

## ASEAN Trade Negotiation Framework

# Automotive Industry

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## 1. Introduction

With rapid technological advances and unwavering trend in regional trading arrangements, the world is progressively becoming integrated. As a result, firms and industries are facing new sets of parameters to work with. The need for innovation, skills and know-how, and new approaches has never been more urgent. This is particularly the case for the automotive industry, where the major players have developed global production networks to sustain, if not improve, their competitiveness and growth. Such developments have posed unique and new challenges to host countries to come up with appropriate strategies and measures that would allow them to share in the bounties of the new environment.

While it is the industry itself that is responsible for its own fate, it is the task of government to at least provide the enabling environment for this to happen, and in a most inclusive manner. The challenge for governments is how to facilitate the process that would benefit business in a way that would stimulate more inclusive growth.

This paper, in particular aims to focus on the ASEAN scheme, particularly the ASEAN plus 3 framework, for the automotive industry which has been envisioned as a means to achieve this. A lot has been said about the need to strengthen ASEAN, the primary regional cooperation institution in the region. A key element for this to materialize is the active support and participation of the business sector in the process. This paper aims to provide inputs toward facilitating this partnership which would yield significant benefits all around from what is negotiated under the ASEAN umbrella. As such, the paper has six main sections. It starts in the next section with the global setting to provide a broad picture and understanding about the industry. Then, it presents briefly the state of the ASEAN automotive industry in Section 3, followed by a discussion of country strategies in Section 4. Section 5 then focuses on the different ASEAN schemes to promote the industry. Section 6 then devotes a short portion on the status of the Philippine car manufacturing industry before the paper finally proceeds to the discussion of trade negotiation and trade facilitation issues and recommendations for the strategic framework and roadmap in Section 7.

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## **2. The Global Setting**

The automotive industry is comprised of intricate international systems of integrated production (ISIP) or global production networks (GPNs), built on the bases of large investments by the leading TNCs (Transnational Companies) driven by the need to continuously increase efficiency. (ECLAC 2004) Especially during the last two decades, establishing and expanding foreign production capabilities have been an important strategy for firms in the automotive industry. (Lynch 2000) Different stages of production (that may or may not involve equity ownership) are increasingly being spread across national borders (deverticalization). As such, as in the case of the electronics industry which is also based on an ISIP, the automotive industry is an important magnet for FDI in the region. On top of this, it provides necessary training for its human resources. (ECLAC 2004)

### **The Changing Assembly Strategy and Supplier Roles**

The assemblers are progressively adopting a global perspective in their operations as well as reorganizing their vehicle portfolios around product platforms and car modules and systems. Increasingly, original equipment manufacturers (OEMs) are moving downstream, passing the role of developing, manufacturing and assembling to suppliers. As automakers move downstream, more engineering and production will shift to suppliers and service providers for engineering or assembly. Suppliers will then become the main engine of job and value growth in the industry.

The stratified relationship between producers and their largest suppliers has changed during the last decades. First-tier suppliers are focusing on modular integration; second-tier suppliers, on their production; and third-tier suppliers, on the manufacture of components and the provision of local content in emerging markets. At the same time, there is movement along the supply chain. How well and how fast this movement is, e. g. from component to sub-assembly manufacturing, would depend on what capabilities the firms have in several manufacturing processes needed to produce the component, the ability to manage its own supply chain, and an improved presence in regions where automakers are assembling the vehicle and where subassembly will be incorporated. (Veloso and Kumar 2002)

The established business designs of automakers and suppliers will not disappear overnight. But they are dissolving gradually and by 2015, will cover only 65% of value creation in the industry. To keep its valued position in the production network, automakers would be induced to turn into suppliers by offering modules and services to other automakers and suppliers, and suppliers would turn into “little automakers” by offering activities along the value chain, from vehicle engineering to assembly. (Dannenberg and Kleinhans 2004)

## The Japanese Strategy

During much of the post-war era and up to the late 1970s, rationalization and diversification were the conventional business formula for executing an export-oriented strategy. Japanese companies have introduced a number of hit products over the years on the diversification side of the equation. However, what has distinctly set them apart from other foreign companies is their excellence in the QCD function—that is, high quality, low cost, and short delivery times—the rationalization side of the equation.

In the 1980s, with the rise of mega-competition in their traditional product markets and the diffusion of their total quality methods to other countries, Japanese companies began to lose their distinctive QCD function advantages, placing pressure on them to consider adding a geographical diversification strategy to their management systems. The absence of formal institutional mechanisms for regionalism create gaps in Japanese GPNs. As such, Japanese companies rely on the available physical and social infrastructure in East Asia. This includes at the first layer, their inter-firm network of expatriates, followed by their inter-personal network of ethnic Chinese, and then the world class infrastructure in the region. (Tachiki 2004)

By destination, the MOF (2002) statistics show that Japanese FDI has been skewed toward the developed countries. Now there is a broadening of the geographical dispersion of Japanese FDI. East Asia now accounts for the largest number of cases, indicating lead companies are drawing their affiliated small- and medium-sized enterprises (SME) into this region. This trend emerges first in Northeast Asia (South Korea and Taiwan) and Singapore, shifting toward Southeast Asia (Indonesia and Thailand), and more recently in China. (Tachiki 2004)

Possible explanation to this trend are the apparent Japanese firms' objectives which is to protect its comparative advantage; minimize costs by taking advantage of cheaper labor from outside as well as through the increased segmentation of production in both products and services; and achieve greater economic activity and widen market in the ASEAN region. The increased segmentation of products would enable Japanese firms to keep the development of high technology in Japan while shifting the production of products which have lower technology in developing countries. Japanese GPNs channel regional trade through a network of closely affiliated local suppliers and markets. As competitive pressures drive Japanese companies towards more open and decentralized GPNs, however, they should seek access to local technology and business capacities.

The organization of FDI into GPNs also affects the direction of regionalization. More opportunities for companies to expand their GPNs within the existing trade and investment corridors are expected with the implementation of bilateral and regional FTAs. The expansion would benefit both the FDI donor and recipient in terms of enhancing or maintaining competitiveness and efficiency. For the host country, the efficient local suppliers would become better integrated into the global network, not only in terms of markets, but in terms of technology transfer as well.

