetary Fund
IPE	International political economy
ISI	Import Substitution Industrialisation
JETRO	Japan External Trade Organisation
JIIA	Japan Institute of International Affairs
LCD	Less Developed Countries
MELCO	Mitsubishi Electric Company
MITI	Ministry of International Trade and Industry
MNC	Multinational Corporations
MRTP	Monopolies and Restrictive Trade Practices
MUL	Maruti Udyog Limited
NAFTA	North American Free Trade Area
NEP	New Economic Policy
NIE	Newly Industrialised Economies

NPT	Nuclear non-Proliferation Treaty
NRI	Non-Resident Indians
ODA	Overseas Development Assistance
OECD	Organisation for Economic Cooperation and Development.
OGL	Open General License
OPEC	Organisation of Petroleum Exporting Countries
PSE	Public Sector Enterprises
QR	Quantitative Restrictions
R&D	Research And Development
SAARC	South Asian Association for Regional Cooperation
SAP	Structural Adjustment Programme
SCAP	Supreme Command for Allied Powers
SDF	Self Defence Force
SEATO	Southeast Asian Treaty Organisation
SOE	State Owned Enterprises
UN	United Nations
UNSC	United Nations Security Council.
WTO	World Trade Organisation

PREFACE

Foreign policy and its major instrument, diplomacy, is an area of activity of a state through which it relates to international environment. It is predominantly circumscribed by the economic motives for which states are undertaking relationships to take comparative advantage. Indeed, economic diplomacy is at the centre stage in the foreign policy arena that is materialised by means of trade, aid and investment. Political animosities and regional tensions were giving way for economic cooperation and regional integration.

The second half of the twentieth century was an era of global economic growth. Waves of technological innovations and their rapid diffusion around the globe had a tremendous impact on the world economy. The developed countries poured direct investment to the developing nations by which they achieved remarkable economic growth. The triad, USA, Western Europe and Japan dominated this process and each one of them sought to increase their presence in their neighbouring regions i.e., USA in the Latin American region, Western Europe in the East and Central Europe and Japan in the Asia-Pacific region. Viewed under this circumstance, Japanese foreign direct investment (FDI) was the most conducive factor of the economic success of the East and Southeast Asian region in the latter part of the Twentieth century.

Some commentators argued that, the attention of the international community would go to the Asia-Pacific from the Western Europe in terms of dictating international political and economic issues. The astounding economic success of the Asia-Pacific region and Japan's increasing role in the region as a major creditor and investor and its contribution to ensuring international peace and stability has brought credence to this argument. At the same time the way of achieving regionalism and regional security in the Asia-Pacific is quite different from the Western approach. In this region countries were sought to achieve regional integration and security through economic cooperation by means of promoting intra-regional trade and direct investment rather than arriving at collective security among the regional countries. For this, Japan took the leadership role in creating peace and stability in the region.

The end of the Cold War changed the political landscape of Asia. During the early 1990s the India and other South Asian countries began liberalisation by emulating the success of the Southeast Asian countries through implementing export led industrial strategy. This policy initiative came into effect under the 'Look East policy' which helped India to integrate into the Asia-Pacific region. At the same time Japan identified South Asia and Southeast Asia as the strategically important regions in Asia, particularly after the 1991 Gulf crisis that disrupted the oil passage to Japan from the Middle East.

Chapter I

Introduction

The level of economic development of a society characterises its role and behaviour in international politics in the contemporary world.[1] The economic motives of a country often determine the rational choice of decision-making in the foreign policy arena. Many scholars have recognised the relevance of economic factors in the formulation of foreign policy and have drawn attention to its importance in terms of national resources and strength. But at the same time they have emphasised its significance as a cause of international conflict. Many wars and conflictual situations in the international system can be seen as a result of the quest for markets and profitable investments by nation-states. When wars failed to achieve this end, peace treaties were concluded to reach this objective. In this respect the dichotomy between political and economic aspects provides international relations with a much more complex perspective. The political imperatives of today might lead to economic consequences of far-reaching significance tomorrow or, for that matter, economic priorities fulfilled today might lead to a far significant political pattern in the future.

The astounding economic growth of the Asia-Pacific countries in the latter part of the twentieth century has been the object of attention around the world. The countries of this region have achieved these growth rates by attracting foreign direct investment (FDI) to accelerate domestic economic development. Japan is by far the most important investing country in the Asia-Pacific region. The Japanese investment spurt towards this region started in the 1970s in order to secure cheap natural resources and raw materials. Japan was also interested in reclaiming its

[1] Anna K. Dickinson, *Development and International Relations: A Critical Introduction*, Cambridge, Polity Press, 1997.

economic and political position in Asia. Tokyo has actively promoted foreign direct investment as a means of securing or reinforcing its strategic market and has used FDI as a tool of foreign policy to maintain good relations between Japan and the host country.

In Western Europe, countries sought to achieve peace and stability by means of collective security through joining military pacts at the regional level. In the Asia-Pacific region there are no such formal military alliances. Instead, the regional countries came together through economic cooperation, which has led to political stability, and economic growth. For these countries, economics dominates politics while dealing with other countries. This economic linkage was made possible mainly through the cross-border activities of direct investment, which were mainly dominated by Japan. Japan considered it as its own responsibility to maintain a healthy environment for the free flow of FDI towards the Southeast Asian countries. In this manner, harmonious relationships have been established, both between the investing country and the host country and among the regional countries themselves.

In the late 1960s, Japan realised that the Southeast Asian region was a strategic location for it to acquire natural resources that were necessary to feed its domestic industry and also as a market for its goods and services. Japan emerged as an economically powerful country and its technology and capital goods permeated the whole world during the 1970s. At the same time, Japanese dependency on developing countries for raw materials and natural resources has increased in a significant manner. The collapse of the Bretton Woods economic system and the 1973 oil crisis followed by the protectionist measures adopted in Western Europe aggravated the economic situation in Japan. The relationship with resource-rich Southeast Asian countries regained prime importance during this period. However, the lingering sentiment against the imperialist policies pursued by Japan during the World War II period in Asia created suspicion and scepticism about the Japanese investment policies among the regional countries. Besides, the vacuum created by the withdrawal of US forces from the Southeast Asian region led to the spreading of political instability and possible communist insurgencies within the region. In response to these developments, Japan has turned to Asia as a hegemonic economic partner and as a voice of Asia in various international bodies like the G-8 and the Organisation of Economic Cooperation and Development (OECD).

Many of the Southeast Asian countries, notably Indonesia, Malaysia, Thailand and Singapore have achieved high levels of economic growth during the 1980s, mainly due to the higher rate of Japanese FDI. These countries adjusted their economic policies in order to attract Japanese investment by which they could manage to overcome their economic backwardness. In turn, this economic progress led to the establishment of domestic political stability and regional order. The healthy economic and political interaction continued till the mid-1990s, when Japan was confronted with economic recession in its domestic economy. At the same time the 1997 East Asian financial crisis culminated in the collapse of many of the economies in the region. As a consequence, Japanese FDI declined compared with the investment of other countries into the region. With this background, the present study is mainly focused on the 1980-1996 period.

At the same time, during this period Japan's relations with South Asia have increased significantly. India began to liberalise its economy in the early 1980s in order to recover from a foreign exchange crisis. It was during this period that the worldwide flow of FDI has increased from the developed countries towards developing countries. The appreciation of the Yen that occurred after the Plaza Accord has compelled Japan to relocate many of its industries to other Asia-Pacific countries and India was not left outside of this Japanese FDI boom.

With the promulgation of the New Economic Policy in 1991, India anchored its liberalisation process with the aim of attracting FDI and steering its economic growth under the leadership of Prime Minister Narasimha Rao. The liberalisation policy has also influenced India's foreign policy. The collapse of the Soviet Union forced India to find new friends and economic partners to achieve its long-term economic and political aspirations. This drive led to the successful implementation of the 'Look-East' policy in the 1990s, which incorporated India into the Asia-Pacific economies. However, the successive governments that followed the Rao regime could not continue the pace of this policy. Moreover, the recession in the Japanese economy and the East Asian financial crises has also affected India-Japan relations in the late 1990s.

Economic Issues and Foreign Policy

The problem of economic issues in international relations has been analysed by different theorists differently. Some of them have looked at the regular pattern of relations between economic structures of production, investment and consumption, and their implication on foreign policy. On the other hand, other scholars have analysed specific economic issues such as inflation or the stability of exchange rates, raw material prices and so on, all of which penetrate and challenge the foreign policy system. The question can be analysed at the macro level. It assumes that one analyses relations between economic and political systems as a whole. Arguments of this type are essentially determinist in nature. The second option is looking at the micro level. It assumes a more specific approach. Both questions suggest areas where the economic contexts in foreign policy play an important role in affecting the performance of the international politics.

There is a broad economic context for foreign policy making which links both domestic and international processes. International monetary instability, problems of trade-management, the growth of protectionism, and the search for markets and raw materials are just a part of this context. The advanced industrialised countries addressed the domestic issues of the control of inflation and unemployment, the search for investment and the control of money supply by making sound foreign economic policy.[2] Chris Ferrands argues that the economic context of foreign policy making has changed in the last century in three major respects. Firstly, the international economic system that emerged at the end of the Second World War, the so-called Bretton Woods system, has become increasingly fragile. Secondly, domestic economies are invariably difficult to manage and there are increasing doubts about the value of Keynesian directives for economic management. Thirdly, the growth of a complex pattern of interdependence has led to a marked increase in the economic context of foreign policy analysis. And lastly, the

[2] Charles Reynolds, *Theory and Explanations in International Politics*, London, Martin Robertson, 1973.

era of globalisation has inextricably linked the complexities of economic issues in the making of foreign policy. [3]

In the early part of the twentieth century, authors like Hobson[4] and Lenin[5] suggested that international conflicts, and the foreign policies which bring them about, are the direct result of specific patterns of economic relations, competition for markets and the search for profitable investments. Hobson's argument directly related the surge of imperial expansion on the part of the European states to the Asian and African countries to economic causes. According to Hobson, a new phenomenon had appeared in the economies of the most advanced industrialised countries towards the latter part of the ninetieth century. This was the appearance of surplus capital arising out of the concentration of production exercised by the formation of the trust capitals.[6] He argued that international economic relations could be understood through the same laws of economics as applied to the domestic economy because interdependence meant that there was increasingly one single global economy rather than a series of separate natural economies.[7]

On the other hand, Lenin placed his emphasis not simply on the actual territorial expansion of the major European empires, but on a general explanation of international politics. Unlike Hobson, Lenin was influenced by the First World War, which was an imperialist war among the capitalist powers, who were anxious for

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[3] Chris Farrands, 'The Context Of Foreign Policy System', in Michael Clark and Brian White (eds.), *An Introduction to Foreign Policy Analysis*, New York, Ormskirk, 1981, p. 45.

[4] J. A., Hobson, *Imperialism: A Study*, London, Allen And Unwin, 1968 (VIII Edition).

[5] V. I. Lenin, *Imperialism: The Highest Stage of Capitalism,* New York, International Publishers, 1939 (IV Edition).

[6] David Long, *Toward A New Liberal Internationalism: The International Theory of J A Hobson*, Cambridge, Cambridge University Press, 1996, p. 164.

[7] Ibid, p. 123.

'the division of the world, for the partition and repartition of colonies, spheres of influence of finance capital.'[8] According to Lenin, countries were striving to create monopolies, and the appearance of finance capital-dominated economy created a drive to maximise profits and to utilise surplus capital through foreign investment.[9] The national economy thus expands internationally and this expansion leads to an expansion of political control over other countries and other territories. Such control is necessary, according to this argument, firstly, to protect and promote investments, and secondly, to prevent other competitors from doing the same. Hence international conflict is endemic and this competition between monopolies for ever-larger markets and investment opportunities. The real cause of war, as of more conflict between capitalist powers, were thus economic not political.

Lenin's argument has, therefore, a wider significance than that of Hobson, since it provides a general explanation of wars, and conflict for economic motives between major powers. These competing empires are motivated by similar lust of political aggrandisement and commercial gain, which then translates into territorial expansion.[10] This process begins with the concentration of national capital into national monopolies, with bank capital merging with industrial capital to become finance capital.[11] From this national economic base the monopolies expand into international cartels which then divide the world into spheres of economic territory. This is then translated into the actual territorial division of the world between the great capitalist powers. This division eventually turn into conflict and war in order to

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[8] Lenin, *Imperialism,* op cit, p. 9.
[9] Ibid.
[10] Ibid, p. 92.
[11] Ibid, p. 50.

achieve a complete monopoly.[12] Wars can therefore be explained by the attempts of capitalists in the final development of capitalism i.e. imperialism, to redistribute the economic territories of the world. These economic territories are not simply colonies, but according to Lenin are dependent units enmeshed in the net of financial and diplomatic dependence.[13] The nature of this dependence is the crucial issue in the analysis of economic factors in international political relations.

Some writers have criticised this argument on the grounds that it is 'empirically unsound as an explanation of colonial expansion in the late nineteenth century'.[14] They point out that while foreign investment was indeed significant in this period, its direction was between the major capitalist powers and not between the capitalists and the non-capitalist countries. In short, colonial expansion cannot be explained on this argument because the colonies did not receive the bulk of capitalist investment during this period.[15] It can be argued that, the crux of this theory is the domination of the economically developed countries by finance capital and, from this, the domination of the rest of the world by finance capitalists. It is true that Lenin conceived of backward countries as receiving such investment but these were nominally sovereign states, not colonies, and the whole point of his argument is that the economically advanced states competed for control and monopoly over the less advanced countries. The consequent imperial hegemony was an 'invisible' one.[16]

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[12] Ibid.

[13] Ibid, p. 85.

[14] Charles Reynolds, *Theory and Explanations in International Politics*, op cit, p. 270. For further details see, D.K. Fieldhouse, 'The New Imperialism: The Hobson-Lenin Thesis Revised', in George Mandal and Perry Curtis (eds.), *Imperialism and Colonialism,* London, Macmillan, 1964.

[15] Lenin, *Imperialism: The Highest Stage of Capitalism,* op cit, p. 63.

[16] Charles Reynolds, *Theory and Explanations in International Politics,* op cit, p. 222.

However, some the post-World War international politics analysts suggest a revised version of Lenin's theory of imperialism known as neo-colonialism. The underlying factor in this period is that the great colonial empires collapsed and were replaced by an 'informal' empire governed by the capitalist powers. The dominance of these economic powers has been considered by some commentators to be a device which maintains both political and economic dependence without incurring social and other responsibilities. The Third World depends on the West for capital and technology. At the same time they are rich with natural resources and also are potential markets. This relationship between developed and developing countries has made significant changes in the traditional foreign policy system.

Nevertheless, the neo-colonialist argument tends to concentrate on relations between the developed and underdeveloped countries, not specifically on those between the former colonial rulers and the ex-colonies.[17] The emphasis is on relations between capitalists and non-capitalists or the peripheral world, excluding the Communist states. The neo-colonialists conceived that the capitalist world is united in exploiting the non-capitalist countries (the developing nations) rather than in fighting over the spoils. This thesis mainly emphasises that foreign policy and political relationships are primarily motivated by economic factors directly related to capitalism. As one commentator puts it, 'the most important branch of the theory of neo-colonialism is... the theory of economic imperialism, which he defines as the economic domination of one region, or country, over other.'[18] According to this

[17] For details, see Charles P. Kindleberger, *Power and Money*, London, MacMillan, 1970, George Lichtheim, *Imperialism*, London, Penguin Press, 1971, Kemp, *Theories of Imperialism*, London, Dobson, 1967.

[18] Charles Reynolds, *Theory and Explanations in International Politics,* op cit, p. 227.

argument, the economic domination and hegemony of developed countries over the under developed world are increasingly tangible in the international system.

Dependency theorists such as A.G. Frank have seen underdevelopment as a process, which has increased dependency of poor countries in the international system.[19] Frank argues that this results from the dominance of the major capitalist states, above all the United States. This dominance has materialised through the aid and developmental assistance that may be regarded as political objectives by which the developed countries are able to maintain an independent foreign policy. He suggests that in order to achieve freedom from this dominance these countries have to unleash fundamental changes in the domestic economy which are under the influence of the international capitalist system.[20] During the 1950s and 1960s many of the developing countries had formulated the foreign policies according to the economic aid and assistance received from the First World.

The interaction of politics and economics in international relations, of the economic aspects and political aspects of the international system, goes on all the time. The interaction is necessarily understated, if not completely ignored, by political scientists who construct purely economic theories about the international system. The oversimplified construction of the influence of the supposed international system on the supposed international economic system is more or less static.[21] This spurt of rapid or radical change in either of the systems registers the

[19] A.G. Frank, *Latin America: Underdevelopment or Revolution,* New York, Monthly Review Press, 1969.

[20] Ibid, p. 78.

[21] Susan Strange, 'International Economic Relations: The Need for an Interdisciplinary Approach' in Roger Morgan (ed.), *The Study of International Affairs: Essays in Honour of Kenneth Younger*, London, Oxford University Press, 1972, p. 54.

nature of its influence over–and its interaction with–the other needs careful assessment. Then, the shape of the resulting international political economy has altered the earlier theories, political and economic, which resulted in the nature of the relationship between economic forces and political authorities and their respective interests.[22] In this way, these developments in the political economy require new efforts and understanding in the foreign policy system.

It can be argued that the shape of the future political relations between states will be based on the increased demands of communication and rapid technological change on the economic system. The accelerated pace of technological change and growth in world economy and its structures, economic techniques, and economic capacities for production, distribution, and finance has made to some extent, the interdependence between the political and economic interests in the international system.[23] The steady expansion of the international market, the growth of international production to cater to the market, and of international finance to cater to the international producers, has inevitable effects on the internal tasks and policies of individual national governments, as well as on their external relations with one another.[24]

Furthermore, the field of foreign policy analysis is not just the study of the policies and attitudes of single states but also of groups of states, which involves considering the dominant economic issues of trade policies, the balance of payment problems, and monetary concerns or the investment interests of the states. In order to

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[22] Ibid, p. 68.
[23] Ibid.
[24] Ibid.

address these issues countries have formed regional groupings such as the European Union, ASEAN and North American Free Trade Area (NAFTA), and formed multilateral institutions like Organisation of Economic Co-operation and Development (OECD), World Trade Organisation (WTO) and International Monetary Fund (IMF) during the latter part of the twentieth century. Geoffrey Godwin has identified 'five striking lacunae in the area of foreign policy analysis, that merit early attention. These five lacunae are; the threat to economic solvency represented by large and/or persistent payments deficits; the interaction of monetary policy on foreign policy; the political implications of creditor-debtor relation, and the motivations of 'economic penetration' of weaker states by stronger ones; and, finally, the political importance to be attached to the growth of inter national business'.[25] These developments in the world economy and its influence on political field have made necessary to development of a new approach in international relation: the International Political Economy approach.

International Political Economy

International political economy (IPE) is both an area of study–a range of issues and problems–and a way of thinking about world politics and economics.[26] The IPE approach emerged as a theory in international relations in the late 1960s and 1970s. The international economic issues such as the collapse of the Bretton Woods system, worldwide inflation, and the 1973 oil crises led to fundamental changes in economic

[25] Strange, 'International Economic Relations', op cit, p. 76.

[26] Roger Tooze, 'International Political Economy in an Age of Globalisation' in John Baylis and Steve Smith (eds.), *The Globalisation of World Politics: An Introduction to International Relations*, Oxford, OUP, 1997, p. 214.

relations among nations. Besides, the developed countries faced vulnerability of raw material prices while some of the raw material exporting countries achieved remarkable economic growth during this period. Subsequently the market-based economy has developed in the Western world. This increasing nature of 'market economy' in the international system constitutes some political rules and regulations on market function that necessitates the interaction between politics and economics in international politics.[27] In a way the political influences affect economic interactions particularly in shaping the composition and magnitude of trade and investments. The balance of payments and adjustments have affected the relations between nation-states. It is this complex interplay in the international contexts between politics and economics, between states and markets which is the core of IPE.

The study of IPE has become a recognised and respected research speciality in Western academics circles since the 1970s. Some of the earliest contributions were made by economists, including most notably Richard Cooper[28] and Charles Kindelberger.[29] Most of the work in recent years, however, has been political scientists, like Robert Gilpin,[30] Susan Strange,[31] Joan E. Spero,[32] and Robert

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[27] Nazli Choucri, 'International Political Economy: A Theoretical Perspective', in Ole R. Holsti, Randolf M. Siverson and Alexander L. George (eds.), *Changes in the International System*, Boulder, Westview, 1980, p. 103.

[28] Richard Cooper, *The Economics of Interdependence*, New York, McGraw Hill, 1968.

[29] Charles Kindelberger, *The World in Depression, 1929-39*, Berkeley, California University Press, 1966.

[30] Robert Gilpin, *The Political Economy of International Relations,* Princeton, Princeton University Press, 1987.

[31] Susan Strange, *States and Market: An Introduction to International Political Economy*, London, Frances Pinter, 1988.

[32] Joan Spero, *The Politics of International Economic Relations,* London, Allen and Unwin, 1990.

Keohane.[33] There are also several important series in political economy, such as ; the Cornell Series edited by Peter Katzenstein, the Columbia Series edited by John Ruggie and Helen Milner, the Macmillan Series edited by Tim Shaw, and *The International Political Economy Year Book* produced under the auspices of the International Political Economy Group of the International Studies Association (North America). A new journal, the *Review of International Political Economy* has been published from the UK since 1994.

While there is no generally agreed definition of the term IPE or any accepted methodology, it reflects certain values and perspectives. It assumes two major inter-connections. First, politics and economics are inseparable -- politics can only be understood if economics is taken into account, and vice versa.[34] Politics constructs economics at the same time as economics constructs politics. This perspective explores IPE as the relationship between power and wealth. The other assertion of an interconnection comes from the interface between the study of International Relations and Economics. This argument is that the extent and depth of the interdependence– created through a transitional economic process that cut across state boundaries, increased trade, multilateral investments, membership of regional economic groupings, and the process of globalisation–has effectively joined national societies and domestic economics together to the international system.[35]

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[33] Robert Keohane, *After Hegemony: Co-operation and Discord in the World Political Economy*, Princeton, Princeton University Press, 1984.

[34] Richard Higgot, 'International Political Economy' in A. J. R. Groom and Margot Light (eds.), *Contemporary International Relations: A Guide to Theory*, London, Pinter, 1999, p. 157.

[35] Tooze, 'International Political Economy in an Age of Globalisation' op cit, p. 215.

As Gilpin says, IPE is 'the reciprocal and dynamic interaction in international relations in the pursuit of wealth and the pursuit of power'.[36] It says that the relationship between the state and market is fundamental to any understanding of the issues involved in economic and political change in the realm of international affairs. This argument is mainly focussed on an international regime based on the hegemonic leadership of the United States and to establish liberal international economic order.[37] While, on the other hand, according to Susan Strange, IPE is bounded by a mix of values (security, wealth, freedom and justice) within a market authority relationship that affects the structure of power in the world economy.[38] Strange argues that although the US hegemony has prevailed, its ability to enforce liberal economic order has been vanishing.

Important historical and structural changes have also affected the evolution of IPE in the post-World War II period. Many political measures taken by the US have changed the rules of the game for the economic market place. In times of economic crisis, it usually becomes clearer that politics and economics hang together. The process of decolonisation had created a new group of politically weak and economically poor states–the Third World countries–in the international system. Most newly independent countries were far from satisfied with their subordinate position in the international economic system. At the UN, during the 1970s they called for a 'New International Economic Order', i.e., political proposals designed to improve the economic position of Third World countries in the international system.

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[36] Gilpin, *The Political Economy of International Relations,* op cit, p. 43.
[37] Ibid.
[38] Strange, *States and Market,* 1988, op cit, p. 35.

Finally, the growth of advanced economies such as North America, Western Europe, and Japan and the political and economic integration in various parts of the world has given a great impetus to the expansion of the IPE.

In summary, there is a complex relationship between politics and economics, between states and markets that international relations have to deal with. This relationship can be analysed on the basis of different sets of themes, Mercantilism, Economic Liberalism, and Marxism. These are 'theories' in the very broad sense of a set of assumptions and values from which the field of IPE can be approached. As will be apparent, the outlook of mercantilism has much in common with realism that has developed principally in the United States. The second section considers important non-US developments affecting the authority outlined in the first section. It does so by highlighting the substantive changes taking place in the structure of global economy, especially the process of globalisation and their implications for the study of IPE. It considers the development of a 'counter hegemonic' international political economy throughout the 1980s and early 1990s. And, lastly, Marxism has its own original theoretical position.

Mercantilism: The notion of mercantilism is intimately connected to the establishment of the modern, sovereign states during the sixteenth and seventeenth centuries. It took the view that economic activity is and should be subordinated to the primary goal of building a strong state. In other words, economics is a tool of politics, a basis for political power. Mercantilists see the international economy as an area of conflict between opposing national interests, rather than an area of cooperation and mutual gain.[39] In brief, economic competition between states is a zero-sum game where one state's gain is another state's loss.

Economic rivalry between states can take two different forms. The first is defensive or 'benign' mercantilism: states look after their national economic interests because they are an important ingredient in their national security: the preponderance of material resource to establish hegemonic stability.[40] The other form, however, is aggressive or 'malevolent' mercantilism. Here states attempt to exploit the international economy through expansionary policies: comprising of raw materials, markets, and capital as well as 'competitive advantages in the production of highly valued goods ... involving the use of complex or new technology.[41] Mercantilists see this economic strength and military-political power as complementary, not competing goals again in a positive feed back. The pursuit of economic strength supports the development of the state's military, and political power can enhance and strengthen the state's economic power.[42]

Mercantilists maintain that the economy should be subordinated to the primary goal of increasing state power: politics must have primacy over economics. But the content of the specific policies recommended to serve that goal has changed over time. The earlier mercantilists advocated trade as the road to national prosperity.[43] Ever since Britain obtained a leading role in world politics through

[39] Robert Jackson and George Sorenson, *Introduction to International Relations*, Oxford, OUP, 1999, p. 178.

[40] Anthony Pyne, 'The New Political Economy of Area studies', *Millennium Journal of International Studies*, Vol. 27, No. 2, 1998, p. 253.

[41] Ibid.

[42] Jackson, *Introduction to International Relations,* op cit, p. 179.

[43] Ibid, p. 180.

industrialisation, mercantilists have underlined the need for countries to industrialise, as it is the best way to obtain national power. Alexander Hamilton, one of the founding fathers of the United States, enunciated mercantilism in the form of protectionist policies aimed at promoting domestic industry in the US.[44] Recent mercantilist thinkers focus on the successful 'developmental' states in East Asia: Japan, South Korea and Taiwan. They emphasise that economic success has always been accompanied by a strong, commanding role for the state in promoting economic development.[45]

Economic Liberalism: Economic liberalism emerged as a critique of the comprehensive political control and regulation of economic affairs which dominated European nation-state building in the sixteenth and seventeenth centuries. Economic liberals reject theories and policies which subordinate economics to politics. Classical economic liberals like Adam Smith and Riccardo believed that markets tend to expand spontaneously for the satisfaction of human needs; provided that governments do not interfere. According to them free trade–i.e., commercial activities that are carried on independently of national borders–will bring benefits to all participants because free trade makes specialisation possible and in turn increases efficiency and productivity.[46] The key notion of this argument is that the economic market place is the main source of progress, co-operation, and prosperity. Political

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[44] Jackson, *Introduction to International Relations* ,op cit, p. 180.
[45] Ibid.
[46] Ibid, p. 182.

interference and state regulation, by contrast, is uneconomical, retrogressive and can lead to conflict.[47]

Liberal economics has been called 'a doctrine and a set of principles for organising and managing economic growth, and individual welfare.'[48] It is based on the notion that if left to itself, the market economy will operate spontaneously according to its own mechanisms or laws. These laws are considered to be inherent in the process of economic production and exchange. They thus reject the mercantilist view that the state is the central actor and focus when it comes to economic affairs. The market system is growing according to the rational choice of the consumer-individual. Economic exchange in the market is a positive-sum game; everybody gains more than they put it in. Individuals and companies would not be active in the market place unless it was to their benefit. The road to human prosperity, then, goes through the unfettered expansion of free market capitalism, not only in each country but also across international boundaries. Liberals thus reject the mercantilist zero-sum view that one state's economic gains are necessarily another state's economic loss.[49]

However, there is a recurring debate among economic liberals about the extent to which political interference by governments may be necessary. The 'laissez-faire' (early economic liberals) argument suggests freedom of the market from all kinds of political restriction and regulations. In a similar view, second generation economic liberals emphasised that the state shall set up some minimal

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[47] Gilpin, *The Political Economy of International Relations,* op cit, p. 30.
[48] Ibid, p. 27.
[49] Ibid, p. 32.

underpinnings that are necessary for the market to function properly.[50] This version of economic liberalism seeking to minimise state interference can be called 'conservatism' or neo-liberalism. Thatcherism in Western Europe propounded this argument in the 1980s.

Economic liberals have from early on been aware that in some cases the market may not work according to expectations of efficiency and mutual gain: such cases are usually called instances of 'market failure'. Political regulation may be necessary to correct or avoid market failure. Some economic liberals thus argue for a larger degree of state interference to the market. J.M. Keynes argued that to escape the evils of market political management of the market is necessary.[51] These ideas paved the way for significantly reformed liberal thinking which remains based on a market economy, but one with considerable degree of state interference and direction. That Keynesian view was popular in Europe in the decades following the Second World War. 'Thatcherism' in the 1980s in the Europe followed by economic globalisation has grown on the basis of these neo-liberal principles.

Marxism: As discussed earlier, the Marxist orientation imparts primacy to the economic factor in both national and international policies. Marx rejects the view of the economic liberals and argued that economy is a site of human exploitation and class inequality. Marx agrees with mercantilists that politics and economics are closely intertwined: both reject the liberal view of an economics sphere operating under its own laws. But where mercantilists see economics as a tool of politics, Marxists put economics first and politics second. For Marxists, the capitalist

[50] Ibid, p. 45.

[51] Ibid.

economy is based on the relations of production between two antagonistic social classes: the bourgeoisie, which owns the means of production; the other, the proletariat, with its labour power, which it must sell to the bourgeoisie. According to Marx, the capitalist economy controlled by the bourgeoisie is exploitative in nature, but Marx did not see the growth of capitalism as a negative or retrogressive event. On the contrary, capitalism means progress for mass in two ways; it increased the dignity of human relationship by destroying feudalism, which was even more exploitative in character, and second, and most important for Marx, capitalism paves the way for a socialist revolution where the means of production will be placed under social control for the benefit of the proletariat, who are the vast majority.[52] That is the revolutionary goal that Marxist economic thought is aiming at.

The Marxists view 'materialism' as the core activity in any society in which human beings produce with their means of production. Economic production is the basis for all other human activities, including politics. The forces of production (the technical level of economic activity) and the relations of production, (the system of social ownership which determines the actual control over the productive forces) come together in capitalist society, which is based on industrial machinery and private ownership.[53] Thus, the bourgeoisie, which dominates the capitalist economy through control of the means of production, will also lead to dominate in the political sphere too.

This brings us to the Marxist framework of the study of IPE. To begin with, states are not autonomous: they are driven by ruling-class interests, and capitalist

[52] Ibid.

[53] Fred Halliday, *Rethinking International Relations*, Vancouver, UBC Press, 1994, p. 60.

states are primarily driven by the interests of their respective bourgeoisie. That means struggle between states, including wars, should be seen in the economic context of competition between the capitalist class of different states. For Marxists, class conflict is more fundamental than conflicts between states. Second, as an economic system, capitalism is expansive, always on the search for new markets and more profits. Because classes cut across state borders, class conflict are not confined to states; instead it expands around the world in the wake of capitalism.[54] Such expansion first took the form of imperialism and colonisation, but it continues after the colonies have been granted independence. It now takes the form of economic globalisation led by giant transnational corporations (TNCs). The history of IPE can thus be seen by Marxists as the history of capitalist expansion across the globe.

The neo-Marxist interpretation of IPE emphasised that the capital system itself determines the political relations between nations. The prominent neo-Marxists like Immanuel Wallerstein[55] place much emphasis on the world economy and tend to disregard international politics. Wallerstein's conception of the world economy is of an unequal development which has produced a hierarchy of core, semi-periphery and periphery.[56] The wealth of the core zone (Western Europe, North America and Japan) has been generated at the expense of the peripheral zones (the Third World). Wallerstein sees the end of the cold war and the destruction of the Soviet bloc as a consequence of the development of capitalist world economy.[57] According to Robert

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[54] Ibid.

[55] Immanuel Wallerstein, *The Capitalist World Economy: Essays*, Cambridge, Cambridge University Press, 1979.

[56] Ibid, p. 78.

[57] Ibid.

Cox, in the post-war political system led by the US, profound transformation have been taking place in three areas.[58]

> First, there is economic globalisation linking what used to be national economies together in a dense of global network. The world economy is increasingly globalised, but it is also increasingly hierarchical because economic power is concentrated in the core. Second, states are of diminished importance compared to non-territorial, political-economic power, such as transnational corporations (TNCs). That may spell the end of the Westphalian system of nation-states; at the very least, international governance by states is challenged and perhaps undermined by increasingly autonomous market force. And, third, a more equal and democratic order is possible, provided that government supported by the popular majority can regain control over the economy for the benefit of welfare purposes.[59]

The Marxist approach may be summarised thus: The economy is a site of exploitation and inequality between social classes, especially the bourgeoisie and the proletariat. Politics is to a large extent determined by the socio-economic context. The dominant economic class is also dominant politically. This approach emphasises that politics is the history of global capitalist expansion, the struggle between classes and states to which it has given rise around the world.

In this respect, the theoretical contribution of IPE to the contemporary international relations has based on two main contributions made by Robert Gilpin and Susan Strange. Gilpin employs all three perspectives but places his main emphasis on mercantilism. According to his argument, 'the world economy should be understood in hierarchical terms with wealthy core zones (comprising Western Europe, North America and Japan) and poor peripheral zones (the Third World

[58] Robert Cox, 'Global Restructuring: Making Sense of the Changing International Political Economy' in R. Stubbs and G.R.D. Under Hill (eds.), *Political Economy and the Changing Global Order*, London, Macmillan, 1994, p. 54.

[59] Robertson, *Introduction to International Relation,* op cit, p. 187.

countries)'.[60] His mercantilist approach is well suited to study the politics surrounding economic activity. This approach reflects his underlying premise that states and their political-military power are more important in IPE than other forms of power, including economic power. Gilpin makes the mercantilist claim that a liberal international economy can function only when it is backed by a leading political power, a so-called 'hegemon'. According to him, a hegemon, a dominant military and economic power is necessary for the creation and full development of a liberal world market economy, because in the absence of such power, liberal rules cannot be enforced.[61]

On the other hand, Susan Strange rejects the priority of states and political-military forms of power in the international economic order. She does not give priority to either politics or economics; instead, she assigns equal importance to both. Her aim is to analyse four related dimensions of structural power, that is, power to shape and determine those political and economic frameworks within which states, companies, and individuals have to function.[62] The four types of structural power are security (political-military power), production, knowledge and finance. Each of these structures 'affects the other, but none necessarily dominates'.[63] Each can be studied in its own right as well as in its relationships to others. Strange attempts to draw all these issues in an overall framework and gives equal importance to all factors. Strange's argument leaves us with a huge research

[60] Gilpin, *The Political Economy of International Relations,* op cit, p. 83.
[61] Ibid.
[62] Strange, *States and Market*, op cit, p. 24.
[63] Ibid, p. 27.

territory of IPE, where only small parts have been covered: many important questions remain unanswered.

This IPE approach to the study of international relations has given much emphasis on the foreign policy analysis in the economic relations between nations. Since the 1970s, the issue of direct investment emerged as a significant aspect in international politics. The importance of regionalism in global politics that materialised through intra-investment by large corporations within the regional framework has necessarily taken into consideration the multilateral investment in foreign relations between nations. More and more advanced economic activities take place among the most developed regions of the world in the field of technology and socio-cultural integration. The less developed countries are left far behind. Thus, national economies outside the triad of North America, Western Europe and East Asia are increasingly marginalised from the process of wealth creation; these countries have to depend on the triad for their economic development. Presently this process of economic concentration dominates the management of the world political economy, which in turn is dominated by direct investments. Thus it is imperative to understand the role of foreign direct investment (FDI) in the study of IPE.

Foreign Direct Investment

It is now widely recognised by policy makers that the potential benefits of foreign direct investment can spur economic development and growth in the host country. Foreign direct investment is perceived as a key vehicle to obtain foreign technology, managerial skills and other vital resources; to integrate into international marketing distribution and production networks; and to improve international competitiveness of firms and the economic performance of countries.[64] Governments strive to create a favourable climate to attract FDI by establishing an enabling framework. They promote macro economic stability, reduce trade barriers and carry the principal weight in industries' location decisions. The host country's government guarantees the liberalisation of FDI by reducing restrictive measures on entry and operation. Many governments have also adopted or agreed to general standards of treatments and provided specific guarantees in key areas such as the transfer of funds, expropriation and dispute settlement.[65] Increasingly, moreover, governments are paying attention to ensuring the proper functioning of markets, for instance through the adoption of competition rules and consumer and financial reporting standards. These trends, which are part of a broader liberalisation process, are in turn an extension of the general tendency to pursue market-oriented policy as a means to achieve greater economic efficiency. At the same time, the investing country can increasingly access the domestic market and natural resources of the host country by which the investing unit will get comparative advantage to expand its market share. Moreover, the investing country will use its official and unofficial mechanism to influence the political elite of the host country to get priority and the comparative advantageous area of the host country. From the political point of view, foreign direct investment should be understood as a weapon of the investing country to influence the decision makers of the host country through which they can reduce tension or make more harmonious relationship between the two countries.

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[64] UNCTAD, *World Investment Report 1996: Investment, Trade and International Policy Agreements*, New York, OUP, 1996, p. 121.

[65] Ibid.

Foreign Direct Investment is the transmission of management resourses in a package of capital, management ability, and technical expertise to a host country. These management recourses encompass, in a wider sense, managerial knowledge and experience, technical and professional knowledge including patents, technical know-how, and market techniques, market positions in regard to sales, materials and procurement, and capital raising, trademarks and goodwill, and organisations for information gathering and research and development.[66]

International capital movements are usually divided into short-term and long-term movements. In general, capital movements are considered short-term if the credit maturity is less than one year, and long term if it exceeds a year or is for indefinite periods. In other words, short-term capital movements play the same role as international transfer of gold did in giving rise to changes in money supply. It is referred to as securities and occurs in dollar denominated transactions. On the other hand, long-term capital includes portfolio investments (indirect) and direct investments. Portfolio investments represent the purchasing of equities of foreign companies subscriptions and the new issue of foreign public and corporate bonds. Principal forms of indirect investments are the issuance of public and corporate bonds, the selling and buying of bonds and stocks already issued and medium and long-term loans by financial institutions. Direct investment implies movement of capital with management rights or corporate management control rather the simple asset management. For investors to maintain management rights it is necessary to acquire and retain total or partial ownership of the firm. Thus direct investment

[66] Richard McCullon, 'New Perspectives on Foreign Direct Investment' in Kenneth A. Froot (ed.), *Foreign Direct Investment*, Chicago, Chicago University Press, 1993, p. 40.

involves: (a) obtaining stocks of an already existing foreign firm with the object of participating in the management of the said firm or purchasing (takeover) of an existing firm, (b) establishing a wholly owned subsidiary or a joint venture (partially owned) in a foreign country (the Japanese refer to them as local corporations), and (c) acquiring physical business assets with the objective of carrying out business activities, viz. establishing new branches, a business office or factory, purchasing an existing one, or expanding an existing office or factories.[67]

It can be argued that foreign direct investment is carried mainly through the multinational corporations (MNC). They are the enterprises that maintain networks of branches and subsidiaries in many parts of the world investing directly in these countries and carrying out business activities in more than one country. Thus a company may be considered an MNC if it possesses at least one direct investment project. These MNCs largely originate in the developed world with extensive networks of many plants and sales bases, and maximise profit through a global strategy. The advanced technology, efficient management skills and wide nature of sales and services have enabled these corporations to go abroad to capture markets. Consequently, their direct foreign investment contains issues that are on a higher level than that of individual investments, which control the lion's share of world total investment.

There are mainly two types of foreign direct investment: the trade oriented (the Japanese Model) and the anti-trade oriented (the American Model). Raymond Vernon and Stephan Hymer argued that the American Model of FDI is based on the

[67] Ibid, p. 62.

dualistic structure of the American economy – the dichotomy between the new oligopolistic industries and the traditional price competitive industries.[68] This type of foreign direct investment is anti-trade oriented and results in balance-of-payments (BoP) difficulties, the export of jobs, the prevention of structural adjustment and trade protectionism. On the other hand, Japanese foreign direct investment is aimed at complementing Japan's comparative advantage position. The major part of investment is directed toward natural resource development in which the Japanese company is comparatively disadvantaged.[69] 'Even investment in manufacturing has been confined either to such traditional industries as textiles, clothing, and processing of steel in which Japan had been losing its comparative advantage or the assembly of motor vehicles, production of parts and components of radios and other electronic machines in which cheaper labour costs in Southeast Asian countries are achieved and Japanese firms can increase export'.[70] In this sense, Japanese FDI is complimentary to changes in its comparative advantage position. In Hamada's view, Japanese overseas investment in developing countries is made with the objective of securing increased imports of primary products which are vitally important for its economy. This is called 'development assistance of import.'[71] A large increase in Japanese direct investment in developing countries so far has been welcomed by them, since they feel that it would contribute significantly to the development of

[68] Reymond Vernon, *The Economic Consequence of US Foreign Direct Investment*, Washington D.C., Basic Books Inc., 1971. Stephen Hymer, 'United States Investment Abroad' in Peter Drysdale (ed.), *Direct Foreign Investment in Asia and the Pacific*, Canberra, Australian National University Press, 1972.

