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# **Negotiating Protection under overlapping Free Trade Agreements:** Dynamic Interplay between Free Trade Agreements and Investment

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# Negotiating Protection under overlapping Free Trade Agreements

Dynamic Interplay between Free Trade Agreements and Investment [1]

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## Abstract

Two decades into the most recent wave of regionalism many of its implications remain to be fully understood. A vast literature has explored the impacts of free trade agreements (FTAs) on investment flows, but less attention has been given to how existing patterns of investment alter FTA liberalization. It is contended here that the dynamic interplay between overlapping FTA areas and the investment sunk in them shapes governments' and firms' positions regarding further FTA liberalization. During trade negotiations, a country may decide to exclude a sector from FTA liberalization to prevent (concession prevention) future FTA partners from making similar demands. Concession prevention could also occur when a foreign firm, holding a dominant market position in a host country, relinquishes liberalization demands in an FTA between host and home countries to prevent that its current position is eroded if the host country grants similar (or better) concessions to competing firms from other countries in future FTAs. Conversely, investment sunk into a country's sensitive sector in the territory of partners from previous FTAs could preempt (concession preemption) the protectionist position of that country when it subsequently negotiates FTAs with the investment-source countries. These arguments were tested in the negotiations on the liberalization of the automotive industry that Thailand and Malaysia had with Japan in their respective bilateral FTAs. The distinct interaction between investment and the FTAs in which these countries participate resulted either in entrenchment of protectionism in the sector or its liberalization across subsequent FTAs.

[1] This paper was originally written in July 2009. Tables 1 and 2 were updated in 2013. The author wishes to acknowledge critical review of several drafts by Professor K. Shadlen. The paper also received review comments from Professor R.E. Baldwin (The Graduate Institute, Geneva, Switzerland) in December 2010 and Professor E. Ornelas (LSE) in March 2011. All remaining errors are solely the responsibility of the author.

**Abbreviations:**

AFTA: ASEAN FTA

ASEAN: Association of South East Asian nations

FDI: Foreign direct investment

FTA: Free trade agreements

JTEPA: Japan-Thailand economic partnership agreement

LCR: Local content requirement

MAJAICO: Malaysian-Japan Automotive Industries Cooperation

MFN: Most-favored-nation

MJEPA: Malaysia-Japan economic partnership agreement

ROOs: Rules of origin

TAFTA: Thailand-Australia FTA

WTO: World Trade Organization

## 1. Introduction

Since the early 1990s, the worldwide number of free trade agreements (FTAs) has been rapidly increasing. This wave of regionalism initially spared East Asia, which, with the sole exception of the ASEAN (Association of South East Asian Nations) bloc, was the only geographical area that by the turn of the century still remained untouched by FTAs. Today, East Asia has become one the main focus of FTA activity, with close to 60 FTAs implemented since 2002.

The impact of FTA proliferation on global trade is the subject of an unresolved debate between those seeing FTAs as stepping stones toward multilateral liberalization and those considering them rather as stumbling blocks preventing it (reviewed in Baldwin, 2005 and Freund and Ornelas, 2010). [2] Existence of empirical evidence in support of both arguments (e.g., Estevadeordal et al., 2008 *versus* Limão, 2006; see below) indicates that other factors, still unaccounted for, affect the balance between protectionist and pro-liberalization groups with respect to FTAs.

While a large body of literature has studied the impact of FTAs on foreign direct investment (FDI) flows (e.g., Te Velde and Bezemer, 2006; Jang, 2011), less attention has been given to how already sunk investment affects firms' and governments' positions on FTA liberalization. It is argued here that, in the context of overlapping FTAs, these positions are influenced by interplays among FTAs and between FTAs and the investment sunk in them. Concessions granted by a country to another in an FTA inform its future FTA partners about that country's ultimate bargaining positions. During FTA negotiations, that country may protect a sensitive sector(s), even from an uncompetitive partner, so as to prevent future

[2] Scholars arguing that regionalism facilitate global free trade contend that, *inter alia*, FTAs strengthen export-oriented sectors, eventually leading to the multilateralization of preferential tariffs. By contrast, the other camp stresses the trade-diverting effects of FTAs that bolster protectionist groups and perpetuate high multilateral tariffs.

FTA partners from making demands to liberalize that sector (*concession prevention*). Concession prevention can also occur when a foreign firm holding a dominant market position in the sensitive sector of the host country foregoes liberalization demands in an FTA between host and home countries, to prevent the host from making similar concessions to other countries in future FTAs. Concession prevention would thus entrench protectionism of sensitive sector(s) across FTAs and multilaterally, creating a stumbling block to future liberalization. On the other hand, the FDI sunk into previous FTA partners can constrain, or even preempt, the bargaining position of a country trying to protect its sensitive sector(s) in subsequent FTA negotiations with countries that have invested in previous FTA partners (*concession preemption*). This interplay between past FTAs and the FDI sunk in them can compel a country to open up a sensitive sector in future FTAs, thus acting as a stepping stone toward global liberalization.

To test these arguments, I explored the extent of liberalization of the automotive sector in the FTAs signed by Thailand and Malaysia—the two most FTA-active developing nations in East Asia—with Japan. In many countries, the automotive sector is one of the most protected manufacturing industries, becoming a contentious issue during bilateral and multilateral trade negotiations. As global automotive production takes place largely within regional clusters, multinational carmakers have often been key proponents of regionalism (Yoshimatsu, 2002; Carrillo et al., 2004). As a group, ASEAN, led by Thailand and Malaysia, has consolidated itself as the world's sixth largest automotive producer (Wad, 2009).[3] Although the sector is protected behind high multilateral tariffs in both countries, a more liberal policy on automotive investment in Thailand has attracted large FDI inflows, creating a competitive export-oriented industry heavily dominated by Japanese carmakers.

[3] Historically, Thailand and Malaysia have been the largest automotive producers in ASEAN but, since 2010, Indonesia has surpassed Malaysia (OICA database; see also below).

Malaysia has instead pursued the development of state-led national automotive brands, but after three decades of heavy protectionism, its national carmakers suffer from weak international competitiveness and remain overwhelmingly domestically-oriented, yet they face increasing competition at home from Japanese firms. In light of this scenario it was surprising that, when both countries negotiated their respective FTAs with Japan, Thailand resisted tariff reductions on vehicles, but Malaysia agreed to complete liberalization of the sector with Japan. Considering their market dominance and political influence in Thailand, why did Japanese carmakers failed to achieve liberalization of the Thai automotive sector in the Thailand-Japan FTA? Or, as is even more surprising, why, after years of fierce protectionism, did Malaysia expose its fragile national car project to Japanese automotive imports? [4]

This study attempts to shed light on this puzzle through the above-mentioned arguments, analyzing whether and how the interaction between FDI and FTAs affected the preferences and positions of carmakers and governments with respect to FTA liberalization. A detailed process-tracing analysis of FTA formulation in Thailand and Malaysia confirmed the initial hypotheses.[5] Thailand resisted automotive liberalization with Japan not only to protect existing investment, but also to prevent similar demands from other partners (e.g., United States, European Union, etc.) in future FTAs (*concession prevention*). Likewise, for Japanese carmakers based in Thailand, even more important than improving their already dominant position by lifting of tariffs on vehicles imported from Japan was preventing firms from other countries from extracting better concessions in their FTAs with Thailand

[4] See Tables 1 and 2 in a working paper by the Author (also in this LSE's International Development Working Paper series) entitled: "Formulation of East Asian Free Trade Agreements: Top-down, bottom-up and across Borders. Government-Private Sector Consultations and Business Lobbying in the Policymaking of Thai and Malaysian Bilateral Free Trade Agreements" for a timeline of the Thailand-Japan and Malaysia-Japan FTAs.

[5] This paper focuses in the automotive sector but draws on 212 in-depth semi-structured interviews with private sector representatives, government officials, academics and civil society in Thailand and Malaysia during two independent trips in 2008 and 2009 complemented with numerous personal communications and secondary research during 2010-2012.

(*concession prevention*), which goal was achieved by the inclusion in the Thailand-Japan FTA of a specific clause to that effect. By contrast, the FTA that Malaysia previously had with Thailand (as members of ASEAN), and the FDI sunk in Thailand by Japanese carmakers, was going to open Malaysia to tariff-free Japanese vehicles made in Thailand starting in 2010, thus preempting Malaysia's protectionist position in its bilateral FTA with Japan (*concession preemption*).

The rest of the article is organized as follows: the next section outlines the analytical framework of the study; section three briefly reviews the automotive sector in Thailand and Malaysia in the context of ASEAN; sections four and five analyze the policymaking of Thai and Malaysian bilateral FTAs with Japan in relation to the automotive sector, and section six discusses main findings.