## **Some Key Developments in the Global Automotive Industry**

From demand to prices to technology, the industry is abruptly facing challenges and opportunities in this new environment of the global automotive market.

First, there is an existing high level of competition due to vehicle production overcapacity in most market segments (Barnes 1999) coupled with the flat pattern of demand for new cars. In any of the Triad regions (Western Europe, Japan, and United States [US]) original equipment manufacturers (OEMs) have been facing a mature market for the past 10 years, with stagnant demand, product proliferation, and stiff price competition. (Veloso and Kumar 2002)

Second, there is the pattern of increased OEM and automotive component investment in certain geographical localities, (despite global overcapacity). (Barnes 1999) Cost-cutting pressures and the drive to gain greater access to emerging markets has led automakers increasingly to shift vehicle production overseas. Scores of countries, once never thought of as bases for vehicle manufacturing, are now competing for investment in their fledgling auto industries. (WMRC 2003) Along with the increasing global cost competition and growth opportunities in distant markets (market dynamics) comes the change in the suppliers manufacturing footprint which could be optimized with a global perspective in a hub and spoke network. (Berger 2004)

Third is the growing consolidation of both OEMs and the world's largest component manufacturers through mergers and acquisitions. The flurry of high profile mergers and acquisitions amongst both OEMs and automotive components firms highlights the fact that the global operating environment has changed and that many previously successful firms are struggling as a result. (Barnes 1999)

Fourth is the tiering of the automotive components industry due to lead source and modularisation tendencies. There is the strong competitiveness pressure amongst OEMs and component suppliers, as well as the transfer of design responsibilities to certain multinational automotive component firms.(Barnes 1999) The global automotive industry is evolving in ways that will result in suppliers, not the automakers themselves, conducting most of R&D and production by 2015. Automakers will restrict their production to those components that are crucial to the success of their brands. (Dannenberg and Kleinhaus 2004) Simultaneously, the growth of outsourcing is moving towards higher sophistication in product development and scale of manufacturing.(UNESCAP 2002)

Fifth is the diminishing production life spans of vehicle models. New models now only have production life spans of approximately two to four years, which is in stark contrast to model life spans of up to eight years in the 1980s. (Barnes 1999)

Sixth, sales growth is now coming from developing regions, with South America, India, People's Republic of China (PRC), and Eastern Europe leading this trend. (Veloso and Kumar 2002) The steady growth of mega economies like China and India, and

growth of the ASEAN Free Trade Area (AFTA) trading bloc in South-East Asia ensure that automobile demand in Asia will experience the kind of S-Curve that the Republic of Korea experienced between 1988 and 1996.(UNESCAP 2002)

Seventh, there is continuing development of new technologies, engineering plastics, electronics, and electric cars. (UNESCAP 2002) The trend for new technology is for comfort, safety, communication, and entertainment, mainly based on electrical systems and electronics.(Dannenbergh and Kleinhans 2004) These new technologies are not only creating new demands for industry players but are also altering the way the auto industry does business. Changes are also happening at the level of the supply chain with the entry of e-commerce initiatives. (Veloso and Kumar 2002)

Finally, there is the China factor (as well as the rising India). China has emerged as both a producer and a huge market for automotive products.

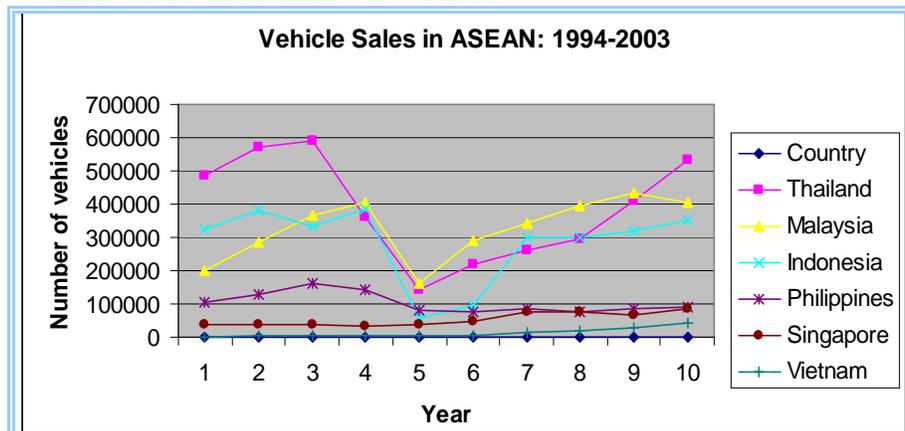
These factors are shaping the new landscape where the automotive industry operates. And in one way or another, local players would need to deal and cope with the attending challenges and opportunities.

### **3. Snapshot of the ASEAN Automotive Industry**

There are currently five major markets in ASEAN: Thailand, Malaysia, Indonesia, the Philippines and Vietnam. Thailand is considered to be the most advanced, while Vietnam is the new comer, still very limited but had some significant investments flowing in starting 1995. Until the 1997 economic crisis in Asia, the ASEAN automobile industry was considered to be one of the most dynamic in the world, with sales and production growing strongly from 1992. (Sturgeon 1998) In general, however, the distortions of high tariffs, local content rules and attempts to protect the local industry have created a sector that is well behind the 21st century standard necessary for success. (UNESCAP 2002) The automotive sector is a scale-intensive industry and none of the ASEAN economies is large enough for an automotive company. The problem is that, due to the restrictive policies that all the members of the region have, very little was exported among ASEAN markets. The same held true for components, whose circulation among countries was limited by local content rules. Therefore, most of the assembly units have not been competitive on an international level. (Veloso and Kumar 2002)

Asia has recovered, faster than anticipated, and becoming again a very attractive investment area. Over the next decade, analysts predict that the Asian and Pacific region will be a key driver of worldwide industry growth. (Veloso and Kumar 2002) Like the rest of Asia, the ASEAN automotive sector appears to be bouncing back from the 1997 crisis. Sales in the ASEAN region recovered strongly in 1999. Thailand, Malaysia and Indonesia have regained pre-crisis level. However, the Philippines market growth remains limited. (Figure 1; Table 1)