[69] Koichi Hamada, 'Japanese Investment Abroad' in Peter Drysdale (ed.), *Direct Foreign Investment in Asia and the Pacific*, Canberra, Australian National University Press, 1972, p. 78.

[70] Ibid.

[71] Ibid.

their natural resources, agricultural production and their processing industries. This investment also involved transferring from Japan those manufacturing industries suitable to the specific developing country.

Japan's foreign investment policy has been an important pillar supporting its overall policy toward the Third World. As early as the mid 1970s, Ozawa recognised that 'overseas production is now emerging as an integral part of both Japan's economic growth strategy and her foreign economic policy'.[72] Tokyo has actively promoted foreign investment as a means of securing or reinforcing its existing trade power over strategic Third World markets, raw materials, energy resources, infrastructure and industries. The greater the amount of Japanese investments in a particular country, the greater the potential to use those investments to influence that country's political elite to grant even greater economic concessions, which inevitably enhances Japan's political power to extract even more economic power'.[73]

India and Indonesia

India and Indonesia are the two largest economies in their respective regions, South Asia and Southeast Asia. Both have considerable political influence in their respective regions. By the end of the Second World War both countries attained their independence along with hundreds of colonised countries in Africa and Asia. Both countries produced great leaders, Nehru and Sukarno, who were united in the fight against post-war imperialism and neo-colonialism and brought together most of

[72] Terutomo Osawa, *Multilateralism: Japanese Style*, Princeton, Princeton University Press, 1978, p. 21.

[73] William Nester, *Japan and the Third World: Patterns, Power and Prospects*, London, Macmillan, 1992, p. 49.

the newly independent countries under the umbrella of the new concept of Non-Aligned Movement (NAM) to protect their independence and sovereignty. They faced common problems after their independence. Both states had to devise a strategy to eradicate poverty and underdevelopment and to generate economic growth. During this period the world was divided into two antagonistic blocks, the West and the East. On the other hand, India and Indonesia needed support from both sides to build strong economies and to increase industrial production at the domestic level. For that matter, India and Indonesia adopted an import substitution industrialisation (ISI) strategy which could protect the domestic economy from outside interference through high tariff walls and restrictive quota methods. At the same time the government intervention in the heavy industrial sector was the important feature in this strategy that continued till the 1960s in the case of Indonesia and the 1980s in India.

India's approach to the economic policy under the leadership Nehru was significantly 'self-reliant' in character. At the Avadi session of the ruling Congress party in 1955, India pursued a path of socialist pattern of development which continued until the early 1990s, when the New Industrial Policy was put into place. However, in the first decade of the post independent India the approach to foreign investment was liberal and many of the sectors were opened up for foreign investment. This policy was aimed at attracting sophisticated foreign technology and capital to promote the industrialisation process, which remained deficient in India during this period. The two hostilities, Sino-Indian and Indo-Pak, created economic difficulties for India and led to a balance of payment crisis in the mid-1960s. In response to this crisis, India embraced a closed-door economic policy to protect the Indian industry and continued large-scale government investment in heavy industry, which kept the private sector away from the industrial activities. This policy continued till the early 1980s.

In the 1980s, India opened up some sectors for foreign investment particularly in electrical, automobiles, electronics, and computer and accessories. The Government changed the regulative framework which was incorporated in Foreign Exchange Regulation Act (FERA) and took away some of the bureaucratic controls over the industries. The United States continued to be the largest investor followed by Germany and Britain. Major Japanese automobile companies invested in India to exploit the emerging Indian market during this period. The South Asian countries formed a regional grouping to address common economic and political problems and to strengthen regionalism in South Asia, though they were unsuccessful in creating a strong regional bloc.

Prime Minister Narasimha Rao began the liberalisation process in 1991 by the announcement of the New Economic Policy, which triggered the flow of foreign investment to India. Almost all the restrictive measures were abolished to create a favourable environment to gain the confidence of the foreign investors. As compared to 1986, in 1996 the inflow of FDI had increased 17 fold from US $ 225 million to $4,379 million, as against a five-fold increase in the inflow of global foreign direct investment.[74]As a result, the share of South Asia in the global FDI flows gradually reached over one per cent from a mere 0.33 per cent. During the

[74] UNCTAD, *World Investment Report: Trends and Determinants,* 1998, op cit, p. 67.

period of 1991-95, Japanese investment in India stood at Rs. 14 billion. Japan became the fourth largest investor in India.[75] Japanese companies have invested in diverse areas such as motor vehicles, chemicals, electrical equipments, and consumer goods.

Until the mid-1960s Indonesia followed an import substitution strategy as the central policy in pursuit of the economic development. However, in 1965, Indonesia faced serious political unrest followed by an abortive military coup that led to the overthrow of the Sukarno regime. The installation of the 'New Order' regime under Suharto fundamentally changed most of the economic policies of the old government. The major changes implemented by the new regime were that it dismantled the restriction over foreign investment policies and opened up the Indonesian economy for foreign investment with regulation on some sectors. Indonesia passed its New Investment Policy in 1967 in order to attract foreign investment and liberalised government control over the industrial sector. In 1968, five regional countries of the Southeast Asia, Malaysia, Indonesia, the Philippines, Singapore and Thailand formed the Association of South East Asian Nations (ASEAN) to consolidate their economic position in the region and to ensure collective bargaining power with the outside world. This economic grouping, in turn, was conducive to attracting FDI from the West particularly from Japan, and became one of the successful economic regions by the end of the twentieth century.

Japan had broken out of its American dominated isolation policy and sought to develop economic relations with the Asia-Pacific countries. By the end of the

[75] *Manual for Foreign Collaboration and Investment in India,* New Delhi, Nabhi Publication, 1998, p. 38.

1960s, Japan realised that Indonesia was potentially the most important country in the region because Japan necessarily needed abundant natural recourses and raw materials to feed its growing industrialisation process. Japan was the last of the Western states to abandon President Sukarno and provided a Yen credit a few months before the events in 1966 which led to his overthrow.[76] By the beginning of the 1970s, Japan was well established as Indonesia's principal trading partner, accounting for nearly one-third of its foreign trade. In addition, it provided more than one-third of its foreign direct investment.[77] At the end of the decade, the dependence syndrome had reached the stage where more than half of Indonesia's revenue was derived from the export of oil, more than 50 per cent of which went to Japan. By the end of the 1980s, Japanese investment in Indonesia was the largest, both where compared with US and European FDI to Indonesia and with Japanese investments in any of the other countries of the region.[78]

During the 1980s, Indonesia triggered an industrialisation process by the inflow of foreign direct investment dominated by Japan. At an earlier stage, Japanese investment in Indonesia concentrated on labour intensive and resource-extraction areas.[79] Labour intensive investments involve small and medium size Japanese companies, while in the capital-intensive sector larger MNCs are the investors. Japanese companies increasingly looked to Indonesia with its huge potential market, cheap labour and expanding infrastructure. Since the early 1980s

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[76] Lawrance Olson, *Japan in Postwar Asia*, New York, Praeger, 1990, p. 1985.

[77] Charles L. Morrison, 'Japan and the ASEAN Countries: the Evolution of Japan's Regional Role' in Takash Inoquchi and Daniel I. Okimoto (eds.), *The Political Economy of Japan: Vol. II, The Changing International Context*, California, Stanford Uuniversity Press, 1988, p. 420.

[78] Masahide Shibusawa, Zakaria Haji Ahmad and Brian Bridges, *Pacific Asia in the 1990s*, London, Routledge, 1992, p. 33.

[79] Nester, *Japan and the Third World*, op cit, p. 30.

the sectoral distribution of FDI began to change. FDI in manufacturing began to rise.[80] The manufacturing industry assumed a more export-oriented character, firms specialising in advanced technologies including electronics began to take root.

Since the 1970s Japan emerged as the major investor in Indonesia in both the number of projects and the amount of FDI. Although the economic motive is predominant, Indonesia's strategic importance has undoubtedly played a part in fostering Japanese interest. Indonesia is the largest of the ASEAN states in terms of geographical extent and size of population. It is the source of strategic raw materials, not only oil, and it links the sea-routes to Australia, the Indian Ocean, the Middle East, Europe and Africa.[81] No other country in the region has such close relations with Japan as Indonesia had in the 1980s, and this has continued in the 1990s as well.

Scope and Objectives

The motive behind selecting the role of FDI in Japan's foreign policy towards ASEAN and SAARC is that these two regions – ASEAN and SAARC – are potentially powerful economic zones. The ASEAN region has emulated the Japanese export orientated growth strategy for its economic development. The ASEAN countries opened their door for foreign investors by liberalising their domestic policies in the late 1970s. Japan holds the highest position in FDI investment in the region. Through Japanese FDI, the Southeast Asian countries accelerated their economic development in the 1980s, and advanced their position in the international politics. It can be argued that investment in these countries minimised their

[80] Ibid, p. 32.
[81] Ibid, p. 90.

unemployment problems, balance of payment problems and gave their people a better standard of living.

Since the 1980s Indonesia has achieved remarkable economic growth by attracting direct investment from Japan. At the initial stage Japanese investment went into infrastructure like roads and ports that were necessary for the extraction of natural resources. Indonesia liberalised its policies for attracting a higher rate of Japanese investments. Indonesia developed better roads and bridges, power generation facilities and efficient communication systems by acquiring Japanese FDI. Subsequently, Japan invested massively in the manufacturing sector and export oriented industries. Indonesian industries became internationally competitive by introducing Japanese technology and managerial skills. These economic interactions harmonised diplomatic relationships between the two countries.

The South Asian countries have started the liberalisation process only in the early 1990s, and hence this region did not evolve as an attractive destination for the Japanese foreign investors even though some joint venture partnerships had been made. India is the biggest country within the region but opened its economy to foreign investors only during the 1990s. India has skilled manpower resources, raw materials, and a comparatively strong economy that could attract Japanese FDI in the areas of infrastructure development, medium and small sized industries.

By the end of the Cold War the South Asian region has achieved considerable importance in the Japanese foreign policy arena. The Japanese perception about India during the period of Cold War was eroded by the collapse of the Soviet Union. India regained an important role in the new Japanese security and foreign policy perceptions. Since the Gulf crisis (1991) Japan has been very much concerned about the free flow of the oil and other commodities through the Indian Ocean littoral area. At the same time the emergence of China as a strong economic and military power in the region and its unresolved disputes over Taiwan and in the South China Sea with neighbouring countries have created a perception of new security challenges for Japan. As a matter of fact, Japan sought to win friendship with other major powers of Asia to protect its continuing access to markets and investment opportunities, which is the main objective of Japan's Asia policy since the 1970s. Moreover, the liberalisation of the Indian economy in the 1990s attracted the confidence of the Japanese investors and made Japan a prominent investor in India.

In this study, an attempt has been made to analyse the role of foreign direct investment in the understanding of foreign policy analysis. It concentrates on the nature and dynamics of Japanese direct investment policies and its foreign policy in general. Japan has played a hegemonic role in the development of the countries of the East and Southeast Asian region and addressed the regional security issues through the higher rate of direct investment into the region. Efforts to understand Japan's foreign relations with India and Indonesia on the basis of Japan's direct investment into both countries during 1980-1996 is the main focus of this study.

This study comprises of six chapters. This chapter presents a theoretical analysis of the economic instrument of foreign policy. It also analyses the international political economy approach to the study of comparative foreign policy. The second chapter provides an empirical analysis of Japanese foreign policy and the characteristics of its FDI policies. It also studies the role of FDI in creating regional security during the period of the 1980s.

The third chapter focuses on the Japanese relations with ASEAN, especially Indonesia, since the 1980s. It would also examine Indonesia's policies towards Japan. It also examines how Japan managed to reduce its tension with the Southeast Asian countries. The fourth chapter explores the growth of Japan-India relations since the 1980s. It mainly covers the Indian policy initiation of economic liberalisation in the 1990s and Japanese responses towards into. The final and fifth chapter summarises and analyses similarities and differences of the two sets of relationship. It also concludes with the major findings of the work.

Chapter II

Japan's Foreign Policy

Since the end of the Second World War Japanese foreign policy has changed in accordance with the currents and issues in the international arena. In comparison with the faster and more spectacular events in Europe, the end of the Cold War has not had considerable influence in East Asia. However, without the end of the super power confrontation, the outside involvement in the Cambodian war could not have been ended. Russia is at present no longer a major concern for East Asia. On the other hand, the degree of American support and involvement in Asia-Pacific has also become less credible. The emergence of regional hegemony has become more visible and this has changed the nature and character of the international system. Power is daily becoming more diffuse. As a result Japan's shadow looms larger than ever and the country has to find new ways of securing its national interests in an increasingly volatile and complex environment. According to former vice foreign minister of Japan Kuruyama Takakuza, 'today's Japan (with its economic power) should participate more positively in international efforts to create a new order, thereby achieving its own security and prosperity. In this sense Japan's diplomacy should transform itself from that of medium and small countries into that of a big country.'[1]

The relative decline of the United States' economic and military position in the Asia-Pacific region has changed the reorientation of the Japanese foreign policy. Japan has become the world's second largest exporter and since the end of the 1986, the largest creditor nation. In 1988 it overtook the US as the largest provider of Overseas Development Assistance (ODA). And in 1993 Japan surpassed the US in

[1] Reinhard Drifte, *Japan's Foreign Policy in The 1990s; From Economic Super Power to What Power?* London, Macmillan, 1996, p. 1.

terms of outward flow of foreign direct investment (FDI) by a substantial margin. In many high technology sectors it has gained a strong position in the world market. For its leaders, the issue in Japan's relationship with the outside world is how to have a foreign policy which is compatible with its economic performance without having commensurate military power, but which at the same time meets the differing expectations of its Asian neighbours and major Western allies.[2]

A nation's foreign policy may directly or indirectly be affected by a variety of factors. It encompasses geography, natural resources, history, culture, language, domestic politics, the economic base and the international environment. However, in order to fundamentally influence a nation's foreign policy, a given factor must not merely exert substantial influence but must also exert that influence continuously over time.

Factors with the potential for exercising such long term influence on a nation's foreign policy may be divided into three groups: the realities of the international environment and national power; the attitudes within the society towards the international environment; and the special characteristics of a nation's foreign policy formulation process.[3] The international environment refers to the relatively durable patterns of mutual contacts between a nation and the various countries with which it maintains relations. National power, which plays a particularly significant role in the shaping of these patterns, include several components – for instance military power, economic power and political penetrative

[2] Ibid, p. 2.

[3] Seizaburo Sato, 'The Foundations of Modern Japanese Foreign Policy' in Robert A. Scalpino (ed.), *Foreign Policy of Modern Japan*, Berkeley, University of California Press, 1975, p. 367.

power – each possess a complex base of their own.[4] These components however, have meaning only in comparison with their strength in other nations. Therefore, national power is both an element in the formation of the international environment and the foreign policy conditioned by it. The widely shared attitudes held within a given society towards the international system are by and large based upon the perceptions and preferences on a particular issue. People do not respond directly to the objective environment but to the perceived environment. Thus the attitude which defines the perceptions and preferences toward the international environment sometimes changes the orientation and directions of foreign policy, which depends upon its domestic constraints. All the Japanese Prime Ministers have faced these conflicting pressures and constraints emanating from domestic issues to the international environment. These constraints can be examined in the light of certain basic interests in Japan's foreign policy, which can be summarised as following. Firstly in an international environment, which is still vulnerable in nature in security terms, Japan is politically, economically and militarily in tandem with the United States. The size of its economic and technological base, however, necessitates substantial relations with the rest of the world. Moreover, growing multipolarity, interdependence and the dismantling of the Cold War structure of the balance power system in East Asia are forcing Japan to reassess Japanese-US relations.

Secondly, geographical contiguity to a militarily assertive North Korea and China and the waning of US strategic influence over Japan has created uncertainty about the continuity of the US security guarantee to Japan. Furthermore, Japan's

[4] See Klaws E. Knorr, *Power and Wealth: The Political Economy of International Relations*, New York, Basic Books, 1973.

economic and technological strengths are putting pressure on it to become once again a major military power. However, the constitutional obligations and the pre-war military experience and the anti-Japanese feeling in the neighbouring Asian countries have forced Japan to continue a largely a non-military contribution to the stability of the East Asian region.

Thirdly, Japan's singular and successful pursuit of economic goals have given rise to conflicts with its major economic partners, the Western developed countries, on trade, investment, and technology. By the 1970s, the European countries implemented various measures to safeguard their domestic markets in order to avoid threat from outside. This protectionist method and the emergence of economic regionalism in the West led to the search for new markets for Japanese goods and services. These economic imperatives have forced Japan to reorient its policy and led it closer to the Asia-Pacific region.

Finally, with the growing tendency of interdependence and globalised world economy, Japan is more and more integrated into global affairs. The outlook of most Japanese citizens and their political leaders are still rather parochial and this, in turn, reflected in their domestic political system. Moreover, the concern of the Japanese for the preservation of their unique national identity makes it difficult to accommodate various external demands for smoother integration into the world economy and greater burden sharing. Nevertheless, the last two decades have witnessed astonishing changes in the domestic environment, which have affected Japan's relations with the outside world.

According to Reinhard Drifte, the modern Japanese foreign policy is based on three major concepts – 'bilateralism, regionalism, and globalism'.[5] Though these concepts are not the fundamental principles of Japanese foreign policy system, they provide a convenient method of structuring the numerous intricate interactions between Japan and the outside world. Bilateralism refers to Japan's foreign and security policy with the United States, that attained significant importance in the post World War period. Regionalism refers to the Japanese policy towards East and Southeast Asia which attained its significance in the 1970s and 1980s as part of the Comprehensive Security policy. Globalism means Japan's role in the maintenance of international peace and liberal international economic order in the post-Cold War period.

In analysing Japan's foreign policy, it can be understood that Japanese policy is not based on the past history or the moral imperatives of the peace constitution, but rather on the complex and changing character of its domestic and international environment. At the domestic level, the immediate priority was to recover from the economic devastation of the Second World War and to maintain internal order by avoiding any type of security threat perception. In order to stabilise the domestic economy, Japan necessarily needed a prosperous and a free market for its comparatively advanced goods and services. For its part, Japan joined the liberal world economic system which was dominated by the West under the leadership of the United States. Accordingly, the early years of Japanese foreign policy

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[5] Reinhard Drifte, *Japan's Foreign Policy*, London, Routledge, 1990, p. 4.

concentrated on the economic sectors rather than giving priority to the political matters.

For security matters Japan signed a security pact with the US in 1951,[6] immediately after the occupation forces had withdrawn, which virtually guaranteed its security internal as well as external. This treaty safeguarded Japan from any form of external threat or regional conflict. Under the treaty Japan allowed American forces to remain on its soil, which in turn allowed Japan to direct its resources fully for the economic rebuilding of the nation. Under the Prime Ministership of Shigeru Yoshida, Japan unleashed a policy of 'separation of economics from politics' as the main objective of its foreign policy. Yoshida pursued Japan's foreign and security policy in tandem with the US policy on every international issue. Every Japanese government that followed Yoshida supported this definition of foreign and security policy and focussed on the economic development of the country. This policy continued until the 1970s without any major changes.

The political landscape of East Asia was the main external factor that influenced Japanese bilateralist policy with the United States. The suspicion and uncertainty over Japan had persisted even after the Second World War among the regional countries. However, with the onset of the Cold War and the new security challenges in East Asia, this attitude faded away. After the outbreak of the Korean War and the triumph of Communists in China, the perceived Soviet expansion to the Far East had become the great concern for Japan. In this scenario, the single most

[6] The Japanese Peace Treaty was signed on 8 September 1951 at San Francisco. It provided the United States a dominant partner in the East Asian region in terms of politically and economically. These attendant security arrangements were not simply in bilateral terms, but with regards 'to the maintenance of international peace,' and security in the Far East which brought them into accord with the broad Cold War aims of the US in the region.

important determinant of Japan's security policy was to join the American security system towards East Asia. Nevertheless, the attendant security arrangements were not cast simply in bilateral means, but with regard to the maintenance of international peace and regional security in the Far East, which brought them into accord with the broad Cold War aims of the United States.[7]

The regionalist orientation in Japan's foreign policy has been strengthened since the 1970s. The increase of economic interactions among the Pacific rim countries and the domestic economic success of its members have led to greater interdependence within this region. Gradually, Japan took over the role of the US as the major market for the products of the region in the latter half of the 1980s. Japan invested heavily in East Asia in order to offset the sudden changes in the world economy due to the oil crisis in 1973, followed by recession in the US economy. As a result of these economic crises, the Western market was no longer so lucrative for Japanese goods and services. Consequently, Japan began to search for new markets as well as free flow of natural resources and raw materials, that led it to play a more considerable role towards the East and Southeast Asian regions in the 1970s. Moreover, the US rapprochement with communist China in the early 1970s caught Japan by surprise. In Japan a feeling emerged that the US was no longer a dependable ally for Japanese long-term interests in East Asia. US President Nixon's visit to China in 1971 without consulting Japan created the impression that the United States was not taking into account the feelings and views of its allies before

[7] Donald C. Hellman, 'Japanese Security and Post War Japanese Foreign Policy' in Robert A. Scalpino (ed.), *Foreign Policy of Modern Japan*, Berkeley, University of California Press, 1975, p. 332.

making major changes in its policy. These developments led to a rethink in Japan's policy that emerged in the name of 'Comprehensive Security Policy'.[8]

As an industrialised and resource poor country, Japan depends on developing countries for the supply of raw material and natural resources. It therefore sought to achieve better relations with resource-rich South East Asian countries in the mid 1970s. The visit of the Prime Minister Tanaka to the Asian countries in 1974 was in keeping with Japan's aim of getting natural resources from this region.[9] However, the tour ended with disappointment and distress because of strident demonstrations against Tanaka about the perception of the pre-War imperialist policies of Japan. In order to attain a dominant position in the region and emerge as the prime source of FDI and the major trading partner in East and Southeast Asia, Japan realised that it had to overcome the negative legacy of the pre-War years. In 1975, the stalemate ended with the post-War reparation agreements between Japan and many of the Southeast Asian countries that began a redefinition of economic co-operation between the two. In addition, the US pressured Japan to shoulder more responsibilities for economic developments and regional stability after its own withdrawal from Vietnam in 1975. Against this background, Japan turned its foreign policy direction towards East and Southeast Asia in the 1970s.

The end of the Cold War generated mainly two types of challenges to Japan's foreign policy. The first was the issue of Japan's contribution to the maintenance of international peace and stability that was increasingly demanded by

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[8] Robert S. Ozaki, 'Introduction: The Political Economy of Japan's Foreign Relations', in Robert S. Ozaki and Walter Arnold (eds.), *Japan's Foreign Relations: A Global Search for Economic Security*, Boulder, Westview, 1985, p. 8.

[9] Drift, *Japan's Foreign Policy*, op cit, p. 8.

the Western countries. By the end of the 1980s, Japan had become the second largest economy in the world smaller only to the US economy. This economic prowess, and the call for larger a role for Japan in the international system, forced Japan to begin to play a significant role in the management of the international economic order. At the same time, Japan considered the multilateral security system as the best possible way to achieve international peace and stability, and for this reason it continued to give the utmost importance to the role of the United Nations in the post Cold War international order.

The second question was how to address the new security challenges emanating in the East Asian region after the dismantling of the Soviet threat, in particular uncertainty in the Korean peninsula, growing militarisation of China and the continuing territorial disputes between China and other regional countries. The post-Cold War Japanese foreign and security policy towards the region more or less depends on the future role of China in the region. [10] China is a rapidly developing country, a nuclear weapon state and a permanent member of the UN Security Council. The unresolved territorial dispute between Japan and China over Senkaku (Diaoyu) islands[11] and disputes over the Spratly islands in the South China Sea with Southeast Asian countries have caused concern about Chinese ambitions. Moreover, the clandestine nuclear cooperation between China and North Korea has increased the threat perception of Japan. On both the occasions, Japan has pursued the policy

[10] Greg Austin and Stuart Harris, *Japan and Greater China: Political Economy and Military Power in the Asian Century*, London, Hurst & Co, 2001, p. 100.

[11] The Senkau/Diaoyu islands is situated in the East China Sea, 350 km off the Chinese mainland cost. Since 1970 both countries were in disputes over the territorial sovereignty of the islands. In 1978, discussion had begun to enter an amicable treaty over the territorial issue, but no final verdict has come out so far.

of cooperative approach to the regional security frame work in East Asia.[12] However, the cooperative security is not a singular policy of Japan but is a part of Japan's globalist orientation that emphasises multilateral security cooperation in a global scale.

Japan's post War foreign policy can be divided into three phases in accordance with the three features of foreign policy: bilateralism, regionalism and globalism. During the first phase from 1952 to 1973, Tokyo followed 'separation of economics from politics', a strategy whereby it avoided involvement in almost all international issues while concentrating on domestic economic development. During this period, the world economic system guaranteed free trade and free access to raw materials fairly well. Therefore, Japan could achieve a higher rate of balance of payment with major advanced economies by processing imported raw materials from third world countries and exporting these products to the Western world. This economic diplomacy combined with the security guarantee under the US umbrella, led Japan to pursue a policy of relying on the United States for economic and security matters. However, by the early 1970s, these conditions had changed and the Japan began to experience difficulties in its trade with the Western world. This phase came to an abrupt end in late 1973 with Organisation of Petroleum Exporting Countries (OPEC) quadrupling oil prices and the oil embargo by the Arab world. It became clear to Tokyo that it was no longer possible to separate economics from politics. Combined with the oil shock and Nixon's 'three shocks' – the dollar

[12] Drifte, *Japan's Foreign Policy in the 1990s*, op cit, p. 50.

devaluation in 1971 and float in 1973,[13] the 1972 restoration of relations with China, and the 1973 threat to embargo of the export of soya beans – dented Tokyo's traditional confidence that it could rely on the US.[14] Against this background, Japan responded with its comprehensive security strategy. The new strategy involved active diplomatic involvement in relatively non-controversial issues while diversifying its search of secure foreign markets, and sources of cheap labour, energy and raw materials. The comprehensive security strategy was aimed at reducing Japan's dependence on any one external partner. Finally with the end of the Cold War Japan began to share the responsibility for building a multipolar world order emphasising a system of free trade. Eventually, for the sake of peace, prosperity, and continued development at home and abroad Japan contributed on a scale commensurate with its as a global economic power. The various faces of post war Japanese foreign policy can be seen in the following chart;

Post War Japanese Foreign Policy

Levels of Analysis	Relationship	Chronology	Thematic
Bilateralism	United States	1952 - 1973	Separation of Economics from Politics
Regionalism	East/Southeast Asia	1973 - 1989	Comprehensive Security Policy
Globalism	International System	1990–	"Normal" Power

[13] The Bretton Woods system was formulated shortly before the end of the Second World War, which allowed converting dollar into gold standards. In August 1971 President Richard Nixon announced the suspension of the full convertibility between the gold and the dollar, forcing all major currencies to float against dollar. This seriously affected Japan. The Japanese yen was fixed at the rate of 360 to a dollar in 1949 under the SCAP regime.

[14] Stephen D. Cohen, *Uneasy Partnership: Competition and Conflict in US-Japanese Trade Relations*, Baltimore, John Hopkins University Press, 1985, p. 85.

Separation of Economics from Politics (1952–73)

The separability of economics from politics in the foreign policy of Japan was an implicit premise in the policies of all post-War Japanese governments. It was a widely accepted policy by the international community and the domestic left-wing critics as well.[15] The repudiation of the politico-military foreign policy has given impetus to separation of economics from politics and concentrated Japan's energies and resources on economic development of the country. Japan viewed its return to the community of nations as its most important post-War foreign policy goal and for this purpose Japan focussed its attention on domestic economic reconstruction.[16] The co-operation with the US occupation forces, the effort to democratise Japan, and the active adoption of Article 9 of the constitution were all motivated by the desire to recover the world's trust and confidence in Japan.

The leaders of the early post-War Japan laid down the foundation for the foreign policy of Japan.[17] They realised that without a strong economic base there could be no political power. The US led occupation regime had been more conducive for regaining its economic strengths, which was underlined by the Peace Treaty of San Francisco in 1951 between Japanese Prime Minister Yoshida Shigeru and the US President Harry S. Truman.[18] Under this treaty, Japan accepted the US hegemony in the region and was guaranteed its protection in writing for which the

[15] Although the concept of 'economic diplomacy' has apart of Japan's approach in the world since the end of occupation, the notion was first developed publicly by foreign minister Shingenutsu setting forth the broader goals of the new foreign policy of the first Hatoyama cabinet. For details see: Seizaburo Sato, 'The Foundations Of Modern Japanese Foreign Policy' in Robert A. Scalpino (ed.), *Foreign Policy of Modern Japan*, op cit, p. 369.

[16] Ibid, p. 379.

[17] Ibid.

[18] Momoi Makato, 'Basic Trends in Japanese Security Policies', in Robert A. Scalpino (ed.), *Foreign Policy of Modern Japan*, op cit, p. 343.

country had to provide the US military bases in Japan. Moreover, Japan placed a ceiling on its military spending to one per cent of the GNP. This helped Japan to divert its resources to the domestic economic development rather than concentrating on military build-up.

Japan and its foreign relations after the war show some striking contrasts to its own past and to the historical norm. Japan emerged after World War II as perhaps the first example in human history of an economic super power that was not at the same time a military power. Economics has dominated Japan's internal policies as well as its dealings with the outside world. It no longer held any territorial or ideological ambitions vis-à-vis other states. Having learned the futility of militarism it turned to pacifism and redefined its goal as an accelerated economic growth rate to catch up with the West. The first diplomatic White Paper in 1957 concluded that the only way to raise living standards and to increase national power lay in the peaceful development of economic strength.[19] As a result the economic effort took precedence over military power and foreign policy became equated with foreign economic policy.

Many favourable conditions enabled Japan to achieve a high economic growth rate during this period. During the 1950s and 1960s the raw materials and natural resources were easily available and their prices remained low. This helped Japan to feed its domestic industry and to export manufactured goods to pay for its imports. With the end of the World War II, many of the less developed countries with abundant natural resources, which were controlled by the colonial powers

[19] Masataka Kosoka, 'The International Economic Policy of Japan' in Robert A. Scalpino (ed.), *Foreign Policy of Modern Japan*, op cit, p. 211.

during the pre-War period, became independent. In turn, these countries started to export their natural resources to available markets in order to finance their domestic economic development. Fortunately, many of them looked at Japan as a favourable destination for their export. A beneficiary of these trends, Japan imported resources from diverse sources around the world far more freely than was imaginable before the War.

After the Korean War, the United States took the leadership to promote and stabilise the liberal economic order under which Japan enjoyed maximum advantage as an economic partner and a supporter of the US policies. The economic framework of Pax Americana was formulated at the Bretton Woods conference shortly before the end of the War. The so-called Bretton Woods system was designed to achieve mutual prosperity of the free nations by encouraging free multilateral trade under US hegemony.[20] To accomplish this end, the International Monetary Fund (IMF) was established with the US dollar as the system's key currency fully convertible into gold. Subsequently the General Agreement on Tariffs and Trade (GATT) and World Bank was funded to settle trade disputes and promote free trade and to provide long-term credit to the less developed countries (LCD) for their developmental projects, respectively. Until the mid 1960s Japan was the largest recipient of loans from the IMF to create a healthy domestic economy by which Japan was converted into an industrially advanced country.

[20] Bruce Russett, 'U.S. Hegemony' in Takashi Inoguchi and Daniel I. Okimoto (eds.), *The Political Economy of Japan: Vol. II, The Changing International Context*, Stanford, Stanford University Press, 1988, p. 420.

The US hegemonic umbrella ensured Japan access to the world market and allowed it to dispense with military expenditures. By the end of the World War II, the US preponderance in the economic and military field far outweighed the rest of the world with the more than the 60 per cent of the world's manufactured products.[21] In this respect, Prime Minister Yoshida captured succinctly a new strategy when he said in 1951 that Japan's destiny:

> was to be a global power, and the expansion as well as the security of the state was best guaranteed by close alliance with the dominant western power in Asia and the Pacific... just as the US was once a colony of Great Britain but is now the stronger of the two, if Japan becomes a colony of the US it will eventually become the stronger.[22]

This policy of 'moving with the powerful' transformed Japan from a small economy devastated by the War to an economically strong and powerful country.

Washington's policies towards the Asia-Pacific region have worked in tandem with Japan to achieve its foreign policy goals. Washington valued Japan as a military as well as political-economic ally in containing Communism in the region. America pumped large amounts of money into Japan as aid during the Occupation period to make Japan the 'workshop of Asia.' All efforts were made to promote Japan's products in the world market. The SCAP (Supreme Command for Allied Powers) regime focused Japan's Government to run a balanced budget and set the yen-Dollar exchange rate at 360, a rate at which all Japan's strategic industries enjoyed a comparative advantage. Gradually, due to the insistence of the US, Japan created a National Defence Police Reserve with the advent of the Korean War,

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[21] Takashi Inoguchi, 'Japanese Foreign Policy' in Takashi Inoguchi (ed.), *Political Economy of Japan*, op cit, p. 30.

[22] Shigeru Yoshida, *The Yoshida Memoirs,* Connecticut, Greenwood, 1962, P. 119-21. Quoted in William Nester, *Japan and The Third World: Patterns, Power and Prospects*, London, Macmillan, 1992, p. 11.

which transformed the Cold War into a hot issue in the East Asian region. Subsequently, Tokyo signed a peace treaty with the US in 1951 to protect in national sovereignty and security. If Tokyo had gone alone, Washington would not have continued to aid Japan's economic development or its rise to economic superiority over the world economy. For Japan, Non-alignment was a meaningless ideology and it had to condemn it. Finally, Japan allowed US military deployment on its territory, as it was necessary for territorial and peace in the region.

For Japan, the US hegemonic umbrella meant primarily three things. With Japan's security tied to US global strategies and US military bases in Japan, it could dispense with most military expenditures. The ratio of military expenditures to overall government spending was about five per cent and its ratio to GNP was less than one per cent until the end of the 1980s. This is a miniscule amount in relative terms, especially when compared with that spent by the other major Organisation of Economic Cooperation and Development (OECD) powers (approximately to 10-30 per cent of total government spending).

Economically, Japan enjoyed liberal access to the world market, both for export of manufactured goods and imports of national resources. Without this unprecedented liberal economic order, Japan would have found it difficult to develop its present-day trading pattern with the rest of the world. The fixed exchange rate system provided much needed stability and predictability for Japanese manufacturers and traders.[23] By 1955, Japan joined in General Agreement on Tariff and Trade (GATT) and in 1964 Japan was admitted into the Organisation for

[23] Takashi Inoguchi, 'Japanese Foreign Policy', op cit, p. 30.

Economic Cooperation and Development (OECD). It was an acknowledgment of Japan's growing economic power status in the contemporary world. And finally on the political stage, the US occupation and its subsequent policies allowed Japan to recuperate from the disgrace of defeat and the damages of the early Occupational reforms. By the end of the 1960s, Japan regained its hegemonic position in the East Asian region with the active support of US policies. If the American support was, as is often said, a major source of the political stability and economic success of Japan in the 1950s and 1960s, then some credit clearly goes to the United States.[24]

The most successful part of the policy of separation of economics from politics is Japan's post-war relation with China. Although Tokyo agreed to sever ties with Beijing and recognised Taipei as China's legitimate Government, extensive trade continued with both China and Taiwan, with Japan typically enjoying immense trade surplus with both.[25] Yoshida exemplified Japan's foreign policy by arguing that 'I don't consider whether China is red or green, China is a national market and it has become necessary for Japan to think about markets.'[26] Yoshida realised that China's revolutionary passion would eventually subside and it would become a moderate member of the world community. Trade would thus simultaneously serve Japan's economic and security interests by mellowing China. From the beginning Yoshida maintained that

> Japan viewed without any anxiety the possibility of a total seizure of China by the communists ...because Chinese Communist Party would soon turn as nationalistic and anti-foreign as previous regimes. The CCP would actually

[24] Ibid, p. 31.

[25] Ibid.

[26] Shigeru Yoshida, *The Yoshida Memoirs.* op cit, p. 127.

> help to mitigate Soviet power in Asia. Sino-Japanese contacts could be made to mutual advantage. [27]

It took Washington another quarter of a century to reach the same sensible conclusion.

In contrast to their conflicting views over China, Tokyo and Washington were in complete accord over Southeast Asia. Yoshida envisioned a division of labour in developing Southeast Asia with the Americans providing the capital and value added products, the Japanese consumer and intermediate products and the Southeast Asian country's raw materials and energy. During Yoshida's 1952 visit to the US, he proposed a 'policy whereby the US should recognise Japan's status in Asia as an independent country with the two nations cooperating on an equal footing for the maintenance and promotion of peace in Asia.'[28] He also claimed 'Japan was ready to do all in her power to contribute to the economic development of the free countries of Asia...' since 'the economic development of Asia was the best means of the defending the freedom and peace of Asia.'[29] Finally, Washington agreed and went so far as to assign officials in its Southeast Asian embassies to promote Japanese trade and tied considerable American aid to the purchase of Japanese goods and services.

Thus, the successful implementation of the so-called 'Yoshida Doctrine' laid the foundation stone for domestic economy and its relations with outside world as well. Japan used money, management and technology as the chief instruments instead of militarism to achieve its goals and to establish its hegemony in the East

[27] Kazuo Sato and Yasuo Hochino, *The Anatomy of Japanese Business*, New York, M.E Sharpe, 1984, p. 271.

[28] Ibid.

[29] Ibid.

and Southeast Asian region.[30] Although, some critics have argued that Japan is an 'economic giant-political dwarf', it achieved its Post War objectives of creating a wealthy country and stable society.[31] Japan's 'economic miracle' of an average 10 per cent annual economic growth during this period was achieved through its skilful foreign policy by concentrating on economic matters, and joining the US umbrella system in order to avoid taking any type of risk to protect its territorial integrity.

Foreign Policy of Comprehensive Security (1973-90)

The period of 1970 was a vulnerable era in the post-War years. There were sweeping changes in the economic and diplomatic fields that hit Japan severely. Nixon's 'Three Shocks' shook the traditional confidence that Tokyo could rely on the US. The collapse of the Bretton Woods system created global recession, which caused increased protectionism in different parts of the world leading to difficulties in the Japanese trade and balance of payment crisis. The biggest blow, however, came in 1973 with the Organisation of Petroleum Exporting Countries (OPEC) quadrupling of oil prices, which caused Japan's economic growth to decline for the first time since the war and unleashed double-digit inflation. Finally, the fall of Indo-China (Vietnam) to Communism in 1975 symbolised the decline of American influence in the region. All these dramatic changes had to be taken into consideration by the Japanese policy makers. They were forced to re-evaluate Japan's so far successful

[30] By the end of the 1960s, Japan surpassed the US as the dominant economic partner in East Asia. Tokyo's foreign aid policy proved a powerful boost to Japan's economic penetration in the region. In 1969, 48 per cent of Japan's total aid went to Southeast Asia, and almost 90 per cent to all of Asia, while Latin America received 5.9 per cent, Africa 2.5 per cent and other regions 1.4 per cent.

[31] Kenneth B. Pyle, 'Japan, The World and The Twenty-First Century', in Takashi Inoguchi and Daniel I. Okimoto, *The Political Economy of Japan*, op cit, p. 452.

policy of minimising diplomatic initiative while concentrating on economic expansion.

The changes in the international environment and in US foreign and security policies during the 1970s threatened all of Japan's traditional assumptions and demanded new responses. Its leaders realised that they could no longer take the benign nature of the international environment for granted but would have to work for it in the face of these political and economic changes.[32] Throughout the 1970s and 1980s, Japan took a stand on a number of regional conflicts. In the Middle East conflict it adopted a pro-Arab stand. In 1973, for the first time Japan departed radically from its position of aligning with US positions on major issues and joined the West European countries in taking a more accommodating line on Arab demands. In addition, the return of the Okinawa to the mainland by the US and the dispute over Northern Territories with the Soviet Union forced Japan to pursue a more active multilateral diplomacy by the end of 1970s. This represented the beginning of a new age in Japan's relationship with the rest of the world. In other words, these changes led to the end of its 'omni directional diplomacy' started immediately after the end of World War II.

As a result of the crisis in the world economy, Japan embarked a more outward oriented foreign policy approach since the 1970s. Japan's immediate necessity was to ensure the free flow of natural resources and raw materials to the

[32] The OPEC's increase of oil prices exposed the vulnerability in Japan's policy of the so far successful policy of separation of economics from politics. Until then Tokyo depended on the Middle East for 80 per cent of its oil consumption. The oil crisis propelled the Japanese government to embark on a policy of diversifying and stabilising its overseas sources, energy conservation, greater use of domestic resources, alternative energy development, energy research and development, and stockpiling.

growing Japanese industries. Although Japan had long-term economic and political relations with the resource rich Southeast Asian region, Japan's interest into these regional countries was not a matter of great importance. However, the oil crisis and the emergence of protectionism in the West, forced Japan to concentrate more on the Southeast Asian region as a source of raw materials and a market for its manufactured products. With these objectives in mind, Japanese Prime Minister Tanaka travelled to the capitals of the Southeast Asian countries in 1974.[33] But the response in Southeast Asia to the Tanaka visit was not enthusiastic. He faced a large demonstration at the Indonesian capital Jakarta about the Japanese intention of the new drive which was reminiscent of the past imperialist tendencies. Consequently, the Japanese foreign minister promised to the Southeast Asian nations at the 1976 ASEAN summit that Japan would assist ASEAN in creating peaceful political cooperation and for economic development. Finally Japanese Prime minister Fukuda's trip to Southeast Asia in August 1977 heralded a new era in Japan's policy towards the neighbouring region.

