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Asia's New Growth Mechanisms Toward 2010 and Beyond

—Suggested strategies for Japanese companies—

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As we approach the 2010s, China and India are assuming greater prominence. In Asia, new growth mechanisms have been emerging in which Japan, NIEs (South Korea, Taiwan, Hong Kong, Singapore), the ASEAN countries, China and India are mutually depending on each other and growing dynamically.

Attention should be given to the Greater Mekong Subregion (GMS) where Vietnam is forming a growth center benefiting from a rapidly developing infrastructure in the region. The GMS is expected to undergo the most significant changes in Asia in the next ten years. Spurred on by the elimination of intra-region tariffs by 2010, production bases within the ASEAN region will be rearranged and most will be relocated to the GMS.

New, remarkable market segments that could be described as the "Asian middle class," chiefly consisting of people in their 20s and 30s who have new awareness and sense of value, are becoming influential. In order to take advantage of the consumption boom in Asia as opportunities to increase companies' revenues, it is essential to deploy marketing and product strategies that specifically appeal to these segments.

In the 2010s, the economic scale of China will exceed that of Japan. Enormous consumption markets will appear in China's costal areas and China will assume leadership of the Asian economy. To take "aggressive approaches" to evolve business in China, the key to success for Japanese companies in expanding business operations in China is whether they can deploy appropriate human resource strategies.

In India, a consumption market is finally in place leading to economic growth. However, such growth involves risks such as undeveloped infrastructure and deficiencies in the legal and structural framework. For firms to fully expand their businesses in India, resolute "defensive approaches" must be taken. Winning the competition in such a challenging market requires fundamental commitment by the top executives at the head offices.

In the future, Asian business should be promoted under an organizational structure that enables business operations covering all Asian countries by envisioning network and division of labor throughout the region, rather than vertically dividing Asian countries by country. This will require the development of human resources well versed in all of Asia and the building of functions of an all-Asia headquarters that will enable decision making based on the circumstances in the whole region of Asia.

I Growth in China and India Vitalizing the Asian Economy

1 China and India Assuming Remarkably Greater Prominence

(1) China's impressive success in the past decade

Before we look ahead to the 2010s, let's first look over the past decade. Figure 1 compares the exports and imports of major Asian countries in 1995 and 2004. The total value of Chinese exports and imports increased by 4.1 times, from 280 billion dollars in 1995 to 1,150 billion dollars in 2004. In comparison, Japan achieved an increase of 1.3 times, from 780 billion dollars to 1,020 billion dollars. Similarly, Singapore recorded growth of 1.4 times. Malaysia and India achieved a slightly higher growth of 1.5 times and 2.7 times, respectively. These figures suggest the highly prominent growth in the value of Chinese trade in Asia. From the perspective of trade, China far surpassed that of other Asian countries in the past ten years.

Figure 2 shows the value of direct investments by Japan in other major Asian countries in 1995 and 2004. Between these two years, only a small difference exists in terms of direct investments by Japan in China. However, in view of such investments in other Asian countries, while the value doubled from 400 million to 800 million dollars for South Korea, the value remained almost the same or rather decreased for other Asian countries. In particular, Japan's direct investments in four ASEAN (Association of Southeast Asian Nations) countries, namely, Indonesia, Singapore, Malaysia and the Philippines, largely decreased in 2004 as compared to 1995.

Investments appeared to have peaked in the "developed ASEAN" where many export-type factories were constructed during the period from the 1980s to the middle of the 1990s. These data suggest that direct investments by Japan for the past ten years have remained concentrated in China.

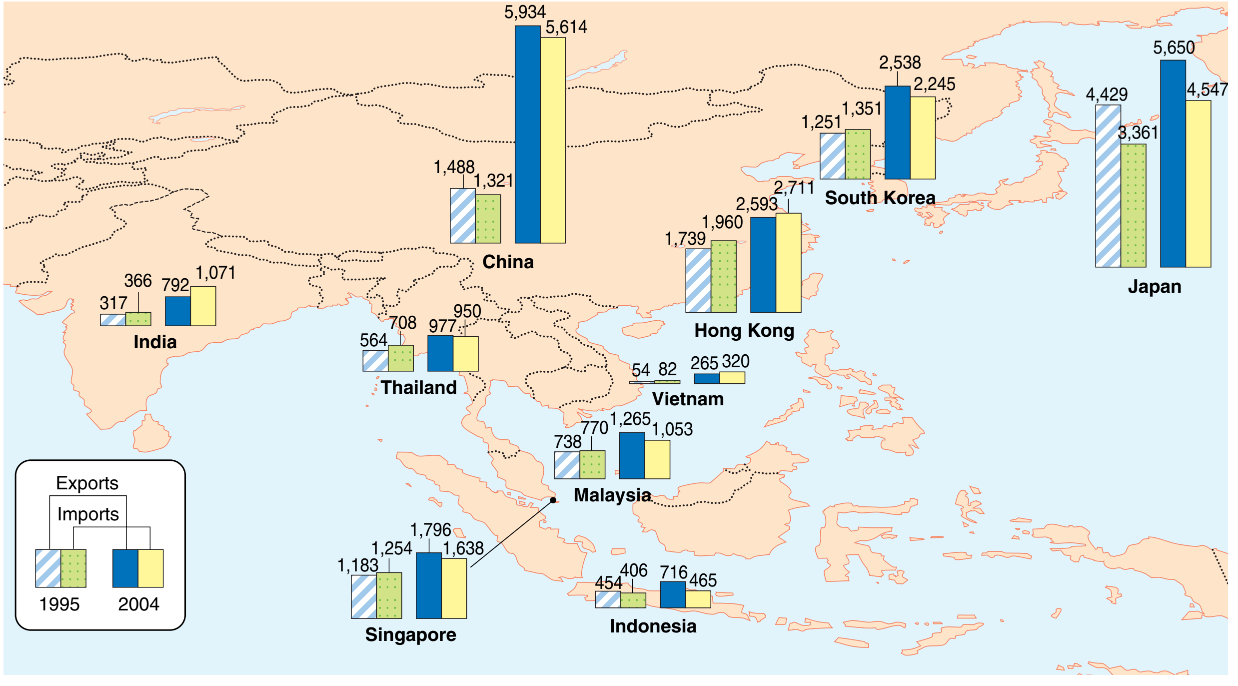
(2) Japan and China driving Asian economy as two major forces

Subsequently, what will occur during the next ten years? Our projections up to 2015 reveal that the Chinese economy will increase its presence in Asia to overwhelm the Japanese economy. As shown in Figure 3, the total GDP (gross domestic product; 2003 as the base year) of 12 major Asian countries and regions was 8.9 trillion dollars in 2005. After ten years, this value is expected to almost double and reach 16.4 trillion dollars in 2015. Of this total, while the share of Japan was 50 percent and that of China was 20 percent in 2005, each country is projected to have 35 percent in 2015.

Figure 4 compares the economic scale of Japan and China. After ten years, the economic scale of both countries will become the same around 2015 and China will subsequently surpass Japan.

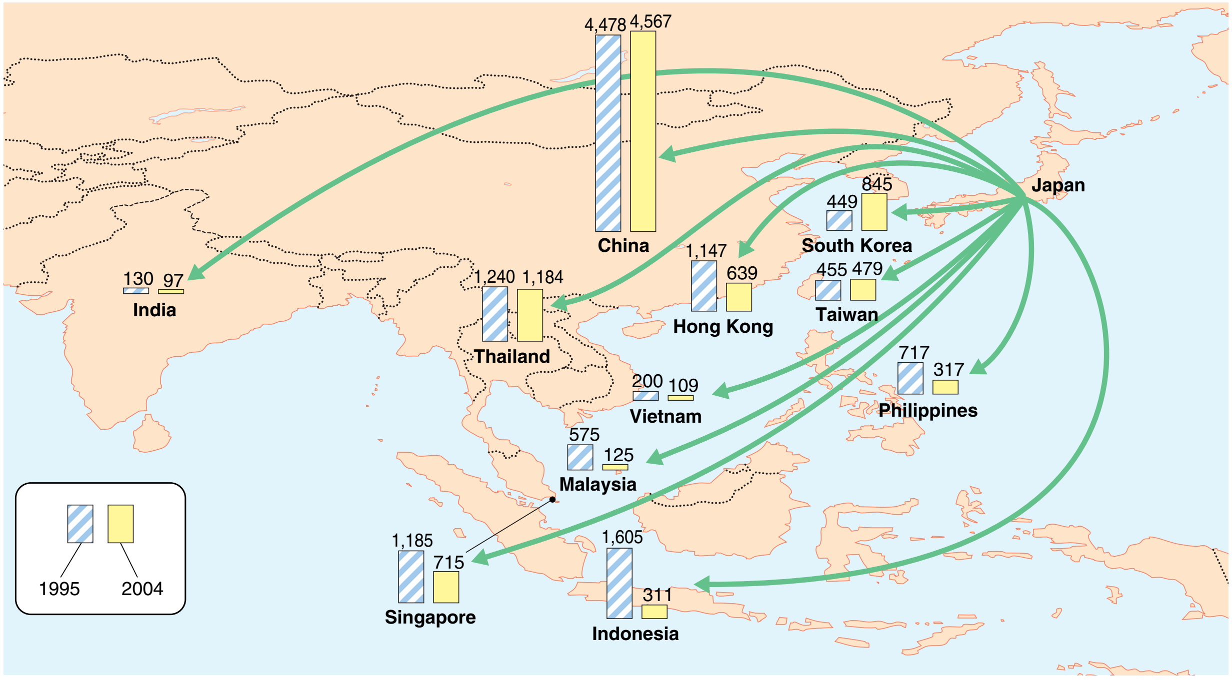
While the per-capita GDP in Japan exceeded that in China by 20 times in 2005, this difference will rapidly narrow and reach about 9 times in 2015 (Table 1). If we consider only China's coastal areas where economic development is rapidly under way, this gap is likely to be narrowed even further. As of 2005, the per-capita GDP had already reached around 6,000

Figure 1. Exports and Imports of Asian Countries in 1995 and 2004 (100 Million Dollars)



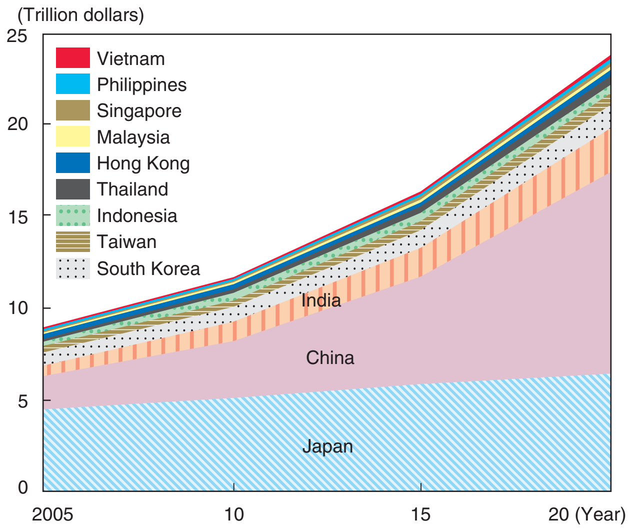
Source: Compiled based on trade statistics of each country.

Figure 2. Direct Investment by Japan in 1995 and 2004 (Million Dollars)



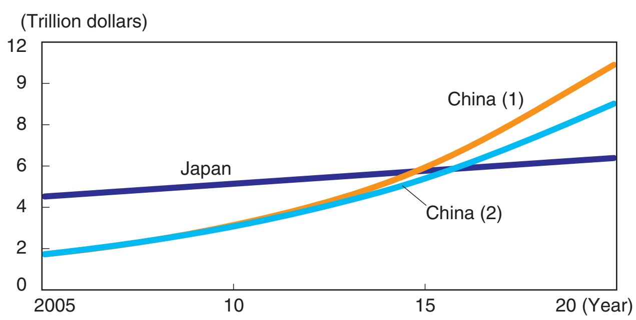
Source: Compiled based on investment statistics published by Japan External Trade Organization (JETRO).

Figure 3. GDP of Asian Countries (2003 as the Base Year)



Note: GDP = gross domestic product.

Figure 4. Comparison of GDP between Japan and China (2003 as the Base Year)



Notes: China (1): The yuan/dollar exchange rate is up-valuated by 3 percent every year until 2010, and by 5 percent every year after 2010. China (2): The yuan/dollar exchange rate is up-valuated by 3 percent every year until 2010, and also by 3 percent every year after 2010.

Table 1. Comparison of Per-Capita GDP between Japan and China

(Unit: %)

	2005	2015
Japan	35,000	45,000
China	1,700	5,000

dollars in the major cities of the coastal areas such as Shanghai.

In the future, the pace at which the economy will develop will remain higher in the coastal areas than in the inland areas. Therefore, growth in the per-capita GDP in the coastal areas in China will be greater than the average growth of China as a whole. The per-capita GDP in such areas possibly will become 15,000 to 20,000 dollars around 2015. If that is the case, the difference in comparison with Japan will become only two to three times, and the per-capital GDP in the coastal areas in China will become almost the same or higher than the current figure in Taiwan or South Korea. In the next ten years, the coastal areas in China will emerge as a huge market consisting of nearly 200 million people.

