



Asia-Pacific Economic Cooperation

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**2004/ASCC/014**

Panel: 7

## **Integrating Supporting Industries-APEC's Next Challenge**

Purpose: Paper Presented to ASCC, PECC Trade Forum – LAEBA Conference

Submitted by: D. McNamara, APEC Academic Centre



APEC Study Centers Consortium Meeting  
**Viña del Mar, Chile**  
**26 -29 May 2004**



## ANNEX E

### EXECUTIVE SUMMARY

#### **Background Information**

Abstract: How can we sustain growth in trade and manufacturing investment across borders within APEC? Complementarity of supporting industries within industrial sectors across member states would encourage long-term investment. This paper looks first to fluidity of global manufacturing capital, then to complementarity of “business environments,” and finally to paths for better integration of supporting industries. I conclude with policy recommendations on information, organization, and inclusion.

#### **Recommendations**

*Please indicate required actions, decision points (e.g. note, approve, etc)*

It is recommended that ASCC Delegate:

1. Submit proposal on “Map of SME Network.” to SME Working Group. “Trade and investment promotion organizations in individual member states have begun to provide data on the composition, sectoral specialization, and location of local SMEs. But this effort differs widely among member states, depending on the resources and commitments of government offices and concerned business associations. Moreover, competing and sometimes cooperating organizations in the private and public sector provide a variety of profiles. Foreign investors would be better served with a more consistent mapping of SME networks within APEC, particularly with the growth of intra-regional trade and investment. Insofar as SME networks have come to represent a regional rather than solely national asset, a coordinated regional profile of networks within specific sectors is both feasible and desirable.”
2. Submit proposal on “SMEs Inclusion in Sectoral Dialogues” to SME Working Group, and to Automotive Sectoral Dialogue. This is a proposal to include organized groups of SMEs in the Sectoral Dialogues on a regular basis. I am most familiar with the automotive dialogues. Fortunately, this sector is distinguished by well-defined supplier networks of larger and smaller SMEs. Major component manufacturers will sometimes join the dialogue, and represent to some degree the SME supplier networks which they coordinate. It would not be difficult to establish a more independent and cohesive representative for these cooperative associations of suppliers, and then to find ways to incorporate them in reviews of major sector-related issues. This might in time serve as a model for other sectoral dialogues, or for more focused, limited dialogues on APEC sectors in transitions of decline or rapid growth.

\*For conciseness, please try to limit the information to one page. Thank you.  
Administrative Circular N° 7 – APEC Study Centers Consortium Meeting. 27

# **Integrating Supporting Industries – APEC’s Next Challenge**

Dennis McNamara, Georgetown University

APEC Study Center Conference, Vina del Mar, Chile.

Part I: From Proliferating PTAs to APEC-Wide Liberalization: Is There a Way Forward?

Panel 7 May 28, Friday, 11-12:30: Sequencing Issues in Practice (PECC TF-LAEBBA Session 2)

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Abstract: How can we sustain growth in trade and manufacturing investment across borders within APEC? Complementarity of supporting industries within industrial sectors across member states would encourage long-term investment. This paper looks first to fluidity of global manufacturing capital, then to complementarity of “business environments,” and finally to paths for better integration of supporting industries. I conclude with policy recommendations on information, organization, and inclusion.

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## **Introduction**

I begin with three questions. How can we sustain growth in APEC trade and investment? How can we strengthen local comparative advantage to maintain and extend links to global production chains? And thirdly, how can we insure effective transfer of knowledge and technology from investing multinational firms to host country SME suppliers? Local host country suppliers “supporting” the FDI manufacturing projects of multinationals provide our subject. Integration of offshore networks into regional nodes in global production chains provides a focus.

Here we confront one of the most difficult challenges in world trade and investment of our era: the fragmentation of globalization. Cost advantages of global sourcing can undermine local supply networks. Global manufacturing FDI seeks ever lower production costs. The constant demand for lowering production costs, coupled with

modularization of production techniques, can force standardization and simplification of manufacture that deprive local suppliers of significant knowledge transfer.