During Fukuda's tour to the Southeast Asia, he announced at the second ASEAN summit in Kuala Lumpur that

> Japan would not become a military power, and that it would cooperate with the Southeast Asian countries in developing practical cooperation in the political, economic, social, and cultural spheres based on "heart to heart" understanding, and that Japan would assist in strengthening the solidarity and resilience of the ASEAN member countries while fostering mutual understanding between them.[34]

[33] Charles E. Morrison, 'Japan and the ASEAN Countries', in Takashi Inoguchi, *The Political Economy of Japan,* op cit, p. 420.

[34] Ibid, p. 422.

This policy initiative dismantled the earlier perception about Japan and was a major turning point in post war Japan-ASEAN relations. It eventually provided Japan with considerable influence in Asia as a whole.

Japan's Southeast Asian diplomacy was explicitly cited as a Japanese contribution to the international order. Fukuda noted that 'Japan should seek global affluence and peace to assure its own affluence and peace. We should seek even stronger ties with the Asian nations since they are closer to Japan racially, culturally, and economically.'[35] He added that 'Japan should take actions, reflecting its increasing responsibilities toward Southeast Asia.'[36] This policy was considered as not only incompatible with its 'omnidirectional diplomacy' but also assumed a degree of Japanese interest in the region based on economic and political initiative rather than on military strength. Foreign Minister Sonada explained that, 'it is the duty of Japan as an advanced country in Asia to stabilise the area and establish a constructive order.'[37]

Subsequently, Prime Minister Suzuki endorsed the proposals of a special committee on the subject of the policy of defining security in a broader sense.[38] The committee mainly looked into the subjects such as economic well being and invulnerability to disruption as well as traditional military security, and the active

[35] Tokyo JOAK television, 22 August 1977, cited in Charles E. Morrison, 'Japan and the ASEAN Countries', op cit, p. 422.

[36] *Strait Times*, 20 June 1978, cited in Charles E. Morrison, 'Japan and the ASEAN Countries', op cit, p. 422.

[37] *Strait Times*, 13 December 1977, cited in Charles E. Morrison, 'Japan and the ASEAN Countries', op cit, p. 422.

[38] In December 1981 the influential Industrial Structure Council, an advisory body attached to the Ministry of International Trade and Industry, appointed a subcommittee of academic experts and prominent business executives to examine the question of economic security. In April 1982 the subcommittee released an interim report meant to stir debate towards building a national consensus.

use of diplomatic, economic and cultural initiatives as well as a strong military defence to guarantee Comprehensive Security, quickly arose in response to the oil embargo.[39] The report characterised the termination of clear American supremacy in both military and economic spheres and stated that US military power was 'no longer able to provide its allies and friends with nearly full security.'[40] According to the committee's report Japan had tended to preach a peaceful world while depending on others to achieve its objectives. The committee suggested that the new situation required efforts at three levels: efforts to run the international environment into a favourable one; self-reliant efforts to cope with threats; and intermediary efforts to create a favourable international environment within a limited scope while protecting a security in solidarity with countries in sharing with the same ideas and interests.[41]

It is a fact that the key economic element of Comprehensive Security is the diversification of foreign sources of energy, raw materials and markets in order to minimise the impact of any country or region's cut-off or dramatic price increase to avoid any circumstance that would disrupt the availability of natural resources. Tokyo attempted to use a combination of economic, diplomatic, and other means by which its comprehensive national security was ensured. The report on Comprehensive National Security emphasised the importance of a comprehensive approach encompassing economic, political, diplomatic, cultural, and educational means and, inter alia made the following recommendations:

[39] Nester, *Japan and the Third World,* op cit, p. 17.

[40] Drift, *Japan's Foreign Policy,* op cit, p. 29.

[41] Comprehensive National Security Study Group, 'Report on Comprehensive National Security' (translation), 2 July 1980, Tokyo, p.7 & 20, quoted in Drifte, *Japan's Foreign Policy,* op cit p. 29.

1. Japan should remove the remaining trade and investment barriers as much as possible and further liberalise its domestic financial institutions, and take initiatives to strengthen and broaden the GATT provision as an instrument of promoting free world trade.
2. High technology should be the engine to boost and revitalise the now-stagnant world economy. To this end, the fruits of research and development in high technology needed to be internationally shared instead of being monopolised by each nation. Japan should encourage and actively participate in joint international high-technology research with other advanced countries.
3. Economic security is not bought by goods and money alone. While conventional economic and technical aids to the LDCs are important, no less important are cultural and educational exchange programs with all nations to promote international friendship and understanding. Japan ought to invest far more in these areas than in the past.
4. Along with such internal measures as conservation, stockpiling and development of alternative energy sources, Japan should work hard towards a greater harmonisation of North–South as well as East–West relations as a way of enhancing its long-term economic security.
5. The best way to ensure Japan's food security is through an increase in world food production. Expanding aid in agricultural technology, export credit for fertiliser, and other means of raising agricultural productivity of the less developed food-producing countries is therefore desirable.

6. A wholesome and realistic way to gain safety of maritime transportation from the standpoint of Japan's economic security is to make positive contribution to peace in areas adjacent to such strategic sites as the Hormuz and Malacca straits, the Panama and Suez Canal, and the Cape of Good Hope.
7. The government should continue to play a developmental and cooperative role vis-à-vis private businesses in generating and disseminating new technologies as well as in facilitating structural transformation of the nation's industries.[42]

Since the inception of the Comprehensive Security Policy as a cornerstone of Japan's relations with the rest of the world, Japan has concentrated on defence security as its prime objective by using economic and other means to achieve these ends. Tokyo considered these national security approaches to integrate into an overall framework of its foreign policy. Even though Japan was a party to US security umbrella, it signed a Treaty of Peace and Friendship with China in 1978 that was clearly directed against the Soviet Union. As a member of the Western camp Tokyo started to take a stand on many of the international issue in the 1980s.

Until the 1970s North America and Western Europe were the main markets for Japanese exports. Japan was systematically a free rider on economic matters during this period.[43] However, after the oil crisis and the flexible convertibility of

[42] Robert S Ozaki, 'Introduction: The Political Economy of Japan's Foreign Relations' in Robert S. Ozaki and Walter Arnolds (eds.), *Japan's Foreign Relations: A Global Search for Economic Security*, Boulder, Westview, 1985, p. 11.

[43] The Japan-US alliance system provided an open world market particularly the Western market for its products during the early years of the post-War period. During this period Japan avoided

dollar-gold exchange rate system, the countries of North America and Western Europe increased protectionism and imposed various tariff measures on Japanese products. Besides, the developing countries of the Asia–Pacific region achieved economic growth by export oriented development strategies in the 1970s and 1980s. Japan considered the Southeast Asian region as a main source of raw materials necessary for the Japanese economy to overcome the protectionist measures taken by the West. In addition, the US pressured Japan to shoulder more responsibility for economic development and regional stability which was basically to put on hold the Communist expansion into the impoverished South East Asian region followed by the withdrawal of US forces from Vietnam. Against this background Japan has concentrated more on Asia in the last two decades.

Another area of success of the Comprehensive Security Policy is the wide spread acceptability of the Japanese FDI in the Asian continent. By the end of the 1980s Japan became the largest investor in Southeast Asia.[44] Japan relocated its traditional and medium and small-scale industries to this region during this period. Most of these products were either imported back to Japan or exported to third country markets.[45] During the 1980s the Asian region attained greater importance in Japan's global investment pattern, which was to cope with the appreciation of the yen and the rising production costs. Japan considered the Asia–Pacific region as strategically important because of its potential economic and political vulnerability which in turn would impact negatively on Japanese interests. Thus Japan has given

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all types of political and economic risk while enjoying all the benefits of the liberal market system under the US hegemony.

[44] UNCTAD, *World Investment Report*, New York, Oxford University Press, 1990, p. 57.

[45] Yamazawa Ippie, 'Gearing Economic Policy to International Harmony', op cit, p. 126.

considerable contribution to the political economy of East and Southeast Asia, which enhance greater co-operation between Japan and the regional countries.

The most successful initiative of the Comprehensive Security Policy was Japan's relations with the Southeast Asian region. Japan acted as the spokesman for Southeast Asia. Japan became the dominant trade partner and has held over one third of all FDI with almost every country in the region since the mid 1970s. After the fall of Indo-China to Communism in 1975, Tokyo began to actively support ASEAN in an attempt to fill some of the diplomatic and aid void left by the reduction of America's regional role. At the same time Japanese policy makers pushed forward with economic co-operation and the extension of ODA and FDI to the developing countries of East and Southeast Asia, by which these countries attained healthy economic growth based upon export oriented industrial development strategies. These policy initiatives helped to shape a regional division of labour based on the idea of the 'flying geese' pattern of development.[46] In essence this model of development posits a vertical division of labour, with Japan as goose at the head of the flock moving to production of goods at a higher level of technological sophistication as the follower geese of other parts of Asia take over the older technologies and develop economically by exploiting comparative advantage and

[46] There were three waves of economic growth in the Asia Pacific region. The first was in the 1960s, when Japan recorded its income doubling-and-beyond-rapid growth, the second in the 1970s the newly industrialised countries (NIEs), and the third in the 1980s by the ASEAN countries and China. These three consecutive waves have created a pattern of growth, which has been aptly characterised as a 'flying goose' pattern. Although this pattern was first postulated by Prof. Kaname Akamatsu in the 1930s, its application has come in the growth pattern in East and Southeast Asia over the last three decades. Glenn D. Hook, 'Japan's Role in the East Asian Political Economy: An Emerging Region?' in Glenn D. Hook and Hasegawa Harukiyo (eds.), *The Political Economy of Japanese Globalisation*, London, Routledge, 2001. For further details, see P. Korhonen, *Japan and the Pacific Free Trade Area*, London, Routledge, 1987.

exporting the goods produced.[47] Metaphorically, each goose has a role to play as the flocks heading in a unilinear direction of transferring older technology further down the flock. Concretely, technology is passed to the NIEs, to the lead economies of Southeast Asia and then to China and Vietnam and India. In other words, as Japan's industrialisation moves to cutting edge realms, the Asian NIEs are shifting from labour intensive industries to more technology-intensive, higher-wage fields, and labour-intensive industries are moving from the NIEs to the ASEAN countries and China. While Japan has served as both as an example and a supplier of capital goods for these countries, it has also played the role of a facilitator in creating the regional economic integration.

Another part of the Comprehensive Security Policy is Japan's 'go-between' role in regional conflicts.[48] Japan has maximised both its trading position and diplomatic prestige at the time of crises. Japan took this position in different crises such as the Vietnamese invasion and occupation of Kampuchea, the Chinese invasion of Vietnam, the Soviet invasion and occupation of Afghanistan, the Iran-Iraq war, the Israeli and Syrian occupation of Lebanon, the US military involvement in Nicaragua and other Central American Republics and the Soviet downing of a Korean aircraft. Chalmers Johnson describes this as 'one of the most skilfully executed foreign policies pursued by Japan in the post war era – a clever, covert adaptation by Japan to the Cold War and a good example of Japan's essentially neo-mercantilist foreign policy.'[49] These efforts, while largely unsuccessful

[47] Glenn D. Hook, 'Japan's Role in the East Asian Political Economy: An Emerging Region?' op cit, p. 211.

[48] Nester, *Japan and the Third World*, op cit, p.19.

[49] Nester, *Japan and the Third World*, op cit, p.19.

diplomatically, have proved very advantageous economically as Japanese firms continued to do trade with both sides. Consequently, Japan was elected to the Security Council more than any other country, in part because of its effective go-between policy, which generated wide spread support.[50] By the end of 1980s, Japan began to play a larger role in the international arena.

Japan's Foreign Policy in the Post-Cold War Period – 'Normal Power'

The changes in the international power configuration at the end of the Cold War has changed Japan's perception of its international role. The importance of Japan in the US strategic paradigm in East Asia has began to wane in the 1990s, mainly because of the US 'strategic engagement' policy to China during the Clinton administration (1992-2000). However, any attempt by Japan to reject American leadership would immediately arouse suspicion and fears in other countries particularly in Asia that might be lead to repeat the mistakes of the past. At the same time, although the Soviet threat perception had been dismantled, vulnerability and uncertainty have persisted in the region. The emergence of China in a bid for a great power in the region and the nuclear standoff in the Korean peninsula, and the demand for a more active role in the international affairs both from home and outside has brought Japan to reorient its foreign policy from the regionalist orientation to the globalist position which eventually elevated Japan as a normal power in the world politics.

It can be argued that, the post-Cold War Japanese foreign policy has emphasised four main approaches; (1) enhancement of the role of Japan's Self

[50] Tokyo has attempted to mediate North-South issues in the United Nations and elsewhere. In UN votes, Tokyo normally avoids taking any stand on controversial issues, and will even vote for a proposal it actually opposes if it knows the US will veto it, as an attempt to curry as much favour in the Third World as possible.

Defence Force (SDF), (2) participation in UN peacekeeping operations, (3) construction of an East Asian security architecture, and (4) bilateral security ties with the United States.

Enhancement of the role of Japan's SDF: As part of the policy of internationalisation unleashed under the Nakasone era (1982-89), Japanese spending on defence build up has substantially increased. Nakasone abolished the one per cent ceiling of the GDP in 1984 in order to enable Japan to be accepted as a full-fledged member of the US alliance system.[51] Japan increased the level of force and budgetary requirements in the 1990s under the changed international circumstances. The Mid-term Defence Plan covering Financial Year 1991-95 called for average annual increase of three per cent for moderation of the SDF.[52] The modernisation programme focussed on the equipment modernisation, not force growth. Its goals were largely based on cuts in spending, at least cuts in the rate of growth. In 1993, Foreign Minister Watanabe called for Japan to move away from its defence only posture and acquire the tools of power projection capability, such as aircraft carriers, bombers, and long-range ships[53] that would reduce the SDF's personnel levels and would equip it to take on challenges in the region, at least for the maritime security.

Participation in the UN peacekeeping operations: Although Japan made significant contributions to a number of UN peacekeeping operations since the

[51] Takashi Inoguchi, *Japan's Foreign Policy in an Era of Global Change*, London, Pinter, 1993, P. 91.

[52] Eugene Brown, 'Japanese Security in The Post-Cold War Era: Threat Perception and Strategic Option', *Asian Survey,* Vol. XXXIV, No. 5, May 1994, p. 438.

[53] Ibid.

1980s, it was largely financial aid and support only.[54] In 1992, the Japanese Diet approved legislation submitted by the Kiichi Miyazawa government to enable the SDF to take part in UN peacekeeping operations abroad.[55] Subsequently, Japan deployed a 600-man SDF contingent to participate in the UN operation in Cambodia, the first overseas deployment of Japanese armed forces for purposes other than training since World War II. Besides, the dispatching of 2000 members of the SDF to UN sponsored peacekeeping operation during the Gulf War (1990-91) was the direct corollary of Japanese commitment to an active role in support for the multilateral security arrangement for the global order.

The Japanese involvement in the UN peacekeeping operations can be seen in other parts of the world during this period. Japan deployed SDF to Mozambique, a non-Asian nation for the first time. This was important in the light of Japan's claim to being a truly global political power and not merely an economic giant with a limited, regional political outlook.[56] Japanese efforts to participate in these peacekeeping operations were in the mode of 'collective security' for the perseverance of international peace and stability. In other words, for Japan, participating in UN peacekeeping operations represents a concrete way of

[54] Japan was criticised of its 'cheque book' diplomacy during the Gulf crisis (1991) as its contribution to the crisis was mainly financial aid to the allied forces. This criticism forced Japan to participate in issues affecting its long-term interests. As a result, Japan passed a legislation which allowed a dispatch of the SDF members up to 2000 for overseas under the UN sponsored peacekeeping operation.

[55] The passage of the UN Peace-keeping bill was indeed a signal event in Japan's evolution from a politically marginal state to one that accepts its responsibility to help maintain the open and stable international order upon which its own safety and prosperity depend. The post Gulf War elite consensus that 'Japan must do more internationally' was being implemented in a form that few would have predicted prior to 1990.

[56] Derek McDougall, *The International Politics of the New Asia Pacific*, Singapore, Lynne Rienner, 1997, p. 38.

discharging its responsibility to help maintain global order, but it is not in itself a viable method of assuring Japan's own national security.

Creation of regional security framework: Japan's growing prominence in Asian economic affairs coupled with the collapse of the Cold War's security structures have generated mounting pressure, both within Japan and in Asia, for Tokyo to take a more active role in addressing the region's political and security agenda. Certainly, Japan's economic stake in the region gives it grounds to take a broader view of its interests than would have been the case two decades ago. Under such circumstances, a high degree of Japanese involvement in the region in order to promote stability and security as well as to continue the economic contribution for regional development remains necessary. Political stability and security is a necessary condition for economic cooperation in the region. In the early 1990s policy makers and opinion leaders have greatly expanded the boundaries of dialogue within Japan over how best to promote Asia-Pacific regional security.

However, Japan realised that its globalist policy would not be complete without addressing its regional aspirations successfully. Essentially, this means that Japan must maintain regional stability and continued access to market and investment opportunities in the Asia-Pacific region. The economic significance of the region to Japan is evident in a number of areas, including trade, aid and investment. By 1995 Japanese investment in the Asia-Pacific region was worth nearly twice that of the United States. In order to achieve this objective, Japanese policy makers worked hard to promote the APEC forum, which emerged as the central means in the region. With a commitment to 'open regionalism' APEC enables Japan to pursue its economic interests, which was realised as part of the agenda to liberalise and deregulate the regional market.[57] This regional integration elevated Japan to the status of a regional super power. There were suggestions that Japan's foreign policy should reflect the changed circumstances and that the Japanese government should seek to balance its relationships with the regional countries.[58] The opportunities for Japan to play a regional role increased considerably in the post-Cold War period with the rise of Asian nationalism, both within and several Asian countries. Lincoln, for example, argued that the region required leadership and that Japan was well placed to fill that role given its economic size and influence and, indeed that Japan was beginning to exercise leadership in order to bring regionalism to fusion.[59] This is evident from the fact that, alongside for the push for regional integration and coherence and the requirement for leadership role, Japan is seeking for permanent representation in the UN Security Council.

Japan's economic importance in the Asia-Pacific region can also be seen in the high level of Japanese involvement in terms on intra-regional trade within East Asia. In 1990, 40 per cent of East Asian imports originated in East Asia, and 39 per

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[57] Driven by the chief donor and dominant foreign investor, Japan turned to the Asia-Pacific region to promote regionalism to catch up with the West. Japan has been very cautious of this process that its foreign policy is unlikely to repeat itself and the process of regional engagement will be peaceful. For meaningful regional integration it is inevitable that Japan be persuaded to take on a more active and assertive political role. However, even as Japan interacts more extensively with East Asian countries. Japanese foreign policy objectives were not served by policies to form institutionalised regionalism, instead Japan has been pursuing a form of regionalism that dampens regional identity and is consistent with the current discussions of the US-Japan relations.

[58] Javed S. Masood, 'Japanese Foreign Policy and Regionalism' in Javed Masood (ed.), *Japan and East Asian Regionalism*, London, Routledge, 2001, p. 10.

[59] Edward Lincoln, *Japan's New Global Role*, Washington, D. C., The Brookings Institution, 1993, p. 171, quoted in Javed Masood, 'Japanese Foreign Policy and Regionalism' op cit, p. 10.

cent of East Asian export went to regional countries.[60] The increasing level of economic integration in East Asia has led to speculation about the development of a 'yen bloc.'[61] In general, by giving greater emphasis on intra-regional economic interaction, Japan has emerged as the economic leader in the region. The growing tendency of regional groupings in other parts of the world has clearly suggested to Japan that it should take on the leadership to create an economic bloc. And this could be characterised as a revival of the older idea of the 'Greater East Asia Co-prosperity Sphere.'[62]

The end of the Cold War has brought Japan to face new security challenges in East Asia. In particular, the collapse of the Soviet-type Communist regime led to the problem of transition for the communist regimes of China, North Korea and Vietnam. In Europe the post-communist regimes have given way to liberal democracy, while in East Asia, in contrast, the problem is the metamorphosis of the communist regime in the post Cold War world. The major challenge of Japan's foreign policy in the post Cold War period is the fact that how to evaluate the resilience of the communist regime in North Korea and its nuclear weaponisation

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[60] Charles Smith, 'The Battle to Come', *Far Eastern Economic Review*, 5 May 1994, pp. 14-15.

[61] The out-ward oriented growth strategy of Japan , which was followed by the four East Asian NICs and recently the ASEAN countries , is one of the most remarkable trends in the world economy over the last four decades. Among them, the NICs and ASEAN countries pursued the Japanese method for their econ0omic growth strategies. And Japan played a significant role in the economic development of these countries through aid and investment. Japanese presence could be seen in every financial activity in the region. In 1991, Japanese direct investment to the region was approximately equal to its investment in Europe, and was much less than its investment in North America. Thus, the increasing proportion of regional trade and finance through the yen has created demand for establishing a yen bloc. For details see, Jeffrey A. Frankel, 'Is Japan Creating a yen Block in East Asia and the Pacific? in Jeffrey A. Frankel and Mikes Kahler (eds.), *Regionalism and Rivalry: Japan and the US in Pacific Asia*, Chicago, Chicago University Press, 1993, p. 67.

[62] Walter Hatch, *Asia in Japan's Embrace*, op cit, p. 40.

programme. Moreover, the military modernisation and the growing economic might of China have caused great concern for Japan. The unresolved issue of Taiwan and China's creeping assertiveness in the South China Sea has raised doubts in the minds of the regional countries about China's long-term ambitions. The Japanese government has also publicly expressed its concern about the possibility that China might use force to resolve the Taiwan question. Any movement from the side of China to settle its problem will have major ramifications on Japan's security and defence policy. As Professor Tsutomu Kikuchi, adjunct fellow of Japan Institute of International Affairs, observed, 'Japan is very serious about the increasing influence of China in the region and our policy towards China is independent and significantly cooperative in character.'[63]

In terms of regional security framework there was no collective security pact for either East Asia or Southeast Asia. Instead, regional countries promoted an open forum for discussing security issues. The commitment to build a platform to discuss security matters materialised with the establishment of the ASEAN Regional Forum (ARF) in 1993 by 18 members of the Asia Pacific Countries. It was formally initiated with the active encouragement of Japan and the United States, with the declared purpose 'for ASEAN and its dialogue partners to work with other regional states to evolve a predictable and constructive pattern of relationship in Asia-Pacific.'[64] On a tour of ASEAN countries in May 1991, Japanese Prime Minister Kaifu made an important speech regarding Japanese role in the region. 'Amidst

[63] Personal interview with Prof. Tsutomu Kikuchi at Tokyo on 29 July 2003.

[64] Michael Yahuda, *The International Politics of Asia-Pacific, 1945-1995*, London, Routledge, 1996, p. 248.

these changing times...' Kaifu noted, 'Japan is expected to make even greater contribution in the Asia-Pacific region– not only in the economic sphere – but in the political sphere as well.'[65] In developing a regional role, Kaifu said, 'We need to go beyond the economic realm and work in political, social, and foreign policy realms as well as to become a major force for stability grounded in freedom and democracy.'[66] Prime Minister Miyazawa expressed similar sentiments in a major speech delivered in Bangkok in January 1993, in which he said that Asia-Pacific countries needed to 'develop a long term vision regarding the future order of peace and security for their region.' He continued, 'various ideas should be thrashed out through political and security dialogue among the countries of the region... Japan will actively take part in such discussion.'[67] It was evident that Japan emerged as an active facilitator of regional consultative institutions in order to promote mechanisms for engagement of the major powers to establish multilateral approach for regional security in the Asia-Pacific region. This was a natural corollary of the Japanese approach to global peace and stability.

The US-Japan security relationship: Although the Cold War security structure ended, the US-Japan bilateral security relationship continued to remain strong during the post-Cold War period also. The emergence of potentially destabilising factors such as vulnerability in the Korean peninsula, the growth of China as a hegemon in the region, developments in Cambodia, Burma, and the Philippines have necessitated the continuance of the bilateral security alliance to underwrite regional

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[65] *Far Eastern Economic Review*, 2 June 1991, p. 13.
[66] Ibid.
[67] *Far Eastern Economic Review*, 23 January 1993. p. 8.

peace and stability. At the same time, the elites in Japan consider the American connection as the sine qua non of Japan's contemporary international position and its bid for global power. Thus the US-Japan security system has to be seen less in bilateral terms, and more in terms of resolving global issues.

Thus, the post-War Japanese foreign policy can be summerised as follows,

- The Japan-US alliance system provided free access to world market of Japanese goods and services.
- The 'separation of economics from politics' policy helped Japan to become an economic powerhouse in Asia by the 1960s.
- Japanese policy towards Asia Pacific region was purely on non-military means.
- The 'Comprehensive Security Policy' censured Japan smooth access to natural resources and raw materials form Southeast Asian region.
- By means FDI Japan managed to build a healthy relationship with the Southeast Asian countries.
- By the end of the Cold War Japan has begun an active participation in the maintenance of international peace and stability.
- Japanese foreign policy in the post Cold War period is aimed to become aan international actor.

Moreover, the impact of FDI in Japan foreign policy in the post-Cold War period could also be seen in Japan's relations with China. Although Japan faced economic stagnation at the domestic level and showed decreasing tendency in its FDI, Japanese FDI to China continued significantly and China became the largest recipient of Japanese FDI in the 1990s. Japan considered that the resurgence of China after the collapse of the Soviet Union as a potential threat for it and also the balance of power in the East Asian region. In order to offset such a threat perception, Japan realised that economic engagement with China is the best policy to reduce 'such' threat perception. Under such circumstances, it is pertinent to understand the nature and characteristics of Japanese FDI that is quite different from the Western FDI.

Role of Foreign Direct Investment

Export led strategy, which has become a trademark of Asia-Pacific development, results not only in increased world trade and rapid economic growth but vastly expanded opportunities for capital investment from the developed world. Foreign direct investment, that is, 'the transmission to the host country of package of capital, managerial skill and technical knowledge' is a potent agent of economic transformation and development.[68] It is capital in search of new economic horizons that characterises today's world economy. Developing countries intensify their efforts to attract FDI and adopt increasingly global strategies to survive and prosper and to speed up the growth rate of their exports. This has prompted one writer to observe in 1977 that, 'as a means of international economic integration, foreign

[68] Kiyoshi Kojima, *Japan and a New World Economic Order*, Boulder, Westview, 1977, p. 77.

direct investment is in its take-off phase; perhaps in a position comparable to world trade at the end of the 1940s.'[69]

The global pattern of FDI inward-outward flows in the early 1980s can be depicted as bipolar, dominated by the United States and the EU, while in the 1990s the global pattern became tripolar, with Japan having emerged as an equally important FDI power at least in terms of outward flows. Japan thereby constitutes the third member of a triad. By 1993 Japan surpassed the United States in terms of outward flows by a substantial margin. [70] Since Japan attained its sovereignty from the US occupation, Japanese FDI had come across the globe through three waves and each stage dominated by different division of production.

The Three Waves of Japanese Investment: Japanese investments have swept across the Asia-Pacific in three successive waves. The first starting in the early 1950s occurred under restrictions imposed by the Occupation Authorities to keep capital from leaving Japan and to pursue Japan's balance of payment.[71] Japanese investment in this period were approved on a case-by-case basis and only if they promoted Japanese exports or resulted in overseas development of the natural resources Japan needed to develop its home industry. Tokyo had slammed the gate on foreign direct investment in to Japan. Competitive foreign firms were prevented from investing in Japan so that they would instead sell their technology to their Japanese rivals.

[69] Ibid, p. 52.

[70] UNCTAD, *World Investment Report 1994, The Triad in FDI*, New York, OUP, 1995, p. 33.

[71] Nester, *Japan and the Third World*, op cit, p. 55.

Japan's first post-war investment began in 1951, when an iron ore development project was opened in Goa, Portuguese India.[72] From then through the 1950s, Japanese foreign investment averaged about $10 million annually, although most of these involved reopening of overseas sales office to promote trade. During the late 1950s and 1960s, Japanese corporations invested in manufacturing and mining ventures in Southeast Asian and Latin American countries in response to those governments' import substitution policies. Over four-fifth or 82.3 per cent of the manufacturing investments by small and medium sized firms and about 70 per cent of all Japanese manufacturing investments were located in Asia, and most of these in Taiwanese and South Korean processing zones.[73] Most of these investments were in relatively standardised labour intensive industries such as textiles, consumer goods, metal products, electrical appliances and chemicals. Moreover, many of these investments were as joint ventures with either indigenous firms or other Japanese or foreign firms. Altogether, however, Japanese FDI in both manufacturing and resource production in the first wave of overseas investment amounted to $166 million in the ASEAN countries in 1966, which was only one-quarter of the American investment to the region at that time.[74]

The second wave of foreign investment from Japan started from the early 1970s as a part of Japan's Comprehensive Security Policy. This was spurred by external as well as domestic factors. During the late 1960s, a range of international and domestic factors pressured Tokyo to drastically ease its controls on foreign

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[72] Ibid.

[73] Terutomo Ozawa, *Multilateralism: Japanese Style*, New Jersey, Princeton University Press, 1978, p. 21.

[74] Vere Simone and Anne Thompson Feraru, *The Asian-Pacific: Political and Economic Development in a Global Context*, New York, Longman, 1995, p. 304.

investments in Japan and Japanese investment overseas. The first major liberalisation step occurred in October 1969 when the Ministry of Finance turned over the reins of foreign investment control to the Bank of Japan and authorised it to give automatic approval for projects worth less than \$0.2 million.[75] In September 1970, the limit for automatic approval was increased to over \$1.0 million and in 1971, completely dismantled, although all projects were still screened. In a series of measures throughout the 1970s, Tokyo selectively reduced its trade barriers to the imports to those manufacturing firms that had set up shops outside Japan.

There are some domestic factors that pushed Japanese overseas investment during this period. Since Japan attained steady balance of payment in 1965, both large and small Japanese firms increasingly pressured the government to allow them more freedom to invest abroad. Although these firms owned surplus capital, the real challenge they faced throughout the 1960s and 1970s was growing labour shortage and the subsequent rise in labour costs. During 1952 to 1972 the average annual growth of wages was 10 per cent. Small and medium sized firms were particularly hard hit by these labour shortages and wage increases. Another domestic aspect to the increase of Japanese capital is land shortage for new industries. The rapid industrialisation during the periods of 'separation of economics from politics', combined with a population of almost 120 million crammed into a small country whose terrain is about 75 per cent mountainous, resulted in an increasingly severe land shortage for industrial sites. This land shortage was exacerbated by a series of anti-pollution norms adopted by the Diet. Moreover, the government had

[75] Nester, *Japan and the Third World*, op cit, p. 57.

implemented 'house clean' strategies to a 'pollution-free' Japan. Foreign investment was increasingly seen as the solution to these problems.

The most significant international factor, however was the imposition of import substitution policies adopted by many of the East and Southeast Asian and Latin American countries during this period, designed to attract foreign direct investment. Japan responded to this initiative with massive flow of foreign investment and started production to export these products to third-country market.

The 1973 oil-embargo and the Nixon's 'shocks' culminated in another international push to foreign investment from Japan. OPEC's action exposed Japan's vulnerability and stimulated a massive rethinking of policy, which resulted in the Comprehensive Security Policy. Tokyo sourced its energy and raw materials from the cheapest sources and tried to spread its imports as widely as possible, so as not to become too dependent on any region or country for its necessities. Another important factor in this policy was the attempt to bypass the foreign middlemen like the Seven Sisters oil corporations, and instead to encourage Japanese corporations to embark on a search of large-scale oil, minerals and raw materials.[76] Moreover, although Tokyo's strategy of spreading its resource suppliers as strategically as possible, the host countries were dependent upon Japan as a market for their abundant natural resources, the tactic provided a leverage for Japan. For example, in the case of bauxite, 96.3 per cent of Malaysian export, 84.6 per cent of Indonesian export and 92.7 per cent of the Filipino exports go to Japan thereby making these

[76] Ibid.

countries heavily dependent upon the latter.[77] As a result the relationship between Japan and these countries became more cordial and interaction between them increased significantly.

A third 'tidal wave' of investment was spearheaded by Japanese banks and security corporations in the mid-1980s, quite apart from Japanese investment in manufacturing and natural resources. Between 1980 and 1985 alone, cumulative Japanese FDI doubled from $36 billion to $70 billion, of which 32.2 per cent went to North America, 23.1 per cent to Latin America, 24.8 per cent to Asia, 12.2 per cent to European Union, 4.5 per cent to Africa, and 2.2 per cent to Australia. [78] These Japanese investment flows generally followed the historical pattern.

The yen appreciation, beginning in September 1985 after the Plaza Accord, began to shift in the growth rate of Japanese investments abroad. [79] The largest recipient of Japanese foreign investment up to 1987 was the US with $25.29 billion, a figure three times larger than the second ranking country, Indonesia with $8.423 billion, eight of the next 12 recipients being developing countries.[80] During this period, particularly after Prime Minister Fukuda's 1977 pledge of major support to ASEAN projects, and Prime Minister Suzuki's effort to refocus Japanese aid and

[77] Ibid.

[78] *Japan 1987: An International Comparison*, Tokyo, Keizai Koho Centre, 1987, p. 56.

[79] In September 1985, the Group Five member countries summoned at the Plaza Hotel in New York. The main agenda was to discuss the ongoing US deficit. The meeting ended with the decision to devalue the dollar against all the major currencies. As a result, the exchange rate of the yen against the dollar rose by about 90 per cent and an effective real exchange rate of the yen by about 50 per cent. This extensive and strengthening of the yen brought about a sharp, wide spread decline in the cost of production in host countries relative to the cost in Japan. Thus the strong yen made difficult for production in Japan and it shifted the production centres to the developing countries in large scale manner in the 1980s.

[80] Nester, *Japan and the Third World*, op cit, p. 65.

investment on clearly designed priority areas, the Southeast Asian region attained significant importance in the flow of Japanese foreign capital.

The staggering current account surplus of over $50 billion by the end of 1980s, the world's eight largest banks, service industries like finance, insurance, real estate and travel has accounted for the largest percentage of Japanese foreign direct investment. In 1988, about one-third of new Japanese investments were in finance and insurance, followed by 17.9 per cent in real estate, 17.6 per cent in manufacturing, 8.7 per cent in other services, 8.6 per cent in natural resources and 7.0 per cent in other categories. According to MITI's 1985 survey of small and medium sized firms investing abroad, there were two factors that motivated Japanese foreign investments.[81] The primary reason for Japanese foreign investment was to capture that country's market (55 per cent), followed by the quest for cheap labour (45 per cent). Of secondary importance was the export of technology (29 per cent), the sourcing of exports to Japan (29 per cent) and a base for exporting to third countries (28 per cent). It is to be noted that the reason for investing in developing countries mainly depends on that country's level of economic development. In 1987, Japanese investment to NIEs was 7.7 per cent of its total foreign investment, while the ASEAN-four captured four per cent of the total outflow from Japan.[82]

During the period of 1980s, the largest FDI flow was to the US that is as high as 32 percent. Then come Asia and its share stood at more than 25 percent followed by Europe and Latin America (see Chart 2.1).

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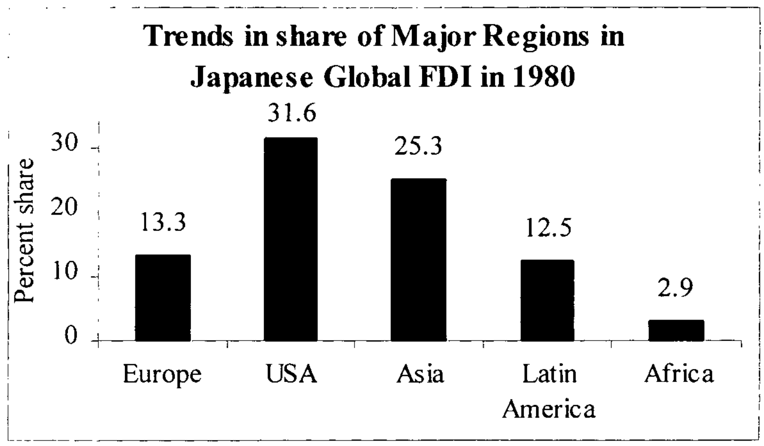
[81] MITI, *Survey of Small and Medium Sized Firms*, Tokyo, 1985.

[82] Richard F. Donor, 'Japanese Foreign Investment and the Creation of a Pacific Asia Region', op cit, p.184.

Chart 2.1



Source: Ministry of Finance, Tokyo, 1981.

The OECD countries captured the largest share in Japanese total FDI flow in 1989. These countries are 23 in number, including the G-8 and other West European and North American countries. The share of Asia had been nearly 13 per cent and the relative share of other major regions such as Latin America and Africa had been at low ebb.

However, the Japanese FDI outflow, after reaching a peak of US$ 48 billion in 1990, declined by 36 per cent in 1991 and 44 per cent in 1992 to the level of $30 billion and $17 billion respectively. Having been the largest source of FDI for two years, Japan lost that position not only to the US, but also fell behind France. After falling to fifth place to the world's largest ranking in 1993 to $12 billion, Japanese

FDI outflow were regained substantially with the increase of 20 per cent in 1994 and 15 per cent in 1995.[83]

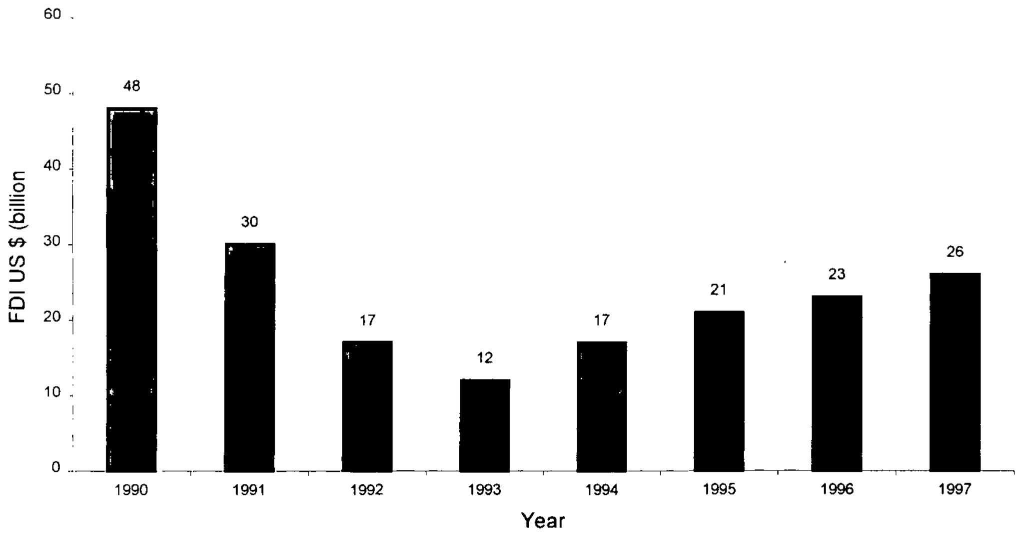
The drastic decline in Japanese outflows was caused by a combination of adverse cyclical and special factors, many of which were interrelated. The decline of Japan's importance as an investor country was mainly due to the burst of the 'bubble' economy in the early 1990s. As in other developed countries, the recession led to decreasing profitability of Japanese investment at home and abroad. Reinforced by special factors, their decline in profitability was probably higher in Japan than in other countries. At home, operating profits of Japanese companies declined by one per cent in 1991 and 20 per cent in 1992.[84] Abroad, profits of Japanese affiliates declined, especially in US and Europe by 30 per cent.

But the Japanese FDI began to increase substantially since 1995. In 1995, Japanese FDI reached to $21 billion and $23 billion in 1996 and it increased by another 15 per cent to $26 billion in 1997.[85] These occurred partly because of the upturn in the world economy in the latter part of the 1990s. While comparing the periods of 1986-1990 and 1991-1997, Japanese FDI flow declined from a yearly average of $32 billion to an average of $22 billion; as a result, Japan's share in world wide outflows was almost went in half to 10 per cent, nearly returning it to the level of the early 1980s.[86]

[83] UNCTAD, *World Investment Report*, New York, Oxford University Press, 1996, p. 59.
[84] UNCTAD, *World Investment Report*, New York, Oxford University Press, 1993, p. 45.
[85] *JETRO White Paper On Foreign Direct Investment*, Tokyo, JETRO, 1997.
[86] UNCTAD, *World Investment Report*, New York, Oxford University Pres, 1998, p. 157.

