3RD KUALA LUMPUR INTERNATIONAL AUTOMOTIVE CONFERENCE 2010

SESSION 5:
Gearing Up for AFTA:
Potential Economic Impact on the Regional & National Automotive Industry
- A View from the Sidelines -

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Developments in the global automotive industry over the past decade have occurred at a frenetic and unrelenting pace. The industry has undergone far and wide-reaching globalization and rationalization and undertaken numerous corporate takeovers and strategic tie-ups. Shakeouts in the global auto parts and components industry have occurred, with many large players buckling under the heat of competition. The past two years have also seen the global market go through a wrenching cyclical boom-bust, one that in the United States (US) has required the government to bailout two of its major companies and subsidise household auto purchases. In the first nine months of 2010, auto sales picked up 16 per cent (year-on-year) and are expected to reach 74 million units for the whole year, although the distribution of growth will be uneven.[1]

Regardless, the writing on the wall is clear: A global shift is in progress and a 'new normal' is being established. Advanced countries cannot be written off by any means because of their superior know-how but the future of mass auto production lies clearly in the large developing economies of Asia and Latin America. Of the top 12 manufacturers today who account for more than three-quarters of world auto production, 11 are from Japan, the US and the European Union (EU). Only one is from South Korea. (Hyundai and Kia, however, are reported to be outselling traditional Japanese marques in the European and North American markets.) Collectively, China is already the world's largest auto manufacturer and, at 17 million units in 2010, the fastest growing market as well. Forecasts are that by early as 2014, over 30 per cent of world auto sales will be generated by Brazil, Russia, India and China (BRIC).[2]

Whether new or established, however, manufacturers show no signs that they are content to merely engage in mass commoditisation of the product. At the same time as they are designing products for local consumer markets, they are also eyeing export markets. India, for example, has become a specialist small car hub with more than a dozen foreign, domestic and joint-venture manufacturers involved in producing low-cost vehicles of 1200 c.c. or less. It intends to start exports to the EU and US of the same in 2011-12. China's auto manufacturers have been more aggressive, buying over whole companies for technology and innovation and specific intellectual property rights for powertrain, engine and gearbox technologies to produce four-

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[1] Draft only. Not be cited or quoted without permission. The author is not an auto industry analyst and accepts that there may be misstatements or misperceptions, hence the added subtitle "A View from the Sidelines'. Please send any clarifications or feedback to steve@isis.org.my. The research assistance of Terence Too and Izzatina Abdul Aziz of ISIS Malaysia is preparing this paper is highly appreciated. The views and opinions expressed in this paper, however, are entirely the author's own.

door sedans for its domestic market.[3] At the same time, an auto major like Volkswagen has announced that it will be investing a massive US$70 billion over the next five years.

Automotive technology has also been rapidly changing and game-changing. This is an area where the established auto majors still have considerable competitive advantage, having invested in everything from high-performance to eco-friendly vehicles such as hybrids, plug-in hybrids and electric vehicles on a large and sustained basis. Despite steep cuts in 2009, research & development (R&D) expenditure is still seen to have exceeded US$70 billion a year, which is an enormous commitment given the considerable softness and uncertainties in many markets. Germany, for example, continues to dominate high-end manufacturing and given the high advanced and integrated nature of its R&D, design, production and assembly and logistics infrastructure, it is unimaginable that it would give up its lead anytime soon.[4] All things considered, the price of remaining in (never mind new entrants to) the auto industry appears not only colossal but also constantly growing.

Where does the ASEAN automotive industry fit in? Compared to the above, developments seem not only behind the curve but also quite pedestrian. This is understandable. At an estimated 2 million units in 2010, total ASEAN automotive sales is just around 3 per cent of the world output or roughly equal to the annual production of Renault, the world's 11th largest manufacturer. The largest domestic markets by sales are Thailand, Indonesia and Malaysia, although sales growth is fastest in the first two countries. It is tempting to think that producers are largely in control of their own futures but given their relative size, major changes and trends, it may well instead be dictated by the global majors and emerging players as they jockey for position. If this is true, then ASEAN producers may, at most, only be able to control some part of the pace of change through their policies and not its content or direction.

Much is made about the fact that at around 600 million people, ASEAN, as a whole, would be equivalent to the world's fifth largest auto market. This, of course, assumes that the regional auto market can be considered to be a seamless whole. Is it? In the creation of the ASEAN Free Trade Area (AFTA), automotive products were designated one of the 11 priority sectors and subject to an explicit integration roadmap. That roadmap covered a comprehensive list of 15 cross-cutting measures, ranging from the normal tariff and non-tariff liberalization to services, investment, standards and conformance, trade facilitation and human resource development. The course of action set was ambitious and while there might have been some wavering on liberalisation commitments in mid-course, the end result on 1 January 2010 was accepted by most quarters to be a credible one.