**Figure 1. Vehicle Sales in ASEAN: 1994-2003**



**Table1. Vehicle Sales in ASEAN-4: 1996-2004**

Country	1996	2000	2002	2004
<b>Indonesia</b>				
Passenger Car	43,914	46,891	26,689	312,865
Commercial Vehicles	288,121	254,073	291,101	170,283
Total	332,035	300,964	317,790	483,148
<b>Malaysia</b>				
Passenger Car	275,693	296,557	375,358	392,139
Commercial Vehicles	89,096	46,616	59,596	95,466
Total	364,789	343,174	434,954	487,605
<b>Philippines</b>				
Passenger Car	88,977	26,076	21,798	33,277
Commercial Vehicles	73,118	48,443	63,859	54,798
Total	162,095	74,519	85,587	88,075
<b>Thailand</b>				
Passenger Car	172,730	83,106	126,353	209,042
Commercial Vehicles	416,396	179,083	283,009	416,936
Total	589,126	262,189	409,362	625,978

Source: JAMA 2006

The major markets have bounced back since the crisis. Recognizing the importance of increasing trade in the region, despite the crisis, most ASEAN governments continued to further liberalize the automotive industry. Thailand is the region's leader in output and export. Malaysia has a large domestic vehicle market, but also has a heavily protected industry with high import tariffs. Indonesia was hardest hit by the financial crisis and its production collapsed. The combination of low sales volume and political instability has been difficult to overcome, and Indonesian sales and production have grown at a slower rate than the other neighboring economies. With the removal of many restrictions, including the easing of the local content program,

automotive production has rebounded and there is apparent improvement in competitiveness in automotive parts after the crisis. (Atje 2006) The Philippine sales of domestically produced vehicles have recovered slightly after the crisis, but not enough to reach the pre-crisis level. It recently modified its automotive laws and opened itself up to greater opportunities for global competition and promotion of its domestic industry. Parts manufacturing has performed much better, with exports recovering since the crisis period. Vietnam has been slower to develop due to heavy government control of the industry.

ASEAN is a major investment region and a premier global production base. Member economies are working to enhance ASEAN's industrial edge and maintain its draw to investors by moving to unify it into one cohesive market. Confidence in the growing market is reflected in the amount of investment made in the region by major car makers. (ITA 2004)

The current ASEAN automotive industry is characterized by strong presence of Japanese OEMs, advantages of a low cost manufacturing base; significant unutilized capacity for vehicles, surplus manufacturing capacity exists in ASEAN, especially for multipurpose utility vehicles (MUVs) >1,600 cc cars, 1T Pick-Up (PU) trucks and components dominance of PU trucks and MUVs and focus on exports for capacity utilization.

In terms of the comparative advantage of individual ASEAN countries, Thailand appears to be the most successful in establishing its foothold in the industry. Thailand is now the world's third largest producer of small pick-up trucks. Its main exports consist of wire harnesses, engines, ignition systems, and tires and it has also managed to broaden its locally produced parts, including radiators and body parts. It claims to produce some type of engine, suspension, clutch and steering more cheaply than Japan. Assembly productivity, however, remains well below the international benchmark (Poapongsakorn 2006). Indonesia seems to be gaining competitiveness in some auto parts and components, especially motorcycle parts and gear boxes. (Atge 2006) In the Philippines, standing out are automotive electronics and wiring harnesses. In general, for ASEAN countries, the motorcycle component of the automotive sector has been performing well.

The next two tables show the relative size of East Asian automotive trade. Japan is the world's second largest exporter of products under Harmonized System (HS) 87 which cover automotive products (15 percent compared to share of top world exporter Germany at 18 percent for the period 2000-2003). It accounts for three fourths of all East Asian exports. Korea is the next largest exporter in East Asia with around 15 percent. ASEAN, as a whole, accounts for around 7 percent, while China accounts for around 3 percent. In ASEAN, Thailand gets the biggest chunk, accounting for more than one third of total ASEAN exports.

**Table 2. East Asian Automotive Exports (in million US \$)**

<b>Automotive Exports</b> (HS 87 excl 8712, 8713, 871491 to 871494 )				<b>Average Share</b>	
	2000	2001	2003	World	ASEAN+3
Indonesia	377	386	538	0.1%	0.4%
Malaysia	314	239	338	0.0%	0.2%
Philippines	614	667	1142	0.1%	0.7%
Singapore	675	646	1042	0.1%	0.6%
Thailand	2455	2690	4042	0.5%	2.5%
Japan	88811	81447	103675	15.3%	75.2%
China	2978	3211	5823	0.7%	3.3%
Korea	15225	15365	22984	3.0%	14.7%
Total ASEAN + 3 *	114167	107121	143036	20.4%	100.0%
Total World	547947	547334	693628	100.0%	

Source: PC-TAS (Personal Computer- Trade Analysis System)

\* Total HS 87 for ASEAN countries

**Table 3. East Asian Automotive Imports**

<b>Automotive Imports</b> (HS 87 excl 8712, 8713, 871491 to 871494 )				<b>Average Share</b>	
	2000	2001	2003	World	ASEAN+3
Indonesia	1891	1868	1890	0.3%	6.7%
Malaysia	1776	1627	1969	0.3%	6.3%
Philippines	1085	1055	1265	0.2%	4.0%
Singapore	2665	2321	2781	0.4%	9.2%
Thailand	2050	2069	3160	0.4%	8.2%
Japan	10351	9799	11730	1.8%	37.3%
China	3612	4532	11787	1.0%	20.8%
Korea	1631	1805	3175	0.4%	7.3%
Total ASEAN + 3 *	25060	25076	37920	4.8%	100%
Total World **	555110	554273	680856	100%	

Source: PC-TAS (Personal Computer- Trade Analysis System)

\* Total HS 87

\*\* Total World Exports HS 87 excl 8712, 8713, 871491 to 871494

While still relatively small compared to the big world players, the Tables above on automotive trade in East Asia highlight and confirm the notable performance of Thailand. Not surprising is the phenomenal growth of China, which is not unlike what is happening elsewhere in other sectors and industries. However, what is more noteworthy is the much higher growth in China's automotive imports compared to its exports. This is a strong indicator that while China is indeed potentially a major competitor and producer,

China is equally, if not even more so at this stage, a big market for automotive products. This is both for CBU (completely built up) vehicles, and for automotive parts and components. In the case of parts manufacturing, the potential growth in demand could be especially robust when China does start to become a major world producer.

