Effectiveness of the Flowchart Approach to Industrial Cluster Policy in Asia

KUCHIKI Akifumi[*]

Abstract

Our static model concludes that a multinational in industry of diminishing returns to scale will increase production of a region in a developing country if its exchange rate to the developing country is appreciated. Our dynamic model also shows that the longer its investment period becomes the more the currency exchange rate of a multinational's country should be appreciated to invest in the developing country. The dynamic model concludes that the longer the investment period becomes the less the country risk of the developing country should be. However, we show that its high country risk can be compensated by lowering the corporate tax rate of the developing country. A more realistic model of countries in East Asia in the 1980s can confirm this conclusion. That is, the preferential treatment of tax reductions or exemptions by the developing countries was effective in inviting foreign direct investment. Our above models imply that roles of central governments are crucial to inviting foreign direct investment to form industrial clusters by building capacity of infrastructure and institutions.

Key words: flowchart approach, industrial cluster policy, capacity building, institutions, exchange rate, country risk, corporate tax rate

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[*]Executive Vice President, Institute of Developing Economies - Japan External Trade Organization; Visiting Research Fellow (From April 2004 to March 2005), Economic Research Center, Graduate School of Economics, Nagoya University.

E-mail: akifumi_kuchik@ide.go.jp