(3) Next to China, India will increase its presence

Following China, the economic size of India will also expand. However, India will not be able to attain the same level as Japan and China within the next 10 to 15 years. When we compared the GDP of India and that of the major ASEAN countries (Singapore, Thailand, Indonesia, Malaysia and the Philippines), the GDP of the latter countries (740 billion dollars) was higher than that of India (690 billion dollars) as of 2005. However, the situation will be reversed in 2010, with India achieving a GDP of 1,010 billion dollars and the five major ASEAN countries registering 960 billion dollars.

When we calculated the incremental portions of GDP during the period from 2005 to 2015, we found that the total incremental portion of GDP (2003 as the base year) in 12 major Asian countries and regions was 7.5 trillion dollars (Figure 5). China accounts for the largest share of this total at 56 percent, followed by Japan (16%) and India (11%). If we view the Japanese market in terms of the expansion of its size, the market is still large although the growth rate is low. We can also see the increased presence of India in its GDP incremental portion. The incremental portions of countries other than these three countries are small. In Asia, the three major markets of China, Japan and India will serve as the principal arenas for companies to compete in the future.

2 Growth in China and India Will Vitalize All Asia

(1) China's rise will lead to rapid increases in intra-regional trade in Asia

What impact will the rise of China and India have on Asia as a whole?

Figure 6 shows recent changes in the intra-regional trade volume in Asia. The upper graph indicates the trade value of each Asian country for 2000, and the lower graph indicates that for 2004, enabling a four-year comparison. The left axis indicates the value of imports by the relevant country from each Asian country, and the right axis indicates the value of exports from the relevant country to each Asian country.

Figure 5. Increases in GDP by Country from 2005 to 2015

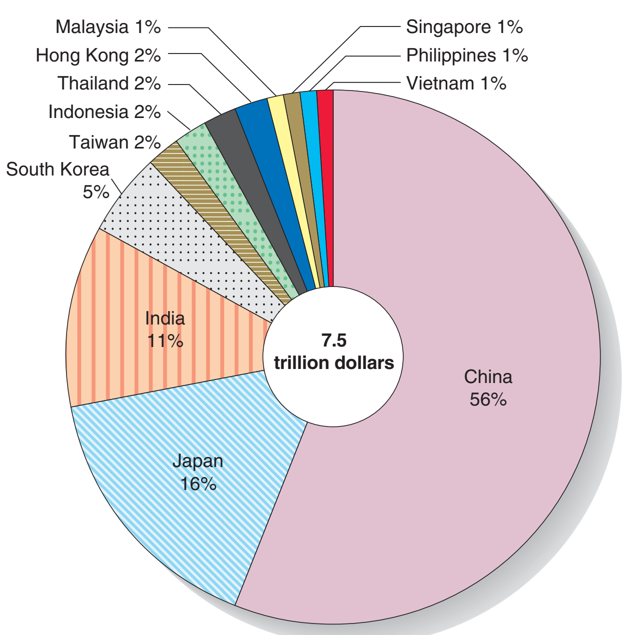
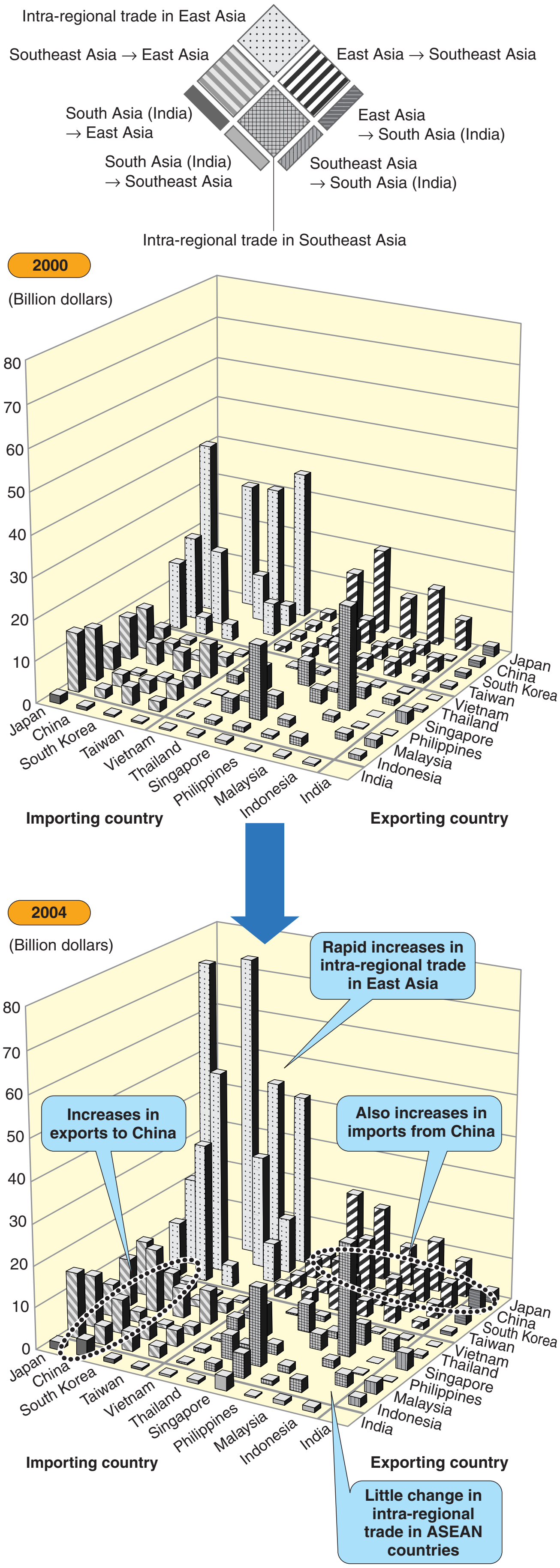


Figure 6. Value of Intra-Regional Trade in Asia in 2000 and 2004



Source: Compiled based on trade statistics of each country.

We would first like to call attention to the bars representing China as an "importing country." The quadrant on the left indicates the value of imports by China from ASEAN countries. By 2004, the bars have grown considerably as compared to those in 2000. The value of exports from China to ASEAN countries we see on the right has also grown substantially. These data indicate that exports and imports between China and ASEAN countries have expanded greatly even over the short four-year period starting in 2000.

With respect to the countries from which China has been importing products, increases in imports from Southeast Asia and India have been higher than those from East Asia. Because the import items from these regions consist mostly of iron ore, pharmaceuticals, foodstuffs and beverages, it is highly likely that China is regarded as the area of final demand for these products. In other words, demand generated in China has brought about an economic ripple effect to Southeast Asia and India.

The quadrant at the top indicates the value of trade (exports and imports) within East Asia. This value also has grown substantially during these four years. Not only imports and exports between China and Japan, but also exports from South Korea and Taiwan to China have largely expanded. However, when we look at the bottom that indicates the value of exports and imports within ASEAN countries, we find little change during these four years.

As such, centered on China, intra-regional trade in Asia has expanded rapidly in terms of both imports and exports by each country. China's growth has been vitalizing the Asian economy as a whole.

(2) Economic relationships between India and ASEAN countries becoming closer

The following section examines the situation in India. Table 2 indicates destination countries with a large rate of growth in the value of exports from Thailand for the past two years. Overall, exports from Thailand to Asian countries have been growing. In particular, exports to India have recorded an annual average rate of growth close to 50 percent.

Thailand signed a Free Trade Agreement (FTA) with India in 2003 and agreed on the elimination of tariffs on 82 items under the Early Harvest Program (removing tariffs on items for which agreement was reached by both countries before the enforcement of FTA) by September 2006. These items include automobile parts (gear boxes, engine parts, bearings, etc.) and electrical appliances (air-conditioners, TVs, cathode-ray tubes, refrigerators, etc.). Japanese companies are also actively making use of this FTA.

For example, Toyota Motor has assembly factories producing 40,000 to 50,000 cars annually in Bangalore, India, and procures some parts from Thailand. Sony closed color TV factories in Delhi in 2004 and switched to exports from Thailand for all color TVs sold in India (in this case, Sony achieved a greater benefit from reducing overall distribution costs by shifting exports from Thailand than from the enforcement of the FTA). As such, exports from Thailand to India have been rapidly increasing partly due to the effect of the FTA.

To further strengthen economic relationships with India, Thailand's Thaksin administration had been implementing plans to develop Ranong port in the southern part of Thailand (Figure 7). Once this port expansion project is completed, goods can be transported from Thailand to India in about one week; currently it takes nearly one month to ship goods from Bangkok through the Strait of Malacca. Because the current administration of Thailand is somewhat unstable, there might be delays in the development of infrastructure.

Nevertheless, Thailand has made clear its strategies to benefit from the economic development of India by expanding exports to that country.

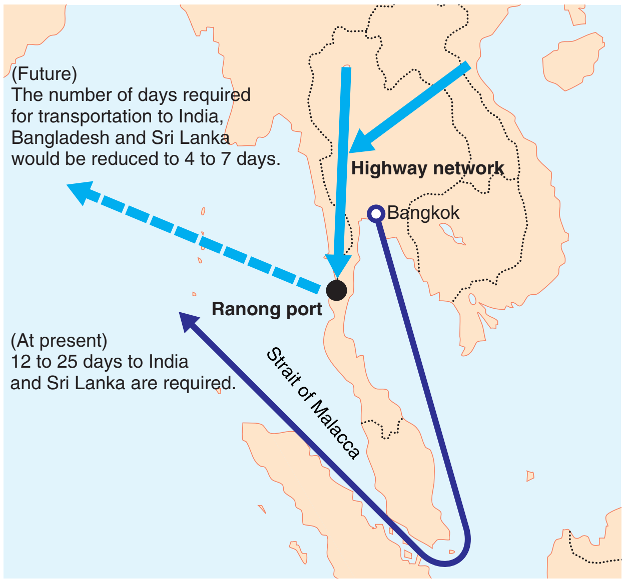
Table 2. Upper-Ranked Countries in Terms of Rate of Growth in Exports from Thailand

(Unit: %)

Export destination	Annual average growth rate (2002 → 2004)
1. India	48.6
2. China	41.5
3. Indonesia	38.4
4. Malaysia	36.9
5. Australia	22.6
6. France	21.3
7. Philippines	20.0
8. Netherlands	17.2
9. Japan	16.7
10. UAE (United Arab Emirates)	16.2

Source: Compiled based on trade statistics of Thailand.

Figure 7. Strengthening Relationships between Thailand and India



3 Asian Market Integration and New Growth Mechanisms

(1) Post-"flying-geese" pattern of growth mechanisms

In the past, economic development in Asia was said to follow the so-called "flying-geese" paradigm, a pattern of growth in which the development of all Asia was achieved by promoting exports, with Japan providing the technology and capital and other Asian countries providing the labor. Specifically, economic development in Asia was led by Japan, followed by the NIEs (South Korea, Taiwan, Hong Kong and Singapore), the ASEAN countries and China. This pattern resembles the formation of a flock of geese in flight.

However, as stated above, China, starting around 2000, and India, in the past few years, have begun to function as countries offering their markets. These moves suggest that economic development in Asia has shifted to a new stage of growth (Figure 8).

Major companies in Japan and South Korea have continued to actively make direct investments in and transfer technology to China, the ASEAN countries and India. Similarly, venture capitalists in Taiwan, Hong Kong and China have also been investing in the ASEAN countries (in particular, Thailand and Vietnam). In addition, exports and imports of the ASEAN countries, China and India have been increasing rapidly, and those between China and India have also been growing (registering a year-on-year increase of 38% in 2005).

Currently, economic development in Asia has shifted to a growth model in which each country/region uses their respective features and cooperates with each other to grow in such a way that Japan and the NIEs offer technology and capital, the ASEAN countries provide production functions, and China and India offer their markets.

The prospectus of the Asian Development Bank, established in 1965, stated that it should aim to achieve "harmonic growth in Asia as a whole." Now, an ideal growth model that was pursued by the Asian Development Bank, in which respective countries and regions grow through deepening interdependence rather than individually, is about to be achieved.

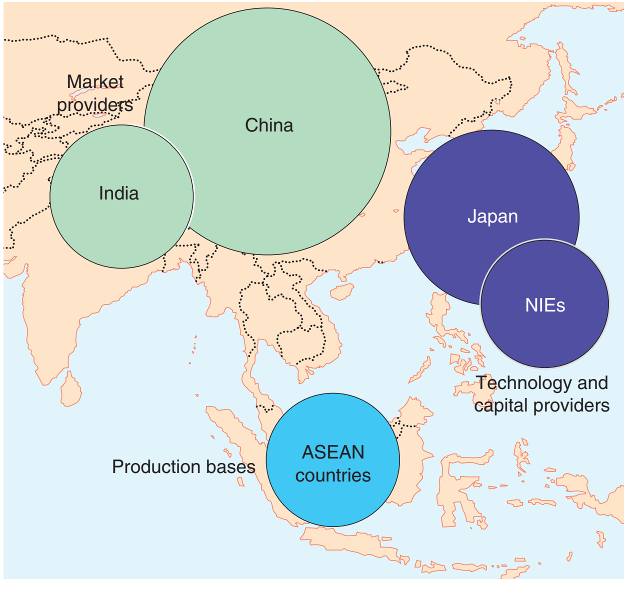
(2) Economic partnerships supporting Asia's growth

This growth model is supported by the moves of economic partnerships in Asia. As shown in Table 3, a number of FTAs and EPAs (Economic Partnership Agreements) are scheduled to be concluded in the future towards 2015.