The next section attempts to provide insights as to what type of policies and strategies have been employed by the different countries that have shaped their automotive sector.

#### **4. Strategies in Selected Asian Countries**

##### **The National Car Model**

For several decades, most Asian nations outside Japan have tried to launch car programs that would enable them to have a national flag vehicle. The Republic of Korea, Malaysia and Indonesia followed a different strategy from Thailand, which can be called the National Car Model, in which the state directed and encouraged either a single manufacturer or, in the case of the Republic of Korea, attempted to control the levels of competition between automotive manufacturers between 1973 and 1994. In this model the state puts very large resources directly or indirectly into a single automotive company. In each case a foreign minority partner is involved to provide the technology. While frowned upon by free trade enthusiasts, in both the Republic of Korea and Malaysia the system has produced viable companies. As the Korean experience shows, there is a tendency to produce companies that are only viable through extensive rationalization, and require that the government release the industry from controls when the infant industry has graduated. (UNESCAP 2002) In addition, it would be very difficult to replicate the success of Korea, especially considering the WTO context with strict rules on TRIMS and export subsidies.

##### **Korea**

One of South Korea's major growth and export industries starting in the 1980s was its automobile industry. Much of the industry's growth was the result of a surge in exports as well as domestic demand. Two-thirds of the cars manufactured were sold domestically. Most of the domestic demand came from first-time car buyers because of the double-digit increase each year since 1987 as well as due to a stable or slightly decreased new car prices because of cuts in special consumption taxes, reduced fuel taxes and growing economies of scale by manufacturers.

Although the industry was badly affected by the economic crisis in 1997-1998, domestic sales were up in 1999 due to gradual economic recovery and to various government measures to stimulate the automotive industry (i.e. lowering of automotive related taxes). Since 2000, major Korean export items include automobiles with increased share in the total value of Korea's exports. Because local players dominate the domestic OEM market, sourcing has mostly been done locally. Korean production accounts for

roughly 94 percent of the automotive parts and accessories market. However, the Korean automobile industry still depends largely on foreign suppliers for important components and parts, such as transmissions, engine parts, body parts, and brake parts. (Veloso and Kumar 2002)

The automotive industry, dominated by Chaebols, has undergone substantial rationalization. After declining in 2001, production growth rebounded by 5% in 2003 (8% in 2002). OEMs and local component suppliers have been working together to improve quality and productivity in the Korean autoparts industry. Over the past three years, Korea's auto industry has undergone restructuring. For instance, Hyundai Motor Company used to follow a strategy of virtual integration, but as its production grew, the company followed Japanese model and built a network of subcontractors.

There have also been a large number of mergers and acquisitions of vehicle assemblers and parts/components suppliers. At present, there are about five car assemblers as opposed to eight in 1998. The Daewoo Motor Company, after bankruptcy in 1999, was taken over by General Motors in October 2002 to form GM Daewoo.

Many assemblers are going global for many of their parts instead of purchasing components from Korean parts suppliers. Korean assemblers are introducing some elements of competitive bidding. Suppliers have to demonstrate their price and quality levels at each model (or platform) change. The assemblers are encouraging suppliers to become more self-sufficient by broadening their customer base. Unlike in the early years of the Korean auto industry, the Korean Government has allowed the market forces to shape the new automotive industry.

Many foreign-owned companies are buying or forming joint ventures with Korean companies in the areas of electrical systems, safety systems, and bearings which the assemblers are telling their traditional suppliers that they must become more competitive. Also, the assemblers are beginning to use more modularization (complete dashboards, assembled drive systems, etc.) systems. It is estimated that some of the top assemblers in other world markets are approaching a 30-40 percent rate for modularization, and the Korean assemblers want to "benchmark" this.

Vehicle manufacturers are also delegating more responsibilities to Korean parts suppliers. Before 1998, the Korean supplier base was flat, consisting primarily of only first tier suppliers, and not many second and third tier suppliers. Now the vehicle manufacturers are expecting fewer first tier suppliers and more second and third to supply the first tier suppliers. This is mandatory when the assemblers are requiring more modules. The efficient suppliers become first tier suppliers which supply more R & D and better quality control, while the less efficient/competitive become second and third tier suppliers. (Mc Elroy 2002)

## **Thailand, “Detroit of Asia”**

Thailand’s model has been considered as a successful case of cross-border cooperation and development Thailand’s steady high growth rate, passing as a third generation tiger, and attracting the attention of the Japanese auto manufacturers and other multinationals. The 1997 Asian crisis place a damper on Thailand’s growth, but it is still posed to continue where it has left off.

A major factor going for Thailand is that government policies were conducive to global integration. This included the removal of import bans and tariff protection for domestic manufactured products in 1991 for the first time in 20 years. For the period 1992-1997, policy measures adopted in Thailand were geared towards liberalization, deregulation, promotion of supporting industry, deepen industry linkage and promotion of regional cooperation mainly on trade aspects. This period was characterized by high economic growth. The relatively open foreign direct investment (FDI) environment also attracted these companies. In addition, what appears to be a significant factor is the foresight of Thai automakers in recognizing the importance of breaking down the barrier further by learning the Japanese language.