The transfer of codified and “tacit” knowledge within local SMEs, as well as between SMEs and multinationals, represents the key to sustained growth in global markets. We can visualize knowledge transfer within the chains along two dimensions. A vertical flow of information develops between the transnationals and the local suppliers. Explicit knowledge of organization and technology moves along this axis in the form of specifications and manuals, and often through seminars or even training sessions at the headquarters of the transnationals. The transfer of tacit knowledge is more difficult along this vertical axis, given differences in culture and experience, and limited opportunities for the shared space and time of communication. Improving complementarities among supporting industries of APEC members will help anchor FDI and insure knowledge-transfer among host nation SMEs. Foreign investors profit from ever more reliable local supply, just as local suppliers prosper with anchored, “patient” foreign manufacturing investment permitting entrée to better technologies and wider markets.

### **Complementarity**

Foreign manufacturing investment includes firms large and small, and organizations of labor, business and state. These institutions as a group help define the “business environment” of a nation’s political economy. Hollingsworth and Boyer described a “social system of production” as a configuration or dominant pattern of complex institutions in the economy. Institutions include individual firms, and ties with other firms in the market, but also society-wide systems of training, finance, labor, as well as state policy for industrial development or restructuring. The thesis raises issues of cause, continuity and indeed, clarity. They argued for instance that because “institutions are embedded in a culture in which their logics are symbolically grounded, organizationally structured, technically and materially constrained, and politically defended,” an institutional logic spurs the consolidation into a dominant pattern. Scholars such as Biggart and Guillén go further than most in defining patterns of social organization that link prominent actors in sectoral development. In a challenge to naive globalists, they identified “institutional logics” embedded in organizational practice as a positive resource for development in the automotive industries of Chile, Portugal, South Korea and Taiwan.<sup>1</sup>

Yet continuity across the society appears a further problem. Recognizing the diversity possible within any one society, they wrote of a dominant system which on the one hand is better aligned with “core national institutions concerning labor, finance, and state interventions,” and is more closely linked to an international regime.<sup>2</sup> The competition itself among a variety of “systems” within a single society may well be the more interesting issue, particularly among those aligned with global value chains dominated by firms of different national origins. Others have cited the possibility of a convergence among firms tightly integrated with global value chains towards a more common, “regional” system of production across societies.

Attention turns quickly then to the coherence or continuity of institutions with a specific system of production or business environment. The term *complementarity* itself might suggest either similarity, or a lack or absence that needs to be addressed. In the first case, one organization might complement another because of corresponding internal structures, inter-firm ties, or ties with the polity. In the second case, one organization would make-up for the deficiencies or weaknesses of another organization. Complementarity likewise suggests a wider coherence across institutions within a social system of production. Institutions would be complementary insofar as the presence or efficiency of one would improve the efficiency of others.<sup>3</sup> For instance, Aoki argued that institutions in one domain such as the polity or economy constitute a framework or “institutional environment” for institutions in other domains and vice versa. He reasoned that such synchronic interdependencies constitute a “coherent whole” where individual institutions cannot “easily be altered or designed in isolation.”<sup>4</sup> But how does the extension of systems across national borders with multinationals investing in local supporting industries affect the coherence of host country systems? Some would suggest simply convergence to global standards, or “world best practice.”

Leading scholars of FDI such as Dunning and Ozawa highlight the distinctive advantages of location, and indeed, the shifting advantages of location in developing economies.<sup>5</sup> Borrus and others argued that the very purpose of cross-border production networks is to “access locational advantages at each network node associated with the increasingly specialized technology, skills and know-how that are resident there.”<sup>6</sup> Complementarities in local systems provide the continuities in supporting industries necessary for long-term manufacturing investment. Cohesion in basic patterns of government policy and business practice, continuity in training and education systems, and in labor-management relations, for instance, provides the stability necessary to anchor fluid global capital. The interaction of foreign and local business systems evident in networks of suppliers for foreign-invested firms may well lead to towards common regional or global standards. But systemic continuities would not preclude the divergence of local comparative advantage, particularly at the level of industrial sectors, or at the level of firms large and small. Indeed, complementarities in local transport and energy infrastructures, in business and trade law, investment incentives etc., would eliminate the diversion of entrepreneurial energies often invested in simply trying to work through the diversity of local business procedures.