There are uncertainties about whether individual FTAs can be signed as scheduled because both countries have to agree through negotiations to actually conclude each FTA. However, the move toward market integration can no longer be stopped because the effect of growing while cooperating with each other is about to become a reality. At the same time, interdependence in Asia will also benefit Japan through the vitalization of the Asian economy and the expansion of the Asian markets. Accordingly, Japan should take the lead in supporting such moves.

The rise of China and India also means that increased expectations will be placed on Japan.For example, while Vietnam is strengthening its economic relationships with China, the country is also making utmost efforts to move closer to Japan in order to maintain an advantageous

Figure 8. New Growth Mechanisms of the Asian Economy



Note: NIEs = South Korea, Taiwan, Hong Kong and Singapore.

Table 3. Moves of Market Integration in Asia

AFTA • Five countries of ASEAN accession in 1967 • New member countries	Target year for zero tariffs 2010 2015
China-ASEAN FTAs • Five countries of ASEAN accession in 1967 • New member countries	Target year for FTA signing 2010 2015
India-ASEAN FTAs • Five countries of ASEAN accession in 1967 • Others	Target year for FTA signing 2011 (excluding the Philippines) 2016
Japan-ASEAN FTAs • Five countries of ASEAN accession in 1967 • New member countries	Target year for FTA signing 2012 2017

Notes: AFTA = ASEAN Free Trade Area, FTA = free trade agreement.

position to negotiate with China. In addition to technology and capital, Vietnam is strongly seeking cooperation with Japan in the overall policy fields. In the past, the core industries of Malaysia and Indonesia, which are now being outstripped by Thailand, were supported by the Japanese manufacturing industry that set up factories in these areas. In order to improve their own industrial competitiveness in Asia, these countries are now again strongly requesting support from Japan. The threat from China in terms of industrial competitiveness constitutes a background factor for such needs.

There are several roles that Japan can assume in terms of two facets, namely, cooperation in Asia and strengthening Asian competitiveness.

II Change in Competitive Landscape in ASEAN and the Rise of GMS

1 "Seaside ASEAN" and "Inland ASEAN"

After the Asian currency crisis, which was triggered by the crash of the Thai baht in 1997, the ASEAN countries have overcome difficult problems through the efforts of each country and with the support of the international community, including Japan. Although its rate of growth is not as high as that of China, the ASEAN economy is now well under way towards stable growth.

However, if viewed as individual countries, a different situation is seen. While direct investments are flowing abundantly from overseas into countries located on the continent of the Indochina Peninsula such as Thailand and Vietnam (inland ASEAN) as production and export bases, investments in Singapore, Malaysia, Indonesia and the Philippines (seaside ASEAN) that had driven ASEAN growth in the past have ceased to grow.

Thailand and Vietnam have secured a competitive edge among the ASEAN countries with an abundant labor force, a stable political situation and cooperation with China. In contrast, Malaysia is awkwardly positioned in the capacity of a country in which investment is made because of delays in promoting the creation of high value-added industries commensurate with increases in personnel costs. High cost of operation is an obstacle for overseas companies to establish an export and production base in Malaysia.

Unlike Singapore, both industry and academia in Malaysia have not yet equipped themselves with the capabilities to develop cutting-edge technologies. In addition, with a total population of only 20 million, its appeal as a market is limited. For these reasons, direct overseas investments in Malaysia are not growing.

While the Philippines and India have large populations of 80 million and 190 million, respectively, except for an extremely limited number of wealthy people, most people are poor, and the gap between the rich and the poor is firmly in place. Accordingly, it is difficult to imagine a scenario of expanding their markets through an increase in the middle class. In addition, the political situation is unstable in both countries, giving rise to concerns over terrorist activities. These circumstances hinder efforts to attract investments.

Currently, the "seaside ASEAN" has nevertheless been growing at the rate of 4 to 6 percent annually. However, the export-led industrialization policy adopted by the "seaside ASEAN" appears to have reached the stage of topping out. In addition, if it is difficult to achieve industrial advancement, as is the case in Singapore, the gap between "seaside ASEAN" and "inland ASEAN" may be widened.

2 Greater Mekong Subregion (GMS) Being Benefited from the Growth of Asia

(1) Development of infrastructure promoting economic development

"Inland ASEAN" has the geographical advantage as a "growth bridge" that links India and China. This enables the "inland ASEAN" countries to grow on their own while benefiting from the growth of India and China. In recent years, the progress made in the development of infrastructure in the areas around the Mekong River has provided momentum to the integrated growth of these areas. The Mekong River takes its rise in the Tibet Heights, runs through China's Yunnan Province, the Myanmar-Laos border, the Thailand-Laos border and Cambodia, and flows to the South China Sea through Vietnam.

The areas around the Mekong River are known as the Greater Mekong Subregion (GMS). The total area of the GMS is about 2.3 million square kilometers and is home to about 250 million people (based on the website of the Ministry of Foreign Affairs as of October 2000).

In 1992, the Asian Development Bank started projects in the GMS with the objective of promoting the economic development of these areas that include countries devastated by war and/or civil war. Economic and social development projects are under way with the support of the Asian Development Bank and Official Development Assistance (ODA) provided by Japan and other countries. The United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) is also supporting such development by designating the years from 2000 to 2009 as the Decade of Greater Mekong Subregion Development Cooperation.

In November 2004, Japan's Prime Minister Koizumi announced a loan worth 42.6 billion yen to assist the development of the GMS to bridge gaps in the ASEAN region. This yen loan is used to construct the Second Mekong Bridge that connects Mukdahan in Thailand to Savannakhet, the second largest city in Laos, which is scheduled to be completed by the end of 2006. In addition, Japan is supporting the development of an intra-regional network by implementing projects to construct roads, airports and communications lines, and to provide training programs to develop human resources on a grant and/or loan basis.

Once Vietnam's Da-nang port in the South China Sea and Myanmar's Mawlamyine in the Andaman Sea are connected overland by the "East-West Economic Corridor", a backbone route for transportation linking the Pacific Ocean to the Indian Ocean would be established. In addition, the development of the "North-South Economic Corridor" will complete a distribution network linking the southern part of China, the northern part of ASEAN and India.

As such, remarkable growth can be expected in the GMS where the most dramatic changes in Asia will occur during the coming ten years (Figure 9).

(2) Vietnam assuming the core role in the growth of GMS

The development of infrastructure in the GMS will improve its potential for growth, particularly in Vietnam. While Vietnam can provide low-cost labor, its supporting industries are not yet fully developed. Accordingly, the development of infrastructure is expected to support the establishment of a division-of-labor network in production, in which Vietnam procures parts, components and materials from neighboring countries such as Thailand and China, processes the procured components and materials within the country, and returns the assembled goods to Thailand and China or exports them to other countries. Vietnam's predominance as an assembling base is expected to increase.

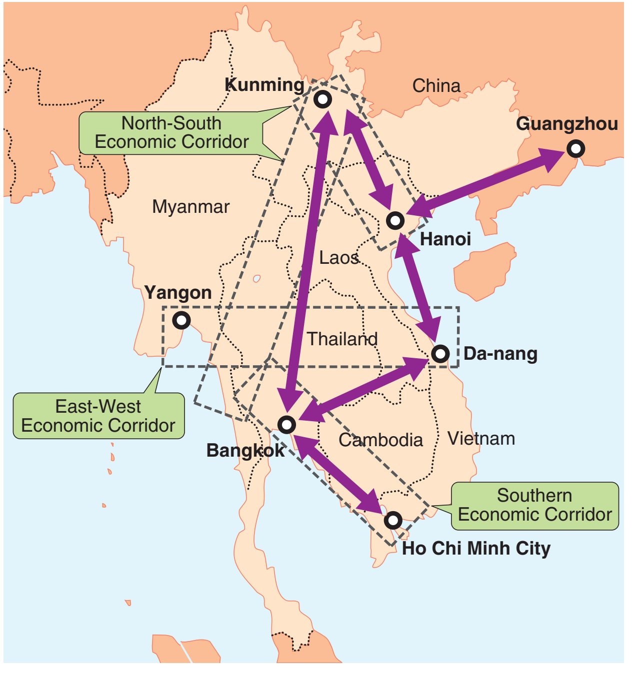
When the economic corridor that links the east and west of the Indochinese Peninsula is completed as part of the GMS development projects, a distribution route connecting Bangkok in Thailand and Hanoi in Vietnam will be established. Currently, more than ten days are required for transportation by sea from Bangkok to Hanoi by going through Singapore, Ho Chi Minh City, Hong Kong, etc. However, if overland transportation using the East-West Economic Corridor becomes available, the travel time between Bangkok and Hanoi will be significantly reduced (Table 4). Furthermore, when the Second Mekong Bridge is completed, such travel time will be further reduced to three days.

In order for this route to be actually used frequently as an overland transportation route, some issues remain such as streamlining complicated customs formalities and the issue of return cargo from Vietnam to Thailand. Nevertheless, the development of infrastructure will further strengthen industrial cooperation between Thailand and Vietnam.

The construction of two economic corridors is also planned for the areas between the northern part of Vietnam and the southern part of China. One route is from Kunming in China's Yunnan Province to Haiphong-Hanoi through Lao Cai in Vietnam. The other route is from the Guangxi Zhuang Autonomous Region in China to Haiphong-Hanoi through Lang Son in Vietnam. For example, the route linking Hanoi and Guangzhou will enable the connection of supporting industries in South China—chiefly in Kwangtung Province—and processing and assembly factories in Vietnam.

Japanese companies such as Canon have already started efforts to establish new assembly factories for exports in the northern part of Vietnam, which will use supporting industries in South China. Future economic development

Figure 9. Expected Development of Infrastructure in GMS



Note: GMS = Greater Mekong Subregion.
Source: Asian Development Bank.

Table 4. Reduction in Travel Time Required for Distribution in GMS

	Transportation by sea		Transportation by land	
	Number of days	Cost (dollar)	Number of days	Cost (dollar)
Bangkok-Hanoi	10 – 15	2,500	3 or 4	1,000
Hanoi-Guangzhou	4 – 6	1,250	2	1,800
Bangkok-Ho Chi Minh City	2 or 3	580	2	1,390
Bangkok-Yangon	About 1 month	1,130	3	730

Source: Compiled based on *JETRO Sensor*, February 2006.

in Vietnam, in particular in the northern part of Vietnam, is noteworthy, and industrial cooperation with South China will support the development of these areas.

Under these circumstances, Japan's direct investments (on an approval basis) in Vietnam were the highest on record in 2005. In addition, more and more factories in the ASEAN region are being relocated to Vietnam. In July 2006, new laws related to foreign capital came into force, relaxing regulations on foreign-capital companies. Vietnam is certain to join the World Trade Organization (WTO) by the end of 2006. This will further accelerate moves to construct factories in Vietnam.

The appeal of these areas as production bases includes an abundant labor force. The population of Thailand and Vietnam will continue to increase. In 2015, Thailand will have a population of 69 million and Vietnam will have a population of 95 million. In addition, both countries have a great percentage of young people. Furthermore, as shown in Figure 10, urbanization in these countries is slow. In China, the urbanization rate now exceeds 40 percent and is expected to reach 50 percent in 2010. However, the GMS still has a young, abundant labor force in the agricultural areas. Labor-intensive factories that are becoming more difficult to sustain in China can still exist in the GMS.

III The Rise of the Middle Class and the Expansion of Consumption Markets in Asia

1 Depth of the High-Income Bracket in Each Asian Country

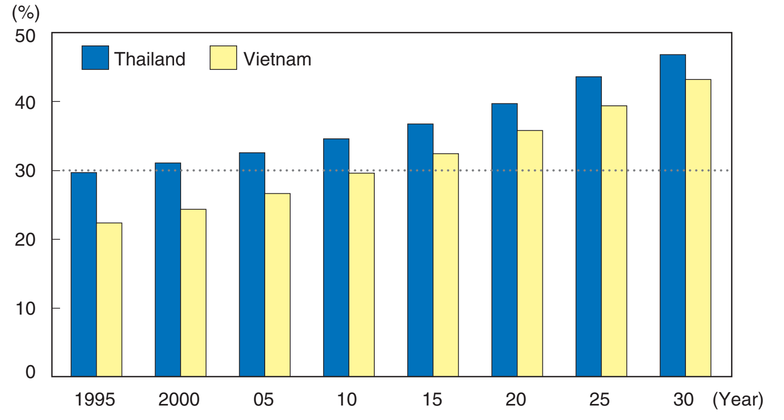
(1) Economic gaps brought about by high growth

While the preceding chapters discussed Asian countries as production bases, this chapter examines Asian countries as markets.

Figure 11 shows the ratios that the top 20 percent and the bottom 20 percent of people in terms of income account for in the overall household income of each Asian country. In Japan, for example, the upper 20 percent accounts for 36 percent of overall household income. This means that wealthy people have 16 percent greater income than that in proportion to the ratio of wealthy people to the total population. The lower 20 percent accounts for 11 percent of overall income, generating a difference of 9 percent.