The Thailand automotive industry suffered the same difficulties as other sectors as a result of the 1997 Asian crisis but there has been sign of economic recovery starting in 1999. Domestic auto market has been visibly enlarging, partly due to the government's promotion-and-support policies on automotive industry. Incidentally, the drop in value of the baht has made Thailand an ideal center for manufacturing for export as well as the MNC regional center for the auto industry. Encouraged by these policies and by the commitment to reduce the 54 per cent local content rule under the trade-related investment measures (TRIMs) agreement, the three major US producers have decided to also build regional hubs in Thailand for the export of cars and parts. (UNESCAP 2002)

The Toyota system (followed by Honda) for South-East Asia goes further than this. Attempting to localize production as much as possible, engineers at both Toyota and Honda focused first on what parts local companies could produce cheaply, and then designed cars with those components in mind. In producing the Honda City and the Toyota Soluna, the Japanese companies built their cars around cheap components made in South-East Asia (principally Thailand). This became a model that has helped build the Thai auto industry.

In January 2000, the local- content-requirement policy has been abolished. At the same time the revised automotive-tariff structure along with the CKD definition, intended to supplement the abolishment of the local-content- requirement policy, has also been enforced. These factors along with introduction of more models and international branch (which likewise induced investment in supporting industry) contributed to the development of Thailand’s production networks. These production networks were used to increase capacity utilization. At this time, Thailand has become one of the production base for CV while global sourcing and new trend in automotive industry carry on. The deepening of the production chain was made through (1) the increase in FDI and number

of parts and components industry in body parts, engine parts, electrical parts, suspension and brake, etc.; (2) increase in exports and trade in OEM among automakers. (Chiasakul 2004)

According to the Japan Automobile Manufacturers Association (JAMA), the quality of automotive parts in Thailand is rated as the best among ASEAN countries. This can be attributed to Thailand's standard compliance. So also, Thai production is well balanced between production for domestic demand and that for export.

All in all, the factors that determined the growth in the Thai automotive industry include economic conditions, market size, capacity utilization rate, and globally integrated strategy from the MNC's perspective and government's policies. (Chiasakul 2004)

## **Philippines**

The Philippine automotive industry developed under heavy protectionism from the 70s to the early 90s through high tariffs and import bans as well as through the local content program which granted generous investment incentives to the firms that were allowed to participate in the industry. However, the complex package of assistance failed to promote an efficient industry capable of competing internationally. Its high cost structure made its performance pale in comparison with assemblers in other ASEAN countries.

Beginning in 1995, the government implemented a series of trade reforms that led to the reduction of tariffs and removal of import bans. Simultaneously, restrictions on the number of models were removed and entry into previously closed industry segments was opened up. Although the local content program was originally set to be abolished in 2000 under our WTO commitments, however, the government extended the program for another two and a half years and completely abandoned it only in July 2003.

The Philippine automotive industry is yet to achieve significant progress as firms are still in the process of restructuring and adjusting to the changes in trade policy and transforming themselves into efficient manufacturers that can compete in their chosen markets. To successfully compete with foreign automotive and automotive part manufacturers, they must make substantial improvements in efficiency, productivity and product quality.

Box 1 below provides a summary of policies adopted by Thailand, Malaysia, Indonesia and the Philippines over the years.

***Box 1. Timeline of Major Developments in the Automotive Industry of Selected ASEAN Countries***

***Thailand***

***1960s*** Thai automotive industry commenced when the Thai Motor Industry Company was established; Office of the Board of Investment, established under the 1962 Investment Act, approved a support for motorcycle assembly, starting in 1964. In 1969, the Automotive Industry Development Committee was formed to implement policies and measures with the aim of establishing auto assembly.

***1970s*** The Ministry announced its first motorcycle-industry policy as well as a car-assembly policy. Later, it also announced a standard matrix on percentage of local contents required for passenger-car assembly as well as bus and truck assembly. This period started the set-up of assembly operations through joint venture and Japanese OEMs started to set up their base. The Auto parts industry was established in 1974

***1980s*** The Industrial Restructuring Committee was formed, Ministry of Industry imposed the 45 per cent local content limitation on passenger-car assembly. In passenger-car assembly, only up to 42 series could be produced by the whole industry, and only 2 models were allowed for each series. Local content policy implementation was flexible. Automotive production networks were created. Cooperative clubs between car assemblers and parts makers were formed.

***1990s*** Liberalization and Deregulation. Abolition of passenger car-import restriction.

***Post-Crisis***

***2000s*** Local-content-requirement policies that have been applied on automotive assembling was abolished. A new automotive-tariff structure to supplement the abolition of local-content-requirement policies was adopted. Among the automotive policies that were implemented since 2002 are: 1. The limitation on the number of automotive firms was abolished. Consequently, new automotive companies enjoy free entry into the automotive industry. 2. The Thai Board of Investment (BoI) offers investors privileges including plant expansion rights in prime industrial areas, as well as tax exemptions on imported machines, raw materials and corporate income tax.

## ***Indonesia***

***1960s*** The development of the automotive industry in Indonesia started in 1964 by assembled parts and components of automobile imported in SKD bases. In 1969, the policy, particularly those for sedan and commercial cars, was changed in which the importation of parts and components should be in a completely-knocked down (CKD) condition.

***1970s*** In 1976 the Government issued a regulation that marked the start of the components manufacturing in Indonesia, through a mandatory deletion program.

***1990s*** In 1993 the Government of Indonesia launched a policy which implemented an incentive system, which grants reduction in import duty and luxury tax for those reaching a certain percentage of local content utilization in their production activity. In 1996, the government launched the National Car Program which granted import duty and tax exemption to the national car company attaining a targeted level of local content at particular years of operation.

Government Regulation No. 20/1994 and Presidential Decree No. 31/95 opened the automotive sector to foreign direct investment, allowing 100 % foreign equity. The minimum capital requirement for foreign investment was eliminated

## ***Post Crisis***

***1999*** -- Indonesia signed a Letter of Intent with the IMF signed on 15 January 1999, abolishing its subsidy programs for automotive industry. On June 1999, the Government launched a new policy of automotive development where import duty is not linked to the achievement of local content.

The government introduced deregulation reforms consisting of: relaxing the Bonded Zone Company regulation, Bonded Warehouse regulations; restructuring import duty and luxury tax tariffs and eliminating import barriers, and reducing the import duty on raw materials for component industry.