## **Integration**

### *Scale*

We can unbundle the formidable task of integrating supporting industries within the trade and investment flows of APEC members by looking separately to scale, space, and place. Scale refers to firm size, whether larger enterprise or SMEs. The initial literature extolling the promise of small enterprise in the post-fordist era of “flexible production” has been tempered with studies highlighting the continuing role of larger multinationals in global value chains.<sup>7</sup> The issue is not scale itself, but rather integration versus isolation in regional nodes of manufacture and marketing for global flows of

capital and goods. Attention to complementarities within specific social systems of production alerts us also to issues of systemic adaptability and openness. Can local supporting industries linked to multinationals of one nationality effectively source to multinationals of another nationality? Timothy Sturgeon argued recently that more “relational networks” based on social capital and tighter personal ties may be effective in global flows of specialized products. He countered however, that with the growing modularization of components in electronics and the automotive industry, more open “modular networks” prospered with the rapid transfer of codified knowledge.<sup>8</sup>

SME networks also face the trade-off between cohesion and flexibility. Brian Uzzi distinguished between the relative cohesion of networked firms. He found loose collections of firms with fluid membership, impersonal and diffuse ties at one extreme. On the other end of the spectrum were “finite, close-knit groups,” stable in time and membership.<sup>9</sup> Granovetter identified the density of associational life as a key component of successful network ties, particularly the strength of crosscutting ties across polity and economy.<sup>10</sup> An argument for the “strength of weak ties” highlights the problem of closure within tightly-knit, highly complementary networks of firms, closely linked among themselves but relatively insulated from new ideas or opportunities beyond their circle. Circles of supporting industries linked to global flows of capital and technology must strike a balance between complementarities and competition.

### *Space*

Knowledge is controlled and shared in global markets today largely within global value chains of production and marketing. The concept of such chains extends the continuity of production and distribution to organization among lead firms and suppliers, and to institutions of the public and private sector sustaining the flows. Gereffi wrote of “sets of inter-organizational networks clustered around one commodity or product, that underscore the embeddedness of economic organization.”<sup>11</sup> Writing further of what he earlier termed “commodity chains,” Gereffi wrote emphasized how they have “expanded the scope of global integration by altering how people, resources, and places are connected in economic transactions.”<sup>12</sup>

FDI provides a critical opportunity for integrating local SME networks of supporting industries into flows across a global space. But what anchors multinational manufacturing investment despite inevitable rises in the cost of production? Investing multinationals look to more than costs in assessing local advantage. Some have suggested an “institutional arbitrage” in which multinationals seek out effective coherence among local institutions as the key criterion for investment.<sup>13</sup> How might institutional coherence among supporting industries in APEC member states foster more effective knowledge-transfer? Intellectual property rights would be one necessary condition to insure knowledge shared is not knowledge lost. But institutional coherence goes beyond legislation to educational institutions, training institutes, and labor practices. Divergent levels of economic development do not preclude basic complementarities in supply networks across the region, as evident in the tariff reduction schemes supporting intra-regional production within ASEAN.

*Structural embeddedness* is one response to globalization among developing nations. To *embed* means to incorporate firms into local, spatially anchored networks, which facilitate information exchange and learning.<sup>14</sup> Global strategies of production have ironically enhanced the specificity of the local. David Harvey wrote of the growing significance of local “fragmentations” for social identity and action, in the face of expanding standardization and homogenization across borders. Emerging global unities enhance local distinctiveness. As borders shrink and global capital seeks out production sites, there is a growing appreciation for what makes a place “special and gives it a comparative advantage.”<sup>15</sup> Ann Markusen later examined why certain places manage to anchor productive activity while others do not. Among factors in the anchoring process, of particular interest here are the role of the state as rule maker and as supporter of innovation, the role of large firms, and the embeddedness of firms locally and in networks across national and international space.<sup>16</sup>

### *Place*

Alfred Marshall’s seminal insight on the social and economic benefits of geographical concentration has been rediscovered in recent studies of industrial districts. Humphrey cited basic features of industrial districts such as a group of SMEs spatially concentrated and sectorally specialized, as well as a set of forward linkages to international markets and backward linkages to the wider local economy. External linkages often appear the priority in cluster promotion as government offices scramble to attract foreign investors and their technology. But weak internal ties linking business and social networks among local SMEs severely curtail the “backward linkages” or spread effects of learning from foreign investment and technology.<sup>17</sup> Successful industrial clusters can thus be distinguished not only by location and sector, but also by vertical ties to transnationals and horizontal links to networks of local SMEs. We find considerable variation in two further features, including a shared cultural and social context, and public and private support for cluster infrastructure. Yet proximity, specialization, and complementarities among small and medium-size enterprise (SMEs) appear fundamental for competitive sourcing in global markets, and for local knowledge transfer.