## 2. Protectionism and liberalization in the presence of sunk investment across overlapping FTAs

The debate on the influence of FTAs on multilateral liberalization remains unsettled. Theoretical and empirical studies provide supporting evidence that regionalism could either hinder (e.g., Levy, 1997; Panagariya, 2000; Limão, 2006) or foster multilateral liberalization (e.g., Ornelas, 2005a; Estevadeordal et al., 2008; Ornelas, 2008; Calvo-Pardo et al., 2011). One of the factors considered in the argument is the impact that previous liberalization—multilateral or through earlier FTAs—has on the preferences of interest groups in regard to further liberalization. Those who see regionalism as an obstacle to global free trade contend that the interest of export-oriented groups in additional liberalization weakens as the share of exports covered by FTAs continues expanding. At the same time, since FTAs can accommodate protection (or even exclusion) for sensitive items, over time FTA proliferation strengthens the political leverage of protectionist coalitions vis-à-vis exporters, which allows

high tariffs in protected/excluded sectors to be consolidated across FTAs and into the multilateral regime. Authors who instead defend FTAs as positive steps toward multilateral liberalization argue, to the contrary, that by expanding their market size, employment and output, FTAs progressively increase the political influence over trade policy of exporters at the expense of import-competing sectors. In addition, regionalism also reduces incentives among import-competing sectors to lobby for high external tariffs (*rent destruction*), eventually leading to the multilateralization of FTA preferential tariffs to countries outside the bloc.[6]

Global liberalization offers greater opportunities than regionalism to expand economies of scale; however, under certain circumstances firms may still prefer FTA liberalization. For instance, producers which have: a) unexploited economies of scale and/or b) fragmented production across several countries could favor regionalism over multilateral liberalization because of FTAs' discriminatory effects against competing firms outside the bloc through preferential tariffs and strict rules of origin (ROOs)[7] (Milner, 1997; Chase, 2003; Chase, 2005; Chase, 2008).

Firms' and states' preferences regarding FTA liberalization are influenced exogenously by the FTAs signed (or projected to sign) by other countries. FTAs generate "club goods" for businesses inside the bloc, while they raise relative costs for those outside. Excluded firms may attempt to redress this discrimination by pressing their governments to join the FTA (or form a new one), leading to a "domino effect" of proliferating FTAs (Baldwin, 1995).[8] This implies that an FTA cannot guarantee that the preferential market access it provides to firms inside the bloc vis-à-vis outside competitors will continue into the

[6] Reductions in external tariffs following the creation of an FTA could also undermine incentives for countries outside the bloc to pursue multilateral liberalization (Ornelas, 2005b).
[7] ROOs determine the origin of a product—and therefore, whether or not it qualifies for FTA preferential tariffs—based on compliance with a minimum level of transformation within the bloc. Included in FTAs to avoid trade deflection, strict ROOs could also be used for protectionist purposes.
[8] Proliferation of FTAs have also been explained by "fear of exclusion" (Shadlen, 2008).

future. Tariff preferences extracted from an FTA partner are subject to *concession erosion* (or even *diversion*) if the partner later offers similar (or better) preferences to a third country (Ethier, 2001; Hallaert, 2008). Although no country can prevent its FTA partners from signing other FTAs, concession erosion or diversion can be limited if the original FTA includes a most-favored-nation (MFN) clause (Ethier, 2001).[9]

Here it is argued that preferences on FTA liberalization in a given country are influenced not only by the FTAs established by competing nations, but also by that country's own agreements. The FTAs that a country has already signed—or could sign in the future—and the FDI sunk in these FTA areas alter the balance between liberalizing and protectionist coalitions, and constrain the position of that government in subsequent FTA negotiations.

Attracting FDI is an explicit goal for developing countries' entering FTAs. A vast number of academic works have explored the multiple mechanisms through which FTAs influence investment flows (e.g., Medvedev, 2006; Te Velde and Bezemer 2006; Jang, 2011).[10] However, less attention has been given to how existing investment alters the preferences and strategies of firms and governments regarding FTAs with FDI source countries.

Because of its numerous spillovers, the automotive industry is one of the sectors governments have most often promoted for investment and/or protected. Until the 1990s it was common for multinational carmakers to engage in tariff-jumping FDI, setting up plants

[9] MFN refers to the principle under the World Trade Organization regime by which any member country should receive equal trade privileges than the MFN by the country granting the treatment. FTAs constitute one of the few exceptions to the MFN principle allowed by the World Trade Organization with no obligation to extend FTA preferential tariffs to countries outside the FTA bloc. Nevertheless, and in order to avoid concession erosion, some FTAs also include MFN clauses.

[10] For instance, many FTAs include provisions liberalizing investment regulations and/or increasing investors' protection. Firms outside an FTA may neutralize trade diversion by investing and producing within the bloc. Depending on the intended goal several types of FDI have been distinguished of which only *market-seeking* and *efficiency-seeking* FDI are of interest here. Efficiency-seeking FDI is pulled in by location-specific advantages that enhance the competitiveness of firms processing inputs for exports. Market-seeking FDI is pulled by the larger market created by an FTA, which could also generate efficiency gains attracting vertical efficiency-seeking FDI. Market-seeking FDI is also attracted to sectors protected by tariff (and non-tariff) barriers, being referred then as *tariff-jumping FDI*. Another way by which FTAs could lure FDI, especially into developing countries, is by signaling commitment to liberal economic policies (Ethier, 1998; Büthe and Milner, 2008). On the other hand, for producers inside a FTA area, FTA liberalization reduces the cost of serving the region through trade, potentially discouraging tariff-jumping FDI from other FTA partners. The latter situation is more likely to occur in bilateral FTAs between developed countries (Jang, 2011).

in multiple countries and assembling similar models for each respective domestic market. In most cases those factories operated at suboptimal scales and required host governments to maintain tariff protection and grant oligopoly rents. Increasing liberalization since the 1990s prompted carmakers to initiate a rationalization of procurement and production. Since sudden multilateral liberalization could lead to excess capacity, firms have instead pushed for FTAs that suit their regional strategies and allow a gradual reorganization from the national to the regional level while discriminating against outside competitors through preferential tariffs, strict ROOs and trade-related investment measures (Milner, 1997; Chase 2004; Chase, 2008).[11]

Consider a firm $F_A$ from developed country A with a production factory at home (plant $F_{A\text{-}A}$), but that has also invested and produces in a protected sector of developing country X (plant $F_{A\text{-}X}$) (tariff-jumping FDI) (Figure 1, left panel). In order to improve its economies of scale, firm $F_A$ would lobby the government in A for an FTA between A and X that *gradually* eliminates trade barriers in X to final and intermediate goods coming from A. Upon liberalization, $F_A$ may decide either to divest from its plant $F_{A\text{-}X}$ , and serve X directly from $F_{A\text{-}A}$ (replacing FDI with trade), or to integrate $F_{A\text{-}X}$ into the regional network through specialization (complementing FDI with trade) (Figure 1, left panel). A competing firm $F_B$ from country B, which also has tariff-jumping FDI in X (plant $F_{B\text{-}X}$), will oppose liberalizing imports of final goods from A in FTA A-X since $F_{B\text{-}X}$ would be unable to compete with plants in country A operating on more efficient economies of scales. If $F_{B\text{-}X}$ procures inputs from A it may still welcome FTA liberalization by X on intermediate goods (but not final goods) coming from A.

[11] The Agreement on trade-related investment measures at the World Trade organization is limited to banning local content requirements (LCRs), trade balancing or foreign exchange. The Agreement imposes costs on investors but provide rents for incumbents. Firms tend to favor FTA over multilateral liberalization for a gradual elimination trade-related investment measures that, at the same time, discriminates against outsiders (Chase, 2004).

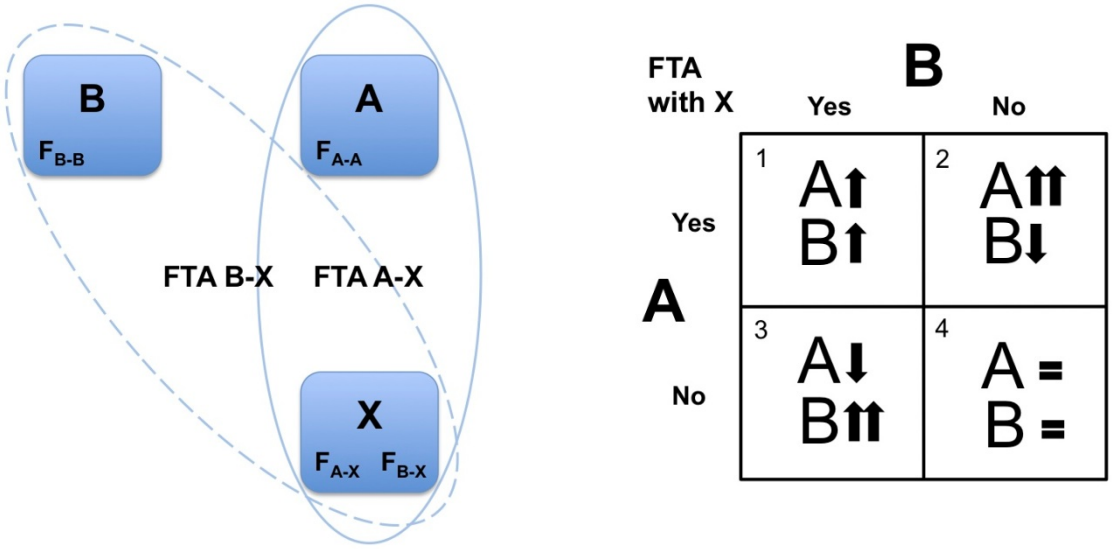


**Figure 1**: *Left panel*: Firm $F_A$ from country A with production at home ($F_{A-A}$) and tariff-jumping investment and production in X ($F_{A-X}$) will favor a FTA between A and X (FTA A-X) that eliminates trade barriers in X while also discriminates against firms from country B. Trade diversion from FTA A-X will prompt country B to create its own FTA with X (FTA B-X). See text for details. *Right panel*: Firms from A and B face a non-zero sum game where each gains the most from an exclusive FTA with X. Gain with respect to the initial situation is represented by an upward arrow (two upward arrows indicate enhanced gains) and loss by a downward arrow. See text for details.