Chart 2.2

Major Trends in Japanese FDI in the 1990s



Source: JETRO, *White Paper On Foreign Direct Investment*, Tokyo, 1998

A Brief Analysis of Japan's FDI Policy Towards Developing Countries

Japan's foreign investment policy has been an important facet supporting its overall policy towards the third world. As early as the mid-1970s, Ozawa had recognised that overseas production was emerging as an integral part of both Japan's economic growth and strategy and its foreign economic policy.[87] Tokyo has actively promoted foreign investments as a means of securing or reinforcing markets in the developing countries for its goods, and also tapped raw materials and energy sources from these countries for its own economy. The greater the amount of Japanese investment in a particular country, the greater the opportunity and tenacity to use those investments

[87] Terutomo Ozawa, *Multilateralism: Japanese Style*, New Jersey, Princeton University Press, 1978, p. 21.

as a means to influence that country's political elite, and thereby enhance Japan's political and economic power. [88]

Japanese FDI around the globe in general and the third world in particular has increased over the past 50 years. Between 1951 and 1974, Japanese corporations directly invested $12.7 billion in 11,416 overseas projects.[89] From 1974 to 1987, the number of Japanese overseas investments quadrupled to 44,707 while the value of the investments increased tenfold to $139.3 billion. Japanese corporations invested almost three-fifths of their total foreign investments in the developing world, of which Asia accounted for $26.7 billion and Latin America $25.1 billion, although the projects in Latin America (5,930 projects) were about twice as capital intensive as those in Asia (13,691 projects).

Moreover, compared to the other industrial nations whose foreign investments comprise of wholly owned ventures by their large corporations, in the case of Japan, over 40 per cent of their foreign investments have consistently comprised of small to medium sized firms and more than half of their investments have been joint ventures between Japanese and local firms.[90] These investment patterns of Japan have contributed immensely to its domestic economic growth and the technological advancement to its domestic industries.

Among the developing countries, Asia has been the most favoured destination of recent global FDI surges, with this region attracting more FDI than the combined shares of Africa, the Middle East, Latin America and Eastern Europe.

[88] Nester, *Japan and the Third World:* op cit, p. 49.

[89] *Japan 1989: An International Comparison*, Tokyo, Keizai Koho Centre, 1989, p. 56.

[90] Nester, *Japan and the Third World*, op cit, p. 50.

Asia Pacific region has experienced three foreign investment waves in recent times; the first was in 1971-73, the second at the end of the 1970s till early 1980s and the third and largest began in the latter half of the 1980s and has continued into the 1990s, although at a slightly reduced pace.[91] These investment waves started with the New Industrialised Countries (NICs) followed by ASEAN countries and finally shifted to China, Vietnam and South Asia.

The single most important reason for this ranking of the different parts of the region is the comparative advantage of the lower wage levels. The advanced countries can themselves bring in the most efficient machinery and infrastructure in order to get the best of the two worlds, a fusion of high technology and high labour productivity. On the other hand, concerned by the high labour costs, these investors, in search of lower costs for its labour-intensive industries, had to relocate initially from the high waged NICs to ASEAN countries, and later on to China, Vietnam and South Asia.

MITI's 1985 survey of small and medium sized industries investing abroad clearly describes the purpose and patterns of Japan's overseas investments.[92] The *raison d'être* of Japan's overseas investments can be divided into two factors, primary and secondary. By far, the most important primary reason for foreign investment was to capture that country's market (55%), followed by a quest for cheap labour (46%). The secondary reasons include the export of technology (29%),

[91] Rob Steven, *Japan and the New World Order: Global Investments, Trade and Finance*, London, Macmillan, 1996, p. 92.

[92] Quoted from Nester, *Japan and the Third World*, op cit, p. 66.

the import of resources and finished goods from these countries to Japan (29%), and to provide base for Japan to export to third countries' markets (28%).

The criteria for investing in developing countries include that country's level of development also. Coming to specific investment character of Japan, it can be seen that the primary factors for investing in NICs were to secure markets (54%) and exploit cheap labour (45%); of secondary importance were exports to third countries (31%), technology transfer (29%) and import of products and resources back to Japan (28%). As far as investments in China are concerned, securing markets (60%) continued to be the major reason, although it was not that important a reason for investing in NICs, while exploiting cheap labour was a major factor in China and NICs. Of secondary importance was import back to Japan (34%), technology transfer (31%) and utilisation as base for export to third countries. In contrast to Japanese investments in the NICs and China, utilising cheap labour (55%) was the most important reason for investing in ASEAN countries, followed by securing markets (50%). Of secondary importance were imports back to Japan (28%), tapping resources (28%) and technology transfer/exports (25%).

Another survey by the Japan Export Import Bank in 1993 revealed that 87% of Japanese companies indicated a desire to invest in China in the future. The rationale for this interest is to tap the emerging market in China (62%), to exploit its cheap labour (47.6%) and to import finished goods back to Japan (22%).[93] Vietnam and India could be the next in line. This amply describes the recognition given to the growth pattern of China as much better than the other countries in the region.

[93] Rob Steven, *Japan and the New World Order*, op cit, p. 92.

Developments could be more rapid in India following the liberalization of India's foreign investment policies. Interestingly, Japanese FDI in India soared manifold in 1992 to $122 million.

Table 2.1

Trends in Japanese FDI in Asia 1951-1989 (US$ million)

Region/Country	Amount	Percentage to Total FDI
NIEs	15,018	46.8
Hong Kong	6,167	19.2
South Korea	3,248	10.1
Singapore	3,812	11.9
Taiwan	1,791	5.6
ASEAN	14,750	46.0
Indonesia	9,804	30.6
Malaysia	1,834	5.7
Philippines	1,120	3.5
Thailand	1,992	6.2
SAARC	270	0.9
Bangladesh	11	---
India	148	0.5
Pakistan	18	0.1
Sri Lanka	93	0.3
China	2,036	6.3

Source: Ministry of Finance, Government of Japan, Tokyo, No.25 February 1990. Quoted from Badar A. Iqbal 'Attracting Investments,' *Seminar* 397, September 1992, p. 25.

According to Kiyoshi Kojima, there are two types of foreign direct investment: US-style FDI and Japanese-style FDI.[94] The Japanese style FDI

[94] Kiyoshi Kojima, 'Japanese Style Direct Foreign Investment', *Japanese Economic Studies*,.

considered as labour-oriented or market oriented because it increases labour opportunities in the host country. This type of FDI is primarily in labour intensive industries where wages are high to a low wage country where cheaper labour cost prevailed. It also a market oriented investment, induced by trade barriers in the host country and to adjust balance-of-payment problems. It promotes import-substitution industrialisation process on the host country, and will bring intermediate materials, machinery, equipment and technology to the host country. On the other hand the US-style FDI does not provide technology and management skills to the host country, it typically carries sophisticated technology and invests in the capital-intensive industries. Detailed analyses of both types of FDI follow.

US-Style FDI: The sudden growth of US based multinational networks after World War II was in fact some time in the making. Many decades earlier, the first signs that large enterprises might find themselves pushed to develop a multinational structure were already beginning to appear. Setting the stages for the development of these multinational networks were the dramatic improvement in the technologies of transportation and communication, coupled with the vastly increased opportunities for scale economies in industrial production. However, in due course of time, the increased competition for market sharing by rival companies from domestic as well as European firms necessitated them to go more widely for searching new markets and business opportunities. Finally a decade or two after the Second World War, the US companies enjoyed technological and financial advantage over their European rivals through innovation and disseminating in the world market. They expanded the

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business horizons to distant locations for marketing their products and the sourcing of their inputs.

The first reaction of most US firms to this expanding product market was to meet demands by increasing exports from the home base. To achieve these ends, the US firms started to setting up subsidiaries in the host country. Almost all of the first wave of manufacturing subsidiaries established in foreign countries after World War II were dedicated principally to serving the local markets in which they were placed.[95] As a consequence, about four-fifth of the sales of such subsidiaries during the 1960s and 1970s were directed to capture local markets.

Another tendency of the US firm's direct investment policy is the fact that the US based firms were engaged in follow-the-leader behaviour in establishment of a new producing subsidiaries abroad.[96] Once a US based firm in an oligopolistically structured industry set up a producing subsidiary in a given country, the propensity of other US based firms–the oligopoly–to establish a subsidiary in the same country was visibly heightened.[97] The US MNCs are larger firms, oligopolistic in character, characterised by high capital intensity, advanced technology and differentiated products.[98] In this matter, both the follower and the leader were responding to a common outside stimulus or the follower was responding in the belief that the leader had done a rational analysis, equally applicable to both their situations.

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[95] Raymond Vernon, 'Where are the Multinational Headed?' in Kenneth A. Froot, *Foreign Direct Investment*, Chicago, Chicago University Press, 1993, p. 59.

[96] Ibid, p. 60.

[97] Ibid.

[98] Stephen Hymer, 'United States Investment Abroad' in Peter Dresdale (ed.), *Foreign Direct Investment in Asia and the Pacific,* Canberra, Australian National University Press, 1972, p. 78.

With the ever-increasing capacity of technology and capital, developed and assimilated by the MNCs through the international movement of the capital, many of the US based firms chose to establish producing subsidiaries rather than to exploit their strategies through licensing or through other contractual agreement with a local firm. In some cases, high transaction costs associated with searching out and dealing with local firms led to some difficulties. Whenever licensing agreements are negotiated, both parties face the uncertainties generated by asymmetrical information: the licensee is uncertain to the value of information it is to receive, while the licenser is uncertain to the use which licensee proposes to put the information.[99] In this regard, the evidence indicate that US firms continue to use their multinational networks to transfer their newly generated products and processes to the US or to other countries through their own subsidiaries. It can be argued that American style of FDI is 'anti trade oriented' or involves foreign direct investment that works against the structure of comparative advantage. The innovative and oligopolistic industries would strengthen their position in the vast market by using their foreign subsidiaries as feeders for manufacturing facilities in the US to use those facilities to fill requirements arising anywhere in the world. Of course, in practically every multinational network, the parent unit in the US typically continued to occupy a unique position. Characteristically, the parents' US sales skill accounted for the bulk of network sales. That is, US facilities were responsible for the most important research and development work in the network, and its US

[99] Ibid.

offices still co-ordinated some of the networks' functions that might benefit from a centralised approach, such as the finance function.[100]

According to Kiyoshi Kojima, the MNC style FDI has four characteristics:

1) A typical FDI in a manufacturing industry advances by means of its monopolistic absolute advantage (particularly of a technological nature) and attempts to achieve monopolistic gains by dominating the host country's domestic market. For this reason foreign investment in this category is most often found in those high technology industries with high degree of product differentiation and oligopolistic set up. Thus the outcome is often anti-trade oriented; as this type of FDI is liable to reduce the investing nation's exports, i.e., reduce imports of host countries.

2) MNCs attempt to internalise their various transactions (markets) through global networks of subsidiaries, thereby reducing transaction costs and maximising profits. A new theory asserts that gains arising from this internalisation are the most important motive for the business operations of MNCs.

3) MNCs tend to maintain that completely owned enclave-type subsidiaries are more desirable for the achievement of monopoly profits through market internalisation and intra-firm division of labour due to the ease in the realisation of unified management and prevention of leaks of corporate secrets. Indeed, they often insist on this point.

[100] Ibid.

4) Overseas direct investment is justified by the MNCs for the growth and profit taking of business enterprises. In other words, FDI is justified and supported solely from the viewpoint of international management approach that protects micro level profits of business enterprises. And it excludes macro-level (national) interests such as effects on national welfare of both the investing and the host countries.[101]

Japanese-style FDI: As compared with the US model of FDI, Japanese FDI has played a pioneering as well as intermediary role in creating and promoting regionalism in the Asia-Pacific (East and Southeast Asia) region. The Japanese direct investment promotes regional linkages between Japan and two major groups of developing capitalist countries in East Asia: the newly industrialised countries which include South Korea, Taiwan, Hong Kong and Singapore; and four members of ASEAN, which include Indonesia, the Philippines, Malaysia and Thailand. To understand this pattern of interaction, Japanese FDI broadly includes not simply foreign direct investment in the form of equity participation in overseas ventures, but also the intermediate forms of foreign investment, such as technology agreements, licensing and machinery sales that yield knowledge-based assets.[102]

The movement of capital across borders from Japan started since the Meiji Restoration. During this time the industrial structure of Japan exhibited some distinctive national characteristics. Dominating the core of Japan's modern economy under half a dozen conglomerate organisations (zaibatsu), each with its own captive

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[101] Kiyoshi Kojima, 'Japanese Style Direct Foreign Investment', *Japanese Economic Studies*, Spring 1986, Vol. 14, No. 3, p.68

[102] Richard F Donor, 'Japanese Foreign Investment and the Creation of a Pacific-Asia Region', op cit, p. 159.

bank, trading company and portfolio manufacturing and service enterprises. This emerging zaibatsu went to the colonial region in order to open up and manage new industries and business. During the colonial period, Japanese investments moved heavy and chemical industries to the colonial region. It expanded them by a large-scale infusion of financial and human resources. Generally speaking, the colonial industry and business served the purpose of supporting the industrial expansion of the colonial power, Japan. At the same time, the colonies also provided the consumer market for the manufactured products of Japan. Through these two channels, the imperial power derived double benefits from the colonial regions. Nevertheless, Japan lost its colonial region and its overseas business empires after its defeat in the Second World War by the Allied forces.

Post-War Japanese investments fall into four categories: investment for resource development, investments in import-substitution industries to maintain foreign market share, investment in production for export to third countries, and service sector industries.[103] Japan's earliest post-war FDI was in ***resource extraction development***, which was principally directed towards the Southeast Asian region. Its purpose was to assure supplies of minerals, oil, timber and pulp for home consumption. Indonesia, the recipient of much of this investment has remained Japan's second largest investment destination after the US. Japan has begun to invest in developing countries with the object of securing increased imports of primary resources, which are vitally important for Japan's economy. This is called

[103] Masahide Shibusawa, Zakaria Haji Ahmad and Brian Bridges, *Pacific Asia in the 1990s*, London, Routledge, 1992, p. 20.

'development assistance for imports.'[104] It was first directed towards natural resource development projects such as oil and natural gas, iron ore, coal, copper, bauxite and other metals. Then the host country can export its abundant natural resource to Japan through which the employment and managerial capacity of the host country will be enhanced. Thailand's successful development maize export to Japan is a good example. Since February 1970 the Asian Trade Development Corporation has been providing subsidies to development assistance wider imports, with regard to various agricultural products produced in the wider Asian arena. The Japanese government gave priority to and provided low interest rate foreign exchange loans to those enterprises, which venture to develop new natural resource deposits.

A second type of Japanese FDI is in ***import-substitution industries.*** These are manufacturing firms that set up shop behind another country's import barriers to produce relatively standardised goods for local consumption – textile goods, toys, electrical appliances, consumer electronics and metal products come under this category. Japan relocated much of its labour intensive industries to South Korea and Taiwan in this way during the 1960s. An important characteristic of this type of Japanese FDI is the larger number of small-and-medium-sized firms that have invested in these countries with the capital and technical assistance of Japan's large trading firms.[105] Forty per cent of Japan's foreign investments are still made by

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[104] Kiyoshi Kojima, *Japan and New World Order*, op cit, p. 77.

[105] Richard F. Donor, 'Japanese Foreign Investment and the Creation of a Pacific Asia Region', op cit, p. 159.

small and medium sized firms that inevitably follow abroad the large corporations with whom they have subcontracting arrangements.[106]

A third type of Japanese FDI is in ***production for export to third-country*** markets. The purpose of such investment is to take advantage of abundant cheap labour and the investment incentives – income tax exemption, free plant sites and duty-free import of raw materials – provided by countries in export-processing zones. In the 1970s and 1980s, after the Japanese government eased its restrictions on overseas investment, investment of this kind were made in NIEs, ASEAN countries as well as in China in the 1990s. In 1992, for instance, 38.6 per cent of total electronic products manufactured by Japanese MNCs in the NIEs and 47.6 pe cent of those in ASEAN were exported to third countries, whereas only 22.1 per cent of those in NIEs and 27.6 percent in ASEAN were exported to Japan.[107] Finally, the fourth type of Japanese FDI is in the ***service sector***; which includes investments in finance, real estate, travel and insurance. In 1988, 32.4 percent of new Japanese foreign investment was in finance and insurance, followed by 17.9 per cent in real estate, 17.1 per cent in manufacturing, 8.7 per cent in other services, 8.6 per cent in natural resources, 8.3 per cent in commerce and 7.0 per cent in other categories.[108] In this category, the banks, securities and insurance companies are the investing units in place of large or small and medium enterprises. In 1988, 77 per cent of Japanese foreign investment that went to Singapore, according to a government

[106] Nester, *Japan and the Third World*, op cit, p. 65-66.
[107] Ministry of International Trade and Industry (MITI), *MITI Report 1993*, Tokyo, p. 93.
[108] Nester, *Japan and the Third World*, op cit, p. 65-66.

estimate, was in non-manufacturing business.[109] Japanese department stores have opened branches throughout Southeast Asia, capturing increasing shares of the retail market as they forced local department stores to sell rather than face bankruptcy. And many of the consumers of these items are the Japanese tourists, since prices in these stores are lower than comparable items at home.

Unlike the MNC-style FDI, Japanese FDI is regarded as 'trade-oriented' or 'development-oriented' FDI. The Japanese direct investment can reduce the costs of production in Japan and the host country. This indicates that Japan should start its foreign investment first in industries in which Japan already has or is moving into comparative disadvantage (by the same token, the host country is gaining comparative advantage). The lack of technology, capital, and management skills minimise the potential comparative advantage to the host country. Direct investment will assist the host country in its potential, consequently allowing these new industries to grow into export-oriented industries. In the meantime, Japan develops a new comparative advantage industry, into which labour and capital are to be transferred from the industries that have developed overseas.[110] Thus, the structural adjustment is facilitated at home. The industrial structures of both Japan and the host country improved through this process, expanding harmoniously trade between them, by which the political and economic relations materialised in a bilateral way.

A substantial portion of Japanese direct investment in manufacturing is undertaken by small and medium sized firms, which have lost their comparative advantage in the home country. As the Japanese economy developed further and

[109] Shibusawa, *Pacific Asia in the 1990s*, op cit, p. 20.

[110] Kojima, 'Japanese Style Direct Foreign Investment', op cit, p. 69

further, its pools of labour become relatively inadequate. Wages rose higher and higher, thus making labour-intensive industries relatively more costly. Japan then turned, for example, to Korea, where wages were one-third or one-quarter to those of Japan and labour efficiency was relatively high. In order to get advantage of this abundant labour, Japan created joint ventures for the manufacturing of textiles combining Korean labour with Japanese capital, technology and management skills. Thus, the strategy is to transfer of those industries in which Japan is losing its comparative advantage, and to invest in developing countries which are gaining a comparative advantage in the same industries. In other words, foreign direct investment in developing countries from Japan has made the situation more conducive for the economic development of the host country than the American style of investment, which are preferred to wholly owned subsidiaries.

The Japanese investment in the Asia Pacific region has created a progressive division of labour among the regional countries. By the beginning of the 1980s, the Asia-Pacific countries unleashed export oriented industrialisation strategy by which these countries attracted a considerable amount of Japanese direct investment. The cumulative Japanese capital flows to the region increased from $ 5.5 billion in 1976 to $ 19.5 billion in 1985 and $32.3 billion in 1988, and $87.0 billion by the end of 1997, an almost sixteen fold increase within 25 years.[111] The NIEs and ASEAN-Four accounted for over 90 per cent of this total. Japan became the primary investor in Indonesia, Thailand and South Korea and the second most important source of foreign investment in Malaysia, the Philippines, Hong Kong, Taiwan and Singapore.

[111] UNCTAD, *World Investment Report: Trends and Determinants*, New York, Oxford University Press, 1998, p. 56.

The Japanese investment into these regions has proceeded by the 'flying geese' analogy which involves each country capturing increasing sophisticated product by acquiring advanced technology and capital, which in turn shifts their attention towards other developing economies. Most typical in this regard is the assembling process of automobiles and electrical appliances.[112]

Another feature of the Japanese style FDI is that it would play a teaching role by starting, guiding and promoting the balanced and orderly industrialisation of receiving developing nations.[113] The foreign direct investment is considered as 'a potent agent of economic transformation and development, not only in the developed countries but also in the developing countries as well.'[114] Japan has transferred its technology in an orderly manner, starting with simplest and easiest, to teach the labour intensive manufacturing that the receiving nations require most, thereby enabling them to utilise management and marketing techniques by the local people, and encouraging them to establish business by themselves.[115] When the foreign firm successfully complete its job as a tutor, it would be better if it faded out. Then the direct foreign investment must shift to the production of more sophisticated intermediate goods. This is the logical conclusion in the case of Japanese-style investment and Japan has been successful in achieving economic development by proceeding with industrialisation step by step as described above.

[112] For details, see Shimokawa Koichi, 'The Internationalisation of the Japanese Automobile Industry', in Glenn D. Hook, *The Internationalisation of Japan*, op cit, p. 156.

[113] Kojima, 'Japanese Style Direct Foreign Investment,' op cit, p. 71.

[114] Kiyoshi Kojima, *Japan and New Economic World Order*, op cit, p. 85.

[115] Ibid.

Thus the Japanese FDI has played a significant role in the economic development of the host country. Japan provided capital, technology and managerial skills to the host country by which the host country's economic efficiency has increased. This economic activity led to the strengthening of political cooperation between Japan and host country. The Japanese public and private sector officials were concerned about the political uncertainty in the Southeast Asian region during the 1960s and 1970s. The Japanese government poured financial aid to the regional countries with concessional interest rates for various projects including infrastructure development which was necessary for Japanese private companies to extract natural resources from the remote region. Moreover, Japanese Banks gave loan to the joint partner of the Japanese investment as its share in the projects. After the announcement of the Fukuda doctrine, the Japanese involvement public as well as private into the Southeast Asian region has increased significantly.

This public-private relationship in the Japanese FDI can be evident from the fact that Ministry of Finance (MOF) and Ministry of International Trade and Industry (MITI) was channelled for many of Japanese FDI projects. The SCAP regime's severe restrictions on Japanese overseas investment continued until the 1970s, when MOF carefully screened all investment request on a case-by-case basis.[116] It was understood that the approved 'Japanese investment had to either promote export from Japan or lead to the overseas development of natural resources vital to Japanese industry and they should not jeopardise the competitive position of other Japanese firms at home, and they should not interfere with Japan's

[116] Nester, *Japan and the Third World*, op cit, p. 55.

macroeconomic policies or disrupt the balance of payments.'[117]Moreover, MITI helped private firms to seek permission from the host country to invest in primary sectors which were of comparative advantage for Japanese industry.

Since the 1970s, MITI actively promoted Japanese private firms to invest abroad. The rapid industrialisation during the first decades severely aggravated pollution problem in Japan. the result was the 14 bills passed by the Diet in 1970 imposing strict restrictions on industrial and automobile pollution.[118] In 1971, MITI pronounced a policy of reorienting Japan's economy away from 'pollution-prone, to clean' industries.[119] These rules forced many of the small-scale industries to shift their production to the Southeast Asian countries. The Japanese government provided financial and logical support to the companies by deregulating the restriction imposed upon the outflow of direct investment.

How the Japanese government's policies spurred the outflow of direct investment can be seen after the inception of the comprehensive security policy. The Japanese government sponsored the Asahan industrial complex in Indonesia during the late 1970s.[120] The complex included the construction of an immense dam and hydroelectric power station on the Asahan river, which in turn fuels an aluminium refinery and a range of related industries. The Japanese-Indonesian agreement was signed in July 1975 and the project billed as the 'TVA of Suharto government' and the 'showcase project' of Japan's comprehensive security project.[121] The project was

[117] Ozawa, *Multilateralism: Japanese Style*, op cit, p. 60.
[118] Nester, *Japan and the Third World*, op cit, p. 60.
[119] Ibid.
[120] Ibid, p. 100.
[121] Ibid.

completely financed and organised by the Japanese government. Over 70 per cent of the projects total cost came from government financial sources, which included Export Import Bank funds for the aluminium refinery, the Overseas Economic Co-operation Fund (OECF) funds for the power station and Japan International Co-operation Agency (JICA) funds for the port, highways and other infrastructure projects, while 20 per cent came from private Japanese banks and the remaining 10 per cent from the Indonesian government.[122] The output was primarily shipped to Japan. For the first decade, the five participating Japanese industrial groups would own 90 per cent of the equity and the Indonesian government would hold the remaining 10 per cent, followed by an increase in the Indonesian share to 25 per cent. After 30 years the hydroelectric plant would be owned by the Indonesian government. Subsequently, the 'Asahan formula' became the prototype for similar projects in Brazil, Iran, Saudi Arabia, Mexico and elsewhere.

Japan's relation with Southeast Asia, particularly Indonesia was strengthened after the successful implementation of the Asahan industrial complex. During the Southeast Asia tour, Prime Minister Fukuda promised that Japan will increase its investment projects to the region. Tokyo agreed to provide $ one billion loan to ASEAN's five industrial projects, which included urea plants in Indonesia and Malaysia, a soda ash plant in Thailand, a phosphate factory in the Philippines and a diesel engine factory for Singapore.[123] Japan realised the strategic importance of the ASEAN region since Japan's oil supply passes through the Strait of Malacca. Any form of political and security vulnerability in the region will severely affect Japan's

[122] Ibid.

[123] Ibid, p. 27.

long term interest, and it considered as its duty to address the problem of economic and political stability. Under such circumstances Japan-Southeast Asia relationship was strengthened during the late 1970s and 1980s.

The foreign direct investment has also played a significant role in the relationship between India and Japan. Japan's first post-War investment came to India in an iron ore development project in the Portuguese Goa in 1951. The early Japanese investment to India was dominated by the natural resources development sectors. During this period Japan had been searching for raw materials and natural resources for its rapid industrialisation process and Japan considered India as a major destination for its endeavour. As a result Japan provided financial aid and support for various developmental projects and joint ventures. This relationship manifested by the reciprocal visit of both Prime Ministers from India and Japan and they sought to strengthen the economic cooperation between the two.

However, India-Japan relations deteriorated during the 1960s and 1970s due to the India-China war and various regulative measures adopted by the Indian government during this period. The Sino-Indian war had caused to erode the traditional confidence in Japan over India's non-alignment policy and India's stature in Japan. At the same time India passed a series of laws to regulate the market. Private investment by foreign as well as Indian companies were restricted in order to overcome the balance of payment crisis. Moreover, due to domestic political compulsions Prime Minister Indira Gandhi implemented vigorous socialist policy at the domestic level and tilted towards the Soviet Union at the foreign policy level. As a result Japan turned away from the subcontinent to the Southeast Asian region. This policy shift negated Japanese FDI to India during the period of 1960s and 1970s.

India-Japan relationship has been revived in the 1980s. Prime Minister Indira Gandhi visited Japan in 1983, after a long period since Nehru's visit. Followed by this visit, India began to liberalise its economy and opened its door to foreign investment in non-strategic and sophisticated technology related sectors. During this period Japan invested in India in the sectors of automobiles, electricals, electronics and computer peripherals. This harmonious relationship was further strengthened during the visit of Prime Minister Rajiv Gandhi in 1987. This relationship continued in the 1990s as well. India announced its liberalisation policy officially in 1991 and Japan emerged as the fourth largest investor in India.[124] The liberalisation policy and India's approach to integrate into the Asia-Pacific economies has brought India to the membership of multilateral security forums in the Asia-Pacific region such as ASEAN Regional Forum (ARF), for which Japanese support was necessary. In pursuance of this partnership India is eagerly looking for membership in the Asia Pacific Economic Cooperation (APEC) forum.

There has been a dramatic shift in Japanese investment since the beginning of the post World War era. During the 1960s and 1970s, Japanese firms invested in developing countries (East and Southeast Asia) to surmount import-substitution barriers, capture local markets and utilise cheap labour in standardised consumer industries. But during the late 1970s, and particularly in the 1980s, Tokyo's investment policy was to consolidate its position in the Asia Pacific region. Japan's

[124] Government of India, Ministry of Finance, *Annual Report*, New Delhi 1995.

industrial targeting continued to develop Japan's heavy industrial base, while adding dynamic high technology sectors and managerial skills to the local partner. Moreover, the withdrawal of American presence from the region forced Japan to undertake burden sharing through a high rate of foreign investment to this region. However, Japan ensured peace and regional stability, which guaranteed its needed natural resources and raw materials. Eventually, many of the Asian countries attracted large quantum of Japanese FDI share by introducing export oriented industrialisation strategy that gave them a significant share to the global economic index.

Japan's is one of the most successful foreign policies in the post-World War period. Especially noteworthy was Japan's ability to accommodate the 'pull and push' factors that emerged in the international arena. In the early stages, most of the Japanese sensed their security threat and vulnerability of the nation due to the advent of the Cold War, which was the priority area for Japan's relations with the outside world. To overcome this challenging scenario, Japan accepted American domination with its successful policy of 'separation of economics from politics.' The US security protection and American dominance in the world economy provided Japan a liberal international market through which Japanese products were available around the world. During this period Japanese foreign and security policies were in tandem with the US policies at every international issue.

However, Japan came out of the American centred foreign policy in the 1970s partly due to the crisis in the world economy. The oil crisis and the protectionism in the Western Europe caused vulnerability in Japan's long-term interest. At the same time the American withdrawal from the Southeast Asia pushed Japan to take more responsibility in the economic and political stability of the region. These developments led Japan to initiate a comprehensive approach to its foreign policy that eventually brought Japan into treating Asia as the priority area in its foreign policy apparatus. The comprehensive security policy ensured Japan its search for natural resources and raw material in a long-term basis and Japan captured the regional markets for its goods and services. If the bilateralist policy generated domestic economic growth in Japan, then the regionalist policy transformed this economic growth in Japan to consolidate its position in the East and Southeast Asian region. Thus, Japan managed to overcome its earlier image as the imperialist power in Asia. Finally, Japan became the spokesperson for Asia at international forums like G-8. Most developing countries looked to Japan for their economic development through aid and investment.

The globalist policy attained its momentum in the post-Cold War period and Japan became a 'normal power' in international politics. Although the Japan-US security system continued as a bedrock of Japan's foreign and security policy, Japan began to participate independently in the international system. Japan has been consistently arguing for the establishment of a multilateral world system under the auspices of the United Nations to maintain international peace and security, which is a slight deviation from the US position. At the same time, Japan pursued a policy of concentrating more on the Asia-Pacific region during this period. The emergence of China as a hegemon in the region economically and politically has created vulnerability in Japan's security policy. The shift in American strategy in the East

Asian region towards China from Japan during the Clinton administration fuelled this perception and forced Japan to create a multilateral security system in the region. Thus, Japan's policy in the post-Cold War period is to establish a multilateral security system in the Asia-Pacific region through which all the major powers could participate to ensure security. This in turn will eventually enhance Japan's role regionally as well as globally.

Chapter III

Japan-India Relations

The relations between Japan and India have been based on perceptions and views about the changes in the international system. On many occasions, both countries had emphasised divergent views which have been directed towards their vital interests. In the early years after World War II, India was annoyed with the US occupation of Japan and sympathised with the Japanese people. The Cold War structures and the Japan-US alliance had widened the gap between India and Japan during this period.

During the 1950s and 1960s India was the champion of the Non-Aligned Movement. Peaceful co-existence and recognition of China's rightful place in the world shaped India's outlook while Japan based its position on alignment, balance of power and containment of China. These were very important differences, which influenced how each nation viewed the other and conditioned their responses to critical world problems.

However, by the end of the 1980s, the scenario had changed and both countries were reassessing the situation and exploring their options in the unipolar/multipolar new world order, and as part of that, taking a fresh look at their relations with each other. Both, especially India, have been undergoing major domestic, economic and foreign policy shifts which impinged significantly on their relations with each other.

Ever since it attained independence, India has sought economic assistance from various sources for its economic development and for which India's economic policy was partially liberalised. During the 1950s, the relationship between the two nations was very fruitful and various trade missions were exchanged between the two. The Indian Prime Minister, Jawaharlal Nehru's visit of 1959 heralded a new era in the Indo-Japan relations, followed by diplomatic channels opening up and running harmoniously.

But their honeymoon ran into trouble by the end of the 1960s and early 1970s, largely due to the introduction of various trade restrictive measures on economic matters such as Monopolies and Restrictive Trade Practices (MRTP) regime and Foreign Exchange Regulation Act (FERA), which tightened the government's grip over the Indian economy. During this period, Japan became one of the major economic powers and was looking for new trade destinations for its economic expansion. Thus Japanese attention towards India and its neighbouring countries faded away and the burgeoning Southeast Asian nations came up in their priority. But things have changed for the better with the liberalization policies adopted by most South Asian countries, and Japan reoriented its attention to this region in the late 1980s and early 1990s. These new approaches contributed to significant changes in the foreign relations between India and Japan.

Trade and aid were the main determinants of Indo-Japan relationship in the early stages followed by trade and investment. In 1984, Japan surpassed the United States as the highest donor of Official Development Assistance (ODA) to India. Most of this aid was for development projects and for creating infrastructural facilities. During this period, India unleashed the liberalization of its economy to attract Foreign Direct Investment (FDI) from various sources. Japan responded positively to these reforms by initiating fresh investments into various industrial sectors, mainly the manufacturing sector. In 1992, Japan was the third largest foreign direct investor in India, even though its investments in India represented only a marginal share of the total FDI outflow from Japan. Japanese investment in other South Asian countries increased substantially during this period.

Economic Situation in South Asia

Ever since the neo-resurgence of economies in the Asian region, South Asia has been lagging behind the Newly Industrialised Economies (NIEs) of Asia and ASEAN in terms of economic performance. Although ODA flows are huge, and Japan is a big donor to this area, it has not played a key role in the expanding trade and private capital flow. South Asia as a region lacks the social and political framework to make optimum use of technological advancement and a pro-active role of private sector, which are key to growth-oriented economic development. Recognising the need for foreign capital, in recent years South Asian countries have radically revised their liberalization plans for foreign investment. Among these, the reform initiated during the 1990s by India and Bangladesh are noteworthy. The success of the structural adjustment policies undertaken by NIEs and ASEAN has obviously inspired South Asian countries to follow a similar path of economic development.[1] In order to attain similar growth patterns in those regions, there is a growing realization that the South Asian nations have to devise and construct similar structural adjustment policies to enable foreign technology and private capital to be on par with the growth levels of NIEs and ASEAN.

[1] Yujiro Hayami. 'Toward an East Asian Model of Economic Development' in Yujiro Hayami and Masahiko Aoki (ed.), *The Institutional Foundations of East Asian Economic Development*, London, St. Martyn's Press, 1998, pp. 35.

However, changes in the international system such as integration of Germany and the disintegration of the Eastern bloc (Eastern Europe) had made matters worse for the South Asian liberalisation programmes. The Western economies had shifted focus to reconstruction of the economies in newly liberalized European economies – former East Germany and other East European countries–which needed more funds and capital to stabilise their economies. Given the reconstruction expenses and the prolonged fiscal deficit and economic vulnerabilities of the US, it was no surprise that fewer funds were pumped by these two giant economies (US and West Germany) to the developing world. Under these circumstances, the major economic power to be relied on to make funds available for the economic revival of South Asian nations, though marginally, was Japan.

Japan's contribution to trade and direct investment in the South Asian region was minimal. It is an accepted fact that this region gained increasing importance in the economic, strategic and foreign policies of Japan. But even then, South Asia as an economic and political region is missing from the Japanese definition of 'Asia' in the 'Asia-Pacific' framework.[2] One reason attributed for this is that most South Asian economies had preferred inward-looking policies. They did not emphasise on export or strive to increas the competitiveness of their products internationally. The *White Paper on World Economy* by the Economic Planning Agency of Japan did not even mention any South Asian countries in its statistics until 1991, which indicates

[2] Takako Hirose. 'Japan in a Dilemma: The Search for a Horizontal Japan-South Asian Relationship' in Purendra C. Jain (ed.), *Distant Neighbours – Japan and South Asia,* New Delhi, Sterling, 1996, p. 39.

the relative lack of weightage given to these countries by Japan.[3] But for the South Asian countries, however, Japan is considered an important trading partner. Japan's share in India's exports jumped from 11.0 per cent in the 1970s to 21.0 per cent in the 1980s. On the other hand, Japan's import share for India remained at about 8.0 per cent in the 1970s and increased only slightly in the 1980s. Similar trading patterns are seen in the countries in the region – Nepal, Sri Lanka, Pakistan and Bangladesh.

The South Asian economies were in a comparatively better position than some East Asian economies in the 1950s and 1960s. The striking fact is that in the 1960s, South Korea was poorer than Pakistan and Sri Lanka and was only marginally richer than India.[4] By 1995, Korea had graduated to a 'high income' economy and became a member of the Organisation of Economic Cooperation and Development (OECD). The South Asian economies on the other hand, still were in a struggle to achieve consistent economic development and growth.

Soon after gaining independence from British colonial rule, South Asia, like other regions in the developing world, embraced a development strategy whose key component was based on the so-called 'Dirigisme Doctrine'. [5] This guided the overall policy approach to the development path. The elements of the doctrine include:

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[3] Shigeyuki Abe and Kazuhiro Igawa, 'South Asia and Japan', *Seminar* 397, September 1992, p. 29.

[4] Moazzem Hossain, Iyanatul Islam and Reza Kibria, *South Asian Economic Development: Transformation Opportunities and Challenges,* London, Routledge, 1999, p. 4.

[5] The intellectual underpinnings of Dirigisme can be traced to the work of a number of 'first generation' development economists, such as Rosenslein Rodan, Nurtse, Singer, Prebisch and Myrdal have reinterpreted this stand of scholarship as encompassing the twin notions of export pessimism and market failure. See H. Arndt, *Economic Development: The History of an Idea,* Chicago, University of Chicago Press, 1987.

- Import Substitution Industrialisation (ISI)
- Extensive state intervention in financial and labour markets
- Significant reliance on state-owned enterprises
- General predilection for detailed planning and regulation.

It should be emphasized that the precise timing of the onset of Dirigisme in South Asia varied between nations. India moved in a resolute manner towards this direction since independence. In the case of Sri Lanka, import controls started at the earliest around the mid-1950s. But, by the end of the 1960s, the tide turned against Dirigisme based policies because of the 'East Asian miracle' in a handful of economies in East Asia, like Hong Kong, Singapore, South Korea and Taiwan. These economies, which were initially the champions of Import Substitution Industrialisation (ISI), later on moved in a resolute fashion towards Export-Oriented Industrialisation (EOI) through a series of policy reforms that were initiated in the early 1960s. The industrial revolution in parts of East Asia can be linked with this decisive policy shift. The South Asian states, on the other hand, were pursuing a restrictive, regulatory framework during the hyper-growth period that occurred in the East.

South Asian policymakers were not completely receptive to the early warning signs that were predicted about the problems associated with ISI. In fact, futile attempts at trade liberalization were made in 1964 in Sri Lanka and in 1966 in India.[6] In terms of timing, these episodes were quite in tune with the much-vaunted policy reforms that were implemented in East and Southeast Asia. Sri Lanka

[6]D, Lal., 'India and China: Contrasts in Economic Liberalization', *World Development*, Vol. 23, No. 9, 1995, p. 94.

followed this up with a more comprehensive programme of liberalization after 1977 that was eventually undermined by an unsustainable public sector investment boom and the rise of ethnic hostility.[7] Pakistan and Bangladesh had also, by then, started introducing liberalisation programmes by making the transition to export oriented industrialization. But, as economists like Bhagwati (1993) and Lal (1995) state, the cultural and social barriers in these societies restricted these initiatives. In India 'Brahmin' bureaucrats with entrenched disdain for business and ingrained attachment to Fabian socialism remained wedded to the policies of the past. In Pakistan, for example, one has always detected a cosy alliance between the military, bureaucrats and big business, while in Sri Lanka, inter-ethnic hostility and the political difficulty of dismantling welfare subsidies profitably played a role in slowing down the reform efforts. These inextricable problems and issues in South Asia kept foreign investments and external expertise at bay.

In the mid-1980s, South Asian countries liberalised their economies with three major preliminary measures: trade liberalization, privatisation and attracting foreign direct investment. South Asia, which had until the end of the 1980s pursued closed and inward looking trade policies, embraced outward-oriented policies unilaterally by bringing down average tariffs structure substantially and removing many Quantitative Restrictions (QR) at the same time.[8] Krueger propounds liberalisation as a system of openness that transforms a closed economy into an open

[7] Moazzem Hossain, *South Asian Economic Development*, op cit, p. 15.

[8] J. M. Dean, Desai S. and Riedel T., 'Trade Policy Reform in Developing Countries Since 1985', *World Discussion Paper,* No. 267, Washington, D.C., World Bank, 1989. p. 68.

one when controls are initially minimised and then removed altogether.[9] The main areas of trade liberalisation have been identified under the following major measures:

- Lowering average nominal tariffs.
- Narrowing the range of nominal and effective tariffs.
- A shift from Quantitative Restrictions (QRs) to tariffs.
- A real devaluation of the currency.
- The unification of multiple exchange rates.
- The removals of export duties.
- The removal of Qualitative Export Restrictions.
- The implementation of exports subsidies, rebates or compensation schemes.

All these measures in hand, however, suggested that for a developing country to achieve a meaningful trade liberalisation strategy, it must transform quantitative restrictions into tariffs at the primary stage and then gradually lower the tariffs and make them uniform. Direct incentives to exports have not been as important to export growth as real devaluation and import liberalization. At the same time, the exporter's access to imported capital goods is crucial in the growth of exports more than export subsidies.[10]

Like trade liberalisation, the privatisation agenda was endorsed by the International Monetary Fund and World Bank through the Structural Adjustment Programme (SAP) in developing countries in the early 1980s. However, privatisation in developing countries so far has been through three major

[9] Moazzem Hossain. *South Asian Economic Development*, op cit, p. 110. For further details see A. Krueger, 'General Issues in Economic Liberalisation' in A. Choksi and D. Papageorgious (eds.), *Economic Liberalisation in Developing Countries*, Oxford, Blackwell, 1986.

