

Liberalization and Protection under overlapping Free Trade Agreements: Dynamic Interplay between Free Trade Agreements and Investment

Antonio Postigo

London School of Economics and Political Science, London, United Kingdom

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 ASEAN (Association of South East Asian Nations), 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 foci 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). Existence of empirical evidence in support of both arguments (e.g., Estevadeordal et al., 2008 *versus* Limão, 2006) indicates that other factors, still unaccounted for, affect the balance between protectionist and pro-liberalization groups with respect to FTAs.

While a large 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, even from an uncompetitive partner, so as to prevent future FTA partners from making demands to liberalize the sector (*concession prevention*). Concession prevention can also occur when a foreign firm holding a dominant market position in the sensitive sector of the host 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 sectors, creating a stumbling block to future liberalization. On the other hand, the FDI sunk into previous FTA partners can constrain, or even pre-empt, the bargaining position of a country trying to protect its sensitive sector(s) in subsequent FTA negotiations with any of the FDI source countries (*concession pre-emption*). 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 further liberalization.

To test these arguments, we explore 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 industry is one of the most protected, 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.¹ Although in both countries the sector is protected behind high multilateral tariffs, a more liberal policy on automotive investment

¹ Historically, Thailand and Malaysia have been the largest producers of motor vehicles in ASEAN but, since 2010, Indonesia has surpassed Malaysia (OICA database).

in Thailand has attracted large FDI inflows, creating a competitive export-oriented industry heavily dominated by Japanese carmakers. Malaysia has instead pursued the development of state-led national automotive brands but, after three decades of protectionism, its national carmakers suffer from weak international competitiveness and remain overwhelmingly domestically-oriented, yet they face increasing competition at home from Japanese models. In light of this 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. 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 automotive industry to Japanese imports?

This study attempts to shed light on this analyzing whether and how the interaction between FDI and FTAs affected the trade preferences and positions of carmakers and governments. A detailed process-tracing analysis of FTA formulation in Thailand and Malaysia confirmed the initial hypotheses.² Thailand resisted automotive liberalization with Japan not only to protect existing investment and production, but also to prevent similar demands from other partners (e.g., United States, European Union, South Korea, etc.) in future FTAs (concession prevention). Likewise, for Japanese carmakers, even more important than improving their already dominant position in Thailand by lifting of tariffs on vehicles imported from Japan was preventing firms from other countries from extracting better concessions in their FTAs with Thailand (concession prevention). By contrast, the

² This paper draws on 212 in-depth semi-structured interviews with private sector representatives and government officials in Thailand and Malaysia during two independent trips in 2008 and 2009 complemented with numerous personal communications and secondary research since then. Informants received assurance that their name (or any identifying information) would not be shown linked to their comments in the article.

ASEAN FTA that Malaysia already had with Thailand and the FDI sunk in Thailand by Japanese carmakers opened Malaysia to tariff-free Japanese vehicles made in Thailand, thus pre-empting Malaysia's protectionist position during its negotiations on a bilateral FTA with Japan (concession pre-emption).

The rest of the article is organized as follows: the next section outlines the analytical framework; section three briefly reviews the automotive sector in Thailand and Malaysia in the context of the ASEAN FTA; 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. Liberalization and protection 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, 2005b; Estevadeordal et al., 2008; Ornelas, 2008; Calvo-Pardo et al., 2011). One of the factors considered in the argument is the impact that earlier liberalization has on the preferences of interest groups in regard to further liberalization. Those who see regionalism as an obstacle to global free trade stress the trade-diverting effects of FTAs and contend 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, 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 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 (Ornelas, 2005b).³

For firms, 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 unexploited economies of scale and/or 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) (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). This implies that an FTA cannot guarantee that the exclusive preferential market access it provides to firms inside the bloc vis-à-vis outside competitors will continue into the 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

³ Conversely, reductions in external tariffs following the creation of an FTA could also undermine incentives for countries outside the bloc to pursue multilateral liberalization (Ornelas, 2005a).

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)-like clause (Ethier, 2001).⁴

Here it is argued that preferences on FTA liberalization within 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 its government in subsequent FTA negotiations.

Attracting FDI is an explicit goal for developing countries' entering FTAs. A vast number of works have explored the multiple mechanisms through which FTAs influence investment flows (e.g., Medvedev, 2006; Te Velde and Bezemer 2006; Jang, 2011).⁵ 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 in East Asia to engage in tariff-jumping FDI, setting up plants 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 (Doner, 1991; Carrillo, 2004). Increasing liberalization since the 1990s prompted carmakers to begin the

⁴ FTAs are one of the few exceptions to World Trade Organization's MFN principle. Still, some FTAs also include equal treatment ("MFN-like") clauses to avoid concession erosion.

⁵ 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. Of the different types of FDI only *market-seeking* and *efficiency-seeking* FDI are of interest here. Efficiency-seeking FDI is pulled by location-specific advantages that enhance the competitiveness of firms processing inputs for exports. Market-seeking FDI is attracted to the larger market created by an FTA, which could also generate efficiency gains attracting vertical efficiency-seeking FDI. Market-seeking FDI is also drawn to sectors protected by trade 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). For producers inside an FTA area, FTA liberalization reduces the cost of serving the region through trade, potentially discouraging tariff-jumping FDI from other FTA partners. The latter scenario is more likely to occur in bilateral FTAs between developed countries (Jang, 2011).

rationalization of procurement and production. Since, under those circumstances, 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 national to regional level while discriminating against outside competitors through preferential tariffs, strict ROOs and trade-related investment measures (Milner, 1997; Chase 2004; Chase, 2008).⁶

Consider a firm F_A from developed country A with a production factory at home (plant F_{A-A}), but that has also invested and produces in a protected sector of developing country X (plant F_{A-X}) (tariff-jumping FDI) (Figure 1, left panel). To improve its economies of scale, firm F_A would lobby governments in A and X for an FTA between both countries 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-X} , and serve X directly from F_{A-A} (replacing FDI with trade), or to integrate F_{A-X} into the regional network through specialization within the value chain (complementing FDI with trade) (Figure 1, left panel).⁷ A competing firm F_B from country B, which also has tariff-jumping FDI in X (plant F_{B-X}), will oppose liberalizing imports of final goods from A in FTA A-X since F_{B-X} would be unable to compete with plants in country A operating on more efficient economies of scales (Figure 1, left panel). If F_{B-X} procures intermediate inputs from A it may still welcome FTA liberalization by X on intermediate goods (but not final goods) coming from A.