The existence of FTA A-X will prompt country B to form its own FTA with X (FTA B-X) as part of the classical FTA domino effect (Figure 1, left panel). In this setting, firms in countries A and B face a non-zero-sum game (Figure 1, right panel). Although each country will gain most from an *exclusive* FTA with X (quadrants 2 and 3), and the worst scenario is not to have an FTA with X while the other does, both would still benefit more from the existence of two separate FTAs with X (quadrant 1) than from no FTA at all (quadrant 4).

The net effect of FTA liberalization on tariff-jumping FDI in X is contingent on multiple factors, as would also be the preferences of government and local suppliers in X.[12] If, as discussed earlier, $F_A$ decides to divest from $F_{A-X}$ and serve country X from home country A ($F_{A-A}$) upon FTA liberalization, country X will experience employment losses. In addition, the government in host country X will also lose unrecoverable sunk "investments"

[12] Businesses are more likely to react in avoiding potential losses from liberalization than in securing potential gains (Baldwin, 1995).

made in the sector in the form of forgone taxes and other incentives to foreign producers ($F_{A-X}$, $F_{B-X}$). Local firms in X supplying intermediate inputs to plant $F_{A-X}$ would resist liberalization of final products and/or intermediate inputs coming from A, but would benefit from FTA A-X liberalization if $F_A$ integrates $F_{A-X}$ into its regional network and expands its production toward exports.

It is posited here that the above preferences could also be shaped by the FTAs that X has already signed or might sign in the future. A country may decide to protect a sensitive sector from FTA liberalization independently of whether or not the FTA partner is a competitive producer. But it may also decide to liberalize that sensitive sector to a non-competitive partner as part of the multi-sectoral package of concessions exchanged during negotiations. One could safely assume the existence of some path-dependence in FTA formulation, in the sense that concessions granted by a country in previous FTAs signal future FTA partners about the boundaries around sensitive sectors. In this line, during negotiations for FTA A-X, country X may refuse to liberalize its sensitive sector to final and intermediate goods coming from A as to prevent other countries' making equivalent demands in subsequent FTAs (*concession prevention*). Furthermore, if firm $F_{A-X}$ holds a dominant market position in country X, $F_A$ may favor the pre-FTA *status quo* of protectionism over a scenario where liberalization by X to country A is followed by X making similar or better concessions to country B in a future FTA (concession erosion or diversion, as noted earlier). In this case, $F_A$ itself can paradoxically relinquish (or soften) its demands for liberalization by X in FTA A-X (again, *concession prevention*) (Figure 2). $F_{A-X}$ is more likely to forego its liberalization demands in FTA A-X if it can secure assurances—through the inclusion of an "MFN clause" in the FTA—that X will not give country B a better deal in their subsequent FTA. In either case, concession prevention would reduce the chance of country X granting

concessions to country A in the given sector. The interplay between tariff-jumping FDI and the imprint of past and future FTAs would prompt that the sector is protected in future FTAs and in the multilateral regime (Figure 2).

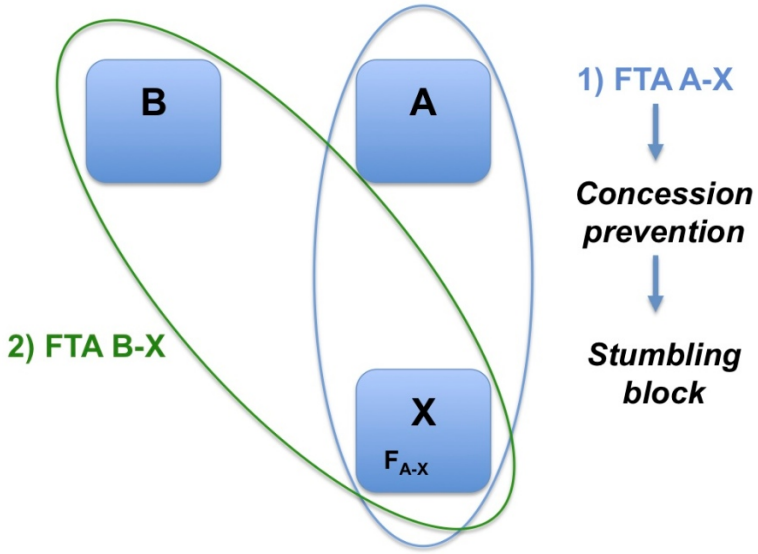


**Figure 2**: Country X can refuse liberalization of a sector to country A in FTA A-X as to prevent equivalent demands from country B in a subsequent FTA B-X (concession prevention). If firm $F_{A-X}$ has a dominant market position in X, $F_A$ could also potentially relinquish on its liberalization demands in FTA A-X in order to prevent creating a precedent for future FTAs (concession prevention). In either case, country X would be less inclined to grant concessions in that sector to country A, prompting the sector to be protected/excluded across FTAs. See text for details.

**Hypothesis 1a**: *Concessions on a sensitive sector granted by a country in an FTA potentially signal ultimate bargaining positions. That country may therefore decide not to liberalize a sensitive sector in an FTA, even with a non-competitive FTA partner, to prevent similar demands by other countries in future FTAs* (concession prevention).

**Hypothesis 1b**: *A foreign firm holding a dominant market position in a protected sector of the host country can potentially favor the status quo—accepting current protectionism—and relinquish liberalization demands in an FTA between home and host countries, to avoid similar concessions by the*

*host to other countries in subsequent FTAs, especially if the FTA incorporates an MFN clause* (concession prevention).

**Hypothesis 1c**: *Following the two previous hypotheses, concession prevention on a given sensitive sector and FTA would result in the entrenchment of protectionism around that sector in subsequent FTAs and multilaterally.*

At trade negotiations it is impossible to know *ex-ante* a partner's future comparative advantage. Signing a bilateral FTA opens up a country to competition not only from firms already established in the partner but also from those that may invest there in the future. Continuing with the previous setting, let us introduce an additional country, Y. Country Y protects a given sensitive sector at the multilateral level, but Y may have liberalized that sector—from the start or gradually—to country X as part of bilateral FTA X-Y if X was not competitive in that sector at the time of FTA negotiations. However, country Y has little or no leverage over investment policy in X, whose competitiveness may change, even rapidly, as a result of FDI from other countries (e.g., $F_{A\text{-}X}$ from country A). As long as products comply with ROOs, $F_A$ could use its production base in X ($F_{A\text{-}X}$) plus FTA X-Y to tariff-jump into Y (Figure 3).

Country Y continues to shield its sensitive sector from imports originating in countries A or B—with high comparative advantage in that sector—through high MFN tariffs. Therefore, if Y should decide later on to negotiate a separate FTA with A, Y may still wish to protect the sensitive sector from A in the bilateral FTA A-Y. However, the FTA that Y signed previously with X (FTA X-Y) and the FDI of $F_A$ into X ($F_{A\text{-}X}$) in Y's sensitive

sector means that $F_{A\text{-}X}$'s products are already entering duty-free into Y by way of FTA X-Y. The concessions and protections that Y could negotiate with A are therefore paradoxically constrained and preempted (*concession preemption*) by the FTAs that Y has itself signed in the past and the FDI sunk into Y's FTA partners (Figure 3). The situation will repeat itself when Y negotiates with B or any other country that has invested into X in Y's sensitive sector. In a context of proliferating and overlapping FTAs, as the current scenario in East Asia, a country may find that the FDI sunk over time into partners of previous agreements could compel that country to open up a sensitive sector in future FTAs, sensitive sector that until then was protected multilaterally from direct imports from other countries. The iteration of this process would therefore act as a stepping stone toward further liberalization (Figure 3).