[10] Moazem Hossain, *South Asian Economic Development*, op cit, p. 110.

approaches: the 'big-bang' approach of Latin American and Caribbean countries, the 'go-slow and institutional' approach of the Asian and East Asian countries and the 'marketisation' political approach of the East European Countries.[11] These approaches have, of course, yielded different results. In the South Asian region, the East Asian way of 'go-slow and institutional' approach has been followed so far.

In the South Asian context, the issue of privatisation means the divesting of the state-owned enterprises (SOEs) and other government controlled institutions to the private sector.[12] The most common practice of this process is direct sale of SOEs, public issue of government shares, conversion sale, 'joint venture' management buy-outs, liquidation and lease. In South Asia, Pakistan and Sri Lanka can be regarded as countries with relatively high privatisation rate, India with a medium privatisation process and Bangladesh the lowest in the scale. In Pakistan, a Privatisation Commission was established in 1993 to implement the government's privatisation agenda. By 1994, a total of 67 state-owned enterprises had been divested and another 51 were at various stages of divestiture. In Sri Lanka, a Privatisation Commission was established to oversee the restructuring and divestment of public manufacturing enterprises. By the end of 1993, the majority shareholding in 35 state-owned enterprises had been divested and another 33 were at various stages of the process. In Bangladesh too, a Privatisation Board was established in 1993 to implement the government's privatisation agenda and pass on SOEs to private hands.[13] Since 1991 the Indian government has introduced a

[11] Ibid, p. 112.

[12] N. Edadan, 'Privatisation Strategies in Developing Countries: External Debt and Domestic Economic Prospects', *Economic and Political Weekly* Vol. XXXII, No. 27, 1997, p. 19.

[13] Moazzem Hossian, *South Asian Economic Development*, op cit, p. 112-113.

programme of disinvestments of shareholdings in a wide range of public enterprises, bringing its share in a number of such organisations to close to 60 per cent.

However, in terms of FDI, South Asia's performance has been abysmal. In order to attract considerable amount of FDI, the policy makers of South Asian countries were increasingly looking at the East Asian economic success by emulating East Asian policies and strategies. The gains were noteworthy, particularly after the emergence of Japan as a major source of both aid and FDI in Asia. Thus Bhagwati (1993), in his review of economic reforms in India, has maintained that India can play the Japan card. Japanese aid and investment can be attracted both because there are no domestic difficulties in doing so and because Japan can successfully be lobbied to play such a role.[14]

According to Bhagwati, the Japan card hypothesis rests on the following: first, Japan's presence in South Asia is potentially acceptable because it does not suffer the liability of lingering and unpleasant memories of colonial domination as the Western nations often create by their presence. This in turn means that Japanese investment can be seen as playing a useful countervailing role to the US and European transnational companies. Second, geopolitical realities are changing in ways that are creating a national role for Japan. Thus, the US is increasingly engaging its attention in South America, while the European Union is understandably focussing its attention on Eastern Europe. This means that Japan is more likely to accommodate demands that it play a more assertive role in Asia.[15]

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[14] Jagdish Bhagwati. *India in Transition: Freeing the Economy*, Oxford, Clarendon Press, 1993, p. 36.

[15] Ibid, p. 60.

Table 3.1
Worldwide Foreign Direct Investment Inflows

(US $ million)

Year	World	Developing Countries	Asia	SAARC Countries
1980-85	49813	12634	5043	179
1986	78283	14184	7011	255
1987	134771	25303	11891	405
1988	160075	30204	15715	326
1989	196159	28644	15221	481
1990	203341	31345	18948	458
1991	158936	41696	23139	463
1992	175841	51108	29651	717
1993	217559	72528	51218	1137
1994	242999	95582	60679	1581
1995	331189	105511	67386	2753
1996	337550	129803	80011	3313
1997	400486	148944	86923	4379

Source: UNCTAD, *World Investment Reports: Trends and Determinants*, various years.

Although much emphasis has been made to attract FDI in the South Asian region, the domestic problems, such as political uncertainties, caste and religious conflicts, infrastructural problems and bureaucratic bottlenecks have restricted the inflow of private capital to South Asia. Trends in FDI inflows to South Asia in the mid-1990s suggest that there are grounds for cautious optimism.

Between 1993 and 1997, India experienced an FDI boom while Bangladesh continued to lag behind in the sphere, although it increased substantially in 1997; Pakistan fares rather well. FDI inflows have increased quite significantly in Pakistan between 1992 and 1997.

Table 3.2
Foreign Direct Investment Flows in SAARC Countries
(US$ million)

Year	SAARC Countries	Bangladesh	India	Maldives	Nepal	Pakistan	Sri Lanka
1980-85	179	-0.1	62	-0.3	0.2	75	42
1986	255	2	118	-1	1	105	30
1987	405	3	212	--	1	129	60
1988	326	2	91	--	1	186	46
1989	481	--	252	-1	--	210	20
1990	458	3	162	--	6	244	43
1991	463	1	155	--	2	257	48
1992	717	18	233	7	1	335	123
1993	1137	10	571	7	4	347	195
1994	1581	8	973	9	6	419	166
1995	2753	2	1964	7	5	719	56
1996	3313	14	2382	8	19	770	120
1997	4379	145	3264	10	20	800	140

Source: UNCTAD, *World Investment Reports: Trends and Det*erminants, various years.

Japanese Investments in South Asia

Although Japan is the fourth largest investor in South Asia, the percentage of total Japanese FDI outsourcing into South Asia has been negligible. According to one report, the total of Japan's investment in South Asia was as little as one sixth of the figure for ASEAN, based on cumulative amount for 1985-89 the period that saw a high rate of growth in Japan's FDI.[16] In 1991, of the $47.5 billion investment by Japanese in Asia, India's share was a trifling $196 million or 1.1 per cent.[17] As for the number of joint ventures, South Asia had a still poorer share. By 1991, the

[16] *The Hindu,* 3 May 1993.

[17] Asian Development Bank, *Asian Development OutlookP: 1996-97*, Oxford, Oxford University Press, 1997. p. 67.

number of investment projects in industrial ventures was close to 2,000, as in the case of ASEAN countries, whereas South Asia attracted only 110 FDI firms.[18] Attracting Japanese FDI seems to be a key to achieve high economic growth for ASEAN economies, although there is no statistical proof of direct linkage.

As for South Asia, political instability and social unrest are, of course, primary deterring factors for effective implementation of Japanese FDI. The drawbacks of the closed economic systems coupled with a frustrating red tape and the psychological barriers that were stumbling blocs for Japanese managers also ratified this perception.[19] Lack of adequate political interaction, corruption, strict regulations coupled with weak trade relations, has naturally discouraged large scale Japanese FDI in this region.

The most important objective and attraction for the shift of Japanese FDI to this region was low cost of labour. In fact, it can be argued that one can expect a shift of production from Asian NIEs to ASEAN, and from ASEAN to South Asia for labour intensive products. According to a survey by the MITI shows that a major objective of Japanese FDI is to expand local sales and to export products to third countries (mainly neighbouring countries).[20] As Japanese FDI expanded in Asian NIEs, they achieved high economic growth and higher wage rate. In order to obtain cheap labour, both Japan and the NIEs had to shift their production base to ASEAN.

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[18] Pshigyuki Abe and Kazutiro Igaua, *South Asia and Japan*, op cit, p. 31.

[19] According to K. Nakajima, Chairman of Sumitomo Corporation (India), a very important factor to consider to invest in India, is the mental blocks or barriers which exists in the minds of Japanese businessman, such as lack of relationships of mutual trust between both parties and discrepancy of opinion on company policy and the ways of management, when they invest in a country like India.

[20] Pshigyuki Abe and Kazutiro Igaua, *South Asia and Japan*, op cit, p. 31.

The commencement of joint ventures between Japan and Korea added to South Asia's woes. On the whole, South Asian countries failed in a considerable manner to address the main obstacles that were blocking FDI growth in their region.

Although small in number and size, most FDI has been concentrated in India and Pakistan. In these large South Asian countries there was, however, a specific trend in the FDI flow. In the 1950s, investment centred on the chemical industry, i.e., glass, dye, vinyl, etc. In the 1960s, the focus was on the electrical sector – watt meters and transformer, wire as well as synthetic fibre and fertilizers. Since the 1970s, FDI has become auto-related with many major Japanese auto manufacturers investing in South Asia.[21] Sri Lanka was favourable to Japanese porcelain and cement while Nepal attracted Japanese tourists. The most popular areas of Japanese investment in Southeast Asia were textiles, clothing and home electronic appliances.

India - Japan Relations

Relations between India and Japan have passed through several phases, each characterised by certain special features.[22] The first phase, which lasted for about five years from the time of the signing of the San Francisco Peace Treaty, was a period of uncertainty and mutual indifference. Neither India nor Japan had any special relations during this period. The second phase begins with Japan's efforts to unwrap itself and seek friendly relations with other countries. This phase covers the period from 1957 to 1962. During this period Indo-Japanese relations warmed up a little and both countries developed close economic relations with each other. There

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[21] Ibid, p. 32.

[22] P.A. Narasimha Murthy. 'India and Japan', in J.D.B. Miller (ed.), *India, Japan and Australia: Partners in Asia*, Canberra, Australian National University Press, 1968, p. 39.

was a mutual appreciation of the economic opportunities they shared between them and an overarching desire to exploit these opportunities. The initiative for better Indo-Japanese relations came largely from Japan because of its desire to gain accessibility to the Afro-Asian world, while the Indian response to Japanese moves were slow. The third phase began in 1963, when, in the wake of the 1962 border conflict with China, India began to show some flexibility in its diplomatic posture. At that time, Japan had become a credible economic power and was looking for new opportunities for keeping with its economic pace and started maintaining close relations with other Asian countries. A characteristic feature of this phase is that while India's expectations on Japan were increasing, the latter did not entertain enough positive sentiments on India. And finally, since the mid 1980s, the relations between the two had come onto a smooth track that was manifested in the form of some fruitful economic and technological cooperation.

As the two leading non-Communist countries in Asia, India and Japan have many things in common. Both are free societies and have a fairly successful parliamentary form of government; both propound peace and stability in Asia and the world so as to pursue unhindered their specific economic objectives; both regard international institutions like United Nations in high esteem; and believe that international peace and stability has to be ensured through the UN mechanism.[23] Also significantly, no wartime relational gaps or memories were stumbling blocs in their relations, as Japan never invaded India during the World War II. Thus, the two

[23] Ibid, p. 40.

countries were spared the feelings of enmity that haunted Japan's relations with other Asian countries.

There were, of course, many differences between them, as for example, in the size of their economies and the scale of their achievement in their economic philosophies and their political outlook and attitudes. Japan was an industrial giant despite its small size and poor natural resources. India was many times bigger than Japan and has vast human and material resources, but was not an industrial power. India believed in a regulated economy, though liberalization started belatedly, whereas Japan is wedded to a free enterprise economy. Trade and capital transactions between a centrally planned economy and a free enterprise economy were slow to grow and perhaps they will never reach the level as those between two free economies.

Ever since independence, India has believed in a political outlook rooted on non-alignment, though now less rigid than before, whereas Japan follows the policy of alliance with the US. While India regarded Japan as a willing and a silent partner of the United States, Japan suspected India's non-alignment to be sympathetic to the former Soviet Union. India has shown vociferous political activism on global issues at most forums, while trade-oriented Japan has chosen to contribute its interests to the problems connected with its trade and development. Finally, for reasons that are partly historical and partly political, both the countries look to the West more than to each other. Their differences are by no means insignificant, and because of that Indo-Japanese relations have remained short of being complete – neither hostile nor cordial. Moreover, the rise of the Cold War and other political factors played a major role in shaping their national outlooks and foreign policy strategies, which left an overwhelming bearing on their economic policies as well.

Indian attitude to the San Francisco Peace Treaty,[24] which heralded Japan's independence, was one of scepticism stating that it was a one-sided arrangement, and held steadfastly to the view that the settlement with Japan should not be influenced by the rivalry of the great powers. The Indian government send a note to the US government complaining that the treaty had failed to give Japan a position of honour and equality in the comity of nations and that it had to be framed taking into confidence all the nations valuing maintenance of peace in the far East.[25]

However, it was found that no attempt had been made in the final draft to accommodate these views. A disillusioned India declined the invitation for the conference. Despite rejecting the invitation, India did not attempt to obstruct the settlement with Japan, but protested against the policies pursued by the West (especially the United States) in Asia. Any misconceptions that India was reluctant to conclude peace with Japan was removed by the Indian government's assurance that a separate peace treaty would be signed with Japan after the termination of the occupation. India's decision was an assertion of its independence and an expression of its policy of non-alignment in a world that was structured on cold war politics.

The Indian position on a peace settlement with Japan had a favourable impact on the Japanese polity. It was hailed both as a courageous and a fair-minded

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[24] The Japanese Peace Treaty was signed on 8th September 1951 at San Francisco. Forty Nine countries including Japan, signed the Treaty. The Soviet Union attended the treaty conference. Neither Communist China nor Formosa (Taiwan) was invited to the conference. India, Burma and Yugoslavia declined the invitation to attend the conference.

[25] Murthy, 'India and Japan', op cit, p. 42.

stand. The radical socialists, in particular, endorsed the Indian view whole-heartedly and felt that peace settlement would enhance Japan's position in the region. Japan had suffered drastically in its defeat and unconditional surrender, and the depressive gloom into which the nation had fallen was further accentuated by a sense of isolation from the rest of Asia. But, the momentum made by the peace treaty did not last long when India recognised the Soviet claim over the Kurile Island. The Indian position on this question of territorial disposition naturally became a source of anxiety in Japan.

By the end of US occupation on Japan, India entered a separate peace treaty with Japan. On 9 June 1952, the Indo-Japanese Peace Treaty was signed in Tokyo. This treaty, which came into effect on 28 August and which was officially designated as a 'treaty of perpetual peace and amity', envisaged the conclusion of agreements to place their trading, maritime, aviation and other commercial relations on a stable and friendly basis.[26] It was the first bilateral treaty that Japan signed with any Asian country in the post-war era, and it served as a model for similar such treaties with Burma and Indonesia.

Indo-Japanese relations since the signing of the peace treaty have predominantly been of an economic nature. There was no long-term political or diplomatic objective in it, and its immediate purpose was to place the relations between the signatories on a normal footing. In the scale of national priorities, both nations have laid great emphasis on economic reconstruction. Japan had sought to achieve this by means of what is known as 'separation of economics from politics'

[26] Embassy of Japan. *The Lotus and the Chrysanthemum: India and Japan*, New Delhi, The Embassy of Japan, 1977, p. 18.

policy. Similarly, an important objective of India's non-alignment policy was to keep out of international rivalries and concentrate on economic reconstruction at home. Both adopted an extremely cautious attitude because of the fear that their actions and utterances might be misunderstood.

As both Japan and India started making economic progress, they found that their economies were complementary. This brought them together in the spheres of trade, investment and economic assistance. India, of course, believed in playing an 'active role' in so far as this was helpful to bring reconciliation between East and West and reduce world tensions. Economic backwardness and pre-independence experience were the prime considerations in India's choice of the role of a neutral mediator. On the other hand, Japan chose to remain 'passive' and in the background, both because of its prevailing military weakness and economic vulnerabilities, and due to the fear that any attempt on its part to play a pro-active role in Asia might revive old wounds of subjugation and defeat.

In spite of the positive atmosphere created by the peace treaty, the growth of Indo-Japanese relations in the post-treaty period was dismally slow. Economic ties were fostered after the lapse of a few years, but politically the two countries remained poles apart despite their common stake in peace, economic progress and democratic institutions. One can explain this by examining the different approaches of the two countries in international relations. When Japan rejoined the comity of nations, it had already forged very close ties of friendship and co-operation with the United States; it was in fact a partner in a military alliance with the latter. India, soon after independence pursued an active and independent foreign policy, a policy of peace and friendship with both power blocs on the basis of mutual respect and non-interference.

The situation saw gradual changes compelled by some economic considerations as well as Japan's growing desire to regain its erstwhile glory as a nation of considerable influence in Asia. Since late the 1950s, Japan slowly began to assert its independence from the United States and began to be involved significantly in the Asian region. This was further strengthened by the Bandung Conference of Afro-Asian nations held in April 1955. By the end of 1956, Japan had succeeded in settling the reparations and other political issues with Southeast Asian nations. The pursuit of a constructive policy towards all Asian countries became more apparent during Nobusuke Kishi's term as Prime Minister of Japan. He visited several Asian countries in 1957, including India and held negotiations on various issues with Indian premier Jawaharlal Nehru. These deliberations tackled issues like the prevention of the spread of nuclear weapons, economic assistance and international peace and security.

In October 1959 Prime Minister Nehru returned the visit. It was an epoch-making event in the relations between the two. For one thing, he was one of the first Asian leaders to visit Japan after 1945. These mutual visits gave an opportunity to the leaders to understand each other's policies and exchange views on pressing problems of the day. Both sides showed concern for the preservation of world peace and the cessation of nuclear tests; no reference was made to any specific political problems of immediate interest to them. The emphasis, in discussing bilateral relations, was mostly on the need to string the cultural ties between the two nations, and to encourage mutual visits by academics, scientists, artists and students. The Japanese side promised assistance in establishing technical training centres for the promotion of medium and small-scale industries and also assured financial help in the implementation of India's Second Five Year plan.[27]

The 1950s may be judged as fruitful years of Indo-Japanese relations and Japan attached considerable importance to its relationship with India. During this period, Japan was undergoing a rapid structural change in response to the rehabilitation and reconstruction of the Japanese economy. Its industries were looking for markets and sources of raw materials. Japanese economic planners and leaders therefore gave high priority to India in view of its potential as a growing economy. India was then on the verge of culminating the first Five Year Plan period and moving over to the Second Plan. India was searching for financial and material assistance from different sources to cater to its rapid industrialisation process. Under such positive circumstances, Japanese policy makers realised the prospect of India being a promising partner in trade and commerce, provided it was helped to maintain a steady rate of economic growth.

The earlier stages of Indo-Japan relations were primarily focused on financial aid and technical assistance. In February 1958, the first yen credit was transferred to India.[28] It was intended to enable India to import capital good and machinery from Japan. This was followed by extension of number of trade credits to India. These credits had been used to finance some major public sector projects, like

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[27] Murthy, 'India and Japan', op cit, p. 46.

[28] P.A. Narasimha Murthy. *India and Japan: Dimensions of their Relations (Documents),* New Delhi, ABC Publishing House, 1986, p. 123.

the Gorakhpur Fertiliser Factory and the Durgapur Alloy and Special Steel Plant, HMT (Bangalore) and Cochin Shipyard, as well as to import Japanese plants, machinery and other resources.[29] It was during this period that plans were laid to expand the Saharanpur (UP) Agricultural Experiment into a chain of demonstration farms for transferring Japanese agricultural experience and methods to Indian villages. Between 1957 and 1966, the government of India had approved 221 cases of collaborations between Indian and Japanese firms. This included both financial participation as well as technical assistance.

As Japan made spectacular economic progress after 1960, its interests also acquired a global character. It was all set to take up a unique top-rung position in the hierarchy of advanced nations and was engaged in redressing the serious problems it had in its foreign relations. India, on the other hand, faced a set of new obstacles that held up economic progress, its relations with China had hit a rough patch since 1959, and the euphoria about a massive growth in Indo-Japanese cooperation fizzled out. When the Sino-Indian border conflict occurred, India was expecting moral and material support from Japan. There were speculations regarding India and Japan coming to an understanding on steps to be taken to check Chinese influence in Asia. Very soon, however, it became apparent that Japan was least interested in any such political enterprise.

During this time, Japan had pursued a two-pronged policy of recognising and maintaining political relations with the Nationalist government of China (the Kuomintang regime in Taiwan) and at the same time pursuing economic and cultural

[29] Ibid, p. 134.

relations with the Communist China.[30] Japan made it clear that its problems with China fell under a different category and that it wanted to evolve a *modus vivendi* with China and solve its problems with China without the influence of any third country.[31] India's adherence to a policy of socialist development and cultivation of close ties with the Soviet Union was another rationale for the declining Japanese interest and affinity with India.

Since the 1960s, Japan started giving higher priority to the nations of Southeast Asia than to the Indian sub continent in its foreign relations. During this period, Japan had been expanding its source of raw materials and market to get comparative advantage for its domestic economy. Like the United States, it has pursued a policy of maintaining a position of equidistance from both India and Pakistan. It had, for instance, excluded both nations from the annual ministerial conferences for Southeast Asia. When in 1965 hostilities broke out between India and Pakistan, it appealed to both countries for an early cessation of the war instead of taking a positive stand on the basis of the merits of the situation. It also suspended its economic assistance to them. It was only in 1969, in the wake of Prime Minister, Indira Gandhi's visit to Tokyo, that Japan resumed economic aid.

No significant changes were seen in the Indo-Japanese relationship during the 1970s. The major issues such as the 1971 Bangladesh crisis, the Indo-Soviet Treaty and the nuclear test of 1974 marred it. At the time of the Bangladesh crisis, Japan followed a wait and watch policy. During the initial phase of the issue, when

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[30] Embassy of Japan, *The Lotus and the Chrysanthemum*, op cit, p. 79.

[31] Harimoto Takenori, 'Synchronizing Japan-India Relations', *Japan Quarterly* Vol. 40, No. 1, Jan-Mar 1993, p. 34.

Sheikh Mujibur Rehman was arrested and millions of refugees poured into India, the government of Japan extended economic assistance to India for the maintenance of refugee camps, even while taking care not to antagonise Pakistan over it.[32]

In August 1971, when India signed the Friendship Treaty with the Soviet Union, Tokyo interpreted it as India's shedding of its non-aligned posture. It also feared this treaty would lead to an extension of Soviet influence in South and Southeast Asia. When, in December 1971, war broke out in the sub-continent, Japan reacted quickly by suspending its economic assistance to India. Following the US announcement on suspension of aid to India, Japan declared on 8 December that it was also choking off the flow of credits to India. A week later another round of embargo was announced for the forthcoming yen credit loan. Finally, the embargo was partially lifted on 31 December 1971, with the announcement that project aid worth $45 million would be released, while the rest of the loans would be held up for release sometime later.[33]

In nuclear affairs, both India and Japan have adhered to a policy of utilising nuclear energy for peaceful purposes, and chalked out impressive civilian nuclear programmes. As members of the Conference on Disarmament in 1970, both have cooperated with each other against the threats posed by nuclear armament. When, in May 1974, India conducted nuclear test, which it called as Peaceful Nuclear Explosion (PNE), Japan reacted with caution and scepticism after India's claim on its peaceful nature. The Japanese Diet passed a resolution expressing concern about

[32] Ibid, p. 40.

[33] P. A. Narasimha Murthy. *India and Japan – Dimension in their relations (Historical and Political),* New Delhi, ABC Publishing House, 1986, p. 384.

India's tests. The political parties in opposition also did not take it kindly. In view of Japan's sharp reaction, the government of India send a special envoy to Tokyo in an effort to assure the government of Japan that the test had no military significance. Japan had since then cooperated with the United States and other nuclear countries in seeking to prevent any further expansion of the nuclear club. It also ratified the Nuclear Non-Proliferation Treaty (NPT) in June 1976. Ever since the tests, the nuclear issue has emerged as one of the core issues being deliberated upon at the official and diplomatic level during bilateral discussion between India and Japan.

Notwithstanding these ideological and political differences, when Japan launched its economic expansion programme based on Prime Minister Hayato Ikeda's 'Income Doubling Plan', Japan was very interested in making India a major base for industrial and technological cooperation. India was envisioned to be a hub for supply of manufactured parts, accessories and the like. India was considered favourable for its production costs, manpower and other advantages. Japan's image as a quality producer received more recognition in the Indian market in 1960s. The Indian corporate sector recognised the importance of establishing industrial relations with Japan. In 1967, the Indo-Japanese Joint Business Cooperation Committee was established as a permanent forum for dialogue between Japanese and Indian trade and industry.[34]

However, this enthusiasm with the economic sector could not continue for long. Japan was to confront with many areas in India's economic system that hinders

[34] Taranath P. Bhat, 'Outlook on Trade, Investment and Technology Transfer' in Rajaram Panda and Kazuo Ando (eds.), *India and Japan: Multi-Dimensional Perspective*, New Delhi, The Japan Foundation, 1997, p. 77.

its economic growth. India's social intricacies, massive illiteracy and grinding poverty were deterring factors. Adding to the disarray, the Indian government introduced draconian laws for private enterprises such as the Monopolies and Restrictive Trade Practices (MRTP) regime in 1969 and Foreign Exchange Regulation Act (FERA) in 1973, both hitting hard at free enterprise and foreign investment. As a result, India lost its prominence in Japan's list of favoured destinations, which was now dominated by the new economies in the East and Southeast Asia.

Besides India prioritising its public enterprises over the private sector, the restrictions on the latter, and constant ethnic strife and political instability came in conflict with the Japanese way of thinking. The bureaucratic delays and organised labour force radicalism frustrated Japanese enterprises. Severe infrastructural retardation, such as inadequate power, water, poor transport networks, and all, led to the Japanese industrial missions virtually bidding goodbye to India. Thus, due to these political and economic deficiencies, India could no longer compete with those Southeast Asian economies with which Japan had clubbed India as an investment destination in the 1960s.[35]

Since the mid-1980s, however, the two countries had again drawn closer, providing a new opportunity to synchronise and improve relations. In 1984, Japanese Prime Minister Yasuhiro Nakasone paid an official visit to India that symbolised the revival of ties. Nakasone's trip, the first in 23 years since the last

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[35] Till late 1960s, India was clubbed with Southeast Asian region. However, after the resurgence of Southeast Asian nations, and at the other end, South Asia being identified as an unstable region, led to the Indian sub-continent losing out from Japan's good books and South Asia getting identified as a separate region.

visit by then premier, Hayato Ikeda in 1961, was aimed at reworking on relations between Japan and the South Asian countries. Closer relations with India meant Japan could establish a solid foothold in South Asia. For India, which had launched a programme of economic liberalisation on a subtle note from the mid 1980s and in a larger manner from early 1990s, substantive economic cooperation from Japan was necessary.[36]

India's efforts on economic restructuring began with the accession to power of Rajiv Gandhi in 1984 following the assassination of Indira Gandhi. Credited with initiating structural changes in Indian economic thinking, Rajiv Gandhi envisioned the importance of advanced technology and capital, and propounded liberalisation as a centrepiece of his political programme. He realised that the root causes of the malaise in the national economy was economic inefficiency that resulted in the poor functioning of the monolithic public sector, which dominated the organised economy, and also the draconian and complex regulatory framework.[37] More particularly, he attempted to liberalise the Indian economy, especially the control over the private sector and initiated public sector reforms by disinvesting government stake in loss making Public Sector Enterprises (PSEs). His emphasis was on shifting the controls of production to the private sector as the vehicle of economic growth and reducing regulatory controls, except those that were necessary for strategic purposes. In order to improve efficiency of the domestic public and private sector, he led business delegations abroad to seek emergent technologies and

[36] Bhat, 'Outlook on Trade, Investment and Technology Transfer,' op cit, p. 78.

[37] Pascale Boureille. 'Liberalisation Policy and Change of Government in India', in Sam Dzever and Jacques Jaussaud (eds.), *China and India Economic Performance and Business Strategies in the Mid-1990s*, London, Macmillan, 1999, p. 165.

capital. To garner momentum for his policies through Japanese FDI, he visited Japan three times between 1985 and 1988. Since this period, diplomatic and economic relations had grown steadily. The Festival of India held in Japan in 1988 proved vastly popular and helped change the stereotypes of India that had developed among the Japanese.[38] The number of Japanese tourists visiting India, though still small, began to rise considerably during this period.

However, the domestic political pressures pushed back India's well-planned onset of the liberalisation process. The trade unions and the Left parties opposed liberalisation terming its as a submission before Western capitalism. Indian National Congress, led by Rajiv Gandhi, was branded as a 'party for the rich and no longer standing for the poor.'[39] The Congress party in power at the centre received setbacks in state elections and by-elections. In the face of a virtual party revolt, as yet another fall out, the government beat a hasty retreat, proclaiming once again 'unequivocally its commitment to socialism'. Moreover, the trade unions, which were heavily dependent on the public sector, opposed reforms and privatisation. The middle class, who initially was supportive of liberalisation, came out on the offensive, not against liberalisation as such, but the increasing price of essential commodities and unemployment. The ideological legacy of Nehru also worked as a major obstacle to the implementation of reforms and policy changes.

A new bold and far-reaching programme of economic restructuring involving a historic retreat from the Nehru model was launched in June 1991, by the minority Congress government of Prime Minister P.V. Narasimha Rao. The political

[38] Harimoto Takenori. *Synchronizing Japan-India Relations*, op cit, p. 38.

[39] *India Today*, 31 May New Delhi, 1985, p. 5.

instability between 1989-91 coupled with the Gulf war between Iraq and the coalition forces led by the US, precipitated a precarious economic crisis in India. The impact of the collapse of the Soviet Union on the Indian economy was also palpable. About one-fifth of India's yearly crude oil imports were coming from the Soviet Union, for which India was paying only in rupees, under the bilateral rupee trade agreement system. Besides, the Soviet Union was the main market for India's export oriented industries. Eventually, all these problems led to a Balance of Payment (BOP) crisis, with a staggering fiscal deficit at a high of 7 per cent of GDP.[40] As a result, the Rao government introduced Structural Adjustment Programme (SAP) as recommended by the IMF and World Bank. It included 'economic stabilization cum deregulation', 'liberalisation', 'privatisation', and 'globalisation', based on the models of neo-classical economics.[41] It is to be noted that the Japanese government decided to supply $3 billion to India as contingency loans to recover from the crisis.[42] As a bilateral assistance, the Japanese contribution was conspicuous and this marked a turning point in the relations and from the policy perspective, it marked the initiation of the 'Look East Policy' that India unleashed during the 1990s.

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[40] A. Vaidyanathan, 'India's Economic Reforms: Performance and Prospects', in K.V. Kesavan (ed.), *Economic Liberalization in India: Japanese and Indian Perspectives*, New Delhi, Indian Council of Social Science Research, 2001, p. 8.

[41] Hideki Esho. 'India's New Economic Policy and the Japanese Response', paper presented at seminar on *Japan – South Asia Cooperation during the Post Cold War Period*, organised by CEAS, Jawaharlal Nehru University, New Delhi, 8-10 March, 1999.

[42] Hideki Esho. 'Japanese Investment in South Asia: The Case of India' in P.C. Jain (ed.), *Distant Asian Neighbours: Japan and South Asia*, New Delhi, Sterling, 1996, p. 66.

India's New Economic Policy (NEP) In 1990s

India's economic liberalisation began with the announcement of a new industrial policy on 24 July 1991. This was the pioneering document of the reformist initiative, which laid down the philosophy for opening of the economy. The government announced policy reforms on seven major areas: fiscal, trade, industrial, finance, agricultural, poverty alleviation and human resource.[43] This was followed by various measures initiated to stem the economic slowdown and guide it to a growth-oriented path. The government devalued the rupee, abolished archaic industrial licence procedures and offered 'single window' approvals for foreign investment for hundred per cent export based industries, and technology agreement in priority sectors. The government reduced the priority list of the public sector investment monopoly areas from 17 to 8, by allowing the private sector to invest in sectors like power, aviation, ship building, and heavy machinery industries, among others. The focus of public sector was to be diverted to newer and strategic areas like high technology and basic infrastructure. Overall, much greater autonomy was given to the public sector management so as to install better professionalism and competitiveness for PSUs in the corporate world. The new policy indicated the government's intention to invite a greater degree of participation of the private sector in crucial areas of the economy.

In a bid to attract higher levels of foreign capital and technology, the government abolished industrial licensing and liberalised regulation concerning foreign investment and technology. Domestic industrial investment was till then

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[43] Government of India, *Economic Survey 1991-92, Part-I*, Ministry of Finance, 1992, p. 23.

tightly regulated for foreign investors. Foreign technology agreements sought by Indian firms as well as their foreign counterparts, were subjected to mandatory approval from the government for each project. The government amended the MRTP and FERA regulations and lifted the cap on foreign ownership from 40 per cent and raised it to more than 51 per cent of the capital, except in some strategic sectors. The Foreign Investment Promotion Board (FIPB) was established to consider investment proposals and speed up the inflow of foreign capital. Similarly, the reform process reworked on tariffs for export and import introduced Quantitative Restrictions (QR) on selective items. The reform process instigated significant economic progress when India achieved an astonishing growth rate of 6 per cent consistently during 1991-1997 periods. The GDP growth rate increased from 0.8 per cent in 1991-92 to 7.5 per cent in 1996-97.[44]

The Look East Policy

Under Narasimha Rao's stewardship, foreign policy got re-activated. Economic diplomacy became a crucial ingredient of foreign policy in the liberalisation period. A more outwardly oriented economic strategy was put into action. This crucial policy shift coincided with the regionalisation drive promoted by some ASEAN countries.[45] By the end of the Cold War, the emergence of regional integration in various parts of the world was quite apparent. Prominent among them were the North American Free Trade Area (NAFTA), European Union (EU) and Association of Southeast Asian Nations (ASEAN). On the other hand, the South Asian regional

[44] Government of India, *Economic Survey 1997-98*, Ministry of Finance, 1998. p. 26.

[45] S. Viswam, 'India's Look East Policy', *World Focus*, Vol. 52, Nos. 1-2, June 1997, p. 18.

grouping was constrained by various socio-political and economic issues that curtailed its growth. In this scenario, India identified the Asia-Pacific region, including ASEAN, as the central focus of economic and diplomatic agenda.

In his five-nation sojourn (Thailand, Indonesia, Malaysia, Singapore and Vietnam) to the Southeast Asian region in 1993, Narasimha Rao emphatically stated that 'with the cold war no more prevalent and the needs of hungry-for-growth economies prompting dialogue, India and the East need each other once again. India is eager for full dialogue partnership with the ASEAN, which is actively considering a free trade zone. India has the stakes of a sectoral partner in ASEAN, but full membership is critical as India is not part of any trading bloc and regional economic effort, and the South Asian Preferential Trade Arrangement as apart of the SAARC initiative going nowhere.'[46]

As a matter of fact, India considered the ASEAN region as a potential area for promoting India's vital interests. A two-pronged approach influenced India's Look East Policy to the ASEAN region. First, it is widely acknowledged that the Southeast Asian countries' economic achievements were strengthened by the FDI inflow from the Northeast Asian countries, particularly Japan, South Korea and Taiwan, to which they maintain geographical and cultural proximity, an aspect that India does not share. Moreover, China has been competing with India for attracting capital from the Northeast Asian nations, to which China too has cultural and geographical proximity. In this context, and given the degree of involvement of the Northeast Asian neighbours in Southeast Asia, constructive relationships between

[46] *India Today*, 30 September 1994, p. 74.

India and Southeast Asian nations might prove to be productive in achieving India's immediate economic objectives and also to realise its general goal of regional integration.

Secondly, India's close relationship with the Southeast Asian nations will strategically enhance India's political involvement in the region. The proximity of China to the Indian Ocean region by close cooperation at the political and military levels with Myanmar is of great concern for India. Countries like Indonesia and Malaysia also have maintained strong anti-China sentiments. And, such shared attitudes with these nations can lead to greater security and political tie-ups between the two groups.[47]

It can be argued that the fundamental philosophy of the Look East Policy was to stabilise India's domestic economy by attracting capital and technology from the Asia-Pacific region. This was clearly emphasised in the *Economic Survey* of 1995-96 that declares the Look East Policy as follows:

(a) India must learn from the experience of East Asia, which was able to attain a healthy macro-economic balance as well as could maintain high production and employment. India's savings rate is comparable to those in the high performing East Asian economies. But India's public savings rate is much lower than those of the East Asian economies. Hence, it is necessary to cut back on the Government's revenue and fiscal deficits.

[47] Sandy Gordon, 'India and Southeast Asia: A Renaissance in Relations?' in Sandy Gordon and Stephen Henningham, *India Looking East: An Emerging Power and Its Asia-Pacific Neighbours*, Canberra, Strategic and Defence Studies Centre, ANU, 1995, p. 215.

(b) India's future economic development depends on the supply of an adequate and reliable economic infrastructure at a reasonable cost. Unless there are improvements in the infrastructure, the recent growth of agriculture, industry and exports will be at risk and the prospects for more rapid development elusive. The old public monopolies in the fields of power, telecommunications, ports and roads, can no longer cope with the rapidly expanding demand for high quality infrastructure. Thus, it is necessary to facilitate the entry of private corporations. For this purpose, institutional structures, and especially long-term financial institutions, must be developed.

(c) Greater access and use of foreign investment will be necessary for promoting higher growth of output, exports and employment. FDI is one of the most important ingredients of the East Asian miracle. It is the most effective rapid method for achieving technology transfers and the effective promotion of comparative advantage through exports. For India to attain seven to nine percent growth rate over the next two decades, it will be necessary to encourage FDI to levels comparable to China's $30 billion or more per year.

(d) The experience of East Asian economies shows that the best way to reduce unemployment and poverty is to ensure sustained, rapid economic growth. Labour-intensive growth patterns are more beneficial in promoting employment. India's labour is among the most competitive in the developing world. As China's experience shows, a rapid expansion of labour-intensive exports can be an important source of new productive jobs. Thus, it is necessary to overhaul the current labour legislation, which discourages employment in the organised sector. Small and medium enterprises have a major role to play in this process.[48]

During this period, Indo-Japan relations have improved substantially. Prime Minister Narasimha Rao visited Japan in June 1992 to explain India's economic policy and seek Japanese cooperation in the economic development endeavours. It was a concerted belief among policy makers that Japanese support would be indispensable to India's efforts to liberalize its economy. India's exports to Japan increased from Rs. 59.8 million in 1980-81 to Rs. 706.8 million in 1995-96, i.e., a 12.4-fold increase in 15 years.[49] Japan's share in total exports from India rose from 8.8 per cent in 1984-85 to 10.7 per cent in 1985-86 and maintained a level over 10 per cent up to 1988-89. But its share began to decline sharply from 1989-90. The share in 1996-97 was just 6.0 per cent.[50]

At the same time, the cumulative amount of Japanese FDI has increased from 115.5 million in 1980s to Rs 956.9 million in 1991-96. It is clear enough that these great strides in FDI were after India's efforts to economic liberalisation beginning in the mid-1980s.

Japanese FDI in India

For more than three decades after independence, India maintained import substitution oriented industrialisation policy, for which the role of foreign investment was selective and over-regulated. This approach was based on the policy

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[48] Government of India. *Economic Survey 1995-96*, Ministry of Finance, 1996, pp.14-15.
[49] Ibid.
[50] Government of India, *Economic Survey*, various issues.

of acquisition of improved technology and knowhow along with capital from abroad, as contributory inputs for the nation to achieve self reliance, protection of its domestic industry, mainly the small and medium scale industries. Greater reliance was placed on technology imports and less on other benefits associated with FDI. Thus, in the post- independence period, FDI had played a supplementary and subsidiary role as it was used largely as a mechanism for technology transfer.

Historically, FDI in India was mainly routed through wholly owned and subsidiaries of multinational companies. This was considered to be the best form of technology transfer by multinationals to countries like India. During the first years of post-independent India, the large number of FDI came from British and German investors. Most of these companies were trading companies. The announcement of the industrial policy resolution in 1956 and the commencement of the Second Five Year Plan, emphasised import-substitution in most of the industrial sectors, primarily because of the acute foreign exchange shortage faced by the country during that period.[51] The main thrust of the policy was to encourage outright purchase of technology through one-time payment of technical know how charges and royalty rather than joint ventures or other comparative advantages of FDI.

It can be argued that the whole scenario of FDI inflows to India had three vital phases. The first phase was from 1951 onwards till the end of the late 1960s. During this period, the Government of India did adopt a liberal attitude towards FDI inflows to the country. The second period ranged from the late 1960s up till the end of the 1970s when the government adopted a tough and selective approach towards

[51] Shankari Banerjee. 'Direct Foreign Investment Through Transnationals in India: Policies and Performance', *Southeast Asian Journal of Social Sciences*, Vol. 19, Nos. 1&2, 1991, p. 82.

FDI inflow to the country. During this period, the Indian economy had been vigorously embraced the socialist model and more rigid laws like MRTP and FERA, enacted during this period, complimented the existing tough regulations. The third phase started in the mid-1980s and continued through the 1990s, during which the liberalization process was tested leading to the greatest ever inflow of FDI into the country. During this period, most anti-FDI regulations gave way to liberal laws that encouraged FDI as the potential element to steer the growth engine of the economy.

After independence, the government adopted a liberal policy to attract foreign capital and enterprise, particularly regarding industrial technology and knowledge. The Industrial Policy Resolution 1948 had emphasised these objectives lucidly. The objective of foreign capital participation was its composite utilisation in a manner advantageous to the new nation state in a changed political and economic environment. The policy enlists no discrimination between Indian and foreign firms, remittances of profit and repatriation of capital were allowed, subject to foreign exchange availability. These were no concerns over the possibility of foreign owned companies being nationalised, and provided such instances were to occur, there were provision for compensation. But lacunae existed in clear demarcation of priority areas of FDI under that policy.