What does the link between geography and society in industrial clusters tell us of knowledge-transfer necessary for industrial upgrading in supporting industries? It appears that collective efficiency within clusters of SMEs “emerges where trust sustains inter-firm relations and where traders connect clusters to sizeable markets.”<sup>18</sup> Trust or *social capital* has been described as “the resource available to actors as a function of their location in the structure of social relations,” or their embeddedness within social networks.<sup>19</sup> Networks in turn might be equated with high-trust relationships, and social networks as interpersonal relationships nurtured through face-to-face interactions.<sup>20</sup> With new appreciation for trust and social capital, scholars have drawn a link between proximity and innovation as a means towards collective learning. Perhaps most important, a consensus is emerging on the social, inter-connected bases of innovation including local business system, universities, research institutes within and beyond the firm.<sup>21</sup>

Effective integration must be pursued with careful attention to corporate scale, the space of global flows of capital and information, and the location or local place of local industries supporting foreign invested firms. SME networks present special challenges of cohesion and flexibility, particularly in links with foreign-invested enterprise. Sharing knowledge within networks demands insulation and closure, yet wider adaptation and learning necessitates knowledge-sharing across networks as well. Incorporating foreign firms within local social systems of production that encourage the sharing of knowledge demands coordination among state, business, and critical spheres of civil society such as education. Finally, place does matter, both for global capital and for local development. The concentration in space of supporting industries in special export zones, industrial parts, and now in manufacturing and business “hubs,” demands coordination among multinationals and local industry, state and business, and ultimately industry and society. Innovation beyond transfer of simple codified knowledge demands complementarities among institutions of industry as well as of research and learning.

### **Policy Directions**

How can APEC members jointly foster more effective integration of host country SME networks in support of foreign invested manufacturing firms? Trade and investment promotion organizations in individual member states have begun to provide data on the composition, sectoral specialization, and location of local SMEs. But this effort differs widely among member states, depending on the resources and commitments of government offices and concerned business associations. Moreover, competing and sometimes cooperating organizations in the private and public sector provide a variety of profiles. This is due in part to the complexity and variety of SMEs, and in part to the difficulty of capturing in time the fluidity of SME corporate structures. Foreign investors would be better served with a more consistent mapping of SME networks within APEC, particularly with the growth of intra-regional trade and investment. Insofar as SME networks have come to represent a regional rather than solely national asset, a coordinated regional profile of networks within specific sectors might be both useful and feasible.

Business associations usually flourish among larger enterprises, often within an oligopoly of a single sector. Leaders from these industry-level associations of larger firms play leading roles in the peak business associations at the national level. “National” Chambers of Commerce then face the familial dilemma of larger firm leadership and funding, despite a membership composed mainly of SMEs. Organization is a perennial problem for smaller scale enterprise with neither the human or financial resources to participate actively in the leadership or planning activities of business associations. But this is a problem not simply for the SMEs, but for the larger enterprise which find themselves more closely linked to the fate of SMEs in global networks. This is a problem likewise for government offices responsible for gathering information on industries, for promoting trade and investment, and perhaps most importantly, for regional development planning. APEC members might well develop case studies of successful cooperatives, regional associations, and sector-specific business associations with active participation of SMEs. Case studies could then provide a basis for discussion and planning among

smaller sets of proximate member states with similar contexts, to promote more effective organization of SMEs. If the dialogue proves fruitful at this meso-level, it might conclude with policy recommendations for the SME Working Group on strengthening the collective voice of APEC SMEs.

Various member states have moved ahead with new strategies for providing information on SMEs. Some member states find themselves also with more cohesive SME business associations, particularly at the local level. Coordinating information profiles across members, or at least across groups of member states with geographical proximity, and promoting associational activity across the members will take time. A final strategy, however, can be implemented relatively quickly in the wider APEC program. This is the proposal to include organized groups of SMEs in the Sectoral Dialogues on a regular basis. I am most familiar with the automotive dialogues. Fortunately, this sector is distinguished by well-defined supplier networks of larger and smaller SMEs. Major component manufacturers will sometimes join the dialogue, and represent to some degree the SME supplier networks which they coordinate. It would not be difficult to establish a more independent and cohesive representative for these cooperative associations of suppliers, and then to find ways to incorporate them in reviews of major sector-related issues. This might in time serve as a model for other sectoral dialogues, or for more focused, limited dialogues on APEC sectors in transitions of decline or rapid growth.