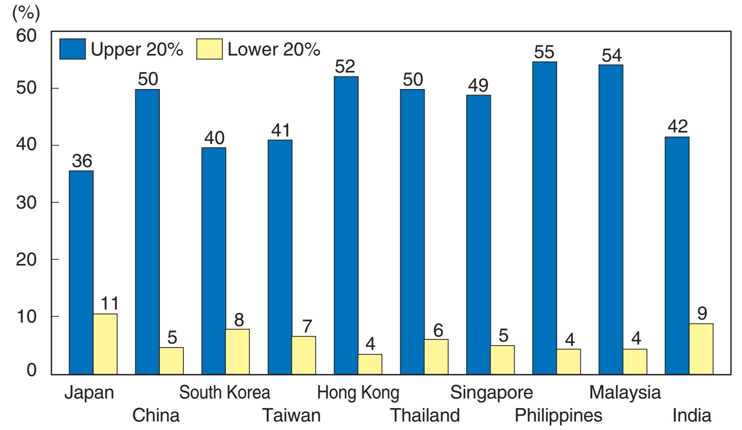
When we see the data for China, the upper 20 percent accounts for 50 percent of the overall household income.

Figure 10. Urbanization Ratio in Thailand and Vietnam (In terms of Population)



Source: *World Population Prospects: The 2002 Revision*, edited by Population Division, Department of Economic and Social Affairs, the United Nations.

Figure 11. Distribution of Household Income in Asian Countries (2004)



Source: World Bank, *World Development Indicators 2005*.

In other Asian countries, such as Hong Kong, Thailand, Singapore, the Philippines and Malaysia, the upper 20 percent also accounts for 50 percent or more of each nation's income. In contrast, in South Korea and Taiwan, where the growth rate remains unchanged, and in India, which is at the stage before achieving a high growth rate, the ratio accounted for by people in the upper income bracket is not so high in terms of those nations' overall household income.

In Asia, there is a tendency of widening economic disparities in countries where high growth continues because the benefits of growth inevitably concentrate in the wealthy class. This tendency makes it almost meaningless to evaluate a country based on its average income. (In truth, there are few people to whom average values apply.) Rather, it is important to examine the depth of those in the high-income bracket.

(2) Growing middle class in China and India

Figure 12 estimates the number of people in the high-income bracket with a per-capita annual income of 3,000 dollars or more. While an income of 3,000 dollars corresponds to a level of 300,000 yen, this figure might be considered small. However, because daily necessities are inexpensive in Asia, this income tends to be high from the perspective of purchasing power parity, and enables people to live a middle-class existence in urban areas.

People who want to buy real estate or an expensive automobile would require a minimum necessary per-capita annual income of 10,000 dollars. If people are assumed to purchase personal belongings and/or electrical appliances that are made in foreign countries, a level of 3,000 dollars is the minimum, and is the lowest threshold for foreign companies in considering marketing strategies in the relevant country.

The number of people (market size) at this level in eight Asian countries in 2004 was 150 million. It will increase to 400 million after five years in 2009 at an average annual growth rate of 20 percent. The ratio that this population accounts for in the overall population was only 5 percent in 2004, but is expected to increase to 14 percent by 2009. As of 2004, only a limited number of top-ranked individuals fell in this category. However, in only five years, the category will account for at least 10 percent of the overall population. In the 2010s, the number of such individuals will continue to increase and will account for 20 percent, 30 percent and more. In this way, people with per-capita annual incomes of 3,000 dollars or more will start to form the middle class in Asia.

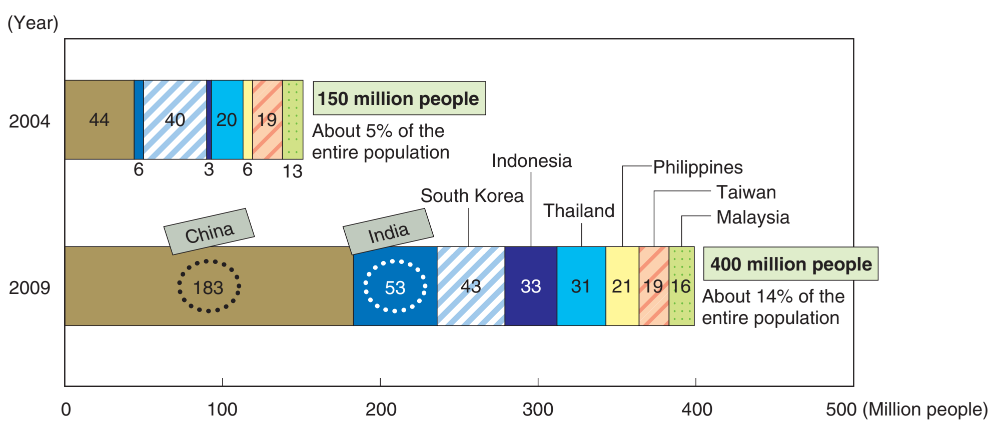
If viewed by country, the obvious country where the expansion of this middle class is most significant is China, followed by India. Consequently, attention must be paid to the rise of the middle class in these major countries. Following India are South Korea (as almost all the population are already earning an annual income of at least 3,000 dollars, there is little meaning in terms of the expansion of this class) and Indonesia. We can envision a situation where the depth of the middle class increases in Asian countries with large populations—first in China, followed by India, and then Indonesia.

2 Asian Middle Class Consisting Chiefly of the Young Generation

(1) The young generation driving Chinese consumption

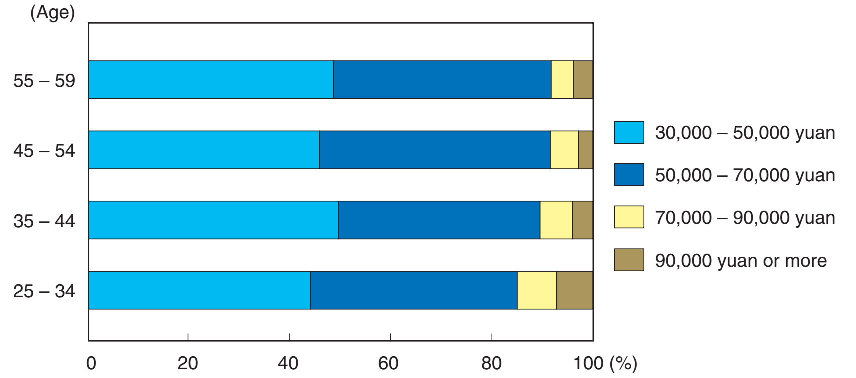
Figure 13 shows income distribution by age in China. A major difference from Japan and other advanced countries is that the lower the age bracket, the deeper the high-income bracket. Young people who are unconcerned with ideology and who have received the latest style of education have accumulated wealth by being employed by foreign companies and/or companies in urban areas that are growing through the benefits of the market economy, or by establishing their own businesses. In contrast, there have been some cases in which members of the old generation have had difficulties in adapting to the new era and have been victims of the employment environment that became unstable when compared to the golden age of state-owned companies. In recent years in China, young people who have a new sense of awareness, knowledge, technology and new

Figure 12. Populations of Households with Per-Capita Income of at Least 3,000 Dollars



Source: Nomura Singapore.

Figure 13. Distribution of Individuals in High-Income Brackets by Age in China (2005)



Notes: (1) Surveys were conducted in 16 major cities (N = 5,203). (2) 1 yuan = about 15 yen

ideas have emerged.

The classification of the generations in China can be considered as follows: the old generation consisting of people in their middle forties or older who were raised in China during the period before the implementation of reforms and the opening up of the country; the first generation consisting of people in their thirties to middle forties who started to benefit from a market economy; and the youngest generation in their thirties or younger.

In particular, people in their thirties to middle forties have stronger monetary desires, have a challenging spirit in their work and life and stand in the forefront of the shift to a market economy in today's China. They have formed China's new middle-class purchasers, and have started to have a major influence on China's overall socioeconomy.

In addition, those individuals in the youngest generation (we call them "the new Chinese") following the people in their thirties to middle forties have been raised under a favorable educational environment, have access to international information via the Internet, etc. and are familiar with the latest products and/or services provided by foreign companies. These new Chinese have the same level of awareness and the same sense of value as that of the young generation in Japan, the United States and Europe. If this generation, with its firmly established sense of balance and international perspective, comes to the forefront of society in the next ten years, China will become an "ordinary country" and might be able to share in large measure the sense of values of the former West.

(2) Asian middle class with the young generation forming the core

The phenomenon seen in China has been taking place in a similar way in other Asian countries. In India, while no one could foresee the situation several years ago, there are a number of shopping malls in large cities such as Mumbai, Delhi and Bangalore, and most people who enjoy shopping and eating out are those in the young generation. Similar phenomena have also emerged in other high-growth countries such as Thailand and Vietnam.

The middle class, which will form the principal purchasing power in Asia in the future, consists chiefly of young people who have new knowledge, technology, awareness and ideas. For companies to be able to incorporate business opportunities in Asia into their own growth, the purchasing behavior of this young generation must be correctly understood. For example, companies in South Korea have been implementing Asian strategies that are most appropriate in this respect and are achieving rapid growth by taking advantage of the consumption boom in Asia.

Samsung Electronics' strategies for China define a group of target consumers as "young and rich purchasers who pursue high-quality lives." The company is deploying high quality, uniquely designed products and services that employ state-of-the-art technology with a focus placed on such target consumers. Samsung has been successful in differentiating itself from Japanese companies in the same industry that continue to have somewhat outdated images of electric home appliance manufacturers by skillfully using mobile phones in establishing its brand image among this consumer segment.

Until the 1980s, the image of Japanese products in Asia was very high with people regarding such products as "the sought-after brand." However, the image that young Asian consumers now have of Japanese products is not necessarily that which is considered first-rate. Specifically, they regard Japanese products as having excellent functions, but offering modest and somewhat old-fashioned designs. Japanese companies will have to review their brand strategies if they are to be in the front position.

IV Growth and Risks Exist Together in the Chinese Market

1 Pressing Need for Reforms in Economic Structure

(1) Macroeconomy continuing to overheat

The following sections present a view of the two major countries of China and India, which will largely influence the future of Asia.

We first look at China in this chapter. The recent economic growth in China has been remarkable. The country continues to stably achieve a high growth rate close to 10 percent in terms of real GDP and is full of the energy needed to achieve further growth. While the growth rate in and after 2006 is projected to decline, as shown in the economic outlook in Table 5, this decline is attributable to measures intentionally taken by the central government to restrain economic overheating. Without such restraint, the Chinese economy will grow endlessly. The Chinese economy is so powerful that it will run recklessly to any extent unless a brake is applied.

A meeting of the National Congress of the Communist Party is scheduled for 2007. If a personnel reshuffle of local governments is conducted, new leaders will launch measures to achieve further growth in order to improve their own performance. Consequently, whenever the National Congress is held, the growth rate is always amended upward. The Beijing 2008 Olympic Games will give rise to a consumption boom for products related to the Olympic Games principally in urban areas. The urban development in preparation for the Shanghai World Expo 2010 will also bring another construction boom in the property sector.

All of these factors will function to spur growth and, currently, there are no negative factors affecting economic growth. Rather, the issue of the Chinese economy is how to make such growth sustainable. This is because the current growth of the Chinese economy will not last long if it maintains the same model.

(2) Distortion caused by overheated investments

As is clear from Table 5, the driving force of recently attained growth is investments in fixed assets. These investments include real estate investments in addition to public investments and capital investments. The year-on-year rate of increase in fixed asset investments during the first half of 2006 was 29.8 percent, which is higher than the annual rate of increase of 25.7 percent in 2005.

Why are investments overheated? Complicated factors are involved in such overheated investments. For example, because the government forcibly purchases land (at costs lower than market prices) and provides the purchased land to developers at low cost, reckless development is taking place to construct industrial complexes, etc. Furthermore, in order to restrain the appreciation of the yuan, the government is purchasing a substantial amount of dollars, which is causing excess liquidity of the yuan and resulting in real estate speculation in urban areas. State-owned companies continue to increase their production in disregard of supply-demand balance to forcibly maintain the rate of production capacity utilization from the perspective of employment. Excess capital investments are made to procure the materials and components required for such operations.

Although efforts are being made to shift to a market economy, portions where price mechanisms do not work remain in China as represented by land transactions, exchange operation and planned economy-like corporate behavior. These distortions are linked to the issue of overheated investments.

One method of restraining overheated investments would be to increase loan rates. However, because uniform increases would have adverse effects on the overall economy (increasing loan rates might cool the economy, giving rise to the possibility of unemployment, which would be a major problem), the extent of such increases must be limited to be extremely small. Other methods that are used are those of absorbing funds from commercial banks that are providing excessive loans through administrative guidance, and of ceasing to provide loans to specific industries and/or specific companies by means of regulations applied to bank operations.