Given the political and socio-economic situation in the country, a mixed feeling prevailed towards Nehru's 'open door' policy of 1949. The fear of imperialism was fresh and alive, together with the threat of competition from foreign firms, which created a hostile attitude towards FDI from the business class and intelligentsia. At the same time, the demand for protection for indigenous traditional industries also became strong. As a result, an uneasy relationship remained between the government, domestic industry and foreign investors in the early years after independence.

The first phase of changes were made in the Industrial Policy Resolution of 1956. Nehru emphasised a greater role for state-owned enterprises in India's development plans, thereby initiating a socialist pattern of development. The industries were classified according to priorities, and investments in the public sector were given priority and the private sector was isolated from the purview of foreign capital. The Second Five Year Plan (1956-61) clearly stated that the plan allocation for industry, particularly for heavy industrial sector, would be increased by which state intervention in industrial development was established. This meant that the country had not only to look for supply of technology but also to arrange for import of capital goods to cater to the installation of modern capital goods industries, i.e., state owned heavy industries. The result was that the state owned enterprises became the Indian partners of the technical and financial assistance from abroad. The major Japanese collaboration with India during this period was the Iron Ore Development Project in Kiriburu, Orissa[52] and establishment of the Gorakhpur Fertilizer Factory with the technical and financial support of Toyo Engineering Company (TEC), Japan in 1962.[53] Since then TEC has built over ten plants in India,

[52] This project can be adjudged as one of the feature of Japanese style of FDI. Japan signed an agreement with the Indian government for the construction of Baitadila mines and to develop the Visakhapatnam inner harbour and thereafter outer harbour for exporting iron ore to Japan.

[53] For details see; Record of the Joint Meeting of the Indian-Japan Study Committees, November 29&30, 1979, New Delhi, p. 26- 28.

in Baroda, Kanpur, Goa, Tuticorin, Bhatinda and Panipat. In addition, it extended its cooperation in the expansion of various other plants.

However, India faced a severe foreign exchange crisis during this period, partially due to the repatriation of profit by the foreign firms to home country and policy of self-reliance. Keeping in mind these foreign exchange problems, Government of India had published a list of industries in the Third Five Year Plan (1961-66), where FDI was to be welcomed to bridge the gap between the capacities and plan targets. This list included some of the industries which where exclusive monopolies of the public sector like drugs, aluminium, heavy electric equipment, fertilisers and synthetic rubber. It was clearly stated that foreign investment to cover the foreign exchange cost of plant and machinery in the approved projects would be welcomed.[54] This was the logical decision taken by the Indian government to ease out the foreign exchange crisis. Similarly, it was also pointed out that the proportion of foreign held equity would depend upon the degree of sophistication of technology and volume of required foreign exchange, while the domestic major stake in ownership, though welcome, was not insisted upon.

The first phase of liberal attitude towards foreign direct investment flows continued till the mid-1960s. This simultaneously resulted in a significant outflow of foreign exchange in the form of remittances of dividends, profit royalties and technical fees. This outflow of foreign exchange caught the government's attention. India had just recovered from the foreign exchange crisis in the late 1960s. To meet

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[54] Indian Institute of Public Opinion. 'FDI Flows to India: Pre and Post Reforms Scenario', *Quarterly Economic Report of Indian Institute of Public Opinion: 147*, Vol. 37, No. 3, 1994, p. 39.

any crisis in the future, the government streamlined the procedure for inviting foreign collaborations and their approvals. In the next stage, the second phase of restrictive regulations came into being. In this direction, the very first step taken by the government was to establish a new agency known as the Foreign Investment Board in 1968 to deal with all the cases involving foreign direct investment and collaborations. Accordingly, three lists of industries were short-listed for which clear-cut demarcation was made for categorization for FDI.

The first list covered those industries where no external collaboration had been considered necessary. The second list included those industries where only technical collaboration could be possible. The third listed those industries where foreign investment could be invited.[55] In the case of the second and third lists, permissible range of royalty payments was specified at a ceiling of 5 per cent. Similarly, the government promulgated the regulatory MRTP Act of 1969 and the FERA of 1973 along with a historic decision of nationalisation of banks and other equally stringent decision in line with the left wing political philosophies.[56]

The government introduced the Foreign Exchange Regulation Act in 1973 in order to regulate and control foreign exchange transactions and also to encourage the local ownership of foreign enterprises in India. The FERA was to be considered as a cornerstone of the Indian regulatory framework for FDI inflow. By FERA, all

[55] Ibid, p. 40.

[56] The ruling Congress party had to face a virtual split in 1969. One section of top leaders criticized the party for radical socialist principles. In response to this crisis, the Prime Minister Indira Gandhi sought the support of the left parties that propagated the radicalisation process. Indira Gandhi nationalized 14 banks and introduced more policy shift to garner the support of the Communist parties. The corporate sector was heavily regulated by various administrative controls such as MRTP regime and FERA, besides other bureaucratic controls invoking the license raj. For details, see Bipan Chandra. *India after Independence*, New Delhi, Viking, 1999.

branches of foreign companies were to transform themselves into Indian companies with not more than 40 per cent foreign equity participation. Companies working under the core or priority sectors, industries exporting at least 60 per cent of output, those engaged in manufacturing operations based on sophisticated technology, and tea plantations, were allowed to retain up to 51 per cent to 74 per cent equity participation. The FERA, therefore, put a general ceiling of 40 per cent on the foreign equity. Accentuated by the regime of controls and restrictions through FERA and MRTP, the inflow of FDI was significantly reduced during the1970s, the share of foreign financial collaboration in investment declined from 36.4 per cent in The Third Plan period to 11.4 per cent during the Fifth Plan.

Table 3.3

Foreign Collaboration Approved by Government of India

Five Year Plans	Period	Total Cases	Financial Participation	% Approved
Up to I FY plan	1948-55	284	N.A	N.A
Second FY plan	1956-60	196	N.A	N.A
Third FY plan	1961-65	1644	598	36.4
Annual plan	1966-68	515	141	27.4
Fourth FY plan	1969-73	1085	178	16.4
Fifth FY plan	1974-78	1481	169	11.4
Annual plan	1979	267	32	12.0
Sixth FY plan	1980-84	2930	421	14.4
Seventh FY plan	1985-88	3760	1002	26.6

Source: CMIE (1987), Bombay, quoted from Shankari Banerjee, 'Direct Foreign Investment Through Transnationals in India: Policies and Performance', *Southeast Asian Journal of Social Sciences,* 19 (1& 2), 1991, p. 83

During this period the United Kingdom had been the largest investor nation, followed by the United States and the West Germany. By late 1970s, Japan emerged in the picture as one of the major investors in India. Between 1957 and 1979, a total of 5,144 foreign joint venture investments were agreed upon. The United Kingdom accounted for nearly 24 per cent of the total collaborations, followed by US, which stood with 19 per cent and West Germany with a share of 17.4 per cent. Japan's share stood at nearly 9 per cent.

Table 3.4

Trends in Indo-Foreign Collaborations Between 1957-1979

Country	Number of Approvals
UK	1221
USA	989
West Germany	895
Japan	462
Switzerland	296
France	233
Italy	151
East Germany	99
Sweden	92
Netherlands	74
Denmark	53
Belgium	46
Austria	39
Canada	37
Total	5144

Source: Indian Investment Centre, New Delhi, quoted from Quarterly Economic Report of the Indian Institute of Public Opinion 147, Vol. 37 No. 4, 1994. p. 41.

The major Japanese investments in India during this period were alliances between Mitsubishi Heavy Industries and the Government of India to construct the shipyard at Cochin; a joint venture between Bharat Electronics and Nippon Electric Company for the manufacture of electronic goods and broadcast equipments; between Nippon Kogaku of Tokyo and National Instruments Factory at Calcutta for production of cameras; and Citizen Watch company's technical alliance with State owned HMT, Bangalore to produce wrist watches.

Trends of Change in the 1980s

After a long regime of controls and regulations in the 1960s and 1970s, the government discovered the technological obsolescence and sluggish growth in many industries. This was the direct effect of the 'Inward Looking Policy' of shielding domestic industry from international competitiveness and keeping foreign equity out of the country's competitive industrial products. Hence, to deal with the trends and situations arising out of these problems, the government announced a plan of action in the Sixth and Seventh Five Year Plans. The action plan had the following elements. First, to emphasise on modernisation of plants and equipments through liberalised imports of capital goods and technology. Second, to expose the Indian economy to desirable competition by gradually reducing the import restrictions and tariffs, and third, to assign a greater role for multinational corporations (MNCs) for promoting exports of manufactured goods on an increasing scale by encouraging them to invest in export-oriented industries.[57] This liberal action plan was reflected in the policy pronouncement that was made in the 1980s.

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[57] Indian Institute of Public Opinion, 'FDI Flows to India', op cit, p. 41.

The industrial policy statements issued in 1980 and 1982, promulgated liberalisation of license raj. A host of incentives and exemptions for foreign equity participation in hundred per cent export-oriented units were also announced. Accordingly, 25 industrial categories were delicensed. The implementation of such policies during the early part of the 1980s was accentuated by the gradual liberalisation of imports of raw materials and capital goods that were included in the Open General License (OGL). Nearly 150 items in 1984 and 200 capital goods in 1985 were included in the OGL.[58] The import duties on various capital goods were slashed in 1985. Likewise, restrictions on imports of parts and equipments for infrastructural projects were also removed.

With the liberalisation of trade and industry, there was popular reception for foreign investments and joint ventures. The government increased the repatriation of foreign exchange for equity participation from Rs Five million to Rs 10 million. The regulations relating to payments of royalty and lumpsum technical charges were also liberalised. Tax rates on royalties were reduced from 40 per cent to 30 per cent in the 1986 budget.[59] Moreover, with an intention of securing a larger flow of FDI from groupings like the Organisation of Economic Cooperation and Development (OECD) nations, the government allowed foreign equity participation even in existing Indian companies employing high technology. Besides, the government also liberalised facilities available to Non-Resident Indians (NRI). For priority industries, NRIs could have 74 per cent equity participation, which would be 100 per cent for export-oriented units.

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[58] Ibid.

[59] Government of India. *Economic Survey, 1986-87*, Ministry of Finance, 1987, p. 64.

With the new economic policy in place, the interest of MNCs once again revived interest in the Indian market. The Indian conditions were much more competitive than many other Asian nations. The de-bureaucratisation process associated with liberalisation simplified the procedural bottlenecks compared to earlier years. India had a comparative advantage in cheap, scientific and technical manpower. As far as FDI was concerned, there had been a marked improvement in the inflows in 1980s and early 1990s, compared to that of 1970s. Between 1986 and 1989, the total FDI registered in the country marked an increase of over 29 times, with the top investing nations being the United States, Britain Germany, Japan and Italy. They were the major sources of both technology and investment. The rise in the number of joint ventures and agreements in the latter half of the 1980s suggested the role of the liberalisation measures during that period in initiating a steady increase in the inflow of technology and capital.

Table 3.5

Country-wise Foreign Investment

(Rs. Million)

Country	1981	1982	1983	1984	1985	1986	1987	1988	1989	Total	Percent
USA	22.5	50.3	138.9	89.5	399.2	293.7	295.1	971.4	621.6	2882.2	25.15
FRG	54.2	36.4	48.4	28.4	118.1	201.6	98.7	310.0	1203.3	2098.0	18.30
Japan	6.5	251.1	160.8	61.5	156.7	56.2	69.1	174.3	87.8	1023.9	8.9
UK	7.1	16.5	98.0	18.1	37.1	77.1	84.5	139.1	334.6	812.2	7.1
Italy	0.4	39.9	11.5	7.7	69.5	23.3	29.7	278.7	69.0	529.7	4.6
NRI	1.3	111.4	65.1	146.4	190.4	79.0	207.7	168.0	211.8	1181.2	10.3
Total*	108.7	628.1	618.7	1130.0	1260.7	1069.5	1077.1	2397.6	3166.6	11457	100.0

Source: India Investment Centre, New Delhi, Monthly News Letter.
*: Including other countries.

In the early 1980s, Japan emerged as the major investor in India and by the end of the 1980s, the US and Germany took the top two positions with 25.15 per cent and 18.3 per cent, respectively. During this period, the largest joint venture investment was mainly in electrical and electronic machinery, industrial machinery, mechanised engineering and also in chemicals.[60] These are the sectors which the government demarcated as priority industries. During the 1980s, the total foreign collaboration signed between major collaborators has registered a rapid and considerable rise. The total number of foreign alliances signed between 1981-89 stood at 7,128.[61] The US occupied the top position with 1,477 investments followed by Germany with 1216 and the United Kingdom with 1,085 investments.

Compared to other countries in Asia during the 1980s, Japan's share of investment in India was at the bottom of the table. With regard to the actual distribution of Japanese FDI in Asia, the NIEs were the largest beneficiaries of Japanese FDI between 1951 and 1988, receiving as much as 47 per cent. Followed by ASEAN with 46 per cent as against 0.9 per cent that went to South Asian countries.[62] During this period Japanese investment in India was 0.1 per cent of Japan's total foreign investment all over the world.[63] Between 1951 and 1990, investments in India accounted for 167 cases totalling over $196 million, while investments in the Philippines accounted for 850 cases totalling $1,580 million during the same period. Between 1980 and 1991, India made 620 collaborations with Japanese firms even though miniscule compared to the investments by other

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[60] Banarjee. *Direct Foreign Investment Through Transnationals in India*, op cit, p. 91.

[61] Indian Institute of Public Opinion, 'FDI Flows to India', op cit, p. 43.

[62] Government of Japan. *Annual Economic Report*, Ministry of Finance, Tokyo, 25 February, 1990.

[63] D. Sridharan. *Japan and the New World Order: Implications for India*, New Delhi, Centre for Policy Research, 1991, p. 46.

developed countries to India.[64] The main obstacles for considerable investments from Japan to India were strong demand for local content, high tariff rate, weak infrastructure (mainly power and transport), complex approval procedures, difficulties in finding partners and parts suppliers and regulations for expatriate Japanese in India.

From the 1980s onwards the participation of Japanese MNCs in Indian enterprises has increased sharply. During this period Japanese FDI was centred on the production of transport machinery and related sectors. The best-known success story of an Indo-Japan joint venture is the Maruti Udyog Limited (MUL), which commenced production in December 1982. Encouraged by this success, Japanese investors flocked to India from 1983-87, investing mainly in two wheeler and four-wheeler vehicle joint ventures, including light commercial vehicles, with technical collaboration and technology transfer being the main component of the ventures.[65]

Apart from the automobile sector, foreign investment and technical collaboration took place in the consumer electronic industry in general and computerisation of product design and related industrial activities in particular. This is a phenomenon Japanese investments have worked on in other Asian countries like

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[64] Ibid, p. 42.

[65] Joint ventures were set up between Punjab Tractors and Mazda (Swaraj Mazda); DCM Ltd and Toyota (DCM-Toyota); Hyderabad Allwyn and Nissan Motors (Nissan Allwyn); Eicher Motors and Mitsubishi Automobiles (Eicher Mitsubishi). In two wheelers the prominent ventures were Sundaram Clayton and Suzuki; Hero Motors and Honda; Escorts and Yamaha; and Kinetic Engineering and Honda. Technical collaboration was agreed upon between Hindustan Motors and Isuzu to produce commercial vehicles and later HM had alliance with Mitsubishi Auto for passenger car manufacturing unit. Honda had agreement with Telco to set up joint venture for four-door vehicle 'Accord' in 1985. But the Indian government did not give the nod for that venture. The rationale for the rejection was that there was a shortage of foreign exchange and limited domestic demand for that type of automobile. Japanese investors were disappointed by the decision and raised suspicions about the government's commitment towards foreign investment and reforms. But this decision was a blessing for Maruti Udyog Limited, who acquired near monopoly for over a decade.

Malaysia, Thailand, South Korea, Singapore and Taiwan, which became a hub and core centres of global consumer electronics industry. Table 3.8 shows the major Japanese joint ventures in India till 1990.

Table 3.6
Survey of Japanese Joint Ventures in India: Profile of Subject Companies

Company	Field of production	Commencement of Operation	Equity share of Japanese partner (%)	Other Japanese equity share (%)
A	Light car	Dec.83	50	--
B	LCV*	July 85	26	--
C	LCV*	June 86	10	5
D	LCV*	Aug. 86	26	--
E	Safety glass for cars	Mar. 87	12	12
F	Air conditioners for cars	Jan. 85	40	--
G	Automobile components	Mar. 87	26	--
H	Automobile components	June 86	13	13
I	Automobile components	Sep. 84	15.52	9.7
J	Car batteries	June 87	15	--
K	Paints for automobile	Jan. 83	26	--
L	Automobile components	May 90	26	--
M	Motorcycles	May 85	26	--
N	Dry cell batteries	June 84	40	--
O	Industrial machinery	May 87	40	--
P	Industrial machinery	Aug. 76	40	--
Q	Ossein**	Jan. 79	26	--
R	Ossein**	Feb. 75	10	--

* LCV: Light Commercial Vehicle, **Ossein: Gelatine made from Ossien (bone)
Source: Ministry of Finance, Government of Japan, Tokyo, quoted from Hideki Esho, 'Japanese Investment in South Asia: The Case of India' in Purendra C. Jain (ed.) *Distant Asian Neighbours: Japan and South Asia*, New Delhi, Sterling, 1996, p. 74.

Trends in the 1990s

The growth pattern of inflows of FDI into India has changed in nature, composition, focus and in totality, because of the introduction of the New Industrial Policy are part of the New Economic Policy (NEP) in July 1991. Till the end of 1991, the total FDI inflow amounted to $135 million. It increased to $280 million in the financial year of 1992-93, making 110 per cent rise and it climbed to $369 million, marking a 75 per cent increase. In the financial year 1996-97, the FDI inflow in India had reached an astounding level of $2,057 million. (See Table 3.7)

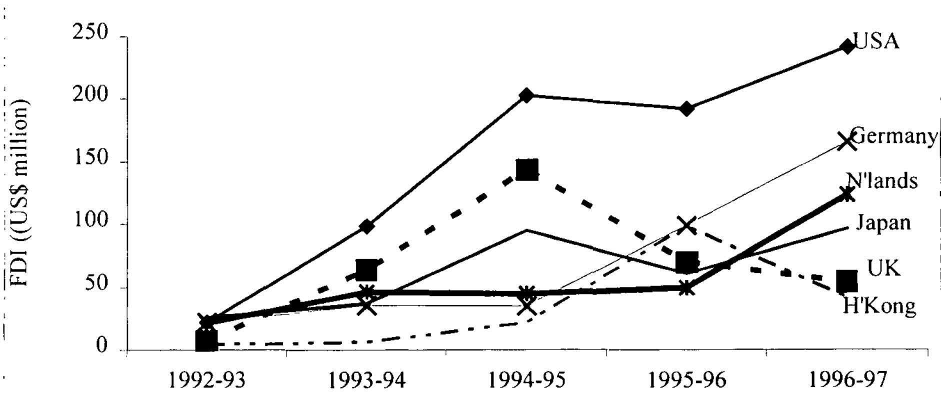
Table 3. 7
Foreign Direct Investment Inflows in the 1990s – Country wise
(US$ million)

Country	1992-93	1993-94	1994-95	1995-96	1996-97
USA	21.7	98.8	202.8	192.4	241.6
UK	6.6	64.1	143.5	70.0	54.2
Japan	25.7	36.9	95.0	60.9	96.7
Netherlands	21.0	46.5	44.6	49.8	123.7
Germany	21.4	35.1	34.6	99.2	166.2
Hong Kong	4.0	6.1	21.4	98.5	41.5
Total	280.0	369.0	872.0	1418.0	2057.0

Source: RBI *Annual Reports*, Various years

As mentioned earlier, under the New Economic Policy, the Indian government liberalised the Indian economy to attract FDI from various sources. The main objective of the liberalisation of economic polices was to encourage FDI that seeks global markets. The policy of 'Export Performance Requirements', which had contributed to the unattractiveness of India as an investment destination, was discarded and more care was taken to formulate 'outward oriented' policy for trade and industry.[66] Many of the archaic regulations were amended or abolished and foreign ownership was made permissible for more than 51 per cent, as per the priority sector. Automatic permission was granted for foreign technology transfer agreements in high priority industries for lump sum payment of up to Rs. 10 million, a royalty payment of five per cent for domestic sales and eight per cent for exports.[67]

Graph 3.1
Top Six Investor Countries in India 1992-97



Similarly, the government removed the 'mandatory convertibility' clause and allowed foreign investors the option of converting part of their loans into equity if felt necessary by their management.[68] Moreover, some of the key changes made in India's regulatory framework for FDI over the 1991-96 period are as follows:

<u>1991</u>

- Opening up of areas previously closed to foreign investors, including power generation.
- Establishment of the Foreign Investment Promotion Board.

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[66] Jagdish Bhagwati and T.N. Srinivasan. *India's Economic Reforms*, Ministry of Finance, Government of India, 1993, p.44.

[67] Government of India, *Economic Survey 1991-92, Part II*, Ministry of Finance, 1992, p. 82.

[68] Ibid, p.81.

1993

- Full ownership allowed in certain industries previously closed to or restricted for foreign investment.
- Adoption of the national treatment principle.
- Finance sector partially opened to FDI.
- Full convertibility of Rupee on current account.

1994

- Telecom and Mining opened to FDI.

1995

- Cable television service also opened to FDI.

Table 3.8

Foreign Direct Investment Inflows in the 1990s – Industry wise

(US$ million)

Country	1992-93	1993-94	1994-95	1995-96	1996-97
Finance	3.7	42.2	97.7	270.0	217.0
Engineering	69.8	32.9	131.6	251.9	730.2
Electronics & Electrical Equipments	32.8	57.1	56.4	129.6	153.6
Chemical & Allied products	47.0	37.5	141.2	126.7	303.8
Services	2.4	20.2	93.4	100.5	15.2
Food and dairy products	27.9	43.5	60.9	85.0	237.5
Pharmaceuticals	3.1	49.5	10.1	54.8	47.6
Computers	8.3	7.6	10.2	52.1	58.7
Domestic Appliances	15.8	2.4	108.3	0.5	15.1
Others	69.1	76.1	162.2	346.9	278.3
Total	280.0	369.0	872.0	1418.0	2057.0

Source: RBI *Annual Reports*, Various years

Table 3.8 shows that FDI inflow into India has been confined largely to engineering, electronics and electrical equipments, chemicals, food processing, tourism, pharmaceuticals and IT sectors. The concentration of FDI in power was largely by US firms, while the Japanese investors were more visible in transportation, electrical equipments, chemicals (other than fertilisers), and heavy machine industries.

As economic liberalisation moved into full swing under the Rao government, direct investment by Japanese firms to India initially became more active. Some leading Japanese companies shifted more concentration to the Indian market. Some of the major ventures during that period were Asahi Glass's tie up with Tata to manufacture high quality float glass, which had wide applications in automotive and construction industries, Fujitsu's production facility for PABX telephone switchboard in collaboration with Punjab National Electronics Corporation, and Nippon Cement's venture for manufacturing special steel in collaboration with Associated Cements. Fanuc started production of numerical controlled machines in collaborations with Voltas and IGE, and Itoch constructed an oil refinery for Reliance Industries.[69]

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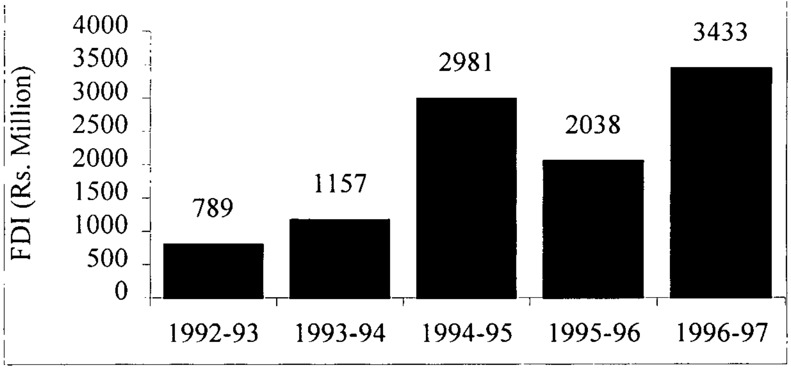
[69] Hideki Esho. 'India's New Economic Policies and The Japanese Response', op cit, p. 18.

Chart 3.2
Japanese FDI to India 1992-97



Ever since the NEP was launched, Japan had recognised India's economic resurgence and has announced officially its intention to become involved in the reform process. A Japanese foreign ministry sponsored delegation consisting of over a hundred corporate representatives, industrialists and financiers, as well as officials from the ministries of foreign affairs, finance, industrial trade and industry visited New Delhi on 26 January 1992 to explore the possibilities for investments in some high potential sectors in Indian economy.[70] The delegation expressed Japanese appreciation for the reform process and sought assurance from that government that there would be no crucial policy reversals on the reform process.

However, despite these improvements on the direct investment levels, Japanese corporates and politicians were sceptical about the continuity of the reforms process. India could not effectively promote abroad its new policy initiatives, especially in Japan. India failed to disseminate its capacity and commitment to implement the NEP successfully. The Japan External Trade organisation (JETRO) in a seminar on South Asia, held in Tokyo in early 1991,

[70] Ibid.

suggested establishment of a South Asian Business Publicity Centre like that of ASEAN.[71]

This anxiety was influenced by the history of political instability in India prior to the reform process, which led to many major decisions being reversed after political pressure from various aggrieved groups. Political and economic stability is a major factor that foreign investors would look for in a potential investment destination, as any unstable elements leading to reversal of major decisions would lead to uncertainty of their investments. However, the economic delegation opined that India's fiscal and industrial policies were still short of their requirements and the advised for the need to address that lacuna positively.[72] The mission suggested that India must make an earnest attempt to restructure its tax system and make it more competitive, keeping in mind the tax structure followed by China, Indonesia, Malaysia, Taiwan, Singapore, Thailand and the Philippines.[73]

The mission also suggested the need for India to remove licensing in the consumer electronic and automobile sectors so as to ensure faster and effective participation for Japanese companies and enable growth and development of these two vital sectors of the economy. Some of the mission's other suggestions include the proposal to seek private sector led initiatives in the economic development process, abolition of restrictions on banking activities and easing of norms for opening foreign currency deposit accounts by foreigners. The report pointed out that in the areas of foreign investment in trading activity; the Japanese investors feel that

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[71] Rajaram Panda, *Japan and the Third World*, op cit, p. 102.
[72] Badar A. Iqbal. *Attracting Investments: A Case of India*, New Delhi, Mittal Publications, 1997, p. 27.
[73] Ibid.

the permissible limits of foreign equity should be raised from 51 to 75 per cent. This, they stated, is all the more necessary in respect of trading houses primarily engaged in export activities.[74] The mission's report was considered to be the long-term Japanese politico-economic policy approach towards Indian economy. The Japan government was searching for new destinations for its private sector and extended its support to their investment missions in India.

According to a Toyo Keizai Survey, as of December 1997, a total of 18,863 Japanese companies were operating abroad with more than 10 per cent equity participation, and among these, 9,462 were operating in Asia.[75] The number of Japanese companies operating in India was 138, so that their share in total number was just 0.7 per cent of the total, and even just a trifling 1.5 per cent of the Asian subtotal.[76] However, India's share of the total increased slightly in 1991-1997 period to 1.0 per cent, compared with the previous period of 0.5 per cent. The total amount of Japanese investments during the period from 1991 to 1996 was $314.3 million, which is 40 times more than that of investments in 1980s. But the share of Japanese investments substantially decreased during this period, from 9.0 per cent to 4.5 per cent. One of the main reasons for this downfall is the decline of the Japanese 'bubble economy' in 1991. During the early 1990s, Japan reported negative growth and that trend continued and was aggravated with the East Asian economic crisis in late 1997. The total Japanese FDI has decreased sharply since 1990, in terms of both numbers and amount invested.

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[74] Rajaram Panda, *Japan and the Third World,* op cit, p. 112.

[75] Toyo Keizai. 'A List of Japanese Companies Abroad 1998', quoted in Hideki Esho. 'India's New Economic Policies and The Japanese Response', op cit, p. 16.

[76] Ibid

Conclusion

By the end of the Cold War, Japan has embarked upon more independent and open foreign policy practices. The Asian region became one of the main destinations for Japan to promote and sustain its comprehensive security policy, which encompasses economic, political and other aspects. The 1991 Gulf crisis accentuated Japan's security concern in a larger perspective. More than 70 per cent of the oil imported to Japan has been going through the Indian Ocean. Lately, Japan realised that instability and the lack of inclusion of South Asian region into Japan's area of influence can undermine Japan's vital interest in the region. Japan has taken a neutral stand on the conflict between India and Pakistan and India and China. The increasing interest of Japan in South Asia is also indicated by the Japanese government backed Japan–South Asia Forum set up in 1991 to promote study and exchange regarding the economic policies of the South Asian countries. This seemed to indicate a very long-term vision to bring South Asia into the orbit of a Japan-centred, economically integrated, politically stabilised and reordered Western Pacific region. The Japanese expectation was that SAARC would eventually develop along the lines of ASEAN where Japan has considerable economic and political influence

Bilaterally, India-Japan relations have grown unfettered by most of the international issues such as Gulf crisis, demise of the Cold War and the resurgence of China as a potential threat. At the same time, there was a fruitful mutual visit by the leaders of the two nations. During these visits various major international, regional and bilateral problems that concerned both countries were discussed. However, politically, these sojourns might have not attained their desired objectives. On many occasions, nuclear issues, particularly Nuclear Non-Proliferation Treaty

(NPT) has come up as a major roadblock for the improvement of relations. Japan has always insisted that India sign the NPT, which is simply not acceptable to India. Besides, the hostility between India and Pakistan has also been a great concern for Japan because if any overt struggle emerges between them it will create a nuclear rivalry in the region.

Although Japanese foreign investment, aid and other loans have reached India in ever increasing amounts, India's share of Japanese FDI has remained abysmally low. Labour laws, poor infrastructure, lack of political will to implement the liberalisation process effectively, and high tariff has made India an unattractive destination for Japanese investors. It is also unfortunate that that India's liberalisation coincided with the Japanese economic downturn that led to slowdown in higher rate of Japanese investment to India. Moreover, more than 40 per cent of the goods produced by Japanese joint ventures have been exported to third countries, predominantly to the neighbouring market. However, India has not emerged as a dominant economic power in the region to create a favourable regional market for its products. In the South Asian region the total intra-trade between the regional countries are less than 10 per cent, in contrast to the Southeast Asian region where regional trade consumes almost one third of the total trade. These weak market performances in the South Asian region have created an image as an unprofitable destination for Japanese corporation.

Finally, India's policy makers have conspicuously neglected Japan and the NIEs as a conducive element for India's economic growth. The Indian political and bureaucratic elite has always looked toward the West for major investment. The Indian Diaspora in the USA and Western Europe has played a crucial role in creating such a relationship. This has not been possible in the case of Japan, since Indian citizens are significantly marginal in number and have collectively not played any role in bringing the two countries closer.

Chapter IV

Japan-Indonesia Relations

Japan is an integral part of the dynamic growth performance of the Asia-Pacific region that culminated in last two decades of the twentieth century. Geographical proximity and economic and political circumstances have brought Japan to play an important role in the Southeast Asian region. The Southeast Asian leaders enthusiastically welcomed Japanese foreign investment to finance their national development. Some even openly advocated schemes to emulate Japan, such as the 'Look East Policy' espoused by Malaysian Prime Minister Mahathir Mohammed and Singapore's 'Learning from Japan Movement' in the late 1970s and early 1980s. At the same time, Japan considered Southeast Asia as a region of great strategic importance and enormous potential for economic growth that made it imperative Japan to have a special relationship with the region as a leader, a donor or a role model.[1]

Japan's policies towards the Southeast Asian countries were probably more indicative of the nature of Japan's evolving international role than its policies towards other regions. The US government had long urged Japan to accept greater international responsibilities and to play a larger economic and political role, especially in developing Asia. As early as October 1962, US President John F. Kennedy told the Japanese leader, Eisaku Sato, then out of office, that Japan should contribute more to the economic development of Southeast Asia.[2]

[1] Paridah Abdul Samad and Mokhtar Muhammad, Japan in Southeast Asia: Its Diplomatic, Economic and Military Commitment, *Indonesian Quarterly*, Vol. 22 No. 3, 1994, p. 261.
[2] Charles E. Morrison, 'Japan and the ASEAN countries: The Evolution of Japan's Regional Role' in Takashi Inoquchi and Daniel I.Okimoto (ed), *The Political Economy of Japan: Vol II, The changing International Context*, California, Stanford University Press, 1988, p. 414.

The first post-War Japanese effort to establish an overseas economic and diplomatic role was evident in its relationship with the Southeast Asian region. Japan has had long-standing economic and political interests in this region, which is significant to Japan as a source of raw materials, a market for Japanese manufacturers, and an area through which many of Japan's products and commerce transited.[3] In the early 1980s, the Southeast Asian countries accounted for approximately 15 per cent of Japan's imports, including most of its natural rubber, tropical timber, palm oil, about half its liquid natural gas, and one-sixth of its petroleum.[4]

The region purchased about 10 per cent of Japanese exports. It stands astride the major trade route connecting Japan with fuel suppliers in the Middle East and iron ore suppliers in Western Australia. Politically, the Southeast Asian member nations were the first in the developing world in which Japanese influence and presence was reasserted after the war. In the foreign policy aspects, Southeast Asia remains an especially important pillar of Japan's relations with the outside world in general and in its comprehensive security policy in particular.

However, Japanese leverage in the Southeast Asian region has increased considerably ever since Japan counted on the United States for leadership in providing external support for maintaining stability in the ASEAN region. Thailand and Philippines were the members of the Southeast Asian Treaty Organisation (SEATO) and were provided with the American security umbrella. The Japanese

[3] In 1979, 78 per cent of Japan's crude oil imports, 41 per cent of its iron ore imports, 35 per cent of steel exports, 63 per cent of its cement exports, and 38 per cent of its automobile exports passed through the Strait of Malacca.

[44] Charles E. Morrison, 'Japan and the ASEAN Countries', op, cit, p. 414.

and Southeast Asian governments have had complementary interests in a stable regional order in East Asia, including preservation of the basic social, economic and political framework of the Southeast Asian societies.

Changes in the international environment forced a more explicit recognition of these interests. American pressure as well as uncertainties about the US regional role in the 1960s and early 1970s raised the question of whether Japan had to assume a more prominent regional role in order to achieve its economic and political goals. Japan has become a important regional actor and its Southeast Asian policy was in time with its relationship with the United States. This ensured Japan's role as a facilitator of economic and political order in the region.

However, the period from the 1960s through the decade of the 1970s witnessed a major shift in large power relationship in Asia. The leaders of the governments in both Japan and in the Southeast Asian region perceived a sense of vulnerability in the region due to the events that occurred in the international economic system and the political turmoil within the Southeast Asian region. Until the late 1960s, the United States and Western European countries remained the main source of both tangible assistance and psychological support for the Southeast Asian governments. However, the collapse of the Bretton Woods system, OPEC's quadrupling of oil prices, combined with American withdrawal from the Southeast Asian region deeply disturbed the political-economic order in the region. Moreover, the growing signs of protectionism in the West, the inability of the United States to respond effectively to the Arab oil embargo indicating a waning in the US hegemony in the world economy, the reappearance of the Soviet Union in world affairs and the rapprochement in Sino-American relations had necessitated both Japan and the Southeast Asian region to come closer and to identify the areas for mutual benefit to both sides.

Apart from the these developments, the domestic political turmoil in the Southeast Asian countries such as the communal riot in Malaysia in 1969 and temporary suspension of Parliament, frequent public protests in Manila prior to the September 1972 declaration of martial law, and political jockeying in Indonesia as the Suharto government gradually entrenched itself, occurred during the same period. These turbulent events went in the direction of lightening governmental control, a policy shift adopted by many countries in the region. Throughout the 1970s, there were considerable political tensions within all the Southeast Asian societies. These political tensions played a major role in the riots that occurred in Jakarta and Bangkok in January 1974 during Japanese Prime Minister Kakuei Tanaka's Southeast Asian tour.

These circumstances helped hasten a much more active Japanese diplomatic interest towards the ASEAN region. Thus, the low-key diplomacy destined to enhance Japan's geo-economic position through bilateral relations gave way to a much more high-profile diplomacy focussed on multilateral relations with ASEAN.[5] In 1977, Prime Minister Takeo Fakuda assured ASEAN that Japan would act as an equal partner and help promote economic development and political stability throughout the region. Tokyo's diplomatic effort in the late 1970s was to alleviate

[5] William Nester, *Japan and the Third World: Patterns, Power and Prospects*, London, Macmillan, 1992, p. 120.

regional tensions and to wean Vietnam away from the Soviet Union, and to broaden its geo-economic interest by expanding Japan's economic penetration of the region.

Since the 1970s, Southeast Asia remains bilaterally, as well as multilaterally, the region with maximum strategic importance for Japan. Tokyo's comprehensive security policy has been primarily directed towards the Southeast Asian region where it has a considerable dependence for markets, raw materials and energy. In turn, these countries have been continuously depending on Japanese sources of capital, technology and markets. Economic aid, largely tied to the purchase of Japanese goods and services, is an increasingly important tool of Japan's regional strategy. Japanese aid accounts for over half of the region's total aid.[6] Throughout the 1980s and in the 1990s, Tokyo increasingly acted as spokes-nation for ASEAN at international forums, such as the annual summit of the Group-8 industrial nations. During the East Asian financial crisis in the late 1990s, Tokyo promptly activated itself into propping up the regional economy by pumping billions of dollars in to most of the ASEAN countries.

JAPANESE POLICY TOWARDS THE ASEAN REGION

Japan's economic penetration of the Southeast Asian region began in the 195C partly by the result of various reparation agreements. Although Japan becan.. reluctant to get involved in regional and international politics after the Second World War, the scarcity of natural resources and the modernisation programme of the Japanese economy forced Japan to concentrate on economic matters such as

[6] Ibid.

would be a collective bargaining organisation which could force Japan to reduce its growing trade surplus with the region. Instead of promoting an original policy, Tokyo followed a classic 'divide and conquer' strategy whereby it cut deals with individual members.

Immediately after ASEAN was formed, Prime Minister Sato extensively toured each country promising increases in aid and better trade terms, but refusing to recognise or even discuss ASEAN. Tension increased between Japan and ASEAN after the organisation declared its non-alignment in 1971. Growing regional resentment of what was perceived as Japanese economic aggression, culminating with mass demonstrations against Prime Minister Tanaka's visit to Thailand and Indonesia in January 1974, forcing Tokyo to make some concessions. In March 1974, Tokyo agreed to establish the Japan-ASEAN Forum on Rubber to allay some of the criticism.[10] Despite this concession, Tokyo's diplomatic strategy centred on playing one Southeast Asian nation against another through largely unfulfilled promises of better trade, investment and aid terms.

In the mid-1970s, several compelling reasons forced Tokyo to re-orient its policy towards Southeast Asia from a low profile one to a high level of neo-mercantilism. This policy shift was part of a 'comprehensive security policy' following the oil crisis of 1973. Tokyo considered Southeast Asia to be an important sphere of influence, just like the Caribbean Basin was to the United States. By the

[10] Sueo Sudo, 'From Fukuda to Takeshita: A Decade of Japan-ASEAN Relations', *Contemporary Southeast Asia*, Vol. X, No. 2, 1988, p. 511.

trade, aid and investment to the Southeast Asian region. It appears that the main theme of Japan's foreign policy in the post-War period emphasised the separation of economics from politics. This policy was enunciated by the Yoshida administration which issued a report in November 1952 clearly outlining Japan's neo-mercantilist strategy towards Southeast Asia: 'with respect to trade promotion, the government shall carry out economic diplomacy, i.e., enter into commercial treaties, broaden and develop trade opportunities by increasing aid and merchandise exports.'[7]

Tokyo's most significant diplomatic initiative during this time was to create and lead the Asian Development Bank (ADB). This action enhanced Japan's economic security, prestige and economic goals, and avoided foreign criticism about Tokyo's 'free-riding' on regional responsibilities.[8] Since its formation in 1957, all ADB presidents have been Japanese citizens. This position, in Yasutomo's words, allows Japanese firms to benefit from ADB procurement awards gained through international bidding, and from despatching employees to serve on the ADB staff for short time periods. [9] The Japanese companies who send employees to the bank become privy to inside information that can be vital to business ventures.

Tokyo, however, snubbed ASEAN, which was formed by the Southeast Asian states, Singapore, Indonesia, Thailand, the Philippines and Malaysia on 8 August 1967. When the idea of ASEAN arose in the mid 1960s, Tokyo had embraced the organisation as yet another forum for asserting Japan's interest, but it rejected ASEAN after Japan's membership was refused. Tokyo feared that ASEAN

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[7] Ibid, p. 122.
[8] Dennis Gasutomo, *Japan and the Asian Development Bank*, New York, Praeger, 1983, p. 38.
[9] Ibid.

mid-1970s, Japan had supplanted the United States as the most important trade partner of almost every nation in the region.

The dramatic events occurred during these periods such as the 'Nixon shocks' – the US opening up to China and the floating of the dollar, the 1973 oil crisis, and the US withdrawal from the Southeast Asian region in 1975 – all of which demonstrated the need for a new foreign policy approach in Japan's policy toward Southeast Asia. Tokyo clearly recognised that a power vacuum was opening up in Southeast Asia which Japan could fill through active, creative diplomacy while simultaneously enhancing Japan's economic hegemony over the region.

