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THE ROLE OF JAPANESE FOREIGN