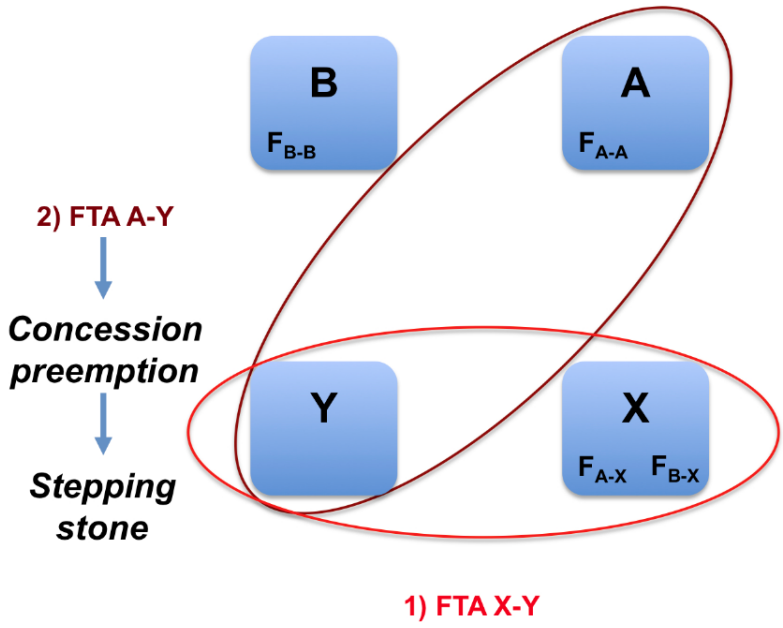


**Figure 3:** Country Y has opened up a sensitive sector to uncompetitive country X as part of FTA X-Y. If firm $F_A$ from country A invests into country X ($F_{A\text{-}X}$) in Y's sensitive sector, $F_{A\text{-}X}$ could use FTA X-Y to export freely to Y. If Y later decides to sign an FTA with A, FTA X-Y and the FDI sunk by $F_A$ into X ($F_{A\text{-}X}$) preempts the protectionist position of Y during negotiations with A (concession preemption). The situation will repeat when country Y negotiates a FTA with other countries that have invested in X (e.g., $F_{B\text{-}X}$ from country B). The FDI sunk in partners from previous FTAs will compel Y to open up sensitive sectors in future FTAs. See text for details.

**Hypothesis 2a:** *If a country seeks to shield a sensitive sector from external competition, the FDI sunk into that sector in the territory of previous FTA partners could constrain and preempt its protectionist position when it later negotiates FTAs with the FDI source countries* (concession preemption).

**Hypothesis 2b:** *Following the previous hypothesis, in a context of ever growing and overlapping FTAs, the FDI sunk in previous FTA areas would prompt that country to open up its sensitive sector(s) in future FTAs and eventually multilaterally.*

## 3. The Thai and Malaysian automotive sectors in the context of ASEAN

### *3.1 Thailand*

Appreciation of the yen in the 1980s and high trade barriers protecting the automotive industry in many countries fostered the relocation of Japanese carmakers overseas, favoring Thailand as their preferred FDI destination in Southeast Asia largely because it lacked a national car program (Doner, 1991; Staples, 2008). Thailand began to unilaterally reduce trade and investment barriers in the automotive sector in 1991, liberalization that was reinforced by the signing of the ASEAN FTA (AFTA) in 1992 and the World Trade Organization (WTO) Agreement on Trade-Related Investment Measures in 1994 that bound Thailand to gradual intra-ASEAN liberalization and to the elimination of local content requirements (LCRs) by 2000, respectively. Nevertheless, high multilateral applied tariffs maintained the automotive industry as one of the most protected sectors in Thailand. Strong

economic growth during the mid-1990s prompted a new surge of FDI into the Thai automotive sector, which was targeted by international carmakers not only as the largest market in ASEAN, but also as a potential regional base for exports (Abbott, 2004; Doner, 2009).

Many of these investment projects ran aground after domestic vehicle demand and production collapsed in the aftermath of the 1997 Asian financial crisis.[13] The government reacted to the crisis by loosening foreign equity restrictions on investment but raising multilateral applied tariffs on vehicles with the vision of transforming Thailand into the regional automotive hub through a combination of import substitution and export-oriented manufacturing by international firms. Despite the crisis, Thailand complied with its commitments to abolish LCRs and progressive elimination of tariffs on ASEAN automotive products.

Although vehicle production recovered by 2002 the Asian crisis represented a turning point in the structure and orientation of the Thai automotive industry.[14] Most Thai firms involved in vehicle assembly went bankrupt and sold their stakes to foreign carmakers while many Thai-owned automotive part producers disappeared, were bought up by foreign firms, mostly Japanese, or downgraded to lower tiers in the supply base. Importantly, the crisis accelerated foreign carmakers' plans to use Thailand as an export base. Since the crisis, vehicle production has grown steadily on the back of strong exports and Thailand is now the world's ninth largest automotive producer and Asia's third largest exporter after Japan and Korea (Trade Map and OICA databases).[15] Since 2007 around half of Thai automotive

[13] See Figure 3 in a working paper by this Author (also in this series) entitled: "Creation and Shifting of Rents within Bilateral Free Trade Agreement Blocs. Firms, States and the Redistribution of Power within Production Networks under Regionalism".
[14] Data for the rest of this section were obtained from the Thai Automotive Industry Association, Thailand Automotive Institute, Automotive Industry Club, Auto Parts Industry Club, Thai Autoparts Manufacturers Associations, Office of Industrial Economics (Thai Ministry of Industry) and individual carmakers and suppliers.
[15] Thai automotive production experienced declines in 2009 and 2011 as a result of the global economic crisis and floods in central Thailand, respectively (Figure 3 in the working paper referred in footnote 13).

production is exported, compared to just 2.5% before the crisis (see footnote 13). This strong export-orientation of the Thai automotive industry attests of the international competitiveness of assemblers and automotive parts producers established in the country.

Automotive production, domestic sales and exports in Thailand are heavily dominated by Japanese firms that have transferred to Thailand manufacturing of all commercial vehicles (pickup trucks) and an array of mid-range passenger cars. For larger-engine luxury models, Japanese firms conduct all the assembly in Japan and export them directly to Thailand, unlike European carmakers that assemble their high-end models in Thailand using kits imported from Europe. Of all vehicles manufactured in Thailand during 2004—the start of Thailand-Japan FTA negotiations—over 80% were Japanese models. Most of the remaining production is of American brands, with only around 1% being European and smaller shares for models of other origins. Over the last decade Japanese carmakers have accounted for over 85% of local market sales (Table 1). European firms only have an important presence in the niche segment of over-2500cc passenger cars. Vehicle exports are also dominated by Japanese makers, which accounted for over 85% of all units exported in 2003-2012, mainly to Australia, ASEAN and the Middle East.

**Table 1: Vehicle market share in Thailand by the home country of the carmaker ***

| Carmaker Nationality | 2003-2004 | 2005-2006 | 2007-2008 | 2009-2010 | 2011-2012 |
|---|---|---|---|---|---|
| **Japan** | 89.0% | 91.3% | 92.3% | 91.8% | 88.6% |
| **United States** | 9.1% | 7.1% | 5.8% | 4.1% | 8.4% |
| **European Union ** ** | 1.5% | 1.2% | 1.2% | 1.2% | 1.2% |
| **Other** (Korean, Chinese, Malaysian) | 0.4% | 0.4% | 0.7% | 2.9% | 1.8% |

Source: Thailand Automotive Institute, Thai Automotive Industry Association, Automotive Industry Club and individual assemblers

* Average market share for total retail vehicle sales (commercial and passenger vehicles) during the indicated period

** European carmakers hold over 60% of the market in the over 2500cc passenger car segment, which represents less than 0.5% of the overall market

The supply base in Thailand is the largest and most developed in ASEAN with the biggest share at the first-tier level in the hands of Japanese firms. Despite the elimination of LCRs, domestic value content in Thailand-made vehicles has kept increasing, and although Thailand produces many automotive parts locally, its still imports some higher-technology components and steel, mainly from Japan. Japanese firms' weight in the Thai automotive sector and in overall Thai FDI inflows, especially in the case of Toyota, translates into significant leverage in policymaking as emerged during interviews with both government officials and other carmakers.

### *3.2 Malaysia*

Malaysia's economic development policy during the last four decades has been guided by two overarching goals: achieving developed-country status and fostering the participation of the ethnic-Malay/bumiputera population in the economy. In 1983, in a bid to develop indigenous technological automotive capabilities, the Malaysian government entered directly into vehicle manufacturing by launching the *National Car Project* and the national carmaker PROTON to produce mid-size cars.[16] From the start the government has supported and protected PROTON from foreign competition—within Malaysia and from abroad—with a panoply of trade and regulatory measures (Abbott, 2004; Rosli and Kari, 2008; Natsuda et al., 2013). PROTON's share in the Malaysian market increased to 74% after only ten years encouraging the government to set up another firm, PERODUA, in 1993 to manufacture subcompact cars in a venture with Japanese Daihatsu.[17] By 1996, PROTON and PERODUA commanded a joint domestic market share of 85%. During much of the 1990s, PROTON and

[16] Although PROTON initially relied on technology from Japanese Mitsubishi—then a minority shareholder in the firm—its management has always been Malaysian bumiputera.

[17] PERODUA is also considered a national carmaker but its production strategy is controlled by Daihatsu and lacks some of the perks granted to PROTON.