Table 5. Economic Outlook for China

Indicator	2002	2003	2004	2005	2006 (estimate)	2007 (estimate)
Real GDP growth rate (%)	9.1	10.0	10.1	9.9	9.6	8.7
Rate of increase of total industrial production (real, %)	12.6	17.0	16.7	16.4	16.0	14.0
Rate of increase of retail sales (nominal, %)	11.8	9.1	17.7	12.9	13.6	15.0
Rate of increase of fixed asset investments (nominal, %)	16.9	27.7	26.6	25.7	22.5	18.5
Trade balance (billion dollars)	30.4	25.5	32.1	102.0	104.3	104.6
Rate of consumer price growth (%)	– 0.8	1.2	3.9	1.8	1.9	2.2
Yuan/dollar (end of year)	8.28	8.28	8.28	8.07	7.85 – 8.05	7.55 – 8.00

Source: Nomura Securities Financial & Economic Research Center.

These methods handle problems individually to avoid affecting the overall economy. However, only symptomatic treatments such as providing guidance to banks without dealing with systematic contradictions will not be able to thoroughly resolve the issue of overheated investments.

Moreover, with respect to the problem of sharp rises in real estate prices in urban areas, there are some cases in which local governments are involved in land sales as a source of revenue. Accordingly, another issue is whether the central government can take a firm stance against local governments that are going too far. China needs the strong leadership of the central government to restrain overheated investments.

(3) Increasing trade frictions with Europe and the United States

In addition to increased investments, rapid growth in exports has supported good economic performance in 2005. However, in view of a growing trade deficit incurred by importing countries, the expansion of exports has already been nearing its limit. Such being the case, the government naturally wants to stimulate domestic demand.

The 11th Five-Year Plan started in 2006 designated the circum-Bohai region (the areas surrounding Bohai Bay such as Tianjin) as the priority development region at the national level following the Zhujiang (Pearl River) Delta and the Yangtze (Changjian) River Delta. This is part of the measures to stimulate domestic demand. The agricultural reform mentioned later in Item 2 is also part of these measures. Turning our eyes to the trends in domestic consumption, we find that the rate of saving remains high even in urban areas where remarkable income increases have been achieved in preparation for increases in expenses to receive medical services and education, and that people are reluctant to spend money for consumption.

This is because the new social system that can substitute for the public services that had supported life in the era of state-owned companies is not yet in place. In order for the government to stimulate domestic demand and shift away from the growth model that relied only on exports, the government must resolve a number of related issues.

When we look at only two aspects of investments and exports that support current economic growth, we find it difficult for China to continue to grow on an as-is basis.

2 Current Issues and Reform Directions of the Agricultural Sector

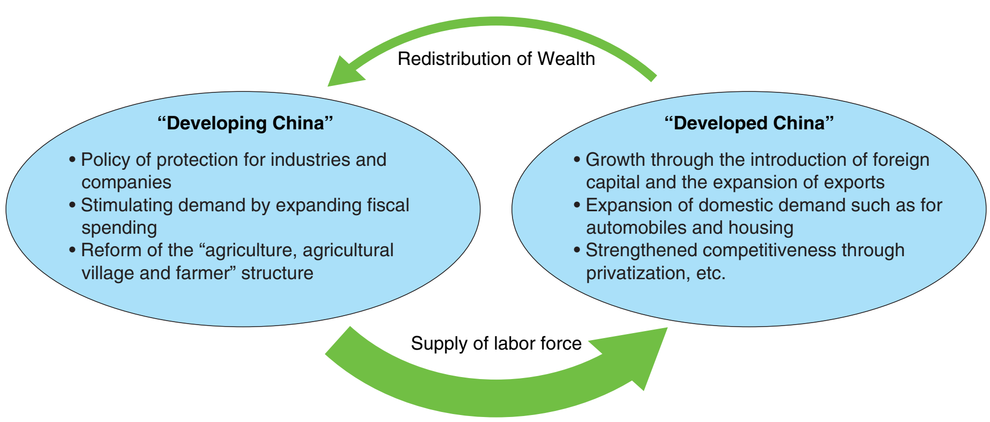
(1) Expanding economic disparities between urban and agricultural areas

Distortions created as a result of continued high growth have emerged as a foremost problem. If steps are not initiated to resolve these distortions at the current stage, this problem is likely to grow as a factor that causes major confusion in the future. The most serious issue is the economic disparity between the urban and agricultural areas.

Figure 14 outlines the mechanism of economic growth in China. China can be divided into "developing China" (inland and agricultural areas) and "developed China" (urban areas mainly in the coastal regions). A large volume of labor is supplied from "developing China" to "developed China." In "developed China," such labor is used to introduce foreign capital and promote exports. Consequently, the income of urban consumers increases, giving rise to demands for consumer goods such as automobiles and housing. In this way, wealth is accumulated.

Wealth accumulated in "developed China" is absorbed as taxes and flows back to "developing China" in the form of public investments. Wealth is also redistributed to "developing China" through workers who came from the inland areas to work in the coastal areas remitting money to their hometowns. While market economy has taken root in "developed China," a planned economy-like system remains in "developing China" such as stimulating demand through the expansion of fiscal spending, or that a local government takes remedial measures for a state-owned company undergoing hardships. It might also be said that the coexistence of a market economy

Figure 14. "Developing China" and "Developed China"



and a planned economy in a single country has enabled China's economic growth.

However, this mechanism has shown some signs of deterioration. Because the wealth accumulated in the urban areas does not flow back to the agricultural areas, income disparities between the urban and agricultural areas continue to grow. In the 1960s in Japan, income gaps between the large cities and rural areas expanded. When the entire nation is achieving high growth, gaps in growth between the large cities and rural areas generally widen. As a city grows, population migration from rural areas occurs, generating new households and giving birth to increased demand for real estate and durable consumer goods. Consequently, investments and consumption are vitalized.

Currently, the population ratio of China's urban and agricultural areas is around 4:6. In the coming five years, this ratio is expected to become almost equal, or the urban population may slightly exceed the agricultural population. In 2020, the urban population is projected to reach 60 percent. If no steps are taken to remedy this situation, while urban areas will become increasingly wealthy, agricultural areas will increasingly be left out of the growth pattern.

(2) Issues of "mingong," surplus labor powers, difficult to resolve

Many of the people who move into the urban areas from the agricultural areas are workers who are working away from home known as "mingong". Currently, the mingong population is estimated to be 140 million people, constituting about 10 percent of China's total population. Nevertheless, most mingong workers are in their 20s and strong workers in the prime of life. Due to restrictions imposed by the hukou (household registration) system, these workers return to their homes when they reach their 30s (they are not entitled to receive public assistance with registration as rural residents even if they continue to live in urban areas). In turn, new, young workers migrate to urban areas as mingong workers. On average, they acquire a disposable income of 3,000 yuan (about 45,000 yen) if they work for one year in urban areas. Usually, they remit almost this entire amount to their home. This remittance accounts for 40 to 50 percent of all the income of their home.

Mingong workers underlie the labor force of urban areas and, at the same time, provide funds to develop rural areas. However, many mingong workers who do not formally enter into employment contracts are sometimes treated improperly such as experiencing non-payment or delays in payment of wages. Even if they return to the rural areas, there are few opportunities for employment, and social systems such as medical services and pension programs are not yet established, preventing improvements of the standard of living.

Economic growth in China has been supported by an inexpensive and abundant labor force, namely the mingong workers. As a result, the urban economy has benefited, but agricultural villages have been neglected. However, if priority were given to the income of mingong workers, labor conditions were improved and wages were increased, the competitiveness of the country would be lost. The issue of the mingong workers is extremely complicated.

(3) Highest priority given to agricultural issues

In addition to mingong workers, there is an excess labor force amounting to as many as 150 million people in rural areas. This means that nearly 300 million people cannot make a living through agriculture. In order to secure a stable society, the government must promote economic development in rural areas by all means possible.

The concept of "building new rural areas" is incorporated in the 11th Five-Year Plan. A huge amount of funds will be allocated to develop the rural economy, establish industries and develop life infrastructure such as social welfare. In 2006 alone, the amount of funds to be injected into building new rural areas is 50 million yuan (about 750 billion yen), which is more than double the amount budgeted under the preceding five-year plan.

Among these projects, the highest priority is given to increasing the rate of participation in a health insurance network (a fund established by accumulated funds from farmers in addition to the national government funds) from 23.5 percent in 2005 to 80 percent in 2010. The plan also aims to increase the number of people covered by the old-age pension system that guarantees a person's senior life by 50 million persons during these five years.

In addressing agricultural problems, the 11th Five-Year Plan promotes permanent residence of mingong workers in urban areas. The hukou system that has strictly limited rural-urban population migration will also be relaxed. There is a need to develop new industries with a large capability of accepting mingong workers in urban areas. Even if mingong workers are not considered, the unemployment rate of young people in urban areas is higher than would be anticipated. There might be cases in which migrants from rural to urban areas and people living in urban areas struggle for job opportunities. In addition, if the number of people living in urban areas increases rapidly, various problems may also emerge, including traffic jams, housing development, urban waste and environmental pollution, and the government budget required to deal with these problems will rapidly increase.

However, if this issue is left untouched, confrontation between rural and urban areas may become more acute. Accordingly, urban residents want to avoid confrontation with rural residents while maintaining their vested economic interests. It is difficult to bridge the disparities between rural and urban areas in a short period. Up to now, the respective interests of both parties were not particularly considered during the period when the whole country was completely devoted to economic growth.

However, in view of growing disparities, the Chinese government must take serious approaches to adjusting the conflicting interests of both parties.

3 Energy and Environmental Issues Restricting Growth

(1) How to address the complicated problem structure

The increase in the national income in China has been stimulating consumption activities. With an increase in the number of people purchasing home electric appliances, automobiles, etc., mass production has been conducted at factories of Chinese companies where environmental measures are somewhat neglected. Consequently, the consumption of energy and the volume of waste have been rapidly increasing.

Causes that are assumed behind such environmental and energy issues in China include delays by the Chinese government and companies in dealing with such issues, undeveloped infrastructural facilities promoting environmental protection and energy savings and immaturity in the behavior and awareness of consumers who are becoming increasingly affluent. In sum, these issues require "responses by the government and companies," "development of infrastructure" and "people's increased awareness about these issues." Comprehensive measures must be taken to meet these requirements.

To promote environmental protection and energy saving measures, the postures of companies towards these measures are important. However, even if strict penalties and/or a system of preferential treatment is provided, managing and/or supervising companies alone will not be able to fully resolve these issues. For example, a company may conduct "by-the-book" operations at the time of an audit, and may then resume pollutant emissions after the audit is complete.

In China, in order to achieve the intended purposes, it is wiser for the government to strictly manage/supervise an administrative organization that oversees companies rather than directly overseeing the companies. The supervision of companies should be strengthened by strictly overseeing administrative organizations.

Specifically, environmental protection and energy saving measures should be included in the priority items of the performance evaluations of administrative officials, and a firm attitude should be taken to such an extent that inability to achieve target values would result in dismissal. If established targets are given to local governments, they will do their utmost to achieve such targets. It would be one way of promoting environmental protection and energy saving measures to skillfully utilize the individual abilities of administrative officials.

(2) Challenging objective of saving energy

The 11th Five-Year Plan aims to shift to growth based on a resource saving and environmentally friendly development model maintaining harmony between population, resources, the environment and economic growth. Specifically, the plan pursues the achievement of economic growth by improving the efficiency of the utilization of resources, although China has so far achieved economic growth by simply increasing the volume of injected resources.

Under this plan, energy consumption per GDP, water consumption per industrial added value (gross profit) and the forest coverage rate are treated as norms, and specific responsibilities are assigned to the central government and local governments for achieving these norms. It is highly significant (almost epochal) that China is working to establish quantitative targets for environmental protection and energy saving measures under a five-year plan.

For energy consumption per GDP, the target of a 20-percent reduction is established. Indeed, Japan has experience in achieving rapid improvement in the efficiency of energy use when Japan overcame two oil crises. For seven years from the first oil crisis in 1973 to the second one in 1980, Japan improved its unit energy consumption per GDP corresponding to about 20 percent. It took another 20 years—in 2001—before Japan was able to achieve its next improvement of 20 percent.

In the 1970s, the per-capita GDP in Japan was rapidly growing in excess of 2,000 dollars, which was close to the level that China will soon be approaching. However, although the rate of economic growth in Japan at that time was 4 to 5 percent, the rate in China remains at a level of 9 to 10 percent. Moreover, in Japan, which has no resources, an energy-saving policy could attain the public's consent, and companies promoted the implementation of streamlining measures because of the restrictions of outside resources imposed by the oil crises. However, China, which ranks as the world's first in terms of coal production, is projected to increase such production in keeping pace with economic growth in the future.

In view of this situation, it may be difficult for China to improve efficiency by 20 percent in the coming five years that took Japan seven years to achieve.

(3) Approaches of the Chinese government to environmental issues

Before the official announcement of the 11th Five-Year Plan, the State Council announced its decision "on adhering to the scientific view of development and further strengthening environmental protection," which represents its mid- and long-term policy on environmental measures. This policy requires the incorporation of the results of environmental measures in the rating items of administrative performance by local governments.

The policy also sets out detailed government roles such as the establishment of environmental standards, green procurement (procurement of environmental-friendly materials and components), applying sanctions to suppliers who disregard the standards, complete monitoring of environmental substances and securing funds to implement environmental measures. The policy also calls for the establishment of indexes to evaluate the performance of local governments such as green GDP (GDP after deducting the cost of environmental damage).