The government abolished restrictions on all CBU imports to enhance competition.

***2000s*** The Decree of the Ministry of Industry and Trade No. 172/200 prohibited the importation of used cars except truck with minimum gross vehicle weight (GVW) of 24 tons. Automotive Importation of CKD cars by car assemblers is not subject to Luxury Tax.

## *Malaysia*

**1960s** The automotive industry in Malaysia started. The policy of encouraging assembly for automobiles and the manufacturing of component parts was announced in May 1964. Assembly plants were set up thereafter.

The policies include local content requirement, import restrictions and very high tariffs on CBU imports.

Until the early **1980s**, there were about 15 assemblers that produce vehicles for European and Japanese manufacturers. There were too many makes and models, causing the demand for a particular component to be low, leading to the difficulty for the manufacturers to achieve the economies of scale.

**1980s** The National Car Project, Perusahaan Automobil Nasional (PROTON), a joint program with Japan's Mitsubishi Motors Corporation was launched in 1984.

**1990s** After the success of the first national car, Perusahaan Otomobil Kedua Sdn. Bhd. (PERODUA) was established in October 1992.

The Malaysian auto market is dominated by Malaysia's national cars. PROTON and PERODUA jointly accounted for 90 per cent of the vehicles sold annually.

## *Post Crisis*

**1998--** Government intervention relaxed financing requirement, such as increasing the duration of payment period and increasing the percentage of car financing.

## ***Philippines***

**1970s** The country started its development of the motor vehicle industry in 1972 through the Progressive Vehicle Manufacturing Program (PVMP) that is now known as the Motor Vehicle Development Program (MVDP).

**1980s** Car Development Program (CDP) was aimed to develop a viable automotive parts manufacturing industry.

**1990s** Major liberalization initiatives started only in 1990 with the creation of new categories in the Program to encourage entry of new participants. Import restrictions on a number of auto parts were also lifted, and eventually, importation of brand-new CBUs units were allowed in October 1995.

Tariff adjustments in CBUs from 40 per cent to 20 per cent and CKD packs from 10 per cent to 3 per cent were made in July 1995, making the new duty rates the lowest in the ASEAN region.

Car and Commercial Vehicle Development Program in 1996 open up the closed vehicle categories to new participants and removed restrictions on the number of models and variants and abolish foreign exchange and local content requirements (CDP and CVDP) in 2000.

## ***Post Crisis***

**2000--** The Philippines in November 2001 concluded an amicable settlement of the dispute earlier initiated by the United States against the country on TRIMS maintained in its motor vehicle sector in accordance with the timetable specified by WTO Council for Trade in Goods in its decision of 31 July 2001 in the context of the “2 years plus maximum 2 years” solution.\*

New Motor Vehicle Development Program (EO 156) in 2002 ban the importation of all types of used motor vehicles and parts and components, except those that may be allowed under certain conditions. (Loophole found thru importation in Subic and other free port areas of “transformed” used vehicles)

There is a continuous modification of the tariff rates on motor vehicle parts and components as well as CBU exports.

*Source: Report Submitted by the Author to JICA, March 2004*

Possibly all ASEAN countries, at the start, wanted to emulate Korea, if not Japan, and develop a national car. For sure this was the strategy followed strongly by Malaysia, Indonesia and the Philippines. To a lesser extent, even Thailand early on implemented a local content program that aimed to progressively reach this goal. However, for the ASEAN countries, the national car model strategy drew little or no success. The protectionist strategy could not compensate for the small market size of individual countries. Instead, the distortions created by restrictive policies of high tariffs, local content rules have cultivated a sector that is well behind the 21st century standard, without the driving force of competition. (UNESCAP 2002) In addition, due to the restrictive policies that all the members of the region have, very little was exported among ASEAN markets. Parts and components appear to have fared better, but circulation among ASEAN countries was limited by local content rules. Therefore, most of the assembly units have not been competitive on an international level. (Veloso and Kumar 2002)

Much of the success of Thailand was based on the recognition of the limitation of such a strategy. As such, the government's liberalization policy was a rational response aimed to shift its orientation toward a globally integrated strategy that would feed into a competitive global production network. Nonetheless, it tries to maintain some balance in its platform by creating a national specialization which made Thailand a hub for pick-up trucks. Indeed, as earlier noted, it has become the world's third largest producer of small pick-up trucks.

## 5. Status of the Philippine Car Manufacturing Industry

### Automotive Assembly

The Philippine motor vehicle assembly sector is basically domestic oriented with very minimal export of CBUs. The auto parts sector is also largely oriented towards the domestic industry serving both the OEM and replacement markets.

The Philippine automotive industry consists of 14 car assemblers with a combined annual capacity of 221,450 units and 21 commercial vehicle assemblers with a total capacity of 145,950 units. The industry is dominated by five Japanese manufacturers namely: Toyota Motor, Honda Cars, Mitsubishi Motors, Isuzu Motors, and Nissan Motors. Together, these firms have a total investment amounting to about P13.8 billion and employment of 5,228 workers. Other major motor vehicle manufacturers include Ford Motors, Columbian Autocar, and Pilipinas Hino.

Table 4 shows that light commercial vehicles have been the source of industry growth after the 1997 Asian financial crisis. The passenger car segment has not grown between 1997 and 2002, except in 2001. The light commercial vehicle segment has performed better in terms of sales as it consistently posted positive growth rates from 1999 to 2002 and reached an almost 28 percent growth rate in 2000. With depressed demand and the increasing availability of both brand new and second-hand imported motor vehicles, competition in the market has been tight and local firms have been operating only at 40 percent of their capacity.