PERODUA were the first and third largest carmakers in ASEAN by production volumes; yet, both remained primarily domestically-oriented.[18]

The Asian crisis caused a sharp decline in Malaysian automotive production and domestic sales, which reignited protectionism (see Figure 4 in the working paper referred in footnote 13). Malaysia requested and obtained from the World Trade Organization (WTO) an extension in the use of LCRs until 2004, exclusively for its automotive sector. More controversially, Malaysia unilaterally excluded its automotive sector from AFTA liberalization schedules (see below). It was only in 2005—later consolidated with the *National Automotive Policy*, issued in 2006—that the government accepted to progressively reduce tariffs on ASEAN-originated vehicles and automotive parts until they were completely eliminated in 2010 as mandated by AFTA. However, these tariff reductions were accompanied by the introduction of a system of excise duties on vehicles that exempts Malaysian-value content, directly benefitting national carmakers with lower import content, especially PROTON. The National Automotive Policy continues to stress the need to promote PROTON and bumiputera participation in the sector. Malaysia has a liberal investment regime in most manufacturing sectors but has remained restricted in the automotive industry. Foreign carmakers cannot have a controlling stake in their Malaysian subsidiaries, and must set up minority ventures with local firms, most often government-linked companies.[19]

Vehicle production and domestic sales regained pre-crisis levels in 2001, but growth since then has been slow compared to Thailand (see Figure 4 in the working paper referred in

[18] Historically, and until 2010, Malaysia represented ASEAN's largest passenger car market and was arguably poised to have become the regional hub for automotive multinationals had its government not launched the National Car Project.

[19] The 2009 revision of the National Automotive Policy eliminated foreign equity restrictions for the assembly of cars with engines over1800cc, electric and hybrid cars and commercial vehicles (outside the core segment of PROTON and PERODUA). A new revision of the National Automotive Policy is expected for late 2013 (see working paper referred in footnote 13).

footnote 13). Although together both national carmakers still account for over half of total production and domestic sales, PROTON has been losing ground not only to PERODUA but also to competitively-priced Japanese models, both locally-assembled and imported (Table 2). Since 2003—just before Malaysia-Japan FTA negotiations started—Japanese brands' market share has grown from 21% to around to 30% (Table 2). As Malaysia started reducing AFTA tariffs on vehicles in 2005 (see below), imports of Japanese models assembled in ASEAN—mainly in Thailand and Indonesia—raised, doubling between 2005 and 2009 (interviews). European and American models represent less than 5% of the local market, in the case of the latter mostly as imports from Thailand. Vehicle exports, mainly by PROTON, have been low due to weak international competitiveness of national carmakers and PERODUA's lack of independence in determining its own export strategy. Likewise, Japanese assemblers in Malaysia cater almost exclusively to the domestic market, following their principals' production and sales plans. Establishment of the National Car Project boosted an indigenous automotive parts industry, although of mostly low technical capabilities. In contrast to Thailand, the large majority of suppliers are locally-owned and serve national carmakers.[20]

Following Mitsubishi's sale of its stake in PROTON in 2004, the national carmaker has seen its market share position progressively deteriorating while repeated financial losses started threatening its viability. The Malaysian government looked for another global partner that could help PROTON with technological upgrading and marketing but negotiations with

[20] Small economies of scales limit the competitiveness of Malaysian-owned suppliers, and their high dependence on PROTON and/or PERODUA compromises their future if national brands' market share continues to shrink.

several international carmakers failed due to the government's refusal to give up managerial control to a foreign firm.[21]

**Table 2: Vehicle market share in Malaysia among main carmakers ***

| Carmaker | Ownership | 2003-2004 | 2005-2006 | 2007-2008 | 2009-2010 | 2011-2012 |
|---|---|---|---|---|---|---|
| **Proton** | Malaysian (National carmaker) | 36.7% | 26.9% | 25.0% | 26.8% | 27.6% |
| **Perodua** | Malaysian (National carmaker) | 27.8% | 28.5% | 31.8% | 31.1% | 33.9% |
| **Japanese carmakers** | Joint ventures with Japanese minority | 21.2% | 24.2% | 31.2% | 31.8% | 27.3% |
| **Naza Kia ** ** | Malaysian (Private, bumiputera) | 1.4% | 4.8% | 3.2% | 1.8% | 1.5% |
| **European carmakers *** ** | Joint ventures with European minority | 1.7% | 1.8% | 1.9% | 2.4% | 5.2% |
| **American carmakers** | Join venture with US minority or imported after 2009 **** | 1.7% | 1.4% | 0.6% | 0.5% | 1.1% |
| **Other** | Korean, Chinese, Indian | 9.5% | 12.4% | 6.3% | 5.6% | 3.4% |

Source: Malaysian Automotive Association
* Average market share for total registered vehicles (commercial and passenger vehicles) during the indicated period
** Naza is a Malaysian business conglomerates that locally assembles and rebadges Korean Kia cars. Since 2010 is also assembles small Peugeot cars and distributes other European and American models
*** Include Peugeot cars assembled in Malaysia by Naza
**** General Motors has no plants in Malaysia and Ford stopped production in mid-2008

### *3.3 ASEAN FTA (AFTA)*

National and corporate interests around the automotive industry were pivotal in the formulation and establishment of early ASEAN functional cooperation programs and AFTA itself. In the late 1980s and mid-1990s, Japanese carmakers succeeded in getting ASEAN governments to implement complementation schemes (e.g., Brand-to-Brand complementation and ASEAN Industrial Cooperation programs) that liberalized pre-approved trade flows in intermediate goods among specific subsidiaries within the region (Yoshimatsu, 2002). Since these programs mostly benefitted foreign multinationals, Malaysia was initially loath to grant approvals, while Thailand, as the regional hub of international carmakers, supported them from the start.[22]

[21] In January 2012, government-linked investment company, Khazanah, sold its shares in PROTON to Malaysian private holding DRB-HICOM (*New Straits Times*, January 16, 2012; *The Edge*, January 17, 2012). Nevertheless, given significant overcapacity and increased competition at home the firm remains at a crossroads.
[22] Eventually, Malaysia approved complementation projects in the ASEAN Industrial Cooperation scheme and automotive firms established

AFTA schedules established that intra-ASEAN tariffs were to be capped at 20% by 2000 and although items could be temporarily excluded, tariffs had to be reduced to 0-5% by 2003 and totally eliminated by 2010. Full liberalization is delayed to 2015 for ASEAN less developed members Cambodia, Myanmar, Laos and Vietnam. As indicated earlier, following the Asian crisis, Malaysia transferred its automotive sector to the exclusion list and increased tariffs on vehicles coming from ASEAN to up to 300%. Malaysia maintained the sector excluded from AFTA schedules beyond the 2003 deadline and tariffs on ASEAN automotive products were only brought down to 20% in 2005 before there were scrapped in 2010.

Small margins between multilateral and AFTA tariffs in many sectors have limited businesses' incentive to use AFTA (Manchin and Pelkmans, 2008; Ravenhill, 2008). However, since the automotive industry has been heavily protected in most ASEAN countries, primary data collected in this research found close to complete utilization of AFTA preferences for trade in automotive products (data from the Thai Ministry of Commerce; interviews). Elimination in 2010 of all intra-ASEAN tariffs allows carmakers, especially Japanese firms with a larger presence, to rationalize scales and strategies on a regional basis, using their largest plants in Thailand to serve demand in other ASEAN countries, including Malaysia.

Japanese and Western carmakers have later become interested in integrating neighbouring countries (e.g., Japan itself, Australia) into their ASEAN network. To that effect, they have lobbied ASEAN governments—particularly in major automotive producers, Thailand, Malaysia and Indonesia—for the creation of a number of bilateral FTAs. However,

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in the country participated in about half of all automotive-related projects in this program. In line with Malaysia's early concerns, the vast majority of projects covered trade exchanges among Japanese firms and only one involved PERODUA, none PROTON (data from the Ministry of International Trade and Industry; interviews). Initially projected to be phased out by 2003, the ASEAN Industrial Cooperation program continued in use until 2010.

for Malaysia, further liberalization of its automotive sector beyond AFTA, particularly to highly competitive automotive producing nations like Japan, could be ominous for PROTON and its suppliers.[23]

## 4. The automotive sector in the Thailand-Japan FTA

Over the last decade, most ASEAN countries, with Singapore, Thailand and Malaysia in the lead, have been actively pursuing FTAs with partners within East Asia and beyond (Sally, 2007; Hoadley, 2008; Sally and Sen, 2011). As of August 2013, Thailand is signatory to AFTA, five bilateral agreements, and five regional FTAs as a member of ASEAN (see Table 1 in the working paper referred in footnote 4). The Thailand-Australia FTA, which fully liberalized the Thai automotive sector for the first (and so far only) time outside AFTA, merits attention here before the Japan-Thailand FTA is analyzed.