As such, through the strengthening of government functions and a review of evaluation indexes, investments in environmental infrastructure will increase throughout China. These moves are expected to lower the pace of environmental degradation throughout China.

4 Frenzied Investment by Local Governments

There is also a need to quickly address the issue of eliminating excessive production. This issue affects far-reaching fields, such as the waste of energy and resources, disordered pressure on exports and the stagnation of inventories.

For example, in the automotive field, while demand even in 2005 was for 5.7 million cars, China currently has a production capacity of 8.7 million cars and will have that of 10 million cars once factories under construction are included. Because the manufacturing industry is capable of providing employment opportunities and generates large production values, and from which revenues from added-value taxes can be expected, local governments are eager to develop the manufacturing industry even by forcibly providing financial support. In the area of materials, such as steel and aluminum where too much demand is already a fact, excessive production has become a serious problem. If production competition is not regulated by taking a hands-off policy on the part of local governments, the costs required for adjustment in the future will become even greater.

There is a phrase in China meaning "if strict control is imposed, vitality will be lost, but if a laissez-faire policy is taken, confusion will immediately take place." During the era of Mao Zedong, the central government had major authority in the form of a planned economy. Deng Xiaoping achieved success by increasing the extent of the freedom of local governments in vitalizing the economy. Jiang Zemin partially strengthened the centralization of administrative power. Now, Hu Jintao faces a situation requiring the central government to further strengthen its control of local governments. While it is ideal if market mechanisms function to adjust industrial balance (planned economy eventually failed; furthermore, strengthened government intervention is likely to cause corruption and inefficiency), the country is too large to smoothly achieve such an ideal.

During the period when everyone was united in achieving growth, the interests of the central and local governments were consistent with each other. Now, the interests of the central government and local governments are no longer consistent.

5 China's Moves in Political Reforms

(1) Promoting reforms within the Party

Even if economic structural reforms move forward smoothly during the next five years, China has another hurdle of the issue of political democratization. If the current administration is reappointed at the National Congress of the Communist Party in 2007 and is to fulfill its roles until the expiration of the term in 2012, the current administration will lay the foundation of political reforms in the five years following 2007; the full-scale moves towards democratization will become the responsibility of the next Chinese leadership. While trial and error will be repeated to achieve democratization, the process towards "development of democracy within the Communist Party of China" has already started to proceed.

In September 2007, the 17th National Congress of the Communist Party will be held. At this National Congress, the members of the Standing Committee of the Political Bureau and those of the Central Committee who constitute the highest leadership in China as well as leaders of local governments will be elected. Before this time, Li Junru, Vice President of the Central Party School of the Communist Party of China, said in a program broadcast on China Central Television in June 2006 that "the realization of democracy within the Communist Party will play a role as a model for developing democracy in the entire nation and push forward the reform of the nation's political institutions through institutional innovation inside the party." This statement can be interpreted as a declaration of the government's intention to promote the development of democracy within the Party before the realization of democracy throughout the entire nation.

In that sense, in addition to the selection of candidates for new leadership positions, the year 2006 will be an important year to ascertain how moves to develop democracy within the Party proceed. For example, Jiangsu Province announced the direct election of members of the Party in 891 towns in 2006 when the term of the current members expires. The municipal government of Changzhi city in Shanxi Province measures the degree of satisfaction with public service provided by municipal leaders by means of questionnaire surveys, etc., and announces the results in the form of ratings in newspapers, etc. In such ways, trials have already begun to hear the opinions of the public.

From 2006 to the first half of 2007, leaders of the Party at each local government level, such as provinces, cities, prefectures and towns, will be elected. In these elections, various attempts at democracy will occur. Rather than a simple format of direct election by individual citizens, democratization in China will be realized by gradually incorporating mechanisms that enable the country to essentially develop democracy while maintaining the systems currently in place in China.

(2) Differences from the Soviet Union

Some people liken China to the former Soviet Union. That country also undertook symbolic national projects such as manned space flight and the Olympic Games and in so doing, increased the authority of the Communist Party. Ultimately, however, the party organization collapsed in the process of promoting a shift to a market economy.

However, the nature of the Communist Party and the concept of the administration of state affairs differ fundamentally between China and the former Soviet Union. When planned economy reigned supreme in the former Soviet Union, it designated and managed more than 30,000 items as subject to planned production. In contrast, the number of items that China designated as subject to planned production at the level of the central government was in the hundreds.

The former Soviet Union formulated strict plans to the extent of covering numerous details. Such strictness had conversely invited rigidity. As all chains collapse when a single link is broken, the introduction of a market economy overturned the basis of social structure. However, in China, the central government determines major policy. Based on such all-encompassing policy, local governments actually administering each area independently formulate their own plans and flexibly implement such plans in accordance with actual situations. This system functions successfully to restrain any confusion in society caused by the introduction of a market economy.

While giving a certain degree of discretion to local governments, the central government firmly assumes the reins of the authority to appoint local leaders to prevent any reckless administration on the part of local governments. The performance of local officials is properly evaluated, and officials who perform well are selected and appointed to positions in central organizations. Having the ability to properly and accurately manage personnel affairs is the underlying factor that enables maintenance of the control of the Party.

The stable administration by the Communist Party of China will continue, and democratization will move foreword on a phased basis with the first step being the development of democracy within the Party.

6 Risks Lying behind China's Structural Reforms

While not discussed in this paper, in addition to the issues mentioned above, there are a number of other themes that are made subject to reforms under the 11th Five-Year Plan. They include reforms relating to the issues of social security, education and medical services that emerged as by-products of the restructuring of state-owned enterprises, and reforms of financial systems as represented by bad debts of banks and the need to create reliable conditions for the development of the stock market. It might be the case that the Chinese government itself is unable to project at present to what levels reforms can be implemented with respect to such a mountainous pile of problems. In any case, what can be done is to initiate reforms, start to achieve some results by implementing reforms and continue to consider what the best measures are while continuing to implement reforms.

Some officials of the central government with whom the authors had interviewed said about a number of reforms included in the 11th Five-Year Plan that "if China cannot achieve even one of them, China's growth in the 2010s will not be a reality." While the central government is determined to accomplish all of these reforms under the plan, at the same time, the risk exists that there is no guarantee that all such reforms can be completed.

For Japanese companies that have been substantially committed in China, the success or failure of this 11th Five-Year Plan constitutes the risks that China encompasses. They must carefully watch the progress of the plan to determine whether China can grow as steadfastly in the 2010s as in the past.

V India's Prospects and Inherent Business Risks

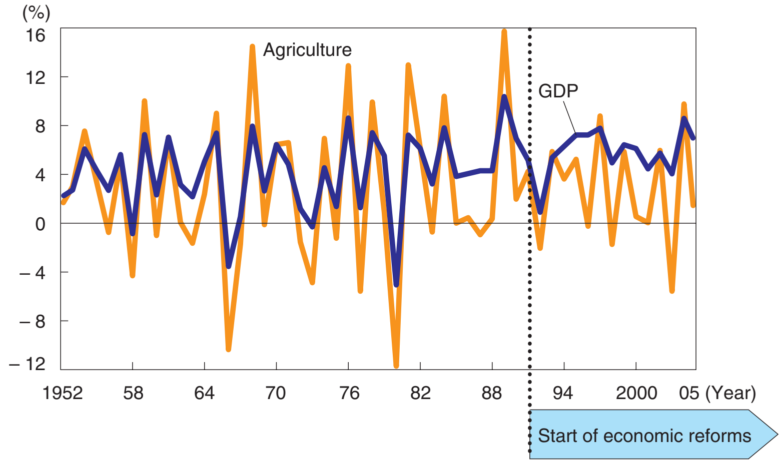
1 Stable Growth Has Come to Stay in India

(1) Economic reforms began in the 1990s

China's reform and opening-up policy started in 1978 with a declaration by Deng Xiaoping at the 13th National Congress of the Communist Party of China. However, India's economic reforms started more than ten years later—in 1991. At that time, India was distressed by the expansion of its trade deficits resulting from the rapid increases in oil prices caused by the Gulf War and the reduction in workers' remittances from the Middle East, and was experiencing a serious shortage of foreign currency reserves. To deal with the situation, India initiated economic reforms in cooperation with the International Monetary Fund and the World Bank. The country implemented measures of economic liberalization such as opening the market from state-owned firms to private companies, relaxing regulations on foreign capital investments and currency devaluation.

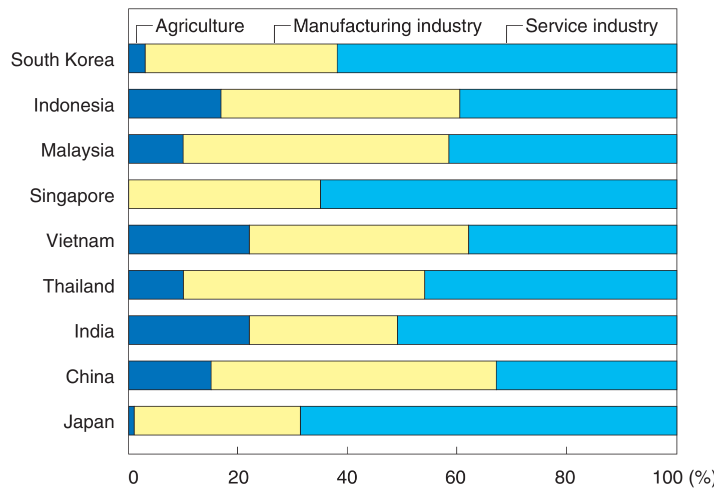
Figure 15 shows the transition in real economic growth rates in India over the past 50 years. According to this chart, prior to 1991, rates of growth fluctuated greatly and were almost synchronized with fluctuations in the agricultural sector. This suggests that India was a typical agricultural country at that time, and that the national economy was dependent upon the weather. However, although the rate of growth dropped sharply in 1991, the economy began to stabilize towards 1996 at a growth rate of around 5 percent because of the subsequent implementation of measures of economic liberalization. The growth rate increased to a level of 6 to 8 percent after 2004. Through taking a series of reform

Figure 15. Change in Rate of Economic Growth in India



Source: JETRO.

Figure 16. GDP Composition Ratio by Industry in Asian Countries (2003)



Source: Compiled based on statistical materials published by the Indian government.

measures, India has finally been able to continue to record positive economic growth.

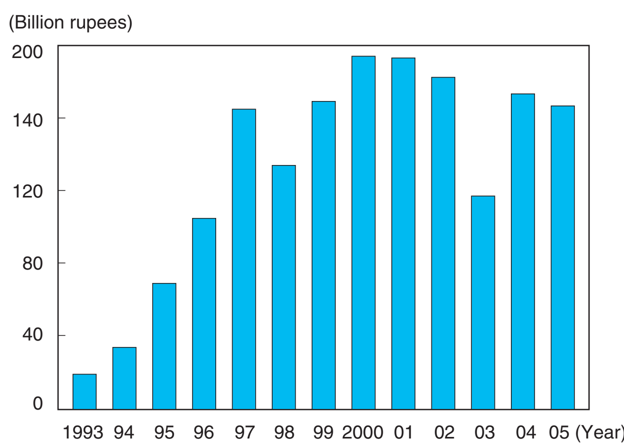
As shown in Figure 16, the significance of agriculture in the Indian economy is still high even in comparison with other Asian countries. Because of this, even after 1990, the fluctuations of the rates of economic growth have been influenced by the performance of the agricultural sector. However, since around 2000 when the Bharatiya Janata Party (Indian People's Party) took the reins of government and further promoted deregulation, the extent of fluctuation has been substantially reduced.

(2) Preparation of environment for foreign companies to enter the Indian market started

Only ten years have passed since the Indian economy started to achieve stable growth. In this sense, India differs greatly in terms of the level of economic development from China, which started its reform and opening-up policy in 1978.

For example, although direct investments from other countries have grown substantially since liberalization,

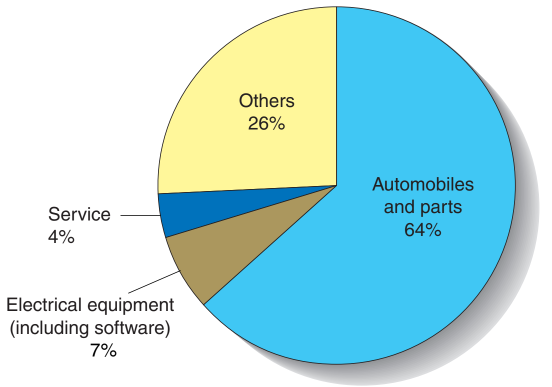
Figure 17. Direct Investments in India (Implemented)



Notes: (1) The figure for 2005 is an estimate. (2) 1 rupee = about 2.5 yen
Source: JETRO.

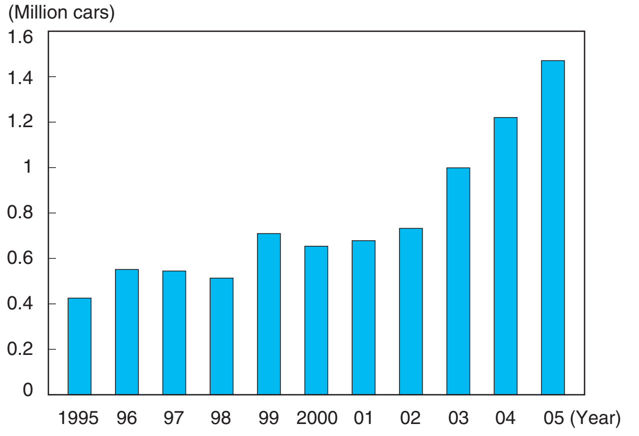
as shown in Figure 17, increases and decreases have been repeated, rather than there simply being increases. If a comparison is made in terms of absolute values, direct investments (those implemented) in India in 2005

Figure 18. Direct Investments from Japan to India by Industry (Total investments implemented in 2000 – 2004)



Source: JETRO.