**Table 4: Sales of Domestically Produced Motor Vehicles, Philippines 1995-2002**

Year	Passenger Cars	Growth Rate in %	Light Commercial Vehicles	Growth Rate in %	Total	Growth Rate in %
1995	65,808		53,392		119,200	
1996	79,673	19.1	58,815	9.7	138,488	15.0
1997	69,070	-14.3	51,418	-13.4	120,488	-13.9
1998	32,134	-76.5	35,769	-36.3	67,903	-57.3
1999	25,130	-24.6	39,505	9.9	64,635	-4.9
2000	22,000	-13.3	52,000	27.5	74,000	13.5
2001	23,684	7.4	52,968	1.8	76,652	3.5
2002	21,728	-8.6	63,858	18.7	85,586	11.0

*Source of basic data: Chamber of Automotive Manufacturers in the Philippines Inc.*

The country's motor vehicle exports are negligible. The top markets for our motor vehicle exports are Japan, Thailand, Singapore, Vietnam, Republic of South Africa and Taiwan (ROC).

### Automotive Parts and Components Manufacturing

The parts and components segment of the automotive industry is composed of 256 companies producing different parts and components made of metals, plastic, rubber and

composite materials for both the OEM and replacement markets. In contrast, Thailand has 700 parts manufacturers while Malaysia and Thailand each have 500 firms. Japan has about 1,000 automotive parts suppliers.

The major players in the automotive components manufacturing sector are Yazaki-Torres Manufacturing Corp. (wiring harness), United Technologies Automotive Phils. (wiring harness), Temic Automotive (Phils.) Inc. (anti-brake lock system), Honda Engine Manufacturing Phils., Inc. (engines), Asian Transmission Corp. (automotive transmissions), Toyota Autoparts Phils. (automotive transmission), Fujitsu Ten Corp. of the Phils. (car stereos) and Aichi Forging Co., Inc. (forged parts). In 1999, the parts industry had total investments of about P27 billion and employment of 45,000 workers.

Of the 256 automotive parts manufacturers, 124 are considered first-tier manufacturers who are directly supplying the needs of domestic automotive assemblers. The remaining 132 are mostly small and medium enterprises. They are sub-contractors serving as second- and third tiers who are supplying the needs of the first-tier manufacturers. Note that the automotive components and parts sector is characterized by a dichotomy. There exist a few firms that have access to the best practice technology and state of the art equipment like Yazaki-Torres and foreign-affiliated companies and a large number of parts manufacturers consisting mostly of SMEs that have low technology levels, are undercapitalized, and handicapped by lack of skills. While the foreign-affiliated automotive parts manufacturers have prepared their future plans in anticipation of the AFTA implementation, most of the automotive sector's SMEs are still groping and without government assistance (protection), they are pessimistic about their survival.

**Table 5: Philippine Exports of Automotive Parts, 1996-2002**

Year	Exports in '000 US\$	Growth Rate in %
1996	830821.5	
1997	759693	-9.0
1998	375387.6	-70.5
1999	515863.5	31.8
2000	1012144	67.4
2001	954686.4	-5.8
2002	1166591	20.0

*Source of basic data: Department of Trade and Industry-Bureau of Export Trade Promotion*

In 1997, the growth of exports of automotive parts and components dropped by nine percent and by another 71 percent in 1998. Strong recovery was felt in from 1999 to 2000. Export growth was disrupted in 2001, then continued strongly in 2002. Japan remains the biggest market for automotive parts and components, followed by the US and Germany. (See Table 5 above)

## 6. ASEAN Cooperative Approaches

This section looks at the evolution of strategies which have been employed by ASEAN. No assessment is made with respect to the effectivity of these schemes, but simply a brief look at what have been done so far.

### AFTA

In 1992, the ASEAN countries agreed to create the ASEAN Free Trade Area (AFTA), under which all internal ASEAN tariffs were lowered to 0-5 percent as applied by the Common Effective Preferential Tariff (CEPT). Under CEPT, the import tariff rate on automotive products with no less than 40 percent ASEAN content is 0-5 percent. (Thailand will lower tariff rates to 0-5% no later than 2010.) The goal is to create one market, where rationalization of production and distribution processes would lead to economies of scale.

All ASEAN-6 automotive products are in Inclusion List (IL) (except for 218 items). Of the issues in the current CEPT negotiations are Malaysia's deferment of CBUs and CKDs as well as Vietnam's deferment of transfer of certain motorcycle parts & components and auto CBUs from Temporary Exclusion List (TEL) to IL. Automotive is one of the priority integration sector in AFTA. Auto sector unification is overseen by the ASEAN Automotive Industry Integration plan.

### The AIJV, BBC and AICO Schemes

There is a long history of formal "complementarity" schemes in ASEAN, including the ASEAN Industrial Joint Venture (AIJV) begun in 1983, the Brand-to-Brand Complementarity (BBC) scheme begun in 1988, and the ASEAN Industrial Cooperation (AICO) scheme begun in 1996. All of these programs have been based on resource-pooling and market-sharing among ASEAN member states as a way to generate and exploit firm- and industry-level economies of scale. See Box 2 for illustration of impact.

## Box 2. Segmentation encouraged by BBC Scheme: An Illustration



AICO is different from previous arrangements mainly in that it allows complementarity schemes to be set up between separate firms. A minimum of two companies in two different ASEAN countries are required for participation. Parts approved under AICO have tariff rates dropped to 0-5% well ahead of AFTA implementation in 2003. The AICO, abolishes the localization schemes in each country, as well as the import tariff exemptions and local capital requirements. Participating companies must also provide evidence of cooperative activities such as technology transfer, inter-firm training, or consolidated purchasing in order to gain project approval.

### ASEAN Auto Integration

The automotive industry has been singled out as one of ASEAN's priority areas for integration. The vision is a single market, with integrated production and distribution channels, starting with these priority areas. Especially for the automotive industry which is characterized by global production networks, this is envisioned to create an ASEAN automotive sector, in partnership with the major Asian automotive producers, which would bring about mutual benefits in terms of enhanced efficiencies and competitiveness arising from economies of scale.

The measures of integration would revolve around the following main areas: intra-ASEAN tariffs, a common external tariff, harmonization in automotive standards, automotive taxes, customs valuation investment rules and rules of origin.

## **7. ASEAN Trade Negotiation Issues and Recommendations for the Strategic Negotiation Framework**

We now turn to the main objective of this paper. What then are the main implications for the industry players in terms of deriving positive results all around from what is negotiated under the ASEAN umbrella? There are three major elements that need to be taken into account. In the first place, what is the ASEAN vision for the industry, embodied in the ASEAN (Plus) direction and framework? Second, what is governments' role? And third, what are the areas for negotiation?