Despite the reservations over Japanese hegemony in the region, ASEAN eventually recognised the need for a constructive Japanese role because the United States was cutting back on its commitments in this region. Their main efforts were directed towards consolidating control on the domestic level, strengthening regional solidarity, and diversifying their foreign relations.[11] Especially in the latter context, the Southeast Asian countries began to view Japan as an economic powerhouse whose interests and interactions in the ASEAN region were rapidly expanding as a potentially greater source of political power.

Singapore's President Lee Kuan Yew articulated ASEAN policy in 1976 when he requested that Japan express firm commitment to ASEAN by extending more aid and particularly to help their proposed industrial projects. Only then could

[11] Charles Morrison, 'Japan and the ASEAN Countries', op cit, p. 419.

Japanese attendance at the ASEAN summit be considered.[12] At its June 1977 Economic Ministers Conference, ASEAN articulated a very specific set of conditions for improved relations, which included requests for Japanese cooperation on four issues:

(1) Funding of five major ASEAN industrial projects;
(2) Creation of an export price stabilisation system based on the European Economic Community's (EEC) 1975 Rome Agreement with 46 developing nations.
(3) Tariff reductions for ASEAN products.
(4) Reduction of Japan's list of non-tariff import barriers.[13]

ASEAN invited Japanese Prime Minister Takeo Fukuda to its August 1977 Manila Summit in order to reach agreement on these issues.

Fukuda Doctrine: Japan's Southeast Asia policy was formally enunciated in August 1977 when Fukuda visited the ASEAN countries (as well as Burma) and attended the second ASEAN Summit in Kuala Lumpur. At the end of his trip in Manila, he announced that 'Japan would not become a military power, that it would cooperate with the Southeast Asian countries in developing practical cooperation in the political, economic, social and cultural spheres based on 'heart-to-heart' understanding, and that Japan would assist in strengthening the solidarity between the ASEAN-member countries while fostering mutual understanding between them and the nations of Indo-China.[14]

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[12] *Far Eastern Economic Review*, 18 February 1979, cited from Nester, *Japan and the Third World*, op cit, p. 125.
[13] Ibid.
[14] Sueo Sudo, 'Nanshin, Superdomino, and the Fukuda Doctrine: Stages in Japan-Southeast Asia Relations', *Journal of Northeast Asia Studies*, Vol. 5, No. 3, 1986, p. 41.

The Fukuda Doctrine has been regarded as a major turning point in post-War Japanese relations with Southeast Asian nations. ASEAN was critical for Japan as it was a major source of energy and other essential raw materials: 98 per cent of its imports of natural rubber, 96 per cent of its tin, 40 per cent of its copper and bauxite come from this area.[15] These interests not only were compatible with Japan's 'omni directional' foreign policy, but also assumed a degree of Japanese political leadership in the region, to be based on economic and political initiative rather than on military strength. Japan's Southeast Asian diplomacy was explicitly cited as a Japanese contribution to the international order. Sonada, Foreign Minister in the Fukuda cabinet explained that 'it is the duty of Japan as an advanced country in Asia to stabilize the area and establish a constructive order.'[16]

Although the Fukuda Doctrine became an underlining factor of Japanese policy towards the ASEAN region, the situation was not conducive for negotiating specific issues. Despite Tokyo's willingness to provide a $one billion loan to finance ASEAN's industrial projects, the loans were contingent on each project's feasibility. The projects included urea plants in Indonesia and Malaysia, a soda plant in Thailand, a phosphate factory in the Philippines and a diesel engine factory for Singapore.[17] After extensive negotiations, Tokyo formally agreed to extend the loan to Indonesia's project in October 1980 and Malaysia's in January 1981, but had put on hold, aid to other three projects.

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[15] Wolf Mendl, 'Changing Perspective of Foreign Policy' in Loukas Tsoukalis and Maureen White (eds.), *Japan and the Western Europe*, London, Francer, 1982, p. 90.

[16] *Strait Times*, December 13, 1977, cited from Charles E. Morrison, 'Japan and the ASEAN Countries', op cit, p. 422.

[17] Nester, *Japan and the Third World*, op cit, p. 127.

A number of other factors seem to have put a brake on an expanded Japanese diplomatic role in Southeast Asia. These included the breakdown of relations between China and Vietnam, the development of close Sino-Thai ties against possible Vietnamese aggression, and the restoration of a more vigorous US defence role. ASEAN however, eagerly sought Japan's support on issues of great political importance to the member countries, especially Vietnam's occupation of Kampuchea and the Indo-Chinese refugee crisis. Rather than a leader, Japan occasionally became a reluctant supporter of ASEAN *demarches* on these issues.

The period of the 1970s was marked by political upheavals and economic uncertainties in the Southeast Asian region. Under these circumstances, Japan played a crucial role in creating political and economic stability in the region. In order to create such stability and integration Japan substantially increased direct investment to the region. The Southeast Asian countries had liberalised their economy and gave various incentives to attract Japanese FDI. Japan invested in natural resources, extraction sectors and in manufacturing during this period. By the end of 1970, Japan emerged as the principal trading partner and major investor in the ASEAN countries.

However, the 1980s heralded the consolidation of this political and economic stability, and promoted regional economic cooperation by the Southeast Asian countries. Nevertheless, since the first step was made in the Bali Summit of 1976, intra-regional economic cooperation gained momentum slowly but steadily during the late 1970s and 1980s. Moreover, the consolidation of cordial political relations among the countries gave investors more confidence in the stability and general business environment in ASEAN. At the same time, the regional countries perceived some sort of security threat perception from outside. The political elites feared that Japanese economic power would eventually lead to commensurate military strength because of the questions raised about whether non-military power can play a strong political role. This emerged in the context of the US military withdrawal from Asia and the US pressure on Japan regarding the burden-sharing of responsibilities to ensure peace and stability in the region.

Despite the opposition to a Japanese security role in Southeast Asia, some of the conservative governments had demands for some security needs that Japan could help to fulfil. For example, in the early 1980s high-level Indonesian officials suggested that Japan could contribute more directly to Indonesian defence by supplying military aid, arms and technology to ASEAN countries.[18] Japan turned this down as inconsistent with its policy since 1976 and of being antithetical to its constitutional obligations. In the early 1980s, Japan responded to Thailand's perceived external security threat from Vietnam by increasing its economic aid and refugee assistance to Thailand in line with a new policy of contributing to the 'comprehensive security' of strategically important countries. It can be argued that although Thai-Chinese informal understanding existed, the Japanese economic assistance to Thailand was intended to curtail further Chinese influence in the Southeast Asian region.

Tokyo's strategy towards ASEAN since 1977 has followed the classic Japanese distinction between principles and *realpolitic*. In principle, Tokyo has

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[18] Morrison, 'Japan and the ASEAN Countries', op cit, p. 426.

repeatedly declared that it has abandoned its 'divide to conquer' bilateral policy and has embraced the spirit of multilateralism focused on expanding relations with ASEAN.[19] Since 1977, every Japanese prime minister, other than Masayoshi Ohira, has attended the ASEAN Summits; Japanese foreign ministers have regularly attended the annual Foreign Ministers' Conferences since the inaugural one in Pattay in 1978.

Ever since the first meeting in 1979 in Tokyo, the economic ministers of Japan and the Southeast Asian countries have periodically met at the Japan-ASEAN Forum. The first official overseas visits of two Japanese Prime Ministers, Zenko Suzuki (January 1981) and Noboru Takeshita (December 1987) were to ASEAN rather to the United States, as was normally the custom.[20] Both these visits occurred during periods of rising ASEAN demands that Japan open its markets and give better terms for Southeast Asian products. Every Prime Minister attending an ASEAN or bilateral summit with Southeast Asian members presents a package of sops assuring that Japan would dramatically improve its trade, investment and aid relations.

But on the ground, each Prime Minister's promises were, more often than not simple reiterations of their predecessor's promises. On many occasions, these promises were channelled by criticism from the regional political elites. Suzuki's reassurances included a pledge to increase Japanese aid towards rural development, tapping energy resources and human resources, and sprucing up small and medium-

[19]Nester, *Japan and the Third World* op cit, p. 131.
[20] Ibid.

sized business; but these promises were mostly reaffirmations of Fukuda's assertions made four years earlier.[21] During Nakasone's visits (1983 and 1985), Tokyo was heavily criticised for continuing to maintain its vast web of trade barriers and unequal trade partnerships between ASEAN and Japan. In 1987, Prime Minister Nakasone announced a $two billion regional developments scheme; in December, newly installed Prime Minister, Takeshita announced the same plan during his summit with ASEAN during a speech on 'Japan and ASEAN: A New Partnership Towards Peace and Prosperity'. [22]

One of the noted factors of Japan-ASEAN relationship during the 1980s was that Tokyo deliberately promoted cultural diplomacy, though marginally, with Southeast Asia. Tokyo instituted ASEAN youth scholarships in 1980s to provide opportunities for Japanese and ASEAN students to visit each other's countries. Japan sent dance and theatre groups to Southeast Asia to organize programmes in most of the countries in the region. The Japan Foundation and Toyota Foundation have been active in exchanges of academics and translation of literature, although these were on a small scale compared with the US Foundations activities in ASEAN. Sueo Sudo describes Tokyo's rationale for this strategy as: 'since growing economic interdependence and a more complex political relationship will eventually increase the chances for a collision of interests, the most effective way of building a strong foundation for mutually beneficial relations between Japan and ASEAN was to foster more extensive cultural exchanges.'[23]

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[21] Ibid.
[22] Sudo, 'From Fakuda to Takeshita', op cit, p. 141.
[23] Ibid, p. 140.

Since the 1980s, Japan has been extending its efforts to improve and build a more solid foundation for its relationship with Southeast Asia. Japan's diplomatic and political role has become more commensurate with its economic strength. By the mid -1980s it had become an economic superpower whose economy and technological prowess had by many measures achieved overall parity with the West. With appreciation of the yen under the Plaza Accord, Japan shifted production and assembly of many Japanese manufacturing firms to other Asian countries (Southeast Asian), which had sharply lower wage levels and controllable production costs. During 1991-1993, Japan began to carve out a constructive and more independent policy towards Asia. During the 1991 visit to Southeast Asia, Prime Minister Toshiki Kaifu made mention of Japan's role in the political and economic spheres as a nation of peace.[24]

The new strength of the yen led to Japan's rapid economic surge into Asia in the late 1980s. By the 1990s, Japan became the largest foreign investor in the Philippines, Thailand and Indonesia, and the second largest in Hong Kong, Malaysia and Singapore. Japan's new foreign-economic strategy had encouraged colossal regional economic development, which Japan used it to establish leadership over the region's dynamic economies. By the end of the 1980s, policies involving close business-government cooperation and the use of private investment and official aid to help Japanese multinationals build vertically integrated production networks throughout Asia were given prominence.[25] These production networks continued to

[24] Parida Abdul Samad, *Japan in Southeast Asia*, op cit, p. 263.
[25] Kenneth Pyle, 'Restructuring Foreign and Defence Policy: Japan' in Anthony McGreen and Christopher Book, *Asia-Pacific in the New World Order*, London, Routledge, 1998, p. 28.

increase ASEAN's dependence on Japanese goods, services and capital and diminished ASEAN's bargaining power with Japan.

It was a challenging task for Japan to continue the well-coordinated political and economic policies in Asia in the 1990s amidst the changing scenarios in world politics. With the end of the Cold War, the Communist countries in the region were to undertake independent foreign policies. At the same time, the breach of the ceiling of one per cent of GDP for defence expenditure by Japan had become a cause of concern among Asian governments. In order to shape a post-Cold War political strategy for Asia that would be compatible with its economic stake in the region, the Japanese government found a low-key multilateralism the most comfortable policy.[26] Japan realized that the best option to continue the harmonious relations with the ASEAN countries was to work through multilateral organizations such as Asia-Pacific Economic Cooperation (APEC) and ASEAN Regional Forum.

Kenneth Pyle rightly points out: 'Japan's economic surge in Asia since 1985 required more involvement in the region to protect its increasing interests. Multilateralism provides some realignment and softening of the dominance of US-Japan involvement in the region; multilateralism provides a cover, a quite approach to the region, one that will help it restore Japan's legitimacy and claim to leadership. Engagement in multilateral organizations not only offers a way to respond to foreign suspicions as well as criticism of its self-absorption, and also a way of overcoming domestic resistance to a more international role.'[27]

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[26] Ibid, p. 130.

[27] Kenneth B. Pyle, *The Japanese Question: Power and Purpose in a New Era* (2nd edition), Washington D. C., The American Enterprise Institute, 1996. p. 56.

Consequently, the Japanese government turned its attention to promoting multilateral organizations as a forum for discussing trade and financial relationships and principles. APEC, as a multilateral organisation was loose, deliberative and informal by nature. At the same time, Japan resisted a Malaysian proposal for an East Asian Economic Caucus that would exclude the USA, Australia, Canada and other non-Asian states. For Japan, APEC helps to keep the USA engaged in Asia; further, it promotes the region's economy and also can attempt to draw China into a more harmonious role in the region. Moreover, the ASEAN Regional Forum (ARF) is another arrangement that Japan was instrumental in forming in 1994 to discuss issues of multilateral security and confidence building measures among the member countries. As prominent Japanese observers affirm: 'building a community requires a lengthy process and participation of all Asia-Pacific people. For the moment, all we can do is waiting for the myriad process of regional interaction and cooperation to bear fruit.'[28]

JAPANESE FDI IN THE ASEAN REGION

Japanese FDI in Southeast Asia has passed through three general phases. Until the late 1960s, it was quiescent and narrowly circumscribed due to Japanese capital controls and pervasive anti-Japanese attitude by host countries.[29] During this period, the largest share of Japanese investment in the region was diverted to natural resource extraction sector. Its purpose was to assure supplies of minerals, oils, timber and pulp for home consumption. Indonesia, the recipient of much of this

[28] Ibid.
[29] Richard F. Doner, 'Japanese Foreign Investment and a Pacific Asian Region', in Jefrey A. Frankel Miles Kahler (ed.), *Regionalism and Rivalry: Japan and the US in Pacific Asia*, Chicago, University of Chicago Press, 1993, p. 182.

investment, has remained Japan's second largest investment destination after the United States, and along with resource rich Malaysia and Brunei, is one of the few countries in the region with which Japan consistently ran a trade deficit.

Investments in the manufacturing sector jumped in the early 1970s, as a result of several factors, including domestic capital liberalization, collapse of the Bretton Woods system, the 1973 oil crisis and increased protectionist pressure from the United States and Western Europe. Import substitution industries were the main sectors that were attracted by this investment boom. These were the manufacturing firms that set up shop behind the facade of another country's import barriers to produce relatively standardized goods such as textiles, electrical appliances and electronics.

At the same time Japan invested in labour-intensive industries intended for the export to a third country's market. The purpose of such investment was to take advantage of abundant cheap labour and investment incentives existing in the Southeast Asian countries. By 1979, of the Japanese foreign investment to Asia (including NICs), 39.3 per cent were in resources, 44.3 per cent in manufacturing and 14.4 per cent in services.[30]

Japanese investments increased in overall volume during the 1980s, especially since the Plaza Accord and the subsequent appreciation of the yen. These new Japanese investments, mostly in service industries, in total $1.43 billion, $2.32 billion and $ 4.86 billion in 1985, 1986 and 1987, respectively, compared to new

[30] Vere Simone and Anne Thompson Feraru, *The Asia pacific: Political and Economic Development in a Global Context*, New York, Longman, 1995, p. 339.

American investments in the area of $ 55 million, $40.5 million and $2.2 billion in the same years.[31] Moreover, the 'house clean Japan' campaign forced heavy polluting petrochemical and metal refining industries to shift their production base to the Asian countries.

To circumvent Japanese vulnerability and spread across Japan's resource suppliers as strategically as possible, the government encouraged Japanese corporations to embark on joint ventures with host countries who depended on Japan as a market for their natural resources and finished products. This applied to Malaysia, Indonesia and the Philippines on whom Japan depended for minerals and metals. This period also witnessed a more pronounced shift of emphasis from natural resources and cheap labour to technology-based developed market oriented investment such as electrical and electronics in the ASEAN countries.

FACTORS AFFECTING JAPANESE FDI IN ASEAN

Domestic political stability and a favourable political relationship between the investing and host countries are the most important factors for a potential foreign investor in any region.[32] Cultural and social climate, including language and business practices, also influence the investment opportunities in the recipient countries. Moreover, FDI as an economic action affects the regional trade practices and the scale of domestic economy of the host country. The factors in all these dimensions need to be examined as they affect Japanese FDI in ASEAN.

[31] Ibid, p. 341.
[32] Sueo Sekiguchi, 'Japanese Direct Foreign Investment and ASEAN-Japan Relations: A Synthesis', in Sueo Sekiguchi (ed.), *ASEAN-Japan Relations: Investment,* Institute of Southeast Asian Studies, Singapore, 1983, p. 7.

Political Factors: Despite its economic super power status, Japan has been considered as a political free rider. Nevertheless, its political leaders increasingly attach importance to the ASEAN countries as reflected in the number of visits to the region by various Japanese prime ministers. The ASEAN countries are a strategically and economically important destination for Japan as they hold sway over the Straits of Malacca through which much of Japan's oil supplies pass. This region is the main source of raw materials and natural resources which have been vital for the industrialization process for Japan. It was, therefore, necessary for Japan to maintain a favourable political climate in ASEAN, and for this purpose, potential Japanese investors regarded ASEAN as a promising market for investment.

There was also a strong belief in Japan as well as ASEAN that establishing domestic stability among ASEAN countries is also an important aspect. Ever since the aborted coup in Indonesia in 1966 and the establishment of the 'New Order' regime under Suharto and social and political tensions in Malaysia, the Southeast Asian countries perceived a security threat that was internal as well as external. ASEAN recognised that economic progress is the most important deterrent to such threats. The political elites of ASEAN realised that the inflow of external capital was needed for economic growth and that official development aid alone was insufficient. Japan had allocated about 30 per cent of its bilateral official development aid to ASEAN in 1969, and provided direct investment for various projects as part of Japan's comprehensive security policy. The best example of this policy was the foreign aid programme for the Asahan Industrial Complex in Indonesia.

Socio-cultural Factors: Due to the geographic and proximity and historical contacts, Japan and the ASEAN countries have had substantial cultural relations. Although the bitter Second World War experiences had left a scar on the Japan-ASEAN relationship, Japan continued to maintain cultural contacts with regional countries though inconspicuously. The Japanese government instituted youth scholarships for ASEAN students to visit Japan and Japan Foundation and Toyota Foundation sponsored students to study in Japan. Moreover, there have been various exchange programmes for academicians, artists, scientists and cultural groups to create mutual understanding and gather information on both parties.

Economic Factors: As pointed out in earlier sections, the domestic economic situation in Japan and the capacity of Southeast Asian markets is the most decisive factor for attracting Japanese FDI. In 1979, the aggregate GNP of the five ASEAN countries was about $130 billion, which was larger than that of Australia.[33] As the national markets are not integrated, they could not be regarded as a single large market. Yet the regional integration and continuing high growth rates increasingly enabled induction of more Japanese DFI. In fact, the ASEAN countries grew at an average annual rate of 6-8 per cent which continued through the 1970s, 1980s and up till the Asian Financial Crisis (1997).

The ASEAN countries have offered abundant raw materials, natural resources and cheap labour for the labour-intensive manufacturing facilities. Indonesia had petroleum and natural gas while Malaysia and the Philippines offered opportunities for investment in forestry and mineral resource development, in addition to those of Indonesia. As for public policy, the ASEAN countries, except Singapore, imposed tariff and non-tariff barriers for the protection of domestic

[33] World Bank, World Development Report, 1981, cited in Sueo Sekiquchi, *Japanese Direct Foreign Investment and ASEAN,* op cit, p. 10.

producers. They provided the motive for Japanese enterprises to invest in order to overcome these barriers and to capture the gains from protection. Moreover, tax incentives were provided to pioneering industries or those industries, which were export-oriented. At the same time, rising wage rates and higher costs in Japan combined as factors promoting increase in Japan's investment in the ASEAN countries. When other industrialized countries strengthened restrictive measures against Japanese exports, this in turn proved advantageous to the ASEAN countries by increased rate of Japanese FDI to the ASEAN countries, particularly in the case of standardised manufactured goods where technologies were easily transferable.

Since the restrictions on outflow of foreign investment were eased by the late 1960s, Japan started direct investment in the resource development sector. The screening and approval requirements were eliminated during this period. Japanese FDI in the manufacturing sector was directed to Asia, particularly to Southeast Asia, centred on labour-intensive industries, which were losing their comparative advantage in Japan. By the mid-1970s, Japanese FDI to the Asian region began to increase, particularly in the fields of electric appliances, electronics, transport equipment, and the secondary chemical products. Statistics provided by official sources and by industry reveal that of the total Japanese FDI; the ASEAN countries received FDI of over 15.8 per cent in 1965, 13.7 per cent in 1970 and 19.2 percent in 1980.

Table 4.1
Japanese Foreign Direct Investment in ASEAN and other Regions (in million US$)

Country/Region	1951-65	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
ASEAN	150	490	642	856	1481	2046	2902	3946	4581	5499	6094	7021
Indonesia	51	242	354	473	814	1190	1775	2703	3128	3739	3888	4424
Malaysia	19	50	62	76	202	250	302	356	425	473	506	650
Philippines	24	74	78	88	131	190	339	354	381	434	537	615
Singapore	17	33	48	90	171	222	278	305	370	544	800	936
Thailand	39	91	10	129	163	194	208	228	277	309	363	396
EAST ASIA	20	147	22	415	783	944	1164	1365	1585	2006	2364	2602
Korea	-	33	61	207	418	495	587	690	785	1007	1102	1137
Taiwan	10	85	97	108	142	175	198	227	244	284	323	370
Hong Kong	10	29	70	100	223	274	397	448	556	715	939	1095
OTHER ASIA	18	116	11	120	124	129	153	153	162	163	185	207
NORTH AMERICA (Canada & US)	241	912	11	1548	2462	3012	3917	4666	5401	6765	8202	9798
OTHERS	520	1913	2306	3833	5416	6525	7806	9274	10481	12376	14958	16868
WORLD TOTAL	949	3577	4435	6773	10267	12662	15943	19405	22211	26809	31804	36497

Source: Ministry of Finance, Tokyo cited from Sueo Sekiguchi , *Japanese FDI and ASEAN Economies*, op cit, p. 233

During the period of 10 years Japanese FDI to Southeast Asia grew 23 fold from $166 million in 1966 to $3.95 billion in 1976. In other words, 34.6 per cent of total Japanese FDI went to the ASEAN countries in 1976, compared with 26.8 per cent to North America, 18.9 per cent to Latin America and 12.3 per cent to West Europe.[34]

The types of Japanese investments vary with each country in Southeast Asia depending on factors such as resource endowments and the policies of the host

[34] Ibid, p. 12.

country. In Indonesia, greater weightage has been given to labour-intensive units such as metal processing, natural resource extraction, and textiles which were easily transplanted because of less sophisticated technology. On the other hand, Japan's FDI was oriented to capital-intensive and technologically sophisticated sectors in Singapore, and both capital and labour-intensive in Thailand, Malaysia and the Philippines.[35]

[35] Nester, *Japan and the Third World*, Op cit, p. 137.

Table 4.2

Japanese Foreign Direct Investment to ASEAN By Sector Cumulative Total 1951-80 (In million US$)

	Indonesia		Malaysia		Philippines		Singapore		Thailand		Total of ASEAN	
	Cases	Amount	Cases	Amount	Cases	Amount	Cases	Amount	Cases	Amount	Cases	Amount
Total Manufacturing Industry	566	1527.0	331	455.9	223	235.7	527	687.6	393	291.7	2040	3198
Food	44	26.3	23	17.5	25	14.1	21	10.4	79	46.4	192	118
Textile	120	344.5	38	104.9	29	21.3	29	11.4	72	126.3	288	608
Wood& Pulp	60	57.4	62	44.9	18	7.6	11	11.3	19	4.1	170	125
Chemistry	93	73.4	41	167	34	65.2	61	82.3	65	28.9	294	417
Metals & Non-ferrous Metals	96	753.1	31	29.7	25	73.8	67	36.7	33	19.6	252	913
Machinery	23	14.8	10	8.9	13	4.5	90	123.3	34	11.5	170	163
Electric Machinery	29	39.0	55	51.8	20	6.7	130	138.5	24	6.8	258	243
Transport	31	61.2	9	7.6	17	27.0	20	113.9	24	29.7	101	239
Others	70	154.3	62	23.1	42	15.5	98	159.9	43	18.4	315	371
Others												
Agriculture & Forestry	99	108.6	37	16.6	83	32.7	3	0.5	17	6.7	239	165
Fishery	69	60.2	7	1.0	14	1.2	-	-	4	1.1	94	63
Mining	35	2522.2	32	119.6	40	276	-	-	26	4.7	133	2923
Construction	37	16.2	25	4.4	24	10.9	50	17.2	30	11.3	166	60
Commerce	32	10.7	69	11.8	69	4.3	219	56.4	130	43.5	519	127
Finance & Insurance	19	65.7	15	6.9	11	17.2	18	12.1	17	8.8	80	111
Others	74	104.7	53	28.4	42	29.8	134	124.5	80	25.0	383	312
Real Estate	41	8.1	14	3.0	7	0.8	27	5.5	5	0.7	94	18
Branch Office	4	0.5	19	2.9	23	5.6	77	32.3	33	3.0	156	44
Total	976	4423.8	602	650.4	536	614.9	1055	936.2	735	396.4	3904	7022

Source .Ministry of Finance, Government of Japan, Tokyo, Cited in Sueo Sekiguchi, op cit p. 235.

Japanese capital and resource extraction FDI involves large MNCs; labour-intensive FDI involves small, medium and large Japanese companies. These varied forms in Japanese FDI character reflects Japan's investment strategy from the late 1960s. Government and corporate leaders saw FDI as a solution to Japan's rising labour costs, mounting public grievances about industrial pollution, and the need to constantly upgrade production as a means of securing markets and resources.[36]

By 1980, the ASEAN countries managed to attain a higher level of political stability and economic prosperity which turned into a favourable atmosphere for capital-intensive and high technology manufacturing investment base for Japan. Beginning with around $1 billion, FDI started to increase rapidly in 1986 and hit a peak of around $8 billion in 1989. This significant increase in the Japanese FDI was due to several factors. The main factors that have driven this rapid increase in Japan's FDI in ASEAN are as follows:

(1) **Appreciation of Yen** – The appreciation of yen after the Plaza Agreement was regarded as irreversible by most Japanese firms. Since corporate ability to maintain export volume by squeezing profits was thought to be limited, firms tended to respond by effecting structural changes in improving their competitiveness in international markets, including shifting production overseas.

(2) **Aggravation of trade friction** – In spite of the sharp appreciation of the yen, Japan's trade surplus did not decrease significantly until 1988, which, after that, further aggravated trade friction. Protective

[36] Ibid.

restrictions were adopted by the United States and Western Europe in certain areas (automobile, machinery, electronics and electrical appliances); and in some cases, anti-dumping duties were imposed on Japanese exports. These restrictions on exports also caused Japanese firms to shift production out of Japan.

(3) **Lower Wages in East Asian Countries** – For most Japanese firms that choose to invest in East Asia, the main reason to shift their production, at least initially, was to take advantage of lower wages in these countries so as to improve their competitiveness in international markets. For example, the average real cost of wages in NIEs was only slightly more than 20 per cent of the average of real cost of wages in Japan, and in ASEAN countries it was less than 10 per cent of the Japanese figure (1986).

(4) **Imports from Asian Countries** – While initially the main purpose for Japanese firms to invest in East Asian countries was to take advantage of lower wages to improve their competitiveness in international markets, as this shift proceeded, Japanese firms started to import certain products from their production sites in East and Southeast Asia, especially low value-added or lower-end goods. For those goods, competition in the domestic market is very severe, and firms have tried

to become non-competitive by importing from their affiliates to ASEAN countries where production costs are lower.[37]

However, centered on the 'flying geese theory', the shift in investment from the Asian NICs to ASEAN occurred in the 1980s. Manufacturing has constituted a major portion of this shift in Japanese investment in the ASEAN region with the cumulative rate of investment rising from 31.5 per cent in 1976 to 43 per cent in 1988. These investments were caused by the intent to target its exports to North America, Europe and Japan.

Investment in the manufacturing sector in Indonesia has increased from 25 per cent to 30 per cent, but remains the lowest in the ASEAN region. Large volume of funds persistently flew into the Indonesian petroleum sector (mining accounting for 63 per cent of Japanese FDI), between 1976 and 1988, whereas Japanese inflows in manufacturing rose from 57 per cent to 74 per cent in Malaysia and 26 per cent to 45 per cent in the Philippines. The share in the manufacturing sector dropped slightly in Thailand, but continued to account for the majority of Japanese FDI, shifting from 75 per cent in 1976 and 73 per cent in 1988.

[37] Mistow Esaki, 'Globalisation and Economic Development: The Newly Industrialising Areas of East Asia' in T Gerard Adams and Shimizhi Ichimura, *East Asian Development: Will the East Asian Growth Miracle Survive*? London, Praeger, 1998, p. 161-62.

Table 4.3
Cumulative Reported Flow of Japanese FDI

Country/Region	Manufacturing percentage of all Industries		
	1976	1985	1988
Asian NICs	61.0	43.0	37.0
Hong Kong	6.2	8.4	7.97
Korea	70.0	56.0	49.0
Singapore	72.0	64.0	52.0
Taiwan	93.0	89.6	82.0
ASEAN-4	31.5	35.8	43.0
Indonesia	25.2	27.7	30.0
Malaysia	57.6	70.3	73.6
Philippines	26.6	39.7	45.5
Thailand	75.5	70.0	73.0

Source: Cited in Richard F. Doner, 'Japanese Foreign Investment and a Pacific Asian Region', op cit, p. 170.

Another indication of the role of Japanese investment in the region's changing structure of comparative advantage is the emphasis on what may be termed as early, middle and late industries.[38] In the case of ASEAN, major shifts occurred mostly in early and late industries. In 1975, early industries accounted for almost 46 per cent of cumulative Japanese foreign investment in manufacturing, but by 1988 this dropped to 19.3 per cent, while the proportion of late industries rose from almost 38 per cent to 66 per cent in the same period. Indonesia saw Japanese investment in basic metals rise from 16.9 per cent of the total manufacturing investment to 47.7 per cent, while Malaysia saw the largest increase in electrical and

[38] The early industries include food, certain textiles and leather. Middle industries include certain wood products, chemicals, petroleum and non-metallic products. Late industries include apparel, paper and printing, metal products, industrial and electrical machinery and transport equipments.

transport machinery, with the former doubling its relative share and the latter growing from under 2 per cent to over 13 per cent.[39]

The Philippines experienced a similar increase in transport-machinery investment, up from 4.2 per cent in 1972 to 26.7 per cent in 1988. Thailand saw the increase in basic metals, machinery and electrical machinery. Thus for ASEAN, Japanese investment evolved away from mining toward manufacturing and within manufacturing itself the focus was on late industries. In the 1980s, Japanese FDI surpassed the US in the ASEAN region. This was due to the fact that the US became a net capital importer, the yen appreciated significantly and the increasing production network of Japanese companies in Asian region that led to the use of the term 'Asianisation of Japanese Economy.'[40]

During this period, Japanese investment worldwide has increased and in the ASEAN region it reached a comparatively higher level. Indonesia and Singapore continued to be the chief beneficiaries of Japanese investment in ASEAN, with average share of 55.9 per cent and 14.4 per cent respectively. Close on their heels were Malaysia with 10.9 per cent, Thailand with 9.7 per cent and the Philippines with 7.7 per cent share.[41]

However, it can be argued that cheap labour was not the principal lure for Japanese FDI to the Southeast Asian region. Yamamura and Hatch suggest that

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[39] Richard F. Doner, 'Japanese Foreign Investment and a Pacific Asian Region', op cit, p. 170.

[40] Shojiro Tokunaga, 'Japan's FDI-Promoting Systems and Intra-Asia Networks: New Investment and Trade Systems Created by the Borderless Economy', in Shojiro Toakunaga (ed.), *Japan's Foreign Investment and Asian Economic Interdependence: Production, Trade and Financial Systems,* Tokyo, Tokyo University Press, 1992, p. 35.

[41] Walter Hatch and Kozo Yamamura, *Asia in Japan's Embrace: Building a Regional Production Alliance,* New York, Cambridge University Press, 1996, p. 22.

Japan's high technology manufacturers were investing in Asia for a strategic purpose, namely, to achieve economies of scale, increase scope of networking by capitalising on the region's deepening divisions of labour. Added to that, this strategy underlined an effort to secure a 'strategic distribution' of management resources and production activities. It is a fact that many Japanese MNCs were breaking the manufacturing process into discrete pieces, retaining at home the research and development (R&D), design and precision manufacturing work, the vital elements that adds the most value to the product while parcelling out the rest of the work to ASEAN countries.[42]

In the overall process, Japan usually supplies hi-tech inputs; the Asian NICs supply the high-to-medium-technological inputs; and the ASEAN-4 nations, as well as China, supply the medium-to-low technological inputs. This production network has brought together, according to MITI report, the region as 'a single market from which to pursue a global corporate strategy.' Thus the ASEAN economies have become an integral part of a production structure that emerged in the Pacific region with Japan as its core.[43]

It can therefore be argued that, the regional integration in the ASEAN region was achieved through the production networks built by Japanese MNCs. These networks have taken three different forms: hub network, cluster network and web network.[44] The first type, the hub network, is a collection of regional affiliates that tie themselves closely to the parent organisation in Japan, but do not interact much,

[42] Ibid, p. 23.
[43] Ibid.
[44] Ibid.

if at all, with one another. Many of these affiliates are joint ventures with well-connected business groups in the host nations, though the Japanese partners usually control the day-to-day management of the regional affiliates. It is assumed that either the Japanese partner would enjoy minority shareholding or the two sides may sign a 'basic agreement'.

In both cases the local partner will be a dummy shareholder – a partner only on paper. In this joint venture, the Japanese partner may have leverage by securing a loan to finance the local partner's equity interest. This type of joint venture is also called as 'screw driver' operation because the components for manufacturing are imported from Japan and only the assembling plant is located in the host country. Fujitsu in Thailand imports around ninety-nine per cent of the essential parts and components used in Thailand, which come from the parent company in Japan, which in turn owns 50 per cent of the joint venture.

By the 1980s, it was increasingly difficult for Japanese MNCs in Asia to continue to import parts from Japan due to the various tariff restrictions adopted by the ASEAN countries. To remain competitive, they had to begin purchasing locally produced parts. They, in effect, had to build a new kind of network, a cluster network based on a denser set of inter-firm relationships. Most of the big assembly firms managed to persuade their Japanese subcontractors to pack up and move to Asia or sign technology license agreements with domestically owned suppliers in the region.[45] In the later 1980s, Mitsubishi Electric Company (Melco) used its own capital to construct a cluster network of local parts producers to supply its TV

[45] Ibid.

manufacturing operation in Thailand. It first set up a joint venture, Thai CRT, to produce Cathode Ray Tubes based on Melco technology.[46] At the same time, Asahi Glass, a member of Mitsubishi's Industrial Keiretsu in Japan soon announced plans to set up another joint venture to manufacture the glass valves in those tubes.

As Japanese MNCs turn more and more to Asia as an alternative site for export-oriented manufacturing, Japanese MNCs in the 1990s have been building a third and even more comprehensive type of network, which can be called as a web network spun together by intra-regional and intra-group trade. This type of vertically integrated network served to unite the scattered production subsidiaries of the Japanese MNCs.[47] Affiliates assemble high-tech parts imported from the parent company in Japan and less sophisticated components from other affiliates established in the region.

As of April 1995, Sony had 15 manufacturing affiliates in Korea, Taiwan, Singapore, Malaysia, Thailand, Indonesia and China employing about 30,000 people and producing billions of dollars worth of audio and video goods, semi-conductors and computer parts. The company has been following an intra-network cooperation, for example, to manufacture VCR at its assembly plant in Bangi, Malaysia. Sony uses integrated circuits (IC) and other sophisticated components imported from Japan and printed circuit boards and other semi-finished goods imported from Singapore. It purchases tape decks, as well as many other basic parts, from local suppliers in Malaysia, many of them Japanese joint ventures.

[46] Ibid, p. 25.
[47] Ibid.

Another Japanese investment in the region which made conditions conducive for creating regional integration is the production network of Toyota Motor Corporation. Toyota established gas engine plant in Thailand, diesel engines in Indonesia, steering parts in Malaysia, and transmissions in the Philippines. It has established a regional trading centre in Singapore, which coordinates the movement of automobile parts between Toyota affiliates throughout Asia. The affiliates were expected to assemble their standardised parts into finished car and trucks that are exported to Western Europe and America.

Although the outflow of FDI from Japan had stagnated during the 1990s, possibly resulting from a decline of the Japanese economy the first time since 1974, the rate of Japanese FDI into the Asian region continued without major obstruction. By 1997, Asia absorbed one quarter of the total FDI flow from Japan.[48] In 1990-91, Japanese affiliates accounted for 40 per cent of total (foreign and domestic) investment in Thailand.[49] By 1994, about 7 per cent of Thailand production workers were employed by Japanese firms. In Malaysia, one Japanese firm, Matsushita, accounts for nearly 4 per cent of the entire country's GNP.[50]

It is to be noted that Japanese FDI in developing Asia has different characteristics from Japanese FDI in developed regions. A 1995 survey found that manufacturers represented 53 per cent of all Japanese allocated firms in Asia, but only 31.6 per cent and 27.7 per cent of the Japanese firms in the United States and

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[48] UNCTAD, *World Investment Report*, 1998, p. 158.
[49] Walter Hatch, *Asia in Japan's Embrace,* op cit, p. 6.
[50] Ibid.

Europe, respectively.[51] Most of the Japanese companies considered ASEAN and China as the favourite destination for foreign investment in 1990s. In addition, small and medium sized firms from Japan are more active in the Asia-Pacific region than those in other parts of the world. Moreover, Japanese banks have aggressively supported their investment growth in the Asia-Pacific region. Asia has become the home to scores of Japanese branch bankers in 1990s.

In the early 1990s, the post-bubble recession accompanied by higher interest rate at home staunched the flow of capital to developed regions such as the Unites States and Europe. But Japanese manufacturers continued to invest heavily in Asia. In 1994, an estimated 44 per cent of the total overseas production of Japanese electrical and electronic machine makers invested in the Southeast Asian region.[52] These increased investments eventually could feed growing local markets. According to the Research Institute for Overseas Investment, this investment spur has driven the reflection of the region as 'a production base to service the global market.'[53] Hitachi, for example, shut down its Anaheim, California plant and moved its production of VCRs for the US market to Malaysia. Other big Japanese investors in the United States, such as Fujitsu General, scaled back their American operations while at the same time beefing up activities in Southeast Asia.[54]

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[51] Ibid.
[52] *Far Eastern Economic Review*, 2 February 1995, p. 23.
[53] *Far Eastern Economic Review*, 16 January 1992, p. 40.
[54] Ibid.

JAPANESE FDI IN INDONESIA

Although Indonesia is the best endowed of all the ASEAN countries in natural resources, its domestic economy was the least developed among the regional countries. The Indonesian economy was heavily dependent on primary sectors such as agriculture, fishing, timber industry and other traditional sectors. The most important tasks that Indonesia faced under the Sukarno regime during the initial years after independence from the Dutch was to provide job opportunities both to the urban and rural populations, reduce the income and productivity gaps between the modern sectors and the traditional sectors of the economy, produce a better balance of economic power between native Indonesians and the Chinese population of Indonesia, and strengthen the manufacturing sector to broaden the industrial base.

After independence industrialisation was placed at the centre of the development programmes starting with the Urgency Economic Programme in 1950 through the First Five Year Plan which began in 1951. Emphasis on industrial development was regarded as a rational strategy not only for bringing about fast and effective increase in per capita income but also for solving the explosive population problem in overcrowded Java and, later on, as a means for achieving Sukarno's grandiose scheme of 'spiritual and mental development'.[55]

However, the various development programmes in the 1950s and through the greater part of the 1960s did not meet with success, not just because of shortage of capital, technology and foreign exchange, but due also to pernicious inflation caused

[55] John Wong, *ASEAN Economies in Perspective: A Comparative Study of Indonesia, Malaysia, The Philippines, Singapore and Thailand*, Singapore, Macmillan, 1983, p. 58.

mainly by a persistent government deficit to meet rising military expenditures. Indonesia's development effort was further thwarted by constant political upheavals, social conflicts, corruption, bureaucratic obstacles, and the like. The economic programme of 'Guided Democracy' emphasised national determination and other political objectives rather than rational management of the economy.[56] The nationalisation of Dutch enterprises in late 1957 and the subsequent suppression of the business activities of the ethnic Chinese virtually made it impossible for foreign participation in the economy – with exception of oil and minerals. Consequently the economy's performance during 'Guided Democracy' deteriorated while inflation became rampant.

The economic policies under Guided Democracy provided a blue print for state-led capitalist development, and the government upheld economic nationalism as its policy objectives. The government promoted Pribumi (i.e., indigenous non-Chinese) ownership in the industrial sector by providing state capital for investment. At the same time government industry was protected through various cartels and policies. Government redirected foreign exchange earned from the export of oil and agricultural products to import substitution industries. However this experiment of building a national bourgeoisie did not achieve its desired objectives. The state apparatus was also unable to administer the accumulation process, largely because of the inexperience and inefficiency of the military managers of state enterprises and their general misuse and misappropriation of state resources. As a result, inflation increased to over 600 per cent and economic growth stagnated which led to a

[56] Ibid.

military *coup* in Indonesia in 1965. Though Sukarno survived the attempted *coup,* he was overthrown by Suharto and a new regime was established.