Figure 19. Number of Automobiles Sold in India



Source: Compiled based on materials published by the Society of Indian Automobile Manufacturers.

amounted to 4.4 billion dollars, which is less than one-tenth of those in China.

According to Figure 18, which shows the composition ratios of total direct investments by industry from Japan to India in the past five years, products related to automobiles account for 64 percent, generating large differences by industry. Investments in export-oriented assembly industries such as electrical equipment and machinery, which are often seen in developing countries in Asia, are limited in India.

Furthermore, although India started to open its markets to foreign companies in 1991, various regulations were applied to the foreign companies that entered the Indian market at that time, which can be characterized as being far from liberalization. Entering the 2000s, however, the Vajpayee Administration of the Indian People's Party has actively promoted a policy of liberalization. Based on this policy, deregulation measures have started to move forward for the participation of foreign companies in the Indian market, such as relaxing export obligations and regulations on the total import volume, and permitting participation in regulated industries. In February 2006, in the distribution fields where strict regulations had been applied, amendments were made to the applicable laws to allow foreign investments up to the rate of 51 percent when products are sold under a single brand name.

While the current situation has not yet reached the stage that can be described as one at which direct investments start to increase at an accelerated pace, direct investments will continue to increase on a stable basis because of the improvement of market appeal and deregulation of foreign capital.

2 Signs of the Expansion of the Consumption Market

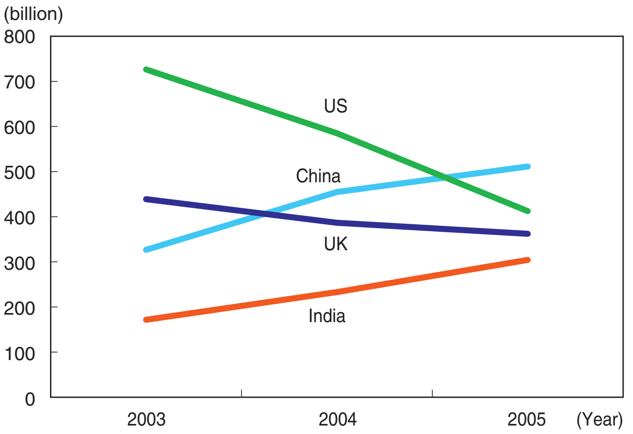
As mentioned above, the automobile industry accounts for a majority of recent direct investments from Japan. Actually, as shown in Figure 19, the number of vehicles sold in India has been increasing rapidly in recent years. Specifically, the number of passenger cars sold in 2005 exceeded one million cars. Even in Thailand, which is the largest automobile market in the ASEAN countries, the number of passenger cars sold in the same year was only 190,000 cars (700,000 cars if commercial cars are included), generating obvious differences. The number of passenger cars sold in China in 2005 was 3.97 million cars. While India falls short of China, it has already formed a market with a size that runs far ahead of the ASEAN countries.

In India, urban population accounts for 30 percent of the total population. The top 10 percent of urban population in terms of income, namely 30 million people and about 10 million households, is considered to constitute a segment capable of purchasing automobiles. Recently, in particular, the popularity of purchases by loans and product strategies of automobile manufacturers has been accelerating expansion of the automobile market.

In India, Maruti Udyog Limited (Suzuki's subsidiary) and Tata Motors are selling low-priced cars, enabling consumers to buy passenger cars at 200,000 rupees (about 500,000 yen). Double-income households in urban areas are fully capable of purchasing a car of this class if a 6- to 7-year loan is arranged. Tata Motors announced that it would offer strategic small cars at 100,000 rupees (about 250,000 yen) in 2008. As such, the passenger car market in India is driven by domestic small cars.

In addition to automobiles, such expansionary trends are also occurring in other industries. For example, the number of mobile phone subscribers exceeded 80 million people as of January 2006. Recently, the number of subscribers has been increasing at a rate of 2 to 3 million people monthly, and may reach 100 million people at the end of 2006. With the increases in the number of subscribers, the market for mobile phone terminals has also been expanding rapidly. As shown in Figure 20, India

Figure 20. Top Four Countries in Nokia Sales



Source: *business Today*, April 2006

ranks 4th in terms of sales of Nokia (Finland) by country. In 2006, India is expected to outstrip the UK and rank 3rd. If the number of subscribers continues to grow at this pace, India may also surpass the US and will approach that of China.

Nokia already has a remarkable share of 76 percent of the Indian market. By projecting that the market size of mobile phone terminals will exceed 400 million units around 2010, Nokia announced in 2006 that it would construct the Nokia Telecom Industry Park (330,000 m^2) at Chennai. At this park, Nokia plans to establish a huge industrial complex where network operation service is provided for communications carriers in Europe, the Middle East, Africa and Asia, in addition to the manufacture of terminals and network equipment. Construction of a research and development center is also planned for this park.

In India, there is only a limited number of highly competitive domestic manufacturers in the manufacturing industries such as automobiles and high-tech equipment. Accordingly, if drastic measures are taken to invest at this time when the market is rapidly expanding, it might be possible to produce reasonable profits without going through intense competition (unlike the case in China).

In India, household income has surely benefited from the open economic policy that started in the 1990s. In the 2000s, the rise in the income of workers' households (wages) especially in urban areas has constituted the background behind the consumption boom in durable consumer goods. Furthermore, while participation in the distribution industry was strictly regulated in the past, the laws amended in February 2006 have permitted equity holdings up to 51 percent (for the sales of products under a single brand name) in the retail sector in addition to the wholesale sector in the manufacturing industry. In the future, it will become possible to establish a sales structure focusing on direct sales. These trends of deregulation in the distribution field will spur on the expansion of the consumption market.

3 Korean Companies Rapidly Growing in the Indian Market

While the Indian market has definitely been expanding, we find it difficult to say that many foreign companies are enjoying success. One of the reasons for failure is that an enormous investment is required if a company attempts to cover an entire market that extends over far-reaching areas.

India has vast land areas amounting to nearly 3,000 kilometers respectively in the east/west and north/south directions, where a population of more than one billion people is scattered. For example, there are only three cities having a population of more than 10 million people, namely Mumbai, Delhi and Calcutta. Even in Bangalore and Chennai, which are well known by foreign companies, the population is about 6 million people. In contrast, there are a number of mid-sized cities throughout the country with a population of one million or less. In order to achieve good performance in the Indian market, a company must provide a sales network that efficiently covers these population centers and a product lineup that conforms to customs that largely differ for each ethnic group and each area, and that meets diversified needs.

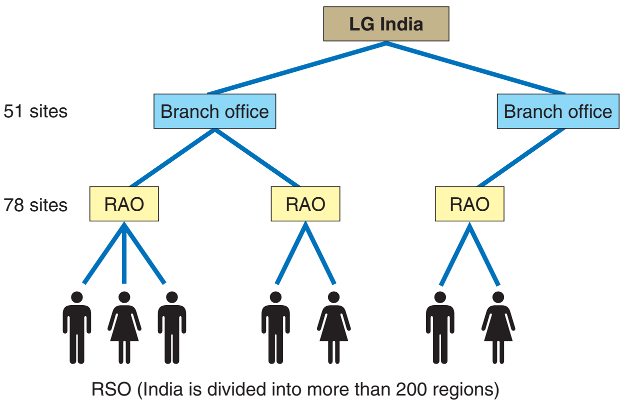
The following section introduces the case of South Korea's LG Electronics, which has been especially successful among foreign manufacturers and has already become the largest manufacturer of electronic products in India. The sales of LG India, its subsidiary, are said to amount to about 170 billion yen, which is extremely large in comparison with the current sales of Japanese manufacturers from most home electronics and AV (audio/visual) business operations in India, which are only at the level of several billion yen.

LG India earns about 70 percent of its sales from mid-sized cities (including agricultural villages) with a population of one million or less. While sales in large cities for which the company has long been making focused efforts are growing, the rapid increases in sales in the 2000s are rather driven by sales in mid-sized cities and agricultural villages.

Take microwave ovens for example. LG India changes the capacity for each area. In order to introduce such functions in small cities and agricultural villages, the company drives a van loaded with such products around these areas to conduct demonstration sales. For the whole of India, the company is trying to establish the impression of a manufacturer of high-tech products under a corporate brand fully pursuing "health." For rural areas, the company provides low-priced models with minimum sets of functions.

As shown in Figure 21, the company divides all of India into as many as more than 200 regions. The head office has about 51 branch offices. Under the management of each branch office, there are a total of 78 remote area offices (RAOs). Each RAO supervises regional

Figure 21. LG India's Sales Structure



Notes: RAO = remote area office, RSO = regional sales officer.
Source: ICFAI Center for Management Research.

sales officers (RSOs) who are vested with authority that covers marketing, sales promotion and the management of agencies and retail stores in the assigned region. While authority is given to front-line offices for activities dealing directly with consumers to the maximum extent possible, the head office strictly controls sales performance through the RAOs and branch offices.

Not only Japanese companies but also other Asian companies such as South Korean, European and US companies participated in the Indian market in the 1990s when economic reforms started or tried to expand business in India at a single stroke. However, most companies were unable to generate profits and were forced to restructure their business operations in India during the latter half of the 1990s. Major European and US companies such as Kellogg, Philip Morris, Unilever and Gillette largely converted their strategies at the end of the 1990s. LG Electronics, referred to above, also rearranged its strategies around 2000 by carefully looking at the situation where Samsung Electronics, which was the first Korean company to enter the Indian market, was having a difficult time.

Because the Indian market is growing fast and changing at a rapid pace, market changes must be monitored continuously, and far-reaching reviews of strategies must be implemented without being bound by past successes. In the case of LG Electronics, the chairman and vice chairman of the head office in South Korea have frequently visited India. This is, of course, because the company has great expectations for its business operations in India. At the same time, it also suggests that the risks of business operations in India are so great that even the top executives at the head office must become involved.

4 Chinese Companies Aggressively Entering the Indian Market

Chinese companies also have strong interest in the Indian market.

Lenovo, a major personal computer manufacturer in China, established a local company in India in 2005, and has been strengthening its production and sales activities in India. In China, the availability of laptop PCs with the world's latest functions is required in major cities such as Beijing and Shanghai. However, desktop, low-priced PCs with minimum functions are popular in small cities and agricultural villages. In order to tap markets with large economic disparities, an extensive product lineup from high-end to low-end products is necessary. In this respect, the Indian market resembles the Chinese market.

A Lenovo executive noted that the expertise accumulated in China to establish a network of sales and after-sale service that covers vast land areas and to efficiently operate such a network can be fully utilized in India. India resembles China in that strategies to cover retail stores by a great number of sales persons can function successfully.

Winner companies in China, which is one step ahead of India in terms of economic development, may have the advantage in the competition by also utilizing their business know-how in India. The reason for India's strong insistence on the issue of designating the place of origin at the negotiation stage for a FTA between India and Thailand is said to be attributable to its concern over the flooding of industrial goods made in China through Thailand (in the name of products made in Thailand). From the future perspective, Chinese companies that have an overwhelming supply capability might rush into the Indian market.

5 Addressing Concealed Risks within Business Operations in India

India has significant appeal as a market. However, attention must be given to the risks to be encountered in India in evolving business operations that are different from those in other countries. While the following section summarizes the typical issues, business operations in India must be more resolute in establishing "defensive strategies" than in adopting "aggressive strategies".

(1) Labor disputes and wage increases

The first issue concerns labor disputes and wage increases. In India, moves to develop democracy have long been promoted from an early stage, and workers are highly aware of their rights. If any problem occurs in relationships with a labor union, workers go on strike, which can sometimes extend over a long period. In Asia, countries where labor disputes frequently take place include South Korea and Indonesia. In terms of the number of occurrences of labor disputes, the figure in India is 1.5 times that in South Korea, and twice that in Indonesia. There are also cases in which a large-scale strike has taken place at a Japanese company. If a strike occurs in which a leftist workers' union from outside participates, a company has almost no choice but to accept high wage increases.

The average annual rate of wage increases in 2005 was 13.9 percent. While the absolute value of wages is still low, many companies are struggling for competent personnel in large cities where many foreign companies have offices. For example, in Bangalore, wages for employees at managerial positions have been rising rapidly.

(2) Delays in developing infrastructure

Because India is constantly plagued with fiscal deficits, the country is unable to make sufficient investments in infrastructure that are necessary for economic growth. For example, outdated buildings and facilities that can hardly be described as modern are used at airports on an as-is basis. The same thing can be said for port facilities. India originally had many river ports and a small number of good harbors. Stevedoring capabilities could not catch up with demand. When cargo arrives, loaded ships must wait offshore, or goods are stored out in the open air and exposed to the elements, often ruining the products.