Even before the Thailand-Australia FTA (TAFTA) was implemented in January 2005, Australia represented the main market for Thailand-made vehicles, which accounted for 25% of total Thai exports to Australia. Field research for this project found that pressure by Japanese and American carmakers on both governments was instrumental in TAFTA negotiations (see working paper referred in footnote 4).[24] Australia was not a direct competitor to the Thai automotive industry and, in fact, automotive production structures in both countries were complementary.[25] Consequently, Thailand agreed to open its automotive industry fully and relatively rapidly to Australia. Thailand eliminated from the start all tariffs

[23] In January 2012, government-linked investment company, Khazanah, sold its shares in PROTON to Malaysian private holding DRB-HICOM (*New Straits Times*, January 16, 2012; *The Edge*, January 17, 2012). Nevertheless, given significant overcapacity and increased competition at home the firm remains at a crossroads.

[24] General Motors and Toyota lobbied the Thai government to speed up the opening of negotiations for TAFTA. Automotive associations in Australia also lobbied for TAFTA to the Australian Parliament (see working paper referred in footnote 4).

[25] Thai strength in light commercial vehicles and small- and medium-size passenger cars was matched by Australia's advantage in large-engine vehicles and higher-technology automotive parts.

on commercial vehicles and large passenger cars and phased out by 2010 those on smaller cars and automotive parts (Table 3).[26]

**Table 3: Thai and Australian concessions in the automotive sector under TAFTA**

| | Thai concessions | Australian concessions |
|---|---|---|
| **Passenger cars < 3000 cc** | 0% by 2010 | 0% at entry |
| **Passenger cars > 3000 cc** | 0% at entry | 0% at entry |
| **Commercial Vehicles** | 0% at entry | 0% at entry |
| **Automotive parts** | 0% by 2010 | 0-5% at entry<br>0% by 2010 |
| **Hot- and cold-rolled steel** | 0% by 2015 | 0% at entry |

Source: TAFTA treaty (DFAT, undated)

As Thailand's main foreign investor, first source of imports and key export market, Japan was a natural FTA partner for Thailand (Manger, 2005). Through the Japan-Thailand Economic Partnership Agreement (JTEPA), Thailand aimed at improving access for its agricultural products and attracting investment, while Japan sought to liberalize the Thai automotive and steel sectors and extract concessions on services.

When JTEPA negotiations began in February 2004, Thailand had just agreed to fully open its automotive sector to Australia under TAFTA, and was about to start bilateral negotiations with the United States, the world's largest automotive producer at the time. In addition, as member of ASEAN, Thailand was also party to ongoing discussions for an FTA with Korea and to plans for another with the European Union. Together, these agreements would place Thailand at the heart of a network of overlapping FTAs with most of the major automotive producing countries. In keeping with the initial arguments, the imprint of previous FTAs on JTEPA negotiations became patent early on and interviews revealed that Japanese carmakers, as the largest investors in the Thai automotive sector, expected to

[26] On its part, Australia eliminated from the start all tariffs on vehicles and by 2010 on automotive parts.

extract in JTEPA the same preferential treatment Thailand had offered to Australia.[27] But these interviews also found that, over all else, Japanese automotive firms wanted to preserve their dominant position in Thailand, avoid the erosion of any preferences they could eventually obtain in JTEPA, and prevent Thailand from later liberalizing its automotive sector with other countries, as it had done with Australia.

An agreement in principle for JTEPA, including the contentious agricultural sector, was reached in March 2005 only for talks to get tangled up over the automotive sector. Japanese carmakers sought full liberalization of the Thai automotive sector as in TAFTA. To cancel the tariff advantage enjoyed by European brands established in Thailand and that dominate the luxury segment, Japan requested the scrapping of tariffs on vehicles of over 3000cc. In addition, and although they already produce small- and medium-size vehicles in Thailand at internationally competitive costs, Japanese carmakers also demanded the gradual elimination of tariffs on models below 3000cc.[28] Finally, Japanese firms also wanted to improve the competitiveness of their plants in Thailand by liberalizing imports of higher-technology automotive parts and steel from Japan.

While liberalization to Australian automotive products posed little threat to the Thai automotive industry, a range of Japan-made vehicles was in direct competition with those produced in Thailand. Also differing from TAFTA, JTEPA's potential benefits were only unidirectional—affecting only Japanese exports to Thailand—, since Japan already offered tariff-free multilateral access to all automotive products. Field research found that Western

[27] Even the Thai Prime Minister made reference to Japanese carmakers' demands for similar treatment than Australia (*The Nation*, April 12, 2005). Also in line with our argument, although in a different sector, having made Japan some concessions on agriculture in its FTA with Mexico, Thailand entered JTEPA talks with high expectations for obtaining greater access for its agricultural products but soon found out that Japan resisted liberalization of the sector.

[28] Liberalization to imports of small- and mid-size vehicles made in Japan would give Japanese carmakers flexibility in planning for future platforms and technologies.

assemblers strongly opposed tariff reductions on vehicles imported from Japan.[29] Japanese and Western assemblers both threatened Thailand with divestments if their interests were not considered. The Thai government, which had been nurturing the sector for decades, did not want JTEPA to make existing investments redundant or to jeopardize future inflows.[30] Research indicated that the Thai government was well aware and concerned that yielding to Japanese demands would cause the United States, European Union, and Korea to press for similar concessions in ongoing FTA negotiations (*concession prevention*) (Hypothesis 1a).

Despite their significant leverage on Thai policymaking, Japanese carmakers eventually obtained only limited concessions in JTEPA (Table 4). Thailand granted a very lengthy liberalization (over a period of up to eleven years) for Japanese automotive parts and steel that, in line with the initial arguments, was made conditional upon the full implementation of AFTA by 2010, being otherwise delayed accordingly. Thai concessions on vehicles were only marginal as tariffs on passenger cars below 3000cc, representing 99.9% of the Thai automotive market, were left unchanged and those on vehicles of over 3000cc were only reduced from 80% to 60%. JTEPA also includes a cooperation chapter whereby, among other programs, Japan provides skill-training for Thai automotive workers.[31]

[29] Strong resistance by Western carmakers occurred despite that, given Japanese firms' dominance of the Thai automotive market, total liberalization to Japan-made vehicles was unlikely to cause drastic changes in market share distribution in Thailand. European firms also opposed liberalization of the Thai large-engine vehicle segment to cars produced at more efficient scales in Japan. In contrast, American carmakers were willing to accept some compromise on less price-sensitive larger models. For some models, American firms also depended on imports of automotive parts and steel from Japan. The two associations of automotive part producers in Thailand opposed liberalization of both vehicles and parts. See working paper referred in footnote 4 for details on JTEPA negotiations.

[30] In any case, given the large sunk investments involved, the automotive sector reacts slower than other industries to changes in the policy environment. As with market share distribution, it was therefore unlikely that full liberalization to Japanese vehicles in JTEPA could have led to significant divestments, at least in the short-term.

[31] The program, known as the Automotive Human Resource Development Program, extended an already existing scheme for technical assistance in the automotive sector. Despite limited automotive liberalization in JTEPA, until December 2009, 41.3% of all imports of luxury cars and 10.0% of automotive parts used JTEPA preferences (data provided by the Thai Ministry of Finance). Low utilization reflects long tariff phase-out periods for automotive parts and availability of other import tariff exemption schemes for parts incorporated into vehicles destined for exports. See also See working paper by this Author (also in this series) entitled: "Utilization of Free Trade Agreements by Sectoral Interests and Binding of Unilateral Concessions".

**Table 4: Thai concessions in the automotive sector under JTEPA ***

| | Thai concessions |
|---|---|
| **Passenger cars < 3000 cc** | unchanged |
| **Passenger cars > 3000 cc** | 60% by 2011<br>(maintained at 60%) |
| **Commercial Vehicles**<br>**< 5 tons**<br>**> 5 tons** | <br>0 % by 2018<br>20% by 2018 |
| **Automotive parts** | * Most items: unchanged or capped to 20% at entry and 0% by 2013<br>* Sensitive items (engines and their parts): unchanged at entry and 0 % by 2015 |
| **Hot-rolled steel** | 0% within quota<br>0% by 2018 |

Source: JTEPA treaty (METI-JTEPA, undated)
* Japan offers tariff-free multilateral access to all automotive products

While Japanese carmakers failed to achieve the liberalization initially sought, their dominance in the local market meant that maintaining the *status quo* was not so unattractive scenario after all, especially since they also succeeded in preventing competing carmakers from other countries from gaining any better access to Thailand in future Thai FTAs (*concession prevention*, Hypothesis 1b). In what effectively amounts to an "MFN clause", Japan got in JTEPA the compromise by Thailand not to extend any better tariff treatment to any "other major automotive manufacturing country in its future FTAs than that extended to Japan" (MOFA, 2007).

As derived from Hypothesis 1c, concession prevention for vehicles in JTEPA was followed by parallel exclusion of the automotive sector in subsequent FTAs, namely ASEAN-Japan, ASEAN-Korea and ASEAN-India.[32]

[32] Negotiations on the Thailand-United States and ASEAN-European Union FTAs were eventually abandoned, although the latter is currently under study as a Thailand-European Union bilateral FTA. From Hypothesis 1c and the MFN clause included in JTEPA, it would be expected that the automotive sector would be excluded in a potential Thailand-European Union FTA.