## Endnotes

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<sup>1</sup> Nicole Woolsey Biggart and Mauro F. Guillén. “Developing Difference: Social Organization and the Rise of the Auto Industries of South Korea, Taiwan, Spain, and Argentina.” *American Sociological Review*, 64 (October 1999): 722-747. Mauro F. Guillén, *The Limits of Convergence: Globalization and Organizational Change in Argentina, South Korea, and Spain*. Princeton NJ: Princeton University Press, 2003. The authors pose two questions – which actors are legitimate players in the economy, and what patterns of social organization bring them together in market activities. They contrast South Korea’s strong patrimonial state, for instance, with flexible networks of SMEs in Taiwan.

<sup>2</sup> J. Rogers Hollingsworth and Robert Boyer, “How and Why Do Social Systems of Production Change?” Pp. 189 – 195 in J. Rogers Hollingsworth and Robert Boyer, eds., *Contemporary Capitalism: The Embeddedness of Institutions*. Cambridge: Cambridge University Press, 1997. J. Rogers Hollingsworth and Robert Boyer, “Coordination of Economic Actors and Social Systems of Production.” Pp. 1-47 in J. Rogers Hollingsworth and Robert Boyer, eds., *Contemporary Capitalism - The Embeddedness of Institutions*. Cambridge: Cambridge University Press, 1997. P. 2.

<sup>3</sup> Peter A. Hall and David Soskice, “An Introduction to Varieties of Capitalism.” Pp. 1-66 in Peter A. Hall and David Soskice (eds.), *Varieties of Capitalism: the Institutional Foundations of Comparative Advantage*. Oxford: Oxford University Press, 2001. P. 17.

<sup>4</sup> Masahiko Aoki, *Toward a Comparative Institutional Analysis*. Cambridge MA: MIT Press, 2001. P. 225.

<sup>5</sup> John H. Dunning, “The Eclectic Paradigm of International Production: A Personal Perspective.” Pp. 119-139 in Christos N. Pitelis and Roger Sugden, eds., *The Nature of the Transnational Firm*. Second Edition. New York: Routledge, 2000. He cites investment criteria of ownership, location, opportunity to internalize markets. Regarding developing economies, he points to changes in Investment Development Paths in line with locational advantages. Terutomo Ozawa, “Japan: The Macro-IDP, Meso-IDPs and the Technology Development Path (TDP).” Pp. 142-173 in J. Dunning and R. Narula, eds., *Foreign Direct Investment and Governments*. New York: Routledge, 1996.

<sup>6</sup> Michael Borrus, Dieter Ernst, and Stephan Haggard. “Introduction: Cross-Border Production Networks and the Industrial Integration of the Asia-Pacific Region.” Pp. 1-30 in Michael Borrus, Dieter Ernst, and Stephan Haggard, eds. *International Production Networks in Asia: Rivalry or Riches*. New York: Routledge, 2000. P. 2.

<sup>7</sup> The best example here is Japan’s political economy, where some scholars see the blend of SMEs and larger enterprise as the key to “flexible mass production,” as opposed to simply SMEs and flexible production. See Toshiya Kitayama, “Local Governments and Small and Medium-Sized Enterprises.” Pp. 367-396 in Hung-ki Kim, Michio Muramatsu, T. J. Pempel, and Kozo Yamamura, eds., *The Japanese Civil Service and Economic Development*. Oxford: Clarendon Press, 1995. For a recent study of cooperation between SMEs and larger firms in electronics, see Dieter Ernst, “Internationalization of Innovation: Why is chip Design Moving to Asia?” *East-West Center Working Papers*,

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Economics Series, No. 64 (November 2003 (revised March 2004). Available at [www.eastwestcenter.org](http://www.eastwestcenter.org)

<sup>8</sup> T. J. Sturgeon, "Modular Production Networks: A New American Model of Industrial Organization." *Industrial and Corporate Change* (2002) Vol. 11, No. 3: 451-496.