One likely reason why this was possible was that ASEAN countries, by and large, posed limited product competition to one another. The advantages of attracting investment to a region-wide platform may, at least in theory, have been considered to offset any distributional costs. This stood in contrast to ASEAN's approaches in its FTAs with China, South Korea and Australia, where automotive products were placed on sensitive lists and excluded. Only in its FTA with Japan, signed in March of 2008, did a wide range of cars and automotive components become exempted from the import duties of most or all of the four vehicle producing countries, presumably because of Japan's substantial auto investments (especially by Toyota) in the region.[5]

The thinking behind this appears straightforward: ASEAN manufacturers, as a whole, want time to strengthen their manufacturing capacity through market integration before opening up their markets to competition. This would be a sensible strategy under normal circumstances except that even this could be no more than merely delaying the inevitable. As previously mentioned, new large players are ramping up production especially at the low end of the market. Over time, productivity and cost, differentials can only widen and the gap can be difficult, if not impossible, to bridge. Indeed, China, India and other mass market auto producers pose a future competitive challenge to ASEAN for which the current response, though understandable, appears to be, as yet, wholly inadequate.

There is also nothing to prevent individual member countries from undertaking bilateral or sub-regional liberalization. Within ASEAN, Thailand has gained significant first-mover advantages by engineering its transition from an automotive assembler to production centre with a special focus on commercial pick-up trucks. It is the 15th largest motor vehicle producer in the world but the world's 2nd largest market for one ton pick-ups after the US. It is promoting the sector with tax and non-tax incentives and practically all the major auto producers have a presence in the country. In conformance with global trends, it too is targeting R&D in order to diversify into fuel-efficient and alternative energy vehicles.

In contrast to its regional position, and as is to be expected from a large exporting country, Thailand's bilateral FTAs take a markedly different approach in automotive products. (Its major export markets are Asia, including ASEAN, the Middle East and Australia.) For example, in its agreement with Australia, tariffs on commercial vehicles and passenger cars, together with their parts and components are eliminated by 2010. The vast majority of automotive parts from China and Japan are also scheduled for removal by 2010 and 2012 respectively.[6] Given that Thailand is also a party to the AFTA, which limits tariffs to 5 per cent or less, its claim to being to gateway to the ASEAN automotive market is not an empty one.

As far as Thailand is concerned, the economic impact of AFTA has therefore been positive, although the greater contribution seems to have been its early decision to focus on a specific vehicle and to substantially liberalise the sector. While it has experienced its own set of struggles with demand slack for commercial vehicles and it has yet to make a significant impact in eco-friendly exports, it has developed vibrant industry players (16 assemblers), strong supplier networks (648 Tier 1 and 1,641 Tier 2 & 3 local suppliers), diversified export markets and responsive supporting institutions.[7] Arguably, it is probably in the best position to withstand the onslaught that will eventually come from abroad.

On the surface, Malaysia and Indonesia seem to be faced with more limited options. Of the two, Indonesia has the much larger domestic market and presumably offers more commercial incentive and the ability to wield greater negotiating strength. It is estimated that in 2007, only one in 35 Indonesians owned a car, compared with one in 7 Malaysians and 14 Thais.[8] Automobile ownership ought to increase as the economy develops and more infrastructure investment is made in roads, and the dominance of key industry players gradually diminishes. The Malaysian market, on the other hand, is smaller and more saturated and the two main manufacturers will need to lift their game very significantly if they are to be at all competitive.

As is often the case, the problem may have to do with political economy. Existing auto manufacturers, assemblers, parts and components suppliers and distributors could be comfortably ensconced in profitable domestic positions. This acts as a disincentive to changing the status quo and distributing away the gains from trade liberalization, at least any faster than is absolutely necessary. Perhaps more importantly, a significant proportion of profits earned under these conditions are often not ploughed back in the form of investments, whether in fixed or intangible form such as R&D. As a consequence, production cannot be considerably ramped up and quality improved.

In most cases, sluggish business investment red flags a sector's prospective decline. If ASEAN automotive investment does not rise, and rise very considerably, there is little hope that it will have the capacity to contest its market in the future. ASEAN's dependence on foreign multinationals (MNCs) for automotive production, however, is considerable, not only for investment but also output, technology employment and exports. As is well known, MNCs devise and implement strategies on a global scale and not according to national or even regional needs and desires. This is presumably the reason why despite the constant requests by some producing countries for product diversification, technology transfer, R&D and so forth, little has actually been forthcoming. The views and opinions of MNCs, whether direct and indirect, on the nature and timing of domestic liberalization programmes therefore also tend to be extremely important.

Obviously, governments need to ensure that while they should seek to cooperate closely with private sector firms, that there is no undue policy capture. They require discretion and latitude to make policy decisions that will impact development for the future and for this, it is imperative to seek suitably diversified participation of industry players rather than over-reliance on a few. Eventually though, some very hard decisions are going to have to be made as to the best ways to participate and value-add in the industry, e.g. concentrating on certain types of products, component manufacturing or services. These decisions should be made on a rational and pragmatic basis of what maximizes the welfare for the greatest number in a country on a sustained basis, rather than that for a select few. The way that global industry trends are heading, the longer that it takes to make these decisions, the greater could be the potential costs of not doing enough.

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[4] Invest in Germany, 'The automotive industry in Germany – Driving performance through technology: Industry overview', *www.invest-in-germany.com*, nd.

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[6] 'Thailand's automotive Industry to see growth accelerate', *Board of Investment Review*, Thailand, (November 2009)

[7] Duangjai Asawachintachit, 'Thailand's investment environment and opportunities', Board of Investment Thailand presentation in Cardiff, United Kingdom, March 12, 2010

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