Turning our eyes to land transportation, we find that in addition to delays in developing roads, India has tax systems that differ by state, and that taxes are levied for goods sold across state lines. Accordingly, it is not uncommon to see a long queue of trucks at a state border crossing. In Japan, it is generally possible to transport goods 800 kilometers per day; such distance is said to be less than 300 kilometers in India. If products and/or components are transported from Delhi to Bangalore (a distance of 2,500 kilometers in a straight line), simple calculation shows that such transportation will take nearly ten days.

Sony closed its TV factory in Delhi and shifted the production of all units to imports from Thailand. As the case with Sony suggests, distribution costs can be lowered by transporting products manufactured overseas to major ports such as Mumbai, Chennai and Calcutta and delivering them by land than when making deliveries from factories in India.

(3) The pace of market growth

Since 2000, consumption has been expanding rapidly. However, it is somewhat doubtful as to what extent this growth rate is sustainable. Even in comparison with China, the India's urbanization rate does not simply increase.

The annual income per taxable income earner in India is said to be more than 100,000 rupees (about 250,000 yen). In the entire country, the number of taxable income earners is only about 28 million people. The absolute number of wealthy people is also still small as compared to that in China. In India, attention must be given to the fact that while it is certain that the market will continue to grow, the pace at which the market grows fluctuates such as sometimes reaching a standstill, rather than growing at a steady rate.

(4) Complicated tax and legal frameworks

The tax systems in India differ by state and are extremely complicated. This issue presents the most burdensome risks in conducting sales activities in India. For example, even if basic tariffs are reduced to zero under the FTA, additional tariffs to maintain a balance with commodity taxes imposed on domestic goods, countervailing duties and education cess (taxes for education purposes) are additionally imposed. In addition, a central sales tax (CST) is also imposed if sales are made across state lines. Because of such extremely complex tax systems, a book the size of a telephone directory is said to be required for preparing product price lists based on tax system details that differ by state.

While the legal framework has been established, there are many problems in terms of implementation. In India, lawsuits are frequently raised with respect to payments for transactions with local distribution agencies. Because a tremendously long time is required to conduct a trial, some say that being the target of a lawsuit is the same thing as losing a lawsuit.

A company must be prepared for the certain number of years of experience required to understand the reality of various systems in India.

(5) Difficult to secure qualified managerial personnel

Due to an Indian boom in recent years, an increasing number of foreign companies have been participating in the Indian market. Accordingly, competition to acquire competent human resources has intensified. To begin with, the literacy rate in India is about 65 percent. Although India has a large population, only a small number of people in the upper class can receive higher education partly because the caste system still preserves vestiges. In addition, the more competent people are, the more likely they are to go to Europe, the United States or Singapore. For these reasons, foreign companies that have entered the Indian market are having a difficult time recruiting managerial personnel who can assume management responsibilities.

Some companies have dispatched Indian staff members (so-called non-resident Indians) employed at their overseas subsidiaries in Singapore, the Middle East, the United Kingdom or the United States to India. These overseas subsidiaries are always looking for personnel who can be assigned to India. However, even for such Indian staff members, the living environment in India is not easy. Accordingly, they are dispatched to India under assignments for only several years. After the expiration of the terms, they are returned to the countries where they were originally working.

While multinational companies can usually undertake such measures, other companies have no other measures than to develop and train people recruited in India. In addition to a high labor turnover rate in India, demand for highly educated workers exceeds supply in major cities, making recruitment of talented workers difficult.

(6) Competing with products imported through unauthorized routes

Because a variety of taxes other than basic tariffs are imposed on products imported through authorized routes, many goods are imported through unauthorized routes. Some wholesale dealers in Singapore and Dubai are selling goods through illegal channels in India. Situations often occur in which the same company's products imported through authorized and unauthorized routes compete with each other in the Indian market. Among some home electrical appliances sold in India, unauthorized products account for 20 to 30 percent of all sales.

From the perspective of manufacturers, it may be possible to have the attitude that there is no problem if sales grow. However, from the perspective of distribution companies, goods sold through unauthorized channels get a free ride on the companies' strengthened efforts to invest in marketing activities and advertising, and in establishing an after-sales network, leading to a substantial decrease in motivation. Even if a manufacturer asks its distribution companies in Singapore and Dubai to be wary of wholesale dealers that handle goods through unauthorized routes, there are cases in which distribution companies pretend not to see such illegal sales on the part of wholesale dealers because they also must meet their sales quotas.

(7) Being bound by NOC restrictions

The Non-Objection Certificate (NOC) restrictions that are distinctive to India require foreign companies that have set up a joint venture in India or established partnerships with Indian companies to obtain consent of their Indian partners when the company launches a new business in India.

Suppose a company sets up a joint venture with an Indian partner to sell Product A and, subsequently, this company plans to develop a new business with a different partner for Product B. The new business for Product B is not permitted without a Non-Objection Certificate from the existing partner for Product A. If a foreign company sets up a joint venture in India and then fails to maintain a good relationship with this first partner, the company will be deprived of options to evolve new businesses in India in the future.

In 2005, the Indian government issued a notice of relaxing the NOC restrictions, narrowing the applicable scope of such regulations from "related business fields" to the "same business field". However, foreign companies that entered the Indian market before this deregulation took effect are still bound by the NOC restrictions.

As stated above, India has unique complicated systems, labor issues and commercial practices. Because of such complexities, it is important to establish partnerships with Indian companies. At the same time, however, if an inappropriate partner is selected, a company will be burdened with a major obstacle for future business evolution.

For example, in many cases, foreign companies enjoying success in India such as LG Electronics and Sony are operating through wholly owned subsidiaries. Samsung Electronics made a large payment to purchase equities held by the partner company of the joint venture that it established, and re-started its business in India through its wholly owned subsidiary. Honda Motor also obtained a NOC after going through difficult negotiations and finally received governmental approval for conducting business through a wholly owned subsidiary.

Even if it is inevitably necessary to establish a joint venture for purposes such as addressing obscure, non-transparent administrative guidance in India, it is, of course, necessary to select a partner carefully. In addition, measures such as minimizing the ownership percentage of the partner must be taken.

VI Asia in the 2010s and Suggested Strategies for Japanese Companies

1 Asia in the 2010s and Japan's Role

The Asian economy is shifting from a growth model in which a single country takes the lead and other countries follow, a model which is described as the flying-geese pattern, to one in which NIEs, ASEAN countries, China and India respectively utilize their own originalities and grow dynamically while mutually cooperating with each other vertically and horizontally.

Rather than taking an approach from the perspective of being one step ahead of other Asian countries, Japan should make strenuous efforts to support the strengthening of alliances within the region and should take the lead in promoting cooperation among Asian countries. Japan should endeavor to become a country that will be respected by neighboring countries and regions because of such efforts. For example, resource and energy conservation and environmental protection measures represent themes for which both the public and private sectors in Japan can take the initiative to resolve related problems existing throughout Asia. Contributing to the resolution of the problems facing Asia will help promote sustainable growth in Asia, which will eventually benefit Japan.

2 Sustainability of Chinese Economic Growth Will Influence All Asia

In considering the next ten years, China's growth potential still remains a most important theme. While China provides a number of opportunities for growth, such opportunities entail business risks that require caution.

The pace at which China has so far achieved growth has been too fast to adequately address the shadow portion of such growth, income disparities, and resource and environmental issues. However, the authors believe that many of these problems can be overcome if China undertakes drastic reforms without delay when the country is in good financial condition and is politically stable. From the short-term perspective, these reforms and growth may serve as a trade-off. Because of this, high political capability will be required to coordinate the interests of people who focus on promoting growth with those who give priority to reforms of the shadow portion.

Many experts are pessimistic with respect to China's future and risks. However, China takes these problems seriously and is making efforts to overcome such issues. Rather than indifferently taking a gloomy view of China's future, Japan should discuss what support it could offer to help China's efforts result in success. This is because the sustainable growth of China will bring about significant benefits not only to Japan but also to the Asian economy as a whole.

In the immediate future, there are no concerns over China's continuing growth. However, whether China can also sustain such growth in the 2010s depends on the economic reforms to be implemented by the Hu Jintao administration in the next five years.

3 Future Asian Strategies for Japanese Companies

The strategies for Asia vary according to business field and company size. When we consider environmental changes that may occur in the future, we can identify the following common viewpoints in establishing corporate strategies.

(1) Human resource strategies to expand business in China

After ten years, the largest consumption market in Asia will no doubt be China, not Japan. The coastal areas will have grown to a huge market consisting of a population of 200 million people. Although there is an option of intentionally avoiding the Chinese market where intensified competition will undoubtedly occur, wining the competition in China will basically have a significant meaning in terms of global strategies (at least from the perspective of market size).

In the past several years, Japanese companies have competed relatively well in the Chinese market. In order to strengthen decision-making capabilities on a local level, top executives were dispatched from head offices in Japan to China. Investments were made to establish sales and after-sales networks, the lack of which was pointed out in the past as weaknesses. Research and development centers were established to promote product planning and design that takes the preferences of Chinese consumers into account. Based on the lessons learned from anti-Japan protests and riots, risk management systems have been strengthened at local offices. As such, major improvements have been made to address substantial parts of the issues that were considered problems.

One issue that is still difficult to resolve is the matter of human resources. While a substantially high level has been achieved in terms of Chinese strategies through various experiences and learning, the structure for successfully implementing such strategies has not yet been completed at local offices. If management continues to consist of mostly Japanese employees, the ability to "thoroughly implement strategies" cannot be achieved. There are many issues to be dealt with in developing human resources, such as a personnel management system that can raise the level of motivation of local staff members, programs to develop and train managerial personnel, and intra-company communication systems to increase employees' loyalty to companies. These matters should not be left up to local offices. Rather, all specialists in personnel affairs at the head office must join to formulate a comprehensive human resource strategy for China.

(2) Formulating strategies for India at the level of the head office

The Indian market is now at the stage of taking off, and is at an optimal time for Japanese companies to fully expand their business in India. Some Japanese companies have been controlling their business in India remotely from Singapore or Dubai. However, the earlier the timing of full-scale participation in the Indian market, the better, since the learning curve takes a long time to level out. (This is because India has a number of complicated issues, and a certain time is required to understand the actual situation.)

However, in spite of the appeal of an emerging market, the Indian market contains many business risks. The formulation of strategy for business in India is not a theme that can be addressed at the level of a department or subsidiary, to say nothing of local offices deployed in Asia. Once a decision is made to enter the Indian market, adequate resources should be allocated to build a firm protective structure against potential risks. Accordingly, top executives at the head office in Japan should also be resolutely involved in formulating a strategy and managing personnel affairs. If a company is determined to fully participate in the Indian market, its commitment should be made to such an extent that top executives at the head office in Japan visit India frequently.

(3) Rebuilding the ASEAN Production Structure after the Realization of AFTA

In the next ten years, the ASEAN countries will also undergo major changes. These changes include the realization of the ASEAN Free Trade Area (AFTA) and tie-ups with the Chinese and Indian markets. ASEAN would be required to re-define its functions as production bases not only within the ASEAN region but also throughout Asia.

The ASEAN countries have adopted an import-substitution industrialization policy by setting high import tariffs. During the period of yen appreciation following the Plaza Accord of 1985, they invited Japanese companies to set up factories in ASEAN countries. However, if intra-region tariffs were lowered based on AFTA, it will not be necessary for Japanese companies to set up production bases in each country. The factories of Japanese companies constructed in ASEAN countries serve two purposes: one is that these factories function as global export production bases and the other is that they function to meet the domestic demand of the relevant country. The former factories have little relationships with AFTA. However, with respect to the impact of AFTA on the latter factories, it would be more efficient to concentrate production activities in a country having an advantageous production capacity than setting up factories in each country.

Matsushita Electric Industrial Co. relocated its factories to meet domestic demand for home electrical appliances in Malaysia to production bases in Thailand. In the future, such moves to shift the production functions to GMS will increase within the ASEAN region.

(4) Response to the rise of new middle-income market segments in Asia

In Asia that continues to grow, the middle classes, chiefly consisting of young people who benefit from such continuing growth, began to come to the fore. Accordingly, it is a vital issue for companies to determine whether they can penetrate these new segments. However, because Japanese products carry with them the traditional image of high quality and high prices, there are concerns that the new middle classes that are assuming greater prominence may have an old-fashioned image of Japanese products. Rather, they may likely believe that European, US and Korean brands are more advanced and refined. Accordingly, it is important for Japanese companies to develop a strategy that promotes the penetration of their brands into the market of young consumers and to develop and offer products and services that appeal to such consumers.

(5) Needs for strategic functions to cover all of Asia

Finally, when we think of the future Asia, we believe that it merits attention to build a structure of business operations that extensively covers all of Asia, such as developing production, marketing and brand strategies that cover multiple countries throughout Asia, rather than conducting business operations by vertically dividing Asian countries.

To name a few, such strategies could include creating a business model linking India and China, planning an Asian brand used by multiple businesses, and drastically rearranging production bases within the ASEAN region. There is no doubt that opportunities to formulate strategies envisioning all of Asia will increase. It will also be necessary to build functions similar to those of the Asian headquarters and to intentionally develop personnel who can take on a broad view of Asia, rather than being well versed in any specific country or region.

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