<sup>9</sup> Brian Uzzi, "The Sources and Consequences of Embeddedness for the Economic Performance of Organizations: The Network Effect." *American Sociological Review*, 61 (August 1996): 666-699. P. 675. See also his "Social Structure and Competition in Interfirm Networks: The Paradox of Embeddedness." *Administrative Science Quarterly* 42 (1997): 35-67.

<sup>10</sup> Mark Granovetter, "A Distinctive Theoretical Agenda for Economic Sociology." Presentation at the Second Annual Economic Sociology Conference at Penn, March 4, 2000.

<sup>11</sup> Gary Gereffi and Miguel Korzeniewicz, eds., *Commodity Chains and Global Development*. Westport CT: Praeger, 1994. p. 2

<sup>12</sup> Gary Gereffi, "Shifting Governance Structures in Global Commodity Chains, with Special Reference to the Internet." *American Behavioral Scientist* 44, 10 (June 2001): 1616-1637. 1616

<sup>13</sup> Peter A. Hall and David Soskice. "An Introduction to Varieties of Capitalism." Pp. 1-66 in Peter A. Hall and David Soskice (eds.), *Varieties of Capitalism: the Institutional Foundations of Comparative Advantage*. Oxford: Oxford University Press, 2001.

<sup>14</sup> Michael Taylor and Simon Leonard, "Approaching 'Embeddedness.'" Pp. 1-18 in Michael Taylor and Simon Leonard, eds., *Embedded Enterprise and Social Capital: International Perspectives*. Burlington VT: Ashgate, 2002. P. 3

<sup>15</sup> David Harvey, *The Condition of Postmodernity*. Cambridge Massachusetts: Blackwell, 1990.

<sup>16</sup> Ann Markusen, "Sticky Places in Slippery Space: A Typology of Industrial Districts." *Economic Geography* vol. 72 (1996): 293-313. p. 295-6.

<sup>17</sup> "The direct effect of linkages on domestic suppliers is generally a rise in their output and employment. Linkages can also transmit knowledge and skills between the linked firms." UNCTAD [United Nations Conference on Trade and Development]. *World Investment Report 2001: Promoting Linkages*. New York: United Nations Publications, 2001. P. 15

<sup>18</sup> Institute of Developing Societies, University of Sussex, "Clustering: Route to Industrial Competitiveness?" *IDS Research*. [www.ids.ac.uk/ids/global/vw.html](http://www.ids.ac.uk/ids/global/vw.html)

<sup>19</sup> Paul S. Adler and Seok-Woo Kwon. "Social Capital: Prospects for A New Concept." *Academy of Management Review* Vol. 27, No. 1 (2002): 17-40. P. 17.

<sup>20</sup> Frank McDonald and Giovanna Vertova, "Clusters, Industrial Districts and Competitiveness." Pp. 38-64 in Rod B. McNaughton, ed., *Global Competition and Local Networks*. Burlington VT: Ashgate, 2002. p. 51

<sup>21</sup> Philip Raines, "Cluster Policy – Does it Exist?" Pp. 21-36 in Philip Raines, ed. *Cluster Development and Policy*. Burlington VT: Ashgate, 2002. p. 27



# APEC's Next Challenge

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Supporting Industries

D. McNamara



# Questions

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- Sustain Growth in Trade/Investment?
- Improve local comparative advantage?
- Promote effective transfer of knowledge?



# Complementarity

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- Social Systems of Production SSPs
- Institutional Logics
- Institutional Advantages



# Scale – Supporting Industries

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- Small & Medium-size Enterprise [SMEs]
- Foreign Direct Investment [FDI] in manufacturing – LEs / SMEs
- From offshore networks to regional nodes in global production chains



# Space – Global Production Chains

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- Anchoring fluid manufacturing capital in global markets
- Effective knowledge transfer, vertical and horizontal
- Complementarity – vertical and horizontal



# Place - SME Clusters or “Hubs”

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- Proximity
- Specialization
- Complementarity



# Convergence?

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- World Best Practice, Global Standards
- Local SSPs versus SSPs of Multinationals
- Complementarity and competition



# Policy Directions

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- Gather Information on SME networks – location, specialization, complementarity
- Improve Business Associations among SMEs
- Bring SME Networks into Sectoral Dialogues