## 5. The automotive sector in the Malaysia-Japan FTA

Just a decade ago, Malaysia was not only reluctant to enter into bilateral FTAs, but it was also critical of those signed by Singapore and Thailand. As recently as 2001, Prime Minister Mahathir criticized Singapore FTAs with non-ASEAN countries for opening a "back door" into ASEAN (Desker, 2004). However, fearing trade diversion from the FTAs signed by other ASEAN members, it took Malaysia only a year to reverse that position and declare its interest in an FTA with Japan. As of May 2013, Malaysia has implemented six bilateral FTAs plus five ASEAN-centered FTAs (see Table 2 in the working paper referred in footnote 4).[33]

Japan's main interest in MJEPA laid in eliminating tariffs on automobiles and steel.[34] In a 2003 joint feasibility study conducted before MJEPA negotiations were launched, Malaysia stressed the difficulty of liberalizing its sensitive automotive sector, which at the time remained still excluded from AFTA liberalization schedules and enforced the use of LCRs (MOFA, 2003). Significantly, in the same document Japan linked MJEPA with AFTA, emphasizing the need for Malaysia to fulfill AFTA commitments in the automotive sector and beyond. Such linkage confirms my initial arguments and reflects Japan's interest, and that of its firms, in exploiting the possibilities offered by overlapping FTAs for its regional strategy.

Bilateral talks began in January 2004 and although by late that year an initial agreement had already been reached, negotiations slowed down over automotive and steel products. Interviews with government officials and national and foreign carmakers in Malaysia indicated that, at the time, it was widely expected that Malaysia would eventually exclude the entire automotive sector from MJEPA. The same interviews showed that

[33] Malaysia has implemented FTAs with Japan, Pakistan, New Zealand, India, Chile and Australia.
[34] In 2003, before MJEPA negotiations started, automotive and steel products jointly represented over 18% of Japanese exports to Malaysia, with only 0.2% going in the opposite direction.

Japanese carmakers lobbied Malaysia for the liberalization of vehicles, automotive parts and steel, while PROTON and PERODUA, still seeking further delays in liberalization under AFTA, resisted opening up the sector.[35] One key reason the Malaysian government established the National Car Project was to develop an indigenous automotive part manufacturing industry. Consequently, the two associations encompassing PERODUA and PROTON suppliers—most of them largely, some completely, dependent on the two national carmakers—maintained a strong protectionist position against the introduction of more competition for national carmakers and/or any increase in their options for procuring automotive parts (interviews).

To sweeten its demands, and as part of the MJEPA cooperation chapter, Japan offered Malaysia technical assistance for human resource development in the automotive sector—the Malaysian-Japan Automotive Industries Cooperation (MAJAICO) program.[36] Even so, Malaysia remained reluctant to liberalize its iconic automotive sector, which persisted as the only sticking point for the conclusion of MJEPA negotiations (interviews).

In January 2005, Malaysia eventually had to start moving its automotive sector back into AFTA's liberalization schedules, slashing tariffs on vehicles from 70-300% down to 20%, with the prospect of their eventual elimination by 2010. Starting in early 2005, Japanese carmakers in Malaysia—with simpler assembly operations than those of subsidiaries in Thailand—were thus able to import Thailand-made Japanese models at reduced tariffs through AFTA.

[35] PROTON had broken its equity and technology tie-up with Mitsubishi in 2004 but PERODUA depended (and still does) to a larger extent upon Japanese inputs. The Malaysian Automotive Association—encompassing non-national carmakers—naturally supported liberalization with Japan as a first step toward breaking down decades of protectionism.

[36] In MAJAICO, that expanded an existing scheme, Japan provided assistance to Malaysian firms in automotive skill training, standards and business matching during 2006-2011.

**Table 5: Malaysian concessions in the automotive sector under MJEPA**

| | Malaysian concessions |
|---|---|
| **Passenger cars < 2000 cc** | 0% by 2015 |
| **Passenger cars 2000-3000 cc, trucks, buses and multi-purpose vehicles** | 0% by 2010 |
| **Passenger cars > 3000 cc** | 0-5% in 2008<br>0% by 2010 |
| **Unassembled Vehicle Kits (*complete knocked-down*, CDK)** | 0% at entry |
| **Automotive parts** | 0-5% in 2008<br>0% by 2010 |
| **Hot-rolled steel** | Import duty exemptions<br>0% by 2015 |

Source: MJEPA treaty (METI-MJEPA, undated; MITI, undated)

AFTA liberalization plus Japanese carmakers' investment in Thailand pre-empted Malaysia's MJEPA bargaining position (*concession pre-emption*). Malaysia eventually gave in and, in May 2005, agreed to opened up its automotive industry to Japan entirely and within a relatively short time (Table 5).[37] At the time of the entry into force of MJEPA in July 2006, Malaysia eliminated all tariffs on unassembled vehicle kits and, by 2010, on passenger cars with engines larger than 2000cc. Tariffs on cars below 2000 cc, at the heart of the PROTON's and PERODUA's market, will be eliminated by 2015. Equally important to Malaysia, given National Car Project's goals and large local ownership of suppliers, tariffs on automotive parts were rapidly liberalized; they were reduced to 0-5% in 2008, and scrapped altogether in 2010. Tariffs on hot-rolled steel for the automotive industry receive duty exemptions and will be brought down to zero by 2015. By eliminating all tariffs on Japan-made automotive products, MJEPA effectively puts Japan on the same level as other ASEAN members within roughly the same period. Even though Japanese carmakers could

[37] According to interviews, Malaysia's decision to liberalize its automotive sector was taken very close to the agreed deadline for the conclusion of negotiations. Several interviewees indicated that Japan threatened to pull out investments in the automotive industry and beyond if requests for liberalization of the automotive sector were not attended.

access Malaysia tariff-free through AFTA after 2010, MJEPA gave them additional flexibility in planning their production strategies.[38] Of note, Malaysia did not grant Japan any other significant concession outside the automotive sector.

With Thailand as the regional hub not only for Japanese but also American and European firms, Malaysia may find itself in a similar concession 31re-emption quandary as it negotiates FTAs with the United States and the European Union.[39] The FDI sunk into partners of previous FTAs would compel Malaysia to open its automotive sector in future FTAs thus acting as a stepping stone toward further liberalization. However, as additional evidence for the argument posited here, Malaysia was able to exclude the automotive sector in later FTAs with Pakistan, India and Korea (e.g. Malaysia-Pakistan, Malaysia-India, ASEAN-Korea and ASEAN-India FTAs) because automotive firms from these countries had very limited (if any) investment in Malaysia's previous FTA partners.[40]

## 5. Discussion

The case studies analyzed here showed how the interplay of FTAs among one another and with the investment sunk in them influenced positions regarding liberalization or protection. The preferences and policy strategies of governments and firms regarding FTAs are determined not only by the agreements subscribed to by competitor countries—the classic "domino effect" (Baldwin, 1995)—but also by its own FTAs and the investment in them. The Thai and Malaysian cases also illustrate the contingent nature of the stumbling block versus stepping stone dilemma. The interaction between investment and FTAs may lead either to the

[38] Between MJEPA's entry into force in July 2006 and December 2012, imports from Japan of large-engine vehicles, unassembled vehicle kits and functional automotive parts have multiplied by more than four times despite negative economic growth during several quarters in this period and the fact that full liberalization of larger vehicles was only realized in July 2010.

[39] Malaysia has joined negotiations for a regional FTA that includes the United States (the Trans Pacific Partnership FTA) and is in the midst of talks with the European Union for a bilateral FTA.

[40] Output by Korean firms in Indonesia during 2005-2011 amounted to less than 1.0% of total production, even lower in Thailand. Vehicle production by Indian carmakers in ASEAN countries remains negligible.

liberalization of previously protected sectors or, instead, to the entrenchment of pockets of protectionism across FTA blocs.

Empirical evidence in this paper allowed us to conclude that, in the presence of tariff-jumping FDI, protectionism for sensitive sectors could potentially perpetuate itself across multiple overlapping FTAs through at least three mechanisms. One occurs when sequential games of FTA negotiations between a host country and its FDI source countries are engulfed in collective action problems dominated by defection (quadrant four in Figure 1, right panel). A foreign firm would oppose FTA liberalization by the host nation with any other except with its own home country and/or where the firm has investment and production stages (e.g., Japanese carmakers supported JTEPA, which was opposed by Western assemblers in Thailand). The eventual result is either no FTA or exclusion of the sector(s) in every FTA negotiated by the host with FDI source countries, even though investing firms would benefit more from multiple and separate bilateral FTAs than from no FTA at all or from the exclusion of the sector in all of FTAs (Figure 1, right panel).[41]

Sectoral protection could also be preserved across overlapping FTAs by the shadow of existing and future FTAs. Concessions or exclusions on sensitive sectors made by a country in a FTA set expectations for future FTA partners. For instance, opening the Thai automotive sector in TAFTA created a precedent that Japan sought to replicate in JTEPA. A country may decide to exclude a sensitive sector from liberalization in an FTA independently of the partner's competitiveness as to prevent other countries from making similar demands in subsequent FTAs (concession prevention). In refusing to liberalize its automotive sector in JTEPA, the Thai government wanted to protect existing investment, but also to prevent

[41] The precise win set depends on the market share distribution in the host country and the comparative advantage of the given foreign firm vis-à-vis other firms in the host country and at home. Given their dominance in Thailand, it could be argued that Japanese automotive firms could have extracted larger concessions in JTEPA if Western automotive firms, especially American, had had less of a presence in Thailand. Firms may nevertheless still favor FTA liberalization by the host to inputs coming from a country different from their home, if they are dependent on those inputs as illustrated by the partial support by American carmakers to the liberalization of automotive parts and steel from Japan in JTEPA.

similar demands by the United States, the European Union or Korea, then also negotiating FTAs with Thailand/ASEAN.