⁶ Trade-related investment measures (TRIMs) still permitted by the World Trade Organization impose costs on investors but provide rents for incumbents. As countries withdraw TRIMs in the context of economic liberalization, firms favor FTAs over multilateral negotiations because the former allow for a gradual elimination of these measures and, at the same time, discriminate against outsiders (Chase, 2004).

⁷ Increases in trade flows upon FTA liberalization are mainly related to increases in intra-industry trade through gains in economies of scale and product differentiation (Egger et al, 2008).

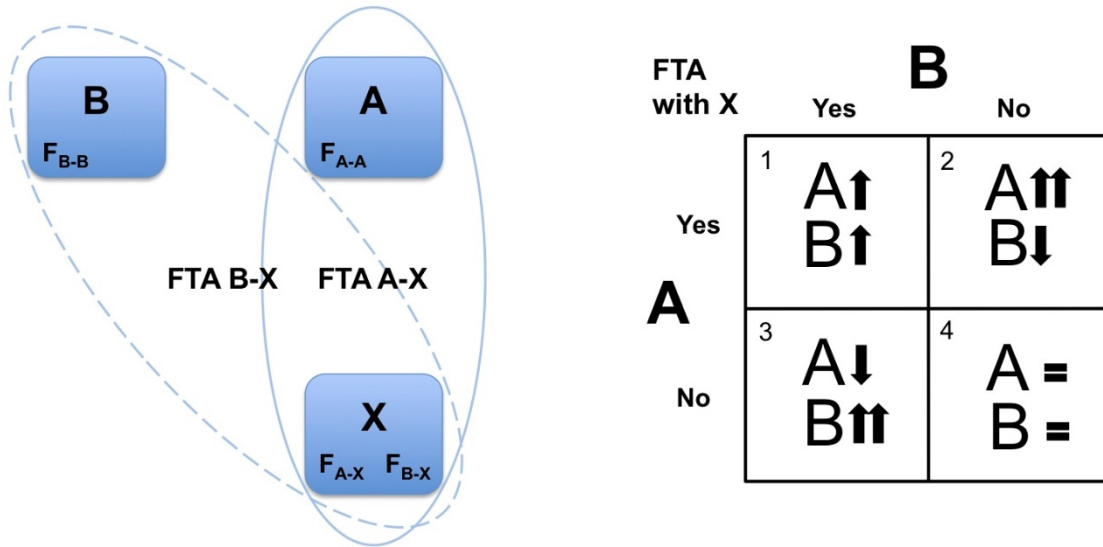


Figure 1: *Left panel:* Firm F_A with production at home (F_{A-A}) and in country X (F_{A-X}) will favor FTA A-X that eliminates trade barriers in X for products coming from A while discriminates against F_{B-X} . Trade diversion from FTA A-X will prompt country B to create its own FTA with X (FTA B-X). 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 over the initial situation (=) are 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 the 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).⁸

The net effect of FTA A-X on the stock of FDI in X and the preferences of government and local suppliers in X toward FTA liberalization would be contingent on multiple factors. Economic actors are more likely to react in avoiding potential losses from liberalization than in securing potential gains (Baldwin, 1995). If, as discussed earlier, F_A

⁸ 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.

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” made in the sector in the form of forgone taxes and other incentives to foreign producer F_{A-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 if F_A integrates F_{A-X} into its regional network and expands its production toward exports.

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 sector to a non-competitive partner as part of a package of cross-sectoral 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 boundaries regarding 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 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-like clause” in the FTA—that X will not give country B (or future

partners) 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 act as a stumbling block for further liberalization by prompting that the sector remains protected in future FTAs and in the multilateral regime (Figure 2).

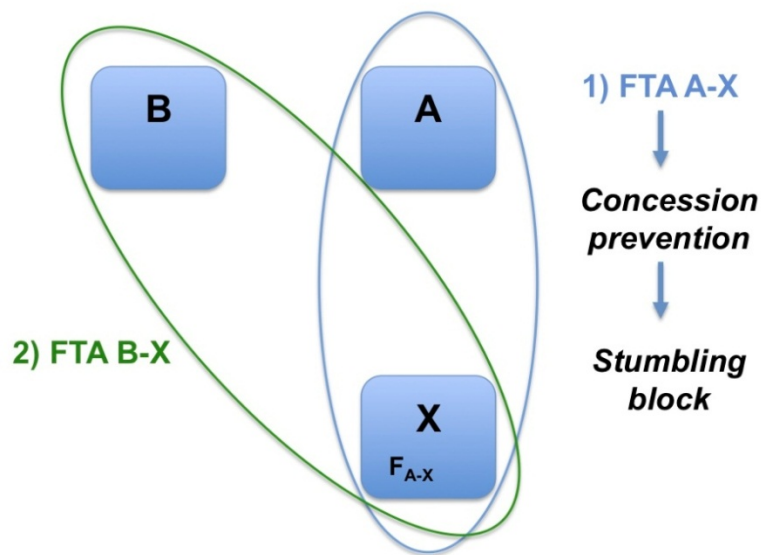


Figure 2: Country X can refuse liberalization of a sensitive sector to A in FTA A-X as to prevent equivalent demands from B in a subsequent FTA B-X (concession prevention). If firm F_{A-X} has a dominant market position in X, F_A could also potentially relinquish on its liberalization demands in FTA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

Hypothesis 1a: *Concessions on a sensitive sector granted by a country in an FTA potentially signal boundaries in 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 a MFN-like 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 may have liberalized it 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, 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-X} from country A). As long as products comply with ROOs, F_A could use its production base in X (F_{A-X}) plus FTA X-Y to tariff-jump into Y (Figure 3).