The change-over from Sukarno to Suharto was accompanied by a fundamental shift in the economic and political outlook. In the 'New Order' proclaimed by Suharto, rigorous efforts were carried out to stabilise and rehabilitate the economy and to dismantle most of the former control systems of Guided Democracy.[57] In addition foreign aid and foreign investment from the West were sought. By the end of the 1960s, Japan became the dominant source of foreign investments (as well as ODA) to Indonesia, and the Indonesia-Japan relationship took the spotlight in the national debate about the role of the foreign sector in Indonesian economic development. These debates were over the comprehensive security policy implemented by Japan after the political turmoil created during Prime Minister Tanaka's tour to the capitals of Southeast Asia.

Indonesia's growth and particularly its ability to attract foreign investments reflect the relatively stable political order maintained since the New Order government in 1966. In contrast to the 'Old Order', the Suharto government pursued more pragmatic and flexible strategies towards development in general and FDI in particular. It sought faster economic growth through greater involvement in international trade and investment. By the early 1970s, the Indonesian economy could show significant growth with an annual average rate of 6 to 7 per cent of GDP. Together with its ASEAN partners, Indonesia became one of the most economically dynamic countries in the world. This macroeconomic stability, combined with

[57] Ibid.

smooth political and social order which continued through the 1970s and 1980s, had created a conducive atmosphere to attract large-scale Japanese investments into Indonesia.

The notion that outward and inward direct investment position of a country is systematically related to its economic development, and relatively to the rest of the world, was first put forward by John H. Dunning in 1979.[58] The Investment Development Path (IDP) suggests that countries tend to go through five main stages of development and that these stages can be fully classified according to the propensity of those countries to be outward and inward to direct investors.[59] According to Dunning, during the first stage of IDP a country is presumed to be in capable of attracting inward direct investment with the exception of those arising from its possession of natural assets. This condition is characterised by limited domestic market-demand levels which are minimal because of the low per capita income; inappropriate economic systems or government policies; inadequate infrastructure such as transportation and communication facilities; and perhaps the most important of all, a poorly educated, trained and motivated labour force.[60] The economy will be predominantly a labour-intensive and primarily a product based one, and may be influenced by the government through an infant industry protection system such as import controls. As far as FDI is concerned in this stage, of course, foreign firms will be prefer to export to and import from this market, or accomplish cooperative non-equity arrangements with indigenous firms.

[58] John H. Dunning and Rajneesh Narula, 'The Investment Development Path Revisited: Some Emerging Issues', in John H. Dunning and Rajneesh Narula (eds.), *Foreign Direct Investment and Governments: Catalyst for Economic Reconstruction*; London, Routledge, 1996, p. 1.
[59] Ibid.
[60] Ibid, p. 2.

Government intervention during stage I will normally take two forms. First, it may be the main means of providing basic infrastructure, and the upgrading of human capital via education and training. Government will attempt to reduce some of the endemic market failures holding back development. Second, they would engage in a variety of economic and social policies, which, for good or bad, will affect the structure of markets. Import protection, domestic content policies and export subsidies are examples of such intervention at this stage of development. At this stage, however, there is likely to be only limited government involvement in the upgrading of the country's created assets such as innovatory capacity and human resources.

In stage II, inward direct investments start to multiply, while outward investment remains low or negligible. Domestic markets may have grown either in size or in purchasing power, making some local production by foreign firms a viable proposition. Initially, this is likely to take the form of import substituting manufacturing investment based upon their possession of intangible assets, such as technology, trademarks and managerial skills. Subsequently, host governments stimulate such inward FDI by imposing tariff and non-tariffs barriers. In the case of export-oriented industries, the extent to which the host country is able to offer the necessary infrastructure (transportation, communication facilities and supplies of skilled and unskilled labour) would be a decisive factor.[61]

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[61] At this stage of development, such inward direct investment will still be in natural resources and primary commodities with some forward vertical integration into labour-intensive low technology and light manufacturers.

In this stage, industries clustered around primary industries and production centres will move towards semi-skilled and moderately knowledge-intensive consumer goods. Outward direct investment emerges at this stage. This may either be of a market- seeking type, or of a trade related type in adjacent territories or of a strategic asset seeking type or of a trade-related type in developed countries. In this stage of development, countries will increase their net inward investment and employment opportunities, and the capacity of skilled labour will also be increased.

Countries in stage III mark a gradual decrease in the rate of growth of inward direct investment, and an increase in the rate of growth of outward direct investment (Net Outward Investment). The technological capabilities of the country are increasingly geared towards the production of standardised goods. With rising incomes, consumers are tempted to demand higher quality goods, fuelled in part by the growing competitiveness among the supplying firms. Comparative advantage in labour-intensive activities will deteriorate, domestic wages will rise, and outward direct investment will be directed more towards countries at their lower stages in their IDP. Finally, the domestic firms will acquire sophisticated technology and become competitive and be able to compete with the foreign firms in the same sectors.

Growing by these competitive advantages, such as an enlarged market and improved domestic innovatory capacity, will make for economies of scale and, with rising wage costs, will encourage non-technology-intensive manufacturing as well as higher value added ones locally. The motives of inward direct investment will shift towards efficiency seeking production and away from import substituting production. In industries where domestic firms have a competitive advantage, there may be some inward direct investment directed towards strategic asset acquiring activities. During this stage, government policies will continue to be directed toward reducing structural market imperfections in resource-intensive industries. Thus, governments may attempt to attract inward direct investment in those sectors in which the local firms are the weakest.

Stage IV comes in play when a country's outward direct investment stock exceeds or equals the inward investment stock from foreign-owned firms and the rate of growth of outward FDI is still rising faster than that of inward FDI. At this stage, domestic firms can now not only effectively compete with foreign-owned firms in domestic sectors in which the home country has developed a competitive advantage, but they are able to penetrate foreign markets as well. When a country reaches this stage of development the production will be based on capital-intensive production techniques, as the cost of capital will be lower than that of labour.

Finally, outward direct investment will continue to grow, as firms seek to maintain their competitive advantage by moving operations which are losing their competitiveness to offshore locations (in countries at lower stages), as well as responding to trade barriers installed by countries at both stages IV and V. Firms will have an increasing propensity to internationalise the market in order to maintain the comparative advantage by engaging in FDI rather than exports. During this stage, intra-industry production will become relatively more important; intra-industry trade will tend to be increasingly conducted within multinational enterprises.

The role of government is also likely to change in Stage IV, while continuing into supervisory and regulatory function, to reduce market imperfections and maintain competition. It will give more attention to the structural adjustment of its location-bound assets and technological capabilities, such as fostering asset upgrading in infant industries and phasing out declining industries. At this stage, government intervention continues to remain and begins to take a more strategic posture in its policy formation, in order to take measures designed to aid the upgrading of domestic resources and capabilities and to curb the market distorting behaviour of private economic units.

When a country reaches at the level of Stage V, both inward and outward FDI are likely to increase. During this stage, per capita income and technologies and the labour force skill will be at par with the developed countries. It has to be suggested that this phenomenon represents a natural and predictable progress of the internationalisation of firms and economies. Thus the nature and scope of activity gradually shifts from arms-length trade between nations producing very different goods and services to trade within hierarchies (or cooperative ventures) between countries producing similar products.

Ever since the Indonesian economy could catch up with dynamic performances in the 1970s and 1980s, it began to move from Stage II to Stage III in its IDP. As a result of the new Foreign Investment Law in 1967 by the New Order government under Suharto, substantial investment by foreign firms began to increase. The manufacturing sector's share of GDP in 1971 was barely 7 per cent and it increased to 10.7 per cent in the 1980s.[62] During the initial stage of this policy, FDI concentrated largely on natural resource extraction and labour-intensive sector and partially in agriculture. The other two sectors that FDI went into were forestry and fishing.[63]

It can be argued that the Indonesian government has played an important role in influencing the inward flow of FDI. The government emphasised the creation of a healthy system of macro-economic variables, namely growth rates, exchange rates, education levels, infrastructure development and trade barriers, all of which has received considerable policy attention. As the IDP model suggests, the inward and outward flows of FDI are influenced by the state of economic development of the host country and its growth over time. And this state of development and growth, in turn, has been influenced by government policy and its administration. Hence, the Indonesian government had a major role within the IDP framework of analysis.

The New Order Period Since 1966

By the end of 1965, such policies led to a critical situation when Indonesia faced an economic crisis due to the adverse effects of the economic policies of the previous President, Sukarno. Inflation was out of control as were government budgets and money supply. Indonesia had accumulated substantial international debt; its foreign exchange position was low; it had substantial trade deficit and access to foreign loans and credits was difficult. Indonesia desperately needed capital for its

[62] Drodjatun Kuntijoro-Jakti, Prinjono Tjiptrherijanto and Slamet Seno Adjni, 'Japanese Investment in Indonesia', in Sekiguchi (ed.), *ASEAN-Japan Relations,* op cit, p. 28.

[63] Tsuorumi Yoshi, 'Japanese Investments in Indonesia: Ownership, Technology Transfer and Political Conflict', in Gustov F. Papanek, *The Indonesian Economy,* New York, Praeger, 1980, p. 297.

development needs and to finance its imports. At the same time, with the fall of President Sukarno, capital inflows from the communist bloc ceased while the Western countries and the financial institutions, IMF and World Bank, acted to assist in the revival of the Indonesian economy through loans and some structural adjustment programmes. [64]

The regime that replaced Sukarno at the end of 1965 introduced fundamental and drastic changes to the general economic policy. Other than successfully combating hyperinflation, the highly state interventionist practices were shed away with a new framework that relied much more on market forces in supporting industrial development.[65] This transformation in attitudes was demonstrated by the enactment of a new Foreign Investment Law in January 1967 and a new Domestic Investment Law in November 1968. These policies were provided by a package of tariff reductions and other incentives to attract foreign investment which was vital for economic growth.

Liberalisation 1967-1973: Under the new policy, substantial changes were undertaken in trade and investment regimes. As part of these initiatives, the government instituted more favourable policies towards private investments in general and

[64] Constant political upheavals, social conflicts, corruption, bureaucratic obstacles and the like further thwarted Indonesia's development efforts. The politico-economic programme of "Guided Democracy" caused to deteriorate growth and inflation became rampant. The attempted coup against the Sukarno regime added fuel to the fire. Finally, the changeover from Sukarno to Suharto had made fundamental shift in the economic and political outlook. For details see John Wong, *ASEAN Economies in Perspective: A Comparative Study of Indonesia, Malaysia, Philippines, Singapore and Thailand,* London, Macmillan, 1985.

[65] Donges et al., *Industrialisation in Indonesia,* op cit, p. 358.

foreign investment in particular. The 1967 Foreign Investment Law allowed 100 per cent foreign ownership at the time of formation of the PMA Project (a project in which there was any foreign equity ownership).[66] However, this time the provisions were quite liberal when compared with the FDI regulations in most other developing countries. This law had stipulated phase down of ownership after a certain period of time and the foreign equity percentage would be reduced to a certain limit.

According to this policy, a foreign investor could hold majority equity for a period of thirty years and after thirty years the foreign investor was to transfer its shares to an Indonesian investor; and upon non-compliance the company would be subject to mandatory liquidation. The regulation also set a minimum investment limit of $1 million for foreign investment projects. The rationale for the regulation was the view by the government that the primary benefits of Multinational Enterprises (MNEs) was their access to large pools of capital that Indonesian investors does not possess. The government believed that Indonesia could benefit by undertaking smaller investment projects and hence excluded MNEs from investing in these smaller projects.[67]

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[66] Lecrew, *Indonesia*, op cit, p. 323.
[67] Ibid.

Table 4.4

Approved Foreign Investment in Indonesia, End of 1972

Investing Country	Number of Project	Percent of Total	Value US$ million	Percent of Total
America	97	17.8	922.5	40.7
US	85	15.6	813.4	35.9
Others	12	2.2	109.1	4.8
Asia	313	57.8	1164.9	51.4
Japan	100	18.5	344.9	15.2
Others	187	34.5	701.6	30.9
Oceania	26	4.8	118.4	5.3
Europe	133	24.4	177.6	7.9
Total	543	100.0	2265.0	100.0

Source. Foreign investment Board, Jakarta,1973 , Cited in Yoshi Tsurumi, 'Japanese Investment in Indonesia', op cit , p. 297.

Ever after the inception of the Foreign Investment Law, foreign direct investment in manufacturing began to rise, and about 75 per cent of the approved foreign investments were joint ventures. By the end of 1972, Japan was the leader in terms of the number of approved foreign investment projects, and second only to the United States in terms of value of approved investments (see Table 4.4). By the first quarter of the 1970s, five projects were sanctioned by Japan and between 1967-1972 the total Japanese FDI reached $311 million (see Table 4.5).

Table 4.5

Japanese direct Investment in Indonesia as of March, 1973

Industry	Number of Investment Projects in Operation	Equity Capital Paid in (US$thousnd)	Ratio of Total
Manufacturing	65	184,008	59
Mining	3	75,930	23
Forestry	11	21,500	7
Agriculture	5	6,590	3
Fishery	9	14,206	5
Real estate and	6	5,800	2
Transportation	4	3,200	1
Total	103	311,324	100

Source. Cited in Yoshi Tsurumi, 'Japanese Investment in Indonesia', op cit, p. 298.

During this period, the Japanese paid their greatest attention to textiles, metal and glass industries and on the other hand the US investors concentrated on chemicals, textiles and rubber. Moreover, when Japanese investments largely took the form of establishing new enterprises, US investments were directed a great extent towards rehabilitation and/or expansion of American companies that had been nationalised under the Sukarno administration.[68] Almost 75 per cent of total private investment in manufacturing industry had been by the Japanese investors and was largely motivated by the Indonesian government's policy of substituting domestic production for imports.

Increasing Restrictions 1974-77: The oil crisis in the early 1970s, followed by the violent demonstrations during the visit of Japanese Prime Minister, Tanaka, were the events preceding the Indonesian government's first significant change in the FDI

[68] Donges et al., *Industrialisation in Indonesia,* op cit, p. 376.

system. President Suharto's statement of January 1974 set the standards for the principles governing foreign investments that continued for the next twenty years. The president stated that the main principles governing foreign investments were:

- All new foreign investments were to be in the form of joint ventures.
- Indonesian equity in these investments would be increased to at least 51 per cent majority share holding within a 'certain period of time'.
- The number of sectors closed to foreign investment was increased.
- Tax incentives were reduced, and;
- The number of foreign personnel permitted to work at each foreign owned company was reduced.[69]

At the same time, as these changes were being made in the FDI system, large number of controls were instituted on all private investments and the financial system in the form of investment licensing and credit allocation of subsidised interest rates to the state owned enterprises (SOEs). The SOEs became the central players in revenue earnings for the state. New policies to restrict the private sector as well as FDI were part of government's economic policy. Moreover, during this period an increasing number of sectors were closed to foreign investment (new weaving mills located in Java). The new investment regulations provided for various sectors, where foreign investments were stymied, was to enable domestic entrepreneurs to undertake business, to promote state enterprises because of its strategic nature and to protect weak and small enterprises.[70]

[69] Ibid, p. 324.
[70] Ibid, p. 325.

During this period, 64 per cent of total foreign investments were planned for textiles, other chemicals (mostly pharmaceuticals), non-metallic mineral products, food manufacturers and electrical machinery. This degree of concentration was to be in balance with comparative advantage for the Indonesian economy. By 1972-73, the cumulative FDI became marginal and the investment boom created since 1960 declined due to various domestic restrictions. FDI in the manufacturing sector attained its highest level during 1974-75 and by the end of the decade the total FDI inflow had began to decline.[71]

A comparison with other foreign investments shows a heavier concentration of Japanese investments in the manufacturing industries in Indonesia. The early 1970s saw Japan as the largest foreign investor in Indonesia. By the end of 1978, FDI in manufacturing accounted for $1.4 billion, followed by mining with $ 335 million, while the traditional sectors of agriculture, trade and services accounted for only $21 million, $29 million and $33 million, respectively. The government's efforts at attracting FDI in areas more compatible with Indonesia's modernisation programme made Japanese FDI move much faster.

During the visit of President Suharto to Tokyo in May 1972, he stressed to the Japanese side the urgency of proceeding with the giant Asahan hydroelectric project and aluminium smelter project at Lake Toba in North Sumatra.[72] This visit brought a quickening of economic contact between the two countries. A number of Japanese missions sponsored by large industrial houses (*Kieretsu*) such as

[71] Slamet Seno Adji, *Japanese Investment in Indonesia*, op cit, p. 38.
[72] Wayne Robinson, 'Imperialism, Dependency and Peripheral Industrialisation: The Case of Japan in Indonesia', in Richard Higgot and Richard Robinson (eds.), *Southeast Asia: Essays in the Political Economy of Structural Change;* London, Routledge, 1985, p. 203.

Mitsubishi, Mitsui, and Marubeni visited Jakarta and expressed their willingness to assist various industrial projects in Indonesia.

Further Restrictions 1978-86: The second oil price increase in 1978-79 again relaxed Indonesia's foreign exchange constraints, accelerated economic growth and increased government budget revenues. As a direct consequence, the government instituted additional restrictions on foreign investment. In 1982, the government reiterated the requirement that foreign-owned companies were to transfer 51 per cent of their ownership to Indonesian shareholders within ten years. Furthermore, the government appeared to move to implement the phase down requirements.

It stated that for foreign companies approved prior to 1974, a minimum of 30 per cent of their equity had to be transferred to Indonesian shareholders by the end of 1984.[73] Also at this time, the government introduced a requirement that at the time of the formation of a venture, there would be a minimum 20 per cent Indonesian shareholding in all foreign sponsored companies. Starting in 1980, the government closed an increasing number of sectors to foreign investment. The 1981 Priority Investment List (DSP) reserved additional sectors for cooperatives.

Furthermore, in early 1982, Indonesia experienced external shocks from failing oil and commodity prices. Over the 1982-83 period, the government introduced measures to stabilize the macro-economy, initiated some structural reforms to mobilise resources and made improvements in customs procedures, ports and shipping. The government's trade and industrial policies, however, became even

[73] Lecraw, *Indonesia*, op cit, p. 326

more inward oriented and interventionist. Against this background, the government also increased the restrictive measures in its foreign investment policies.

Liberalisation 1986-89: In 1986, the economy again suffered a series of external shocks due to a sharp fall in oil prices and the appreciation of the yen. These events led to 34 per cent fall in Indonesia's terms of trade and an increase in the debt service rates from 26 per cent in 1985 to 37 per cent in 1986.[74] In response, the government again undertook macroeconomic stabilisation procedures (i.e., fiscal austerity and devaluation) as well as substantial financial sector reforms. In the area of foreign investment, the government initiated a sustained but gradual liberalisation on all aspects of the FDI system.

The liberalisation of the economy as a whole and the foreign investment process was linked to the government's policies to promote non-oil exports and to encourage participation by the private sector in the economy. As in the past, under the pressure of diminishing economic growth, foreign exchange and strained international credit, the government moved once again towards the private sector and foreign investors by relaxing regulations on private and foreign investors. In May 1986, restrictions on foreign equity ownership in joint ventures were relaxed. Indonesia allowed 95 per cent equity ownership by foreign partners for certain joint ventures;[75] such as those located in remote areas (mainly Eastern Indonesia); those involved in high technology; those that were export-oriented (i.e., exported at least

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[74] Ibid, p. 327.

[75] Achmad Az, *Foreign Direct Investment in Indonesia: Policies and Trends, in Foreign Direct Investment in the Asian and Pacific Region*, Manila, ADB, 1988, p. 37.

85 percent of their produce); or investments requiring a large amount of capital (i.e., project costs above $10 million).[76]

In September 1986, Indonesia devalued its currency by 31 per cent in order to safeguard its balance of payments position and to strengthen its economy and also to provide competitiveness to the domestic industry, which improved the foreign investment climate. In the DSP List of 1986, the number of activities, which were designated to be open up for foreign investments increased from 475 to 926. In December 1987, the government further relaxed foreign investment restrictions. The minimum Indonesian ownership at the time of the formation of the company was lowered to five per cent for foreign companies which exported 100 per cent of their production. Furthermore, foreign owned companies with minimum capital of $10 million or located in one of the provinces in Eastern Indonesia or exporting at least 65 per cent of their production could also be formed with a five per cent minimum Indonesian shareholding. The most significant change in the December 1987 package was the recognition that the last three categories of the DSP list functioned on a negative list for PMA companies.

In May 1989, a negative list replaced the DSP list. In principle, any sector not on the negative list was 'open' for investment by PMA companies.[77] In effect, by this change, the government further opened additional activities to foreign investment. And the government introduced deregulation packages that lowered the minimum capital investment required for PMA companies from $1 million to

[76] Ibid.
[77] Lecraw, *Indonesia,* op cit, p. 328

$250,000 if the project was labour intensive (i.e., employed more than fifty workers), export-oriented, or supported downstream industries which did not compete with existing industries.[78] Moreover, in October 1989, the government also further liberalised foreign ownership restrictions, albeit in certain areas only: 100 per cent foreign ownership was allowed in the Batam Economic Zone with 5 percent divestment to Indonesian shareholders within five years. For this type of investment, the October 1989 regulations required no further divestment if the PMA company exported 100 per cent of its products.

Large trading houses, which have been engaged in manufacturing subsidiaries and exploration of export possibilities, dominated Japanese investment in Indonesia. These investments were directed to export the product to a third market such as the United States. Although most of the Japanese manufacturing subsidiaries were established in Indonesia merely to avoid tariff and other import barriers, they benefited from various investment incentives offered by the Indonesian governments from time to time.

During 1982-84, the Japanese investment in the manufacturing sector increased at a rate of 4.5 per cent and many of these investments were joint ventures. In the manufacturing sector, Japanese investments were mostly concentrated on automotive and related industries.[79] The spurt of the manufacturing sector was due to the fact that the reduced demand for oil in the international market, which led to

[78] Ibid.
[79] Toshihiko Kinoshita, 'Japanese Investment in Indonesia: Problems and Prospects', *Bulletin of Indonesian Economic Studies*, Vol. XXII, No.1, April 1986, p. 43.

OPEC's decision in March 1983 to lower the price of crude oil, brought a decline in Indonesia's export earnings, 80 per cent of which were derived from the oil sector.[80]

Moreover, another underlying factor of Japanese investment in Indonesia was the transfer of technology which occurs when foreign personnel transmit their skills and expertise to local employees. The private Japanese firms in Indonesia have been assisting in technological transfer by training local staff at the factory floor level and on development project sites. The Indonesian government made mandatory as one of the conditions of its import contracts with foreign firms that they should undertake to train local workers in such skills as welding, building techniques and in listing procedures on project sites and in the maintenance of plant and machinery at the factory. The technology transfer and managerial skills from Japan to Indonesia could accommodate Japanese work practice and industrial culture, which in turn made productivity and efficiency in the Indonesian domestic sector.

A Lull Followed By Substantial Liberalisation - 1990s: The government's liberalisation policy continued during the 1990s without any major obstacles. During this period, the Indonesian economy expanded rapidly with an average growth rate of 7 per cent annually. With healthy economic growth and increased inflows of FDI, the pressure on the government for further liberalisation was reduced. However, in 1991, rapid growth and the resulting accelerating inflation and the increasing current account deficit led the government to institute macro-stabilisation measures of light monetary practices, as well as to impose limits on foreign borrowing by state-controlled entities. Beginning in 1992, external factors such as the recession in

[80] Ibid.

Japan, the division of substantial amounts of foreign investments to China, and the decline in general investment climate in Indonesian led to a perceived decline in foreign investor interest.[81] As a result, the government introduced two important policy reforms in 1992-93.

A significant initiative came in the government's 1992 decree, whereby it allowed 100 per cent foreign ownership for certain types of investment: investments of over $50 million, investments located in Eastern Indonesia, and investments located in an export-oriented zone if all production were exported. For these types of investments, phase down from a maximum 100 per cent foreign ownership to maximum of 80 per cent foreign ownership was required. The other changes introduced by the government were that for foreign investment in labour-intensive operations (defined as those employing more than fifty persons), export oriented projects (defined as projects that export 65 per cent of production) and supplier industries producing raw materials or intermediate goods, the minimum Indonesian shareholding at the time of investment was set at 5 per cent with a phase down to 10 per cent in ten years and 51 per cent in twenty years from the start of commercial production.[82] The lower minimum investment also applied to foreign investment in the service sector, but with 20 per cent minimum Indonesian shareholding at formation and phase down to 51 per cent in twenty years.

In June 1994, the government announced a dramatic liberalisation package for the FDI system by removing phase down regulations. FDI with up to 100 per

[81] Lacraw, *Indonesia*, op cit, p. 329.
[82] Ibid, p. 330.

cent foreign ownership was permitted in a wide range of sectors without the previous conditions on investments, the minimum capital requirements were eliminated, and nine 'public-interest' sectors – ports, production, transmission and distribution of electricity, telecommunications, shipping, air transportation, drinking water, railways, atomic generation plants, and mass media – which had previously been closed to FDI were opened to majority, but not 100 per cent, foreign ownership.[83]

Table 4.6

Approved Foreign Investment by Country Origin in Indonesia 1985-96

($ million)

Major country	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
USA	1414	1538	727	6718	348	1537	2756	9225	4445	977	2.7705	6421
Australia	361	139	25	532	425	1865	484	835	153.2	53.3	3.7124	4464
UK	771	461	127	1209	435	578	5356	9782	3011	2.9571	6.3221	3.3906
Germany	655	165	3306	9559	67	134	599	367	1206	1131	1.3446	1649
Netherlands	116	233	1228	2709	2819	5673	1836	942	3114	1657	3600	1.3995
Hongkong	534	96	1348	2314	4068	9933	2777	1.0179	3841	6.0417	1.7633	1.1056
Japan	1271	3289	5318	1470	7687	2.2408	9293	1.5032	8360	1.5625	3.7921	7.6553
South Korea	587	120	230	2090	4661	7229	3013	6171	6614	1.8491	6747	1.2314
Singapore	0	1015	60	2402	1661	2643	3464	4479	1.4546	1.6644	1.4685	3.1311
Taiwan	0	180	79	9102	1582	6183	1.0565	5633	1314	2.4876	5674	5346

Source: Bank of Indonesia, *Indonesia Financial Statistics*, , Jakarta, various years.

Since the 1990s there has been a shift in prominence of Japanese investment in Indonesia. Over 70 per cent of Japanese investment was made in export-oriented enterprises to take comparative advantage of the liberalisation of the Indonesian

[83] Ibid.

investment regime. Firms specialising in advanced technologies, including electronics, have taken root. Nurtured by low labour cost, political stability and accelerated economic growth, by the late 1980s Indonesia had reached self-sufficiency in many of the sectors which were the high propensity areas to have received Japanese FDI.

A notable investment made by Japan in Indonesia and a standing testimony to the Indonesian efforts to attract FDI is the Industrial Park in Batam Island located about 20 miles south of Singapore. The Industrial Park, developed with the assistance of Mitsui and Co., one of Japan's giant trading companies, has its own water supply, new power generators (built by Kansai Electric Power), a microwave communications network and a container shipping facility.[84] There were no import duties, and no restrictions on equity. With such a generous package, the park has attracted multinationals from all over the world; but especially from Japan. Worthy to note is the fact that of the park's 37 tenants in 1993, 15 were Japanese.[85]

Sumitomo Wiring Systems, which produces electrical parts for cars, was the park's first tenant. The Singapore headquartered Sumitomo Electric International coordinated the activities of Batam facility. It has purchased the plant's raw materials from Japan, exported its finished goods, handled its financing and tried to develop new markets in Southeast Asia. The Batam Industrial Park has allowed Sumitomo to consolidate its entire Southeast Asian network.

[84] Yamamura, *Asia in Japan's Embrace,* op cit, p. 36.
[85] Ibid.

CONCLUSION

On a brief overview of Japan-ASEAN relations, it can be argued with conviction that the region achieved its economic development mainly due to the higher level of Japanese involvement in the region. Japan has decisively acted as a regional economic hegemon, and the Southeast Asian regional countries have willingly supported this role. Even an economic regional power like Malaysia has strongly demanded a Japan Inc. in Asia comprising East and Southeast Asian countries. The ASEAN countries have chosen to rely on Japan for its export market for finished goods, natural resources and imported parts and components for its industrialisation process. Foreign investment has played a vital role in bringing regional integration within the Southeast Asian region and its harmonious political relationship with Japan. Japan has a multi-faceted investment model by which a manufacturing system is divided among production units in various countries, with components being produced at one such unit in one country and the assembling done at a unit in another country. Thus, intra-trade has become strengthened and regional rivalry has vanished.

Politically, the Japan-ASEAN relationship has increased significantly. Until the 1970s, Japanese policy was considered as an expansion of the pre-War imperialistic attitude towards the region. Japan, however, managed to reduce this hostility by higher volumes of direct investment to the region and brought into its fold ASEAN's vital economic and political interests. Although Japan pursued its foreign policy with Southeast Asia independently, it has notably been in tandem with US interests in the region. Japan unequivocally displayed its non-military interest in the region and this policy has been conducive for establishing harmonious relationship between the two partners.

Indeed from the point of view of the developing countries in the Asia-Pacific region, economic development is the most important factor for internal political stability as well as regional peace and progress. Therefore, Japan's assistance in this field has greatly contributed to the maintenance and promotion of peace and stability in the region. Moreover, after the collapse of the Soviet Union, China emerged as a political and economic power in the region. This resurgence of China had created concern in many of the Southeast Asian nations, which expect Japan as an economic power to maintain a balance of power with the Chinese political and military threat that looms over the region.

Ever since Japan's inception of its 'comprehensive security policy' as a major foreign policy orientation towards Southeast Asia, Indonesia has been considered as a strategic country in the region. The major Japanese investments in the region are evident at the Asahan Industrial Complex in Indonesia set up in 1970s. This heralded a new approach to economic diplomacy and a model for the development of better relationships between nations by investing in a nation which was not politically affable to Japan. At the same time, Indonesia's economic relations with Japan constitute a kind of dependency in which Indonesia is impelled to follow the logic established by Japan's economic needs rather than by the logic of a perceived Indonesian national interest.

The development of productive forces in Indonesia and the flow of foreign capital move more in accordance with pressures emanating from Japan and only to a limited extend in response to domestic Indonesian dynamic. On the whole, it is not Indonesian policies that effectuated massive Japanese investments in Indonesia. Instead, the causal factor was largely the internal dynamics of the Japanese economic system and an impulsive growth push from inside that propels Japanese economic concentration in the Southeast Asian region.

Chapter V

Conclusions

Stemming from the theoretical analysis of this study, it can be argued that modern foreign policy analysis is dominated by the economic imperatives of states. States seek better relationships either for capturing markets and raw materials or for utilising cheap labour resources; in the latter case this results in disseminating production centres to other countries. Ideological constraints or forms of government are usually not an impediment for undertaking these relationships. Countries are liberalising their domestic policies in order to attract foreign direct investment by which the relationship between the investor and host country becomes cordial. This harmonious economic cooperation will eventually pave the way for diffusing political tensions and regional issues and could lead to ensuring peace and stability in the region. Thus regional integration and security will be materialised by means of a higher degree of trade and investment among the regional countries.

However, these relationships cannot materialise without a regional hegemon. It becomes the duty of the hegemon to create peace and stability in the region upon which its own security is guaranteed. For this, the hegemon gives concessional aid and direct investment to other regional countries in order to create a favourable environment. In this situation regional countries get the benefit of direct investment by achieving economic progress and a high growth rate. Domestic economic problems became political problems that will eventually lead to hostility between countries. Ever since the hegemon consolidates its position in the region and establishes a regional security framework, it begins to search for a larger role in the international arena. At the international level its *modus operandi* will almost be the same as it was at the regional level. Viewed in this context, the post-War Japanese foreign policy has successfully achieved its goal of transforming Japan into an economic power in the contemporary world.

Although Japan is not a hegemon in Gilpin's view, it has played a hegemonic role in the Asia-Pacific region. Japanese economic strength has helped this role at the same time that the US security umbrella ensured Japan's political position. Japan has become the largest investor and a major trade partner in the region. Japan has used its investment policies to influence the elites of the Southeast Asian countries to achieve its desired objectives. At the same time, Japanese FDI has faced less criticism of its political implications. Japan managed to avoid the earlier criticism of imperialist tendencies against its FDI in mainly two ways. Firstly, Japan has its pacifist constitutional obligations. Secondly, Japan promised to the Southeast Asian countries that it will not become a military power and the relationship will be based on 'heart-to-heart' understanding. Accordingly, Japanese economic and political leadership has been widely accepted in the region. Japan represents Asia in the G-8.

This policy has emerged as a successful combination of Japan's regional and global perspective. The three concepts of Japan's foreign policy – bilateralism, regionalism and globalism – elevated Japan as a global player by end of the twentieth century. The bilateralist policy helped Japan to create a strong domestic economy, regionalism consolidated the Japanese position in the East and Southeast Asian region, and the globalist policy is aimed at transforming this economic status to become an international actor, politically and economically.

There are many factors that influenced Japanese investment in a particular country or region. The most important among them is the search for making profits. This includes capturing markets and utilising the host country's cheap labour resources. However, this will also be subject to the host country's infrastructure facilities, strength of the market and policies adopted to attract foreign direct investment. At the same time the creation of a regional framework in strengthening the economies of regional countries has played a significant role in attracting a large volume of Japanese FDI. This clearly shows that, Japanese FDI was not concentrated in a particular country *per se*. Instead, it was aimed at capturing the whole regional market.

Another factor for considering Japanese FDI in a particular region is the region's strategic location for Japan. If a particular country or region falls within the strategic perimeter of Japan then Japan will increase its economic activity with that region. At the same time the degree of its relationship with the United States has also played a major role. The US strategic interest has largely influenced Japan's relations to a particular region. During the 1970s and 1980s it was Southeast Asian region, in the 1990s it was China and India–though Japan's interest towards India is marginal compared with that of China.

Japanese investment policy towards Asia was not only based on making profits. It contributed to political stability and economic growth in the Southeast Asian countries. The large part of Japanese investment in the East and Southeast Asian region were done by small and medium scale enterprises which created more job oppurtunities in these countries. Moreover, Japanese companies prefer to participate in the joint venture investment with the host country. This joint venture investment would help the local partner to acquire advanced technology from Japan so that their product becomes more competitive in the international market. On the other hand, the American and European companies were pursuing wholly-owned subsidiary system in the developing countries, which in turn provides least comparative advantage to the host country. Thus, for developing countries Japanese FDI is more conducive to their economic progress and Japan's network of production facilities promotes regional integration.

As far as India and Indonesia are concerned, both liberalised their economies when the situation worsened in their respective countries. During the 1950s, India and Indonesia had continued with their anti-imperialist policies and were pursuing an import-substitution industrial strategy. At the same time, the Indian position towards FDI was more liberal than Indonesia's particularly in the context of Japanese investment. India had no adverse experience of Japan during the World War II period compared with Indonesia; indeed, India promised goodwill and sympathy towards the Japanese people in Japan's early post-War history.

After an upswing in the 1950s, the Indo-Japanese relationship suffered a downturn in the 1960s. The two major hostilities engaging India – the Sino-Indian War in 1962 and the Indo-Pak conflict in 1965 – created a foreign exchange crisis and problems in the domestic economy. In order to overcome these crises, India followed a 'closed-door' policy by implementing regulated laws and discouraged private investment in the industry.

On the other hand, when Indonesia faced its economic crisis in 1965 followed by the overthrow of the Sukarno regime, the New Order regime under Suharto liberalised its economy. The Sukarno regime opened Indonesia up to foreign investment and passed the Foreign Investment Law in 1967 to regulate private foreign investment in a positive manner. The Indian laws Monopolies and Restricted Trade Practices (MRTP) Act and Foreign Exchange Regulation Act (FERA) tightened regulation over the Indian economy and kept away foreign investors from the Indian industry. These laws created a negative image of India in the minds of foreign investors over a long period.

Since the 1970s, Japan sought to challenge Euro-American capital in Asia to exploit national resources and raw materials. With its withdrawal from the Southeast Asian region, the US forced Japan to share the security burden of Southeast Asia. Many of the Southeast countries were facing political uncertainty and economic problems during this period, and China was emerging as a 'potential threat' in the region which could threaten the interests of Japan in Asia.

This security perception of Japan shifted its interest to Southeast Asia. Moreover, the establishment of ASEAN as a regional entity to address political and economic issues attracted Japanese investment to the region. Thus, Indonesia received higher priority than India during the 1970s in the Japanese foreign policy calculations.

Indo-Japan relations revived considerably during the 1990s due to the liberalisation process under Prime Minister Narasimha Rao. Rao realised that Japan and other APEC countries were potential investors in India and he unleashed the 'Look East Policy' to reach out to the APEC region. The Industrial Policy 1991 allowed foreign investment in many of the sectors which were closed over the years, and other incentives and deregulated policies attracted higher amounts of FDI from Japan. However, India did not succeed in attracting the larger Japanese corporations in manufacturing and related sectors. In their perception, India continued its policy of bureaucratic nepotism, government control over industry and an unproductive domestic market. Last but not least, India had failed to create a larger regional market. Besides, India's liberalisation has been a policy of the government not an act passed by the legislature. FERA continued to create a shadow in the eyes of Japanese investors though many of the negative part of the law had been taken away. On the other hand, Indonesia's investment law in 1967 created a positive impression in Japanese investors and gradually Indonesia deregulated many of the restricted list for foreign investors. By the 1990s almost all the sectors opened up for foreign investment even in 100 per cent ownership. On the other hand, Indian decision makers did not give enough attention to Japanese investment to India, though Japanese investment methods and policies are more conducive for the economic development of a developing country like India.

Thus, although India and other South Asian countries liberalised their economies in the 1990s, and the Indian economy partly integrated with the Asia-Pacific economies, Japanese investment to South Asia did not increase substantially in terms of percentage of total Japanese worldwide FDI flow. There are mainly three reasons for this trend. Firstly, the Japanese economy became stagnant and its economic growth showed a negative trend in the 1990s largely due to the burst of the 'bubble' economy, which led to the decreasing trend of worldwide Japanese FDI. Secondly, Japan shifted its focus to China in the 1990s as part of the comprehensive national policy and Japan became the largest investor in China. The Chinese liberalisation policy and its huge market attracted Japanese investors in large numbers. At the same time, the geographic location of China and its modernisation policy has brought home to the Japanese policymakers that the best way to maintain the balance of power in East Asia is to engage China economically and to give support to integrating the Chinese economy into the APEC forum. So South Asia missed the opportunity in the 1990s in place of China as the 'flying goose' analogy of the Japanese FDI – that it went down from East Asia (South Korea and Taiwan) region in the 1950s and 1960 to the Southeast Asian region in the 1970s and 1980s. And thirdly, the lack of a regional market in the South Asian region was an important factor in the failure to attract Japanese investors to the regional countries. The underdeveloped infrastructure in India has also been keeping away Japanese private investors from India. The problem between India and Pakistan generated a feeling in Japan that the tension between these two countries would lead to the nuclear rivalry in South Asia. This has undermined Japanese economic interest in the South Asian region.

Nevertheless, the diplomatic relationship between India and Japan increased significantly during the 1990s. The end of the Cold War made the Asia-Pacific region a focal point in the Japanese foreign policy arena. Japan increased its area of influence in the Asia-Pacific region through active diplomacy. After the Gulf crisis

(1991), the Indian Ocean littoral area had come within the Japanese strategic policy. India's overtures to Japan led to India being invited to the ASEAN Regional Forum (ARF) as a sectoral dialogue partner. India later became a full fledged member of the ARF in 1996. This is one of the important areas in which India and Japan can cooperate more constructively in the coming years. Japan is an ardent supporter of establishing multilateral security not only in the Asia-Pacific region but also in the world at large. The end of the Cold War made irrelevant Japan's impression of India as a pro-Soviet and socialist country in Asia. At the same time, the end of the Cold War helped to improve the Indo-US relationship which led Japan to broaden the level of interaction with India. Traditionally, Japan has maintained good relations only with those countries that share a harmonious relations with the US. As a gesture of India's importance in the strategic domain of Japan, discussion between the two countries has already begun in the areas of strategic importance for both countries such as maritime security, communication of sea lanes and military-to-military consultation. At the same time, the India-Japan Comprehensive Security Dialogue provided a joint effort to promote peace and stability in the Asia-Pacific region. If India continues to develop strategic cooperation with Japan then it would be beneficial for India to acquire or jointly develop technology for defence as well as civilian purposes.

Thus, Japan's foreign policy in the 1990s shifted its focus from economic motives to a wider perspective. The end of the Cold War brought a feeling in Japan that the balance of power system in East Asia, which ensured its security, was going to change. This new order emerged in the context of the US policy towards East

Asia during the Clinton administration, which emphasised 'strategic engagement' with China. As a result, Japan embarked on its foreign policy giving increased importance to strategic affairs in the Asia-Pacific region based on greater diplomatic cooperation with other regional countries. The resurgence of China in the region has created a great concern for Japan as it could not compete with China on traditional military terms. In this matter Japan's policy is primarily to strengthen the Japan-US relationship and to create Cooperative Security in the Asia-Pacific region. For this purpose, Japan continues to strengthen its traditional role in the Southeast Asia region and at the same time is increasing its area of influence to other parts of Asia, particularly South Asia.

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