The Vision of ASEAN is to become one community. In particular, in the more immediate future, the goal for the priority sectors ASEAN is to build a single production base. For the automotive industry, this is consistent with and supportive of its global production networking structure. It is important that the regional, as well as national strategy would be aligned with if not patterned after regional and international trail, specifically the trends in the global production network and the impact of the global trading arrangements on this structure.

In general, the key implication here is that the strategy for the ASEAN automotive industry is to build around the basis of ASEAN being an integral part of Japanese competitiveness.

Japan would strive to maintain its leadership in the region. While the new age economic partnership Japan aims to foster is based on cooperation, underneath, there is inherent competition between Japan and China. Japan is still the world leader in automotive technology but it needs to continually guard its competitiveness, especially against the threat of China as a major potential competitor. Hence, it is essential for Japan to widen its production base to include ASEAN. This means that Japan's competitiveness is entwined with ASEAN competitiveness. Japan's competitiveness relies on ASEAN's competitiveness, and ASEAN's competitiveness could draw on Japan's competitiveness.

Of course there are prerequisites for this to happen. In the first place, each individual ASEAN country should create the proper environment. In broad strokes, this includes strengthening the foundation in

- Improving QCD and meeting international standards
- Human resource development
- Engineering capacities – value engineering
- Global supply networking infrastructure
- Good ICT infrastructure

Basically, the vision is not just for ASEAN to become one production base, but one closely linked with Japan. This means each ASEAN country should identify parts and components where it has comparative advantage within which to specialize. This would supply the production network not just in the ASEAN-Japan, but , along with

Japan's export drive, the rest of East Asia and the rest of the world. Various suppliers may combine resources to complete a sub-assembly auto component. However, at the same time, each country could still specialize on a particular model, especially where there a strong domestic base could be established, but with view to exporting not just within ASEAN but the rest of the world. This would enable each country to take respective advantage of economies of scale, while at the same time drawing on and supporting Japan's competitiveness. It goes without saying that there would be needed technology transfer and foreign direct investments.

Local industries should work for more division of labor between ASEAN and Japan. Forward looking strategies should be sought, where countries try to create new niches, based on natural (and unique) endowments and comparative advantage. One possible area in looking ahead would be establishing new grounds in the environment-related areas of the automotive industry.

In the ASEAN trade negotiation framework, what are the implications of this vision and strategy with regards to the areas for negotiation? *Collaborative approaches* among parts manufacturers are needed. In this regard, regional agreements, particularly the ASEAN plus framework, could be designed to suit the collaborative approach.

A necessary condition to building one ASEAN production base is free movement of labor and capital. This means, reducing barriers to trade and investments. This has direct implication on:

- Market access:
  - Tariffs
  - Non-tariff barriers- standards and technical barriers
  - Rules of origin
  - Negative list
- Ability to attract FDI.

The direct impact is increased inter-industry trade in the region and greater movement of people. The objective of the negotiation process is to facilitate these flows by reducing the barriers to market access and flow of investments.

There are of course adjustments involved in opening up and becoming exposed to increased competition. But there is need as well for longer-term view. Hence in the negotiation process, negotiations should cover the flexibilities needed to manage the transition. But this concern should not lose sight of the long-term view of moving forward—that is, toward a ASEAN-Japan automotive production base. This means that a progressive mindset, should, at the outset be created.

**On market access**

- a. *Rules of Origin*. Key role for industry to be involved in designing suitable Rules of Origin. In general, ROO should be characterized by simplicity, transparency but industry should be knowledgeable about what is practical.
- b. *Negative List*. How can the negative list be improved?

<b>Table 6. Number of Tariff Lines in the Negative List</b>										
Sector	Brunei Darusalam	Camodia	Indonesia	Lao PDR	Malaysia	Myanmar	Philippines	Thailand	Vietnam	Singapore
Automotive	128	94	516	21	485	345	443	173	235	0
Electronics	322	293	52	0	45	82	2	236	42	0
Textile & Apparel	0	127	11	8	3	1	129	24	206	0
Agro-based Products	0	19	16	0	8	3	10	20	0	0
Rubber-based Prods	80	67	58	0	68	76	21	83	11	0
Wood-based Prods	33	30	0	0	12	0	25	52	0	0
Fisheries	0	11	7	0	36	23	14	26	0	0
Health care	21	29	5	16	13	58	9	90	41	0

- c. *On TBTs and standards*— more affordable testing and certification facilities could often spell the difference; training and capability building. What kind of MRA agreement is feasible?

**On investment measures** – what are needed to facilitate investments? This is an area where the business sector should strongly recommend measures that would facilitate investment, in terms of both pre- and post-establishment measures. While many governments are still apprehensive about relaxing national treatment restrictions, this is largely due to uncertainty of what it means to industry players. An open support and concrete recommendations would facilitate needed reforms in this area.

**Other areas for negotiation**

- Thru trade facilitation, e. g. in Customs paperless trading
- Capacity building for MRA
- Creation of conformity assessment body for the automotive industry
- Capability building/ technical assistance for ISO standard testing and certification
- SME cooperation

- Providing and strengthening the networking infrastructure- ASEAN +3
- Implementing supportive HRD policies

Again, open support and concrete recommendations from industry would provide the need boost to move the reforms.

In sum, the regional cooperation (ASEAN + 3) framework would cover

- Reducing barriers to trade, investments, and movement of people
- Building the networking infrastructure for:
  - Fostering closer linkages with markets
  - For identifying impediments and strategic actions to deal with the related problems
  - For greater interaction between parent and local company
  - Reducing language barrier
  - For information sharing. particularly on management and technology
- Strengthening cooperation and links:
  - Between private and public management
  - Between academe, business and government.

Toward this end, there is a need for industry and academe to have close coordination with respective governments. The goal is to come up with concrete development initiatives in support of capability building in the various areas of cooperation.