Lastly, concession prevention, and subsequent protectionism for a given sector across multiple FTAs, could also emerge from firms of an FDI source country. A foreign firm with a dominant market position in a host country could potentially favor the *status quo* and relinquish demanding liberalization between its home and host countries to prevent other countries' competing firms from getting a similar (or better) deal in the host country's future FTAs, especially if the *status quo* could be locked in by including an MFN clause in the FTA. Field research found that Japanese carmakers in Thailand actively sought to liberalize the Thai automotive sector, without concern about creating a precedent since the precedent already existed in TAFTA. But interviews also revealed that, given their overwhelming dominance in Thailand, their primary interest was not so much to improve their market position as to avoid or limit future losses. Japanese automotive firms wanted to prevent the then ongoing ASEAN-Korea FTA negotiations from allowing competitively-priced Korean vehicles to enter Thailand tariff-free.[42] By including an "MFN clause-like" in JTEPA—solely for the automotive sector—, Japanese firms prevented that the concessions it extracted from Thailand, small as they were, could be exceeded by concessions Thailand might make later to other countries.

Either way, concession prevention for a sector in an FTA increases the chances that the FDI host country will protect/exclude the sector in subsequent FTAs and multilaterally. For the government and firms with sunk investment in the host country, the shadow of future FTAs becomes a stumbling block to further liberalization. In that regard, inclusion of the

[42] Korean Hyundai started a very small assembly operation in Thailand in 2007. Japanese carmakers based in Thailand also wanted to shield their position from concessions to the United States and the European Union in FTAs that Thailand was negotiating at the time.

automotive MFN clause in JTEPA will block Thailand from granting meaningful tariff reductions in the automotive sector in future FTAs.

By contrast, Malaysia's most protected manufacturing sector was suddenly liberalized the first time its government negotiated a bilateral FTA, and with Japan, one of the world's most competitive automotive producers. There is no question that both the more liberal government of current Prime Minister Najib but also of his predecessor Prime Minister Abdullah (2003-2009), which negotiated MJEPA, had slowly realized the impossibility of maintaining indefinitely the protection for PROTON and PERODUA as well as the costs Malaysia has incurred in the process. However, automotive concessions in MJEPA cannot be explained as the Malaysian government's seizing an opportunity to implement externally-imposed structural reforms that would otherwise have proven unachievable. Field research interviews indicated that the government resisted automotive liberalization until the very end of MJEPA negotiations. In addition, as elaborated elsewhere in this paper, Malaysia continued to shield the sector in its National Automotive Policy and in subsequent FTAs with automotive producing-countries that lack significant investment in ASEAN (e.g., ASEAN-Korea, ASEAN-India and Malaysia-India). Although Malaysian government officials interviewed accorded MAJAICO a significant weight in the decision to liberalize the sector with Japan, this is little more than a face-saving exercise toward local automotive firms, since MAJAICO cannot compensate for potential loses resulting from liberalization.[43]

The reason the Malaysian automotive sector was fully opened in MJEPA is to be found elsewhere. Countries may liberalize a sensitive sector in an FTA when the partner is not considered a competitor (e.g., Thailand to Australia in TAFTA) but also at the end of a long tariff phase-out period (e.g., all ASEAN countries, including Malaysia, in AFTA). The

[43] MAJAICO, already provided at a smaller scale before MJEPA, lasted only five years. In addition, a similar arrangement was also granted to Thailand despite marginal Thai concessions to Japan in the automotive sector.

Malaysian case shows that FDI sunk into a given sector in partners of previous Malaysian FTAs (e.g., AFTA), shapes its liberalization in later FTAs (e.g., MJEPA). Since establishment of the National Car Project, Malaysia has fiercely protected its automotive sector against competition within ASEAN and beyond through trade barriers and FDI restrictions. But, obviously, Malaysia could not control investment policy in other ASEAN fellow members. When Japanese and Western carmakers started steeping up their FDI in Thailand, and more recently in Indonesia, they gained a potential beachhead for their automotive products to enter other ASEAN countries freely once AFTA was fully implemented. Malaysia reinforced the protection of its automotive sector in the wake of the Asian crisis. However, in January 2005, seven years after Malaysia had withdrawn the automotive sector from AFTA liberalization and just five months before an agreement on MJEPA was reached, the Malaysian government could no longer maintain the sector excluded and eventually conceded to pressures from other ASEAN countries to start bringing it back into AFTA schedules. In little over a year, Malaysian tariffs on vehicles from other ASEAN countries were reduced from 70-300% in December 2004 to just 0-5% in March 2006, four months before MJEPA finally came into effect. It could be therefore argued that Malaysia's liberalization of its sensitive automotive sector in MJEPA amounted to no more than a *fait accompli*. With Japanese carmakers exporting automobiles from Thailand to the rest of ASEAN at tariffs of 5% in 2005 and tariff-free since 2010, Malaysia saw her protectionist stand in MJEPA preempted (*concession preemption*). Consequently, Malaysia eventually accepted to extend to Japan the same level of liberalization (and at about the same time) as to other ASEAN countries.[44]

[44] Even though a larger presence of Western carmakers in Malaysia would have hindered collective action among non-national firms in support of automotive liberalization in MJEPA—as occurred in Thailand—, foreign carmakers (both Japanese and Western) in the Malaysian Automotive Association saw MJEPA as an opportunity to start opening up the sector. Malaysia's concession to the immediate

AFTA has opened the Malaysian automotive sector to competition not only from carmakers established elsewhere in ASEAN at the time of AFTA creation back in 1992, but also to any other automotive producer that has invested in ASEAN since then, or that may invest in the future. With all tariffs among the main ASEAN economies now eliminated, Malaysia may therefore see its negotiating position constrained once again when trying to protect the sector in future FTAs with countries with automotive investment and production in ASEAN (or other FTA areas in which Malaysia participates). The interaction between previous FTAs and the FDI sunk in them may thus act as stepping stones toward further liberalization of the Malaysian automotive sector. One could also speculate that, within a tariff-free AFTA bloc, PROTON and PERODUA may feel the need to lobby the Malaysian government for tariff reductions—unilaterally or through other FTAs—on automotive parts and components imported from beyond ASEAN so both national carmakers can compete with more efficient carmakers in Thailand that until recently benefited from a broader network of FTAs.[45]

At least on paper, the interaction between FDI and FTAs could also allow circumvention of the high tariffs on vehicles applied by Thailand at the multilateral level. For instance, firms with limited or no assembly presence in Thailand (e.g., Korean and Indian firms or Japanese luxury carmakers) could potentially take advantage of the fully open Thai automotive sector under AFTA and TAFTA by investing and establishing production in other ASEAN countries or in Australia. However, firm- and locational-specific advantages may favor investment into Thailand itself. High multilateral tariffs on vehicles in Thailand have helped to maintain and increase FDI into the Thai automotive sector (tariff-jumping market

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elimination of tariffs on unassembled vehicle kits (completed knock-down kits) in MJEPA aimed at encouraging Japanese firms to produce models in Malaysia for export to ASEAN.

[45] Carmakers based in Thailand have used of TAFTA and the Thailand-India partial liberalization agreement to import automotive parts (see working paper referred in footnote 13). In fact, automotive transmissions are the single largest item imported through the Thailand-India agreement. Malaysia has already established FTAs with India and Australia.

seeking FDI), but investment has also (and primarily) been attracted by the indirect rents derived from the agglomeration economies associated with Thailand being an automotive parts cluster and export-oriented hub (efficiency seeking FDI). The network of Thai FTAs and a liberal investment regime also contributed to attracting FDI into the Thai automotive sector. All these reasons would help persuade those potential firms to invest directly into Thailand rather than in other ASEAN countries or in Australia.

Malaysian Prime Minister Mahathir's early predictions about bilateral FTAs being a "back door" to AFTA ended up, ironically, working the other way around. Liberalization under AFTA constrained Malaysia's position in its bilateral FTA with Japan, and has the potential to do the same in regard to future FTA partners. As ASEAN countries—and Asian nations more generally—keep signing into more overlapping FTAs, such situations will only become more frequent.

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