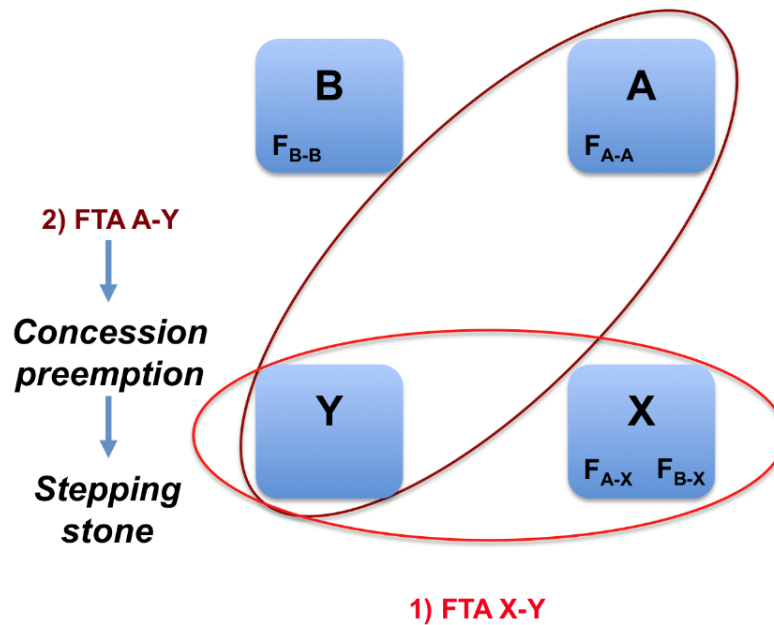


Figure 3: Country Y has opened up a sensitive sector to uncompetitive country X as part of FTA X-Y. If firm F_A from country A invests into X (F_{A-X}) in Y's sensitive sector, F_{A-X} could use FTA X-Y to export freely to Y. FTA X-Y and the FDI sunk by F_A into X (F_{A-X}) could pre-empt the protectionist position of Y during bilateral FTA negotiations with A (concession pre-emption). The FDI sunk in partners from previous FTAs will act as a stepping stone toward further liberalization. See text for details.

Country Y could continue to shield its sensitive sector from imports originating in 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, since F_A 's products are already entering duty-free into Y by way of FTA X-Y, the protectionist stand of Y during FTA negotiations with A could be paradoxically constrained and pre-empted by the FTAs that Y has itself signed in the past (FTA X-Y) and the FDI sunk into Y's FTA partners (F_{A-X} in X) (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 trade liberalization (Figure 3).

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 pre-empt its protectionist position when it later negotiates FTAs with the FDI source countries (concession pre-emption).*

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; Yoshimatsu, 1999; Abbot, 2004). 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 at the time, 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.⁹ The government sought to transform Thailand into the regional automotive hub through a combination of import substitution and export-oriented manufacturing. To that effect, in the aftermath of the crisis, multilateral applied tariffs on vehicles were raised while foreign equity restrictions on investment were loosened. In any case, Thailand complied with its commitments to abolish LCRs multilaterally and to progressively eliminate tariffs on ASEAN automotive products.

Although vehicle production recovered by 2002 the Asian crisis represented a turning point in the Thai automotive industry. Most Thai firms involved in vehicle assembly went bankrupt and sold their stakes to international carmakers while many Thai-owned automotive part producers disappeared or were bought up by foreign firms, mostly Japanese. Importantly, the crisis accelerated 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. Since 2007 around half of Thai automotive production is exported,

⁹ Between 1996 and 1998, production and domestic sales of motor vehicles in Thailand dropped by 71.7% and 75.6%, respectively. 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 Auto Parts Manufacturers Association, Thai Ministry of Industry, individual carmakers and automotive part producers firms and the Trade Map and OICA databases.

compared to just 2.5% before the crisis. This strong export-orientation attests to the international competitiveness of Thai-based assemblers and automotive parts producers.

Automotive production, domestic sales and exports in Thailand are heavily dominated by Japanese firms that have transferred to Thailand manufacturing of all light commercial vehicles (pickup trucks) and an array of small- and mid-range passenger cars. For larger-engine luxury models, Japanese firms conduct all the assembly in Japan and export directly to Thailand. Of all vehicles manufactured in Thailand during 2004—the start of Thailand-Japan FTA negotiations—over 80% were of Japanese brands. Most of the remaining production is of American firms, 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-2500 cc passenger cars.¹⁰ Vehicle exports are also dominated by Japanese carmakers, which accounted for over 85% of all units exported in 2003-2012, mainly to Australia, ASEAN and the Middle East.

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

Carmaker Nationality	1999 2000	2003 2004	2005 2006	2007 2008	2009 2010	2011 2012
Japan	88.8%	89.0%	91.3%	92.3%	91.8%	88.6%
United States	7.2%	9.1%	7.1%	5.8%	4.1%	8.4%
European Union	3.1%	1.5%	1.2%	1.2%	1.2%	1.2%
Other	0.9%	0.4%	0.4%	0.7%	2.9%	1.8%

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

* Commercial and passenger vehicles

¹⁰ European carmakers hold over 60% of the market in the over 2500 cc luxury passenger car segment, which represents less than 0.5% of the overall market. Unlike Japanese carmakers, European firms assemble their high-end models in Thailand using kits imported from Europe.

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, it 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 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 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.¹¹ From the start the government has supported and protected PROTON from local and foreign competition with a panoply of trade and regulatory measures (Abbott, 2004; Rosli and Kari, 2008). In only ten years, PROTON's share in the Malaysian market increased to 74%, encouraging the government to set up another firm, PERODUA, in 1993 to manufacture subcompact cars.¹² By 1996, PROTON and PERODUA commanded a joint domestic market share of 85%. During much of the 1990s, PROTON and PERODUA were the first and third largest carmakers in ASEAN by production volume; yet, both remained primarily domestically-oriented.

¹¹ Although PROTON initially relied on technology from Japanese Mitsubishi—then a minority shareholder in the firm—its management has always been Malaysian bumiputera.

¹² Since establishment, Japanese Daihatsu holds a minority stake in PERODUA. Although PERODUA is also considered a national carmaker its production strategy is controlled by Daihatsu.

The sharp decline in automotive production and domestic sales that occurred as a result of the Asian crisis reignited protectionism.¹³ The government requested and obtained from the WTO a four-year extension over the 2000 deadline in the use of LCRs, exclusively for its automotive industry. More controversially, Malaysia unilaterally increased applied tariffs on passenger cars and excluded its automotive sector from AFTA liberalization schedules. It was only in 2005—and later consolidated with the *National Automotive Policy*, first issued in 2006—that the government accepted to significantly reduce tariffs on ASEAN-originated vehicles and automotive parts. However, these tariff reductions were accompanied by the introduction of a system of excise duties on assembled vehicles that exempts Malaysian-value content, directly benefitting national carmakers with lower import content, especially PROTON. The National Automotive Policy stressed the need to promote PROTON and bumiputera participation in the sector. Malaysia has a liberal investment regime in most manufacturing sectors but this 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.¹⁴

Vehicle production and domestic sales regained pre-crisis levels in 2001, but growth since then has been slow compared to Thailand.¹⁵ Although together both national carmakers still account for over half of total production and domestic sales, since the crisis PROTON has been losing ground not only to PERODUA but also to competitively-priced Japanese models, both locally-assembled and imported (Table 2). As Malaysia reduced AFTA tariffs

¹³ Between 1997 and 1998, production and domestic sales of motor vehicles in Malaysia dropped by 63.2% and 59.7%, respectively.

¹⁴ The 2009 revision of the National Automotive Policy eliminated foreign equity restrictions for the assembly of passenger cars with engines over 1800cc, electric and hybrid cars and commercial vehicles, all outside the core segment of PROTON and PERODUA. Release of a new revision of the National Automotive Policy is expected for early 2014.

¹⁵ Data for the rest of this section were obtained from the Malaysian Automotive Association, PROTON Vendors Association, PERODUA Vendors Club, Malaysian Automotive Component Parts Manufacturers, Ministry of International Trade and Industry, Malaysian Investment Development Authority, and individual carmakers and suppliers.

on vehicles to 20% in 2005, imports of Japanese models assembled in ASEAN—mainly in Thailand and Indonesia—raised, doubling between 2005 and 2009. European and American models represent 3-6% of the local market, in the case of the latter mostly as imports from Thailand. Malaysian 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. 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.¹⁶

Table 2: Vehicle sales in Malaysia by the home country of the carmaker *

Carmaker Nationality		1999 2000	2003 2004	2005 2006	2007 2008	2009 2010	2011 2012
Malaysia (National)	PROTON	52.1%	36.7%	26.9%	25.0%	26.8%	27.6%
	PERODUA	28.3%	27.8%	28.5%	31.8%	31.1%	33.9%
Malaysia (Private) **	Naza Kia	N/A	1.4%	4.8%	3.2%	1.8%	1.5%
Japan		10.7%	21.2%	24.2%	31.2%	31.8%	27.3%
United States ***		1.2%	1.7%	1.4%	0.6%	0.5%	1.1%
European Union		N/A	1.7%	1.8%	1.9%	2.4%	5.2%
Other		N/A	9.5%	12.4%	6.3%	5.6%	3.4%

Source: Malaysian Automotive Association

* Commercial and passenger vehicles. Note that figures for 1999-2000 do not add to 100% because data for some carmakers were not available. Japanese, American and European carmakers operate in minority joint ventures with Malaysian firms

** Naza is a bumiputera conglomerate that locally assembles and rebadges Korean Kia cars. Since 2010, it also assembles Peugeot cars and distributes other European and American models

*** General Motors and Chrysler have no plants in Malaysia and Ford stopped local production in mid-2008

Following Mitsubishi’s sale of its stake in PROTON in 2004, the national carmaker has seen its market share position progressively deteriorate while repeated financial losses started threatening its viability. The Malaysian government looked for another global partner

¹⁶ Still, many international parts and components producers have manufacturing plants in Malaysia. Small economies of scales limit the competitiveness of Malaysian-owned suppliers and their high—and for some firms, complete—dependence on PROTON and/or PERODUA compromises their future if national brands’ market share continues to shrink.

that could help PROTON with technological upgrading and marketing but negotiations with several international carmakers failed due to the government's refusal to give up managerial control to a foreign firm.¹⁷

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 of 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 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.¹⁸

AFTA schedules established that intra-ASEAN tariffs were to be capped at 20% by 2000 and although items could be temporarily excluded, all tariffs had to be reduced to 0-5% by 2003 and totally eliminated by 2010.¹⁹ Thailand complied with the established AFTA liberalization timeline. However, as noted earlier, following the Asian crisis Malaysia transferred its automotive sector to the exclusion list and increased tariffs on vehicles to up to 300%. Import duties on automotive products from the rest of ASEAN were brought down to 20% in 2005 (five years behind AFTA schedule) and to 0-5% in 2006 before being scrapped in 2010.

¹⁷ In January 2012, government-linked investment company, Khazanah, sold its shares in PROTON to Malaysian private holding DRB-HICOM.

¹⁸ Eventually, Malaysia also approved projects in the ASEAN Industrial Cooperation scheme and firms established in the country participated in half of the 116 automotive-related projects. 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 Malaysian Ministry of International Trade and Industry; interviews).

¹⁹ Full liberalization is delayed to 2015 for Cambodia, Myanmar, Laos and Vietnam.

According to some studies, small margins between multilateral and AFTA tariffs in many sectors could have limited businesses' incentives 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. 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, for Malaysia, further liberalization of its automotive sector beyond AFTA, particularly to highly competitive automotive producing nations like Japan, were potentially ominous for PROTON and its suppliers.

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 December 2013, Thailand is party to AFTA, five bilateral agreements, and five regional FTAs as a member of ASEAN. The Thailand-Australia FTA (TAFTA) fully liberalized the Thai automotive sector for the first (and so far only) time outside AFTA. Even before TAFTA was implemented in January 2005, Australia represented the main market for Thai-made vehicles, which accounted for

25% of total exports to Australia.²⁰ Field research for this project found that pressure by Japanese and American carmakers on both governments was instrumental in TAFTA negotiations. Australia was not a direct competitor and, in fact, automotive production structures in both countries were complementary.²¹ Consequently, Thailand agreed to open its industry fully and relatively rapidly; Thailand eliminated from the start all tariffs on commercial vehicles and large passenger cars and phased out by 2010 those on smaller cars and automotive parts (Table 3). On its part, Australia granted tariff-free access for vehicles at entry and by 2010 for automotive parts.

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 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 (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.²²

When negotiations began in early 2004, Thailand had agreed only four months earlier to fully open its automotive sector to Australia, and was about to start bilateral negotiations

²⁰ Negotiations for TAFTA took place between June 2002 and October 2003.

²¹ 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.

²² Negotiations on JTEPA took place between February 2004 and August 2005. The agreement entered into force in November 2007.

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 industry, expected to extract in JTEPA the same preferential treatment Thailand had offered to Australia, full liberalization of the sector.²³ 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 industry. To cancel out the tariff advantage enjoyed by European carmakers established in Thailand and that dominate the luxury segment, Japan requested the scrapping of Thai tariffs on vehicles of over 3000 cc. 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 3000 cc.²⁴ 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.

²³ Even the Thai Prime Minister made public 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.

²⁴ Liberalization to imports of small- and mid-size vehicles made in Japan would give Japanese carmakers flexibility in planning for future platforms and technologies.

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, since Japan already offered tariff-free multilateral access to all automotive products. Interviews found that Western carmakers strongly opposed any tariff reduction on vehicles from Japan despite that, considering Japanese dominance of the sector in Thailand, liberalization was unlikely to cause drastic changes in market share distribution.²⁵ Japanese and Western assemblers both threatened Thailand with pulling out investment plans and 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. Our research also 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 and future FTA negotiations (Hypothesis 1a).

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

²⁵ Interviews revealed that American carmakers were willing to accept some compromise on less price-sensitive larger engine models but this was opposed by European firms that dominate the segment in Thailand because these models are produced at more efficient scales in Japan. Associations of automotive part producers in Thailand opposed liberalization of both vehicles and parts.

a cooperation chapter whereby, among other programs, Japan provides skill-training for Thai automotive workers.²⁶

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

	Thai concessions
Passenger cars < 3000 cc	unchanged
Passenger cars > 3000 cc	60% by 2011 (maintained at 60%)
Commercial Vehicles < 5 tons > 5 tons	0 % by 2018 20% by 2018
Automotive parts	* Most items: unchanged or capped to 20% at entry and 0% by 2013 * Sensitive items (engines and their parts): unchanged at entry and 0 % by 2015
Hot-rolled steel	0% within quota 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, especially since they also succeeded in preventing competing carmakers from other countries from gaining any better access to Thailand in future Thai FTAs (Hypothesis 1b). In what effectively amounts to an “MFN clause”, Japan got in JTEPA the compromise by Thailand not to extend better tariff treatment to any “other major automotive manufacturing country in its future FTAs than that extended to Japan” (MOFA, 2007).²⁷

²⁶ The program, known as the *Automotive Human Resource Development Program*, extended an already existing scheme for Japanese technical assistance to the Thai automotive sector. The importance of JTEPA for Japanese carmakers is illustrated by its utilization for the few automotive items it covered. Between its implementation in November 2007 and October 2009, 41.3% of all Thai imports of large engine cars used JTEPA preferences despite tariffs had not reached yet the 60% lower limit (data from the Thai Ministry of Finance, interviews).

²⁷ Japanese carmakers wanted to shield their position in Thailand from American, Korean and European firms whose home countries were then negotiating FTAs with Thailand/ASEAN. Japanese firms were particularly concerned that competitively-priced Korean vehicles could enter Thailand tariff-free through the ASEAN-Korea FTA. Korean Hyundai started a small assembly operation in Thailand in 2007.

As derived from Hypothesis 1c, concession prevention for vehicles in JTEPA was followed by parallel exclusion of the automotive sector in subsequent FTAs participated by Thailand, namely ASEAN-Japan, ASEAN-Korea and ASEAN-India.²⁸

5. The automotive sector in the Malaysia-Japan FTA

Just a decade ago, Malaysia was not only reluctant to enter into bilateral FTAs, 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, it took Malaysia only a year to reverse that position and declare its interest in an FTA with Japan. As of December 2013, Malaysia has implemented six bilateral FTAs plus five ASEAN-centered FTAs.

Japan’s main interest in the Malaysia-Japan Economic Partnership Agreement (MJEPA) lay in eliminating tariffs on automobiles and steel.²⁹ 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 excluded from AFTA liberalization schedules and enforced the use of LCRs (MOFA, 2003). Meantime, the Japanese government linked MJEPA with AFTA, emphasizing the need for Malaysia to fulfill AFTA commitments in the automotive sector. Such linkage confirms our initial arguments and reflects Japan’s interest, and that of its firms, in exploiting the possibilities offered by overlapping FTAs for its regional strategy.

By late 2004 an initial agreement had been reached with the only exception of automotive and steel products. Interviews with government officials and national and foreign

²⁸ Negotiations on the Thailand-United States and ASEAN-European Union FTAs were eventually abandoned, although the latter is currently under negotiation as a bilateral Thailand-European Union FTA. From Hypothesis 1c and the MFN clause included in JTEPA, it would be expected that the automotive sector would be excluded in the Thailand-European Union FTA.

²⁹ Just before the start of negotiations, automotive and steel products jointly represented over 18% of Japanese exports to Malaysia, with only 0.2% going in the opposite direction. Bilateral negotiations on MJEPA took place between January 2004 and May 2005. The agreement was signed in December 2005 and entered into force in July 2006.

carmakers in Malaysia indicated that, at the time, it was widely expected Malaysia would eventually exclude the entire automotive sector. Japanese carmakers lobbied Malaysia for the elimination of tariffs on vehicles, automotive parts and steel and, as in Thailand, threatened to pull out investments if their requests for liberalization were not attended. On the contrary, PROTON and PERODUA, still seeking further delays in the implementation of tariff reductions under AFTA, resisted any liberalization of passenger cars.³⁰ 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 maintained a strong protectionist position.

To sweeten its demands, and as part of the MJEPA cooperation chapter, Japan offered Malaysia technical assistance in the automotive sector through the Malaysian-Japan Automotive Industries Cooperation (MAJAICO) program.³¹ Even so, Malaysia remained reluctant to liberalize the sector, which persisted as the only issue for the conclusion of negotiations.

In January 2005, Malaysia eventually had to start moving its automotive sector back into AFTA's liberalization schedules. Japanese carmakers in Malaysia—with simpler operations than in Thailand—were thus able to import Thailand-made Japanese models at reduced tariffs through AFTA. AFTA 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 open its automotive industry to Japan and within a relatively short time (Table 5).³² 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

³⁰ 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 all non-national carmakers, Japanese and Western—supported liberalization with Japan as a first step toward opening the sector.

³¹ Through MAJAICO, Japan assisted selected automotive firms in Malaysia in skill development and business matching.

³² According to interviews, Malaysia's decision to fully liberalize its automotive sector in MJEPA was taken very close to the agreed deadline for the conclusion of negotiations.

passenger cars with engines larger than 2000 cc. Tariffs on cars below 2000 cc, at the heart of the PROTON's and PERODUA's market, will be eliminated by 2015. Equally relevant 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. 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 access Malaysia through AFTA, MJEPA gave them additional flexibility in planning their production strategies.³³ Of note, Malaysia did not grant Japan any other significant concession outside the automotive sector.

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 0% by 2010
Unassembled Vehicle Kits (complete knocked-down, CKD)	0% at entry
Automotive parts	0-5% in 2008 0% by 2010
Hot-rolled steel	Import duty exemptions 0% by 2015

Source: MJEPA treaty (METI-MJEPA, undated)

With Thailand as the regional hub not only for Japanese but also American and European firms, Malaysia may find itself in a similar concession pre-emption quandary as it negotiates FTAs with the United States and the European Union.³⁴ The FDI sunk into

³³ 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 economic slowdown during several quarters in this period and the fact that liberalization of larger vehicles was only fully realized in July 2010.

³⁴ Talks on a bilateral Malaysia-United States FTA were abandoned in July 2008 but Malaysia has joined negotiations for a regional FTA that includes the United States (the Trans Pacific Partnership) and is in the midst of talks with the European Union for a bilateral FTA.

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, and as additional evidence for the argument posited here, Malaysia was able to exclude the automotive sector in subsequent bilateral and/or ASEAN-centered FTAs with Pakistan, India and Korea because automotive firms from these countries had limited (if any) investment in Malaysia's previous FTA partners.³⁵

5. Discussion

The case studies analyzed showed that the preferences and policy strategies of a country's government and firms regarding FTA liberalization are determined not only by the agreements subscribed to by competitor nations (Baldwin, 1995), but also by its own FTAs and the FDI sunk in them. The Thai and Malaysian cases also illustrate the contingent nature of the stumbling block versus stepping stone dilemma. The interplay of FTAs among one another and with the investments in them may lead either to the liberalization of previously protected sectors or, instead, to entrenchment of pockets of protectionism across FTA areas.

Field research 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 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 with any other except with its own home country and/or where the firm has investment and production stages. The eventual result is either no FTA or exclusion of the sector(s) in every FTA negotiated by the host with FDI

³⁵ 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.

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).³⁶

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. In refusing to liberalize its automotive sector in JTEPA, the Thai government wanted to protect existing investment, but also to prevent similar demands by countries 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. Japanese carmakers strongly lobbied the Thai government for the liberalization of the Thai automotive sector without much concern about creating a precedent since the precedent already existed in TAFTA. But, 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. By including an "MFN-like clause" in JTEPA, exclusive for the automotive sector,

³⁶ Following footnote 8, and 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.

Japanese carmakers prevented the concessions it extracted from Thailand, small as they were, could be exceeded by concessions Thailand might make later to other FTA partners.

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 investing firms in the host country, the shadow of future FTAs becomes a stumbling block to further liberalization. In that regard, inclusion of the automotive MFN clause in JTEPA will limit 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. Both the more liberal government of current Prime Minister Najib but also of his predecessor Prime Minister Abdullah (2003-2009), which negotiated MJEPa, had begun to realize the high costs, but also the impossibility, of maintaining indefinitely existing pockets of protectionism in services and some manufacturing industries, particularly the automotive sector. However, automotive concessions in MJEPa cannot be explained as the result of cross-sectoral bargaining or 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 final negotiations on the automotive industry occurred once talks on all other sectors had been closed and that the Malaysian government resisted its liberalization until the very end of talks. In addition, as discussed earlier, 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.³⁷

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 Malaysian case shows that FDI sunk into a given sector in partners of previous Malaysian FTAs (e.g., AFTA), shaped its liberalization strategy 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 stepping up their FDI in Thailand, and more recently in Indonesia, they gained a potential beachhead for their vehicles to enter other ASEAN countries freely once AFTA was fully implemented. Malaysia reinforced the protection of its automotive industry in the wake of the Asian crisis. However, seven years later and just five months before an agreement on MJEPA was reached, the Malaysian government could no longer ignore pressures from other ASEAN countries and significantly reduced tariffs on ASEAN automotive products and started bringing the sector back into AFTA schedules. Only four months before MJEPA finally came into effect Malaysian tariffs on vehicles from other ASEAN countries were capped at 5%. It could be therefore argued that Malaysia's automotive liberalization amounted to no more than a *fait accompli*. With

³⁷ Although some 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 losses resulting from liberalization. MAJAICO, that was already provided at a smaller scale before MJEPA, lasted only five years and a similar arrangement was also granted to Thailand despite marginal Thai concessions to Japan in the automotive sector.

Japanese carmakers exporting automobiles from Thailand to Malaysia at reduced tariffs since 2005, Malaysia saw her protectionist stand in MJEPA pre-empted. Consequently, Malaysia eventually accepted to extend to Japan the same level of liberalization (and at about the same time) as to other ASEAN countries.

With all tariffs among the main ASEAN economies now eliminated, Malaysia may 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.³⁸ 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 now feel the need to lobby the Malaysian government for tariff reductions on automotive parts and components imported from beyond ASEAN so both national carmakers can compete with more efficient carmakers in Thailand.³⁹

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 (e.g., Korean and Indian firms or Japanese luxury carmakers) could potentially take advantage of AFTA and TAFTA by establishing production in other ASEAN countries or in Australia and export from there to Thailand. However, firm- and locational-specific advantages may favor investment into Thailand itself. High multilateral tariffs on vehicles in Thailand have helped maintain and increase FDI into the Thai automotive sector (tariff-jumping market seeking FDI), but investment has also (and primarily) been attracted by the indirect rents derived from the

³⁸ 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.

³⁹ Carmakers based in Thailand have used of TAFTA and the Thailand-India partial liberalization agreement to import automotive parts. Malaysia has already established FTAs with India and Australia.

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 has also contributed to attracting FDI. All these reasons would help persuade 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.

6. References

- Abbott, J.P. (2004), *Developmentalism and dependency in Southeast Asia: the case of the automotive industry*. (London, England: Routledge Curzon).
- Baldwin, R.E. (1995), A domino theory of regionalism. In: R. Baldwin, P. Haaparanta, and J. Kiander (eds.) *Expanding membership of the European Union*. (Cambridge, England: Cambridge University Press).
- Baldwin, R.E. (2005), Stepping stones or building blocs? Regional and multilateral integration. In: J. McKay, M.O. Armengol, and G. Pineau (eds.) *Regional economic integration in a global framework*. (Frankfurt, Germany: European Central Bank).
- Büthe, T., and H.V. Milner (2008), 'The Politics of Foreign Direct investment into Developing Countries: Increasing FDI through International Trade Agreements?' *American Journal of Political Science*, **52**, 4, 741-762.
- Calvo-Pardo, H., C. Freund, and E. Ornelas (2011) The ASEAN Free Trade Agreement: Impact on Trade Flows and External Trade Barriers. In: R.J. Barro, and J-W. Lee (eds.) *Costs and Benefits of Economic Integration in Asia*. (Oxford, England: Oxford University Press).
- Carrillo, J., Y. Lung, and R. van Tulder (eds.) (2004), *Cars, carriers of regionalism?* (New York, NY: Palgrave MacMillan).
- Chase, K.A. (2003), 'Economic Interests and Regional Trading Arrangements: The Case of NAFTA', *International Organization*, **57**, 1, 137-174.
- Chase, K.A (2004), From Protectionism to Regionalism: Multinational Firms and Trade Related Investment Measures. *Business and Politics*, **6**, 2, 1-38.

- Chase, K.A. (2005), *Trading blocs: States, firms, and regions in the world economy*. (Ann Arbor, MI: University of Michigan Press).
- Chase, K.A. (2008), 'Protecting Free Trade: The Political Economy of Rules of Origin', *International Organization*, **62**, 3, 507-530.
- Department of Foreign Affairs and Trade (DFAT) [of Australia] (undated), *Thailand-Australia Free Trade Agreement. Annex 2: Tariff commitments and quotas*. Downloaded on October 12, 2006 at: http://www.dfat.gov.au/fta/tafta/tafta_annexes_sideletters_index.html
- Desker, B. (2004), 'In defence of FTAs: from purity to pragmatism in East Asia', *The Pacific Review*, 17(1):3-26.
- Doner, R.F. (1991), *Driving a bargain: automobile industrialization and Japanese Firms in Southeast Asia*. (Berkeley, CA: University of California Press).
- Doner, R.F. (2009), *The politics of uneven development: Thailand's economic growth in comparative perspective*. (Cambridge, England: Cambridge University Press).
- Egger, H., P. Egger, and D. Greenaway (2008), 'The trade structure effects of endogenous regional trade agreements', *Journal of International Economics*, **74**, 2, 278-298.
- Estevadeordal, A., C. Freund, and E. Ornelas (2008), 'Does regionalism affect trade liberalization toward non-members?' *Quarterly Journal of Economics*, **123**, 4, 1531-1575.
- Ethier, W.J. (1998), 'The new regionalism' *The Economic Journal*, **108**, 449, 1149-1161.
- Ethier, W.J. (2001), 'Theoretical problems in negotiating trade liberalization', *European Journal of Political Economy*, **17**, 2, 209-232.
- Freund, C., and E. Ornelas (2010), 'Regional trade agreements', *Annual Review of Economics*, **2**, 1, 139-166.
- Hallaert, J.-J. (2008), 'Proliferation of preferential trade agreements: Quantifying its welfare impact and preference erosion', *Journal of World Trade*, **42**, 5, 813-836.
- Hoadley, S. (2008), Thailand's and Malaysia's Cross-Regional FTA Initiatives. In: S.N. Katada, and M. Solis (eds.) *Cross Regional Trade Agreements. Understanding Permeated Regionalism in East Asia*. Berlin, Germany: Springer.
- Jang, Y.J. (2011), 'The impact of bilateral Free Trade Agreements on bilateral foreign direct investment among developed countries', *The World Economy*, **34**, 9, 1628-1651.
- Levy, P.I. (1997), 'A political-economic analysis of free-trade agreements', *The American Economic Review*, **87**, 4, 506-519.
- Limão, N. (2006), 'Preferential Trade Agreements as stumbling blocks for multilateral trade liberalization: evidence for the United States', *American Economic Review*, **96**, 3, 806-914.
- Manchin, M., and A.O. Pelkmans-Balaoing (2008), 'Clothes without an Emperor: Analysis of the Preferential Tariffs in ASEAN', *Journal of Asian Economics*, **19**, 3, 213-223.
- Manger, M.S. (2005), 'Competition and bilateralism in trade policy: the case of Japan's free trade agreements', *Review of International Political Economy*, **12**, 5, 804-828.
- Medvedev, D. (2006), Beyond trade: the impact of preferential trade agreements on foreign direct investment inflows. *World Bank Policy Research Working Papers Series*. Number 4065. (Washington D.C.: The World Bank).

Milner, H. (1997), Industries, governments and the creation of regional trading blocs. In E.D. Mansfield, and H. Milner (eds.) *The Political Economy of Regionalism*. (New York, NY: Columbia University Press).

Ministry of Economy, Trade and Industry [of Japan] (METI-JTEPA) (undated), *Agreement between Japan and the Kingdom of Thailand for an Economic Partnership*. Documents downloaded on October 3, 2006 from: http://www.meti.go.jp/english/policy/external_economy/trade/FTA_EPA/thailand.html

Ministry of Economy, Trade and Industry [of Japan] (METI-MJEPA) (undated), *Agreement between Japan and the government of Malaysia for an Economic Partnership*. Documents downloaded on October 3, 2006 from: http://www.meti.go.jp/english/policy/external_economy/trade/FTA_EPA/malaysia.html

Ministry of Foreign Affairs (MOFA) [of Japan] (2003), *Japan-Malaysia Economic Partnership. Joint Study Group Report*. Accessed in August 21, 2007 at: www.mofa.go.jp/region/asia-paci/malaysia/joint0312.pdf

Ministry of Foreign Affairs (MOFA) [of Japan] (2007), *Joint statement at the signing of the agreement between Japan and the Kingdom of Thailand for an Economic Partnership*. Accessed in May 24, 2007 at: <http://www.mofa.go.jp/region/asia-paci/thailand/epa0704/joint.html>

Ornelas, E. (2005a), 'Endogenous free trade agreements and the multilateral trading system', *Journal of International Economics*, **67**, 2, 471-497.

Ornelas, E. (2005b), 'Rent destruction and the political viability of free trade agreements', *The Quarterly Journal of Economics*, **120**, 4, 1475-1506.

Ornelas, E. (2008), 'Feasible multilateralism and the effects of regionalism', *Journal of International Economics*, **74**, 1, 202-224.

Panagariya, A. (2000), 'Preferential Trade Liberalization: The Traditional Theory and New Developments', *Journal of Economic Literature*, **38**, 2, 287-331.

Ravenhill, J. (2008), 'Fighting irrelevance: an economic community "with ASEAN characteristics"' *The Pacific Review*, **21**, 4, 469-488.

Rosli, M., and F. Kari (2008), 'Malaysia's National Automotive Policy and the Performance of Proton's Foreign and Local Vendors', *Asia Pacific Business Review*, **14**, 1, 103-118.

Sally, R. (2007), 'Thai trade policy: from non-discriminatory liberalization to FTAs', *The World Economy*, **30**, 10, 1594-1620.

Sally, R., and R. Sen (2011), 'Trade policies in Southeast Asia in the wider Asian perspective', *The World Economy*, **34**, 4, 568-601.

Te Velde, D.W., and D. Bezemer (2006), 'Regional integration and foreign direct investment in developing countries', *Transnational Corporations*, **15**, 2, 41-70.

Yoshimatsu, H. (1999), 'The state, MNCs and the car industry in ASEAN', *Journal of Contemporary Asia*, **29**, 4, 495-515.

Yoshimatsu, H. (2002), 'Preferences, interests and regional integration: the development of the ASEAN industrial cooperation arrangement', *Review of International Political Economy*, **9**, 1, 123-149.

Internet Databases

Organisation Internationale des Constructeurs d'Automobiles (OICA) (undated), 2012 Production Statistics. Accessed multiple times at: <http://oica.net/category/production-statistics/>

Trade Map (undated), *Trade statistics for international business development*. Geneva, Switzerland: International Trade Centre (United Nations Conference on Trade and Development-World Trade Organization). Accessed at several dates from: <http://www.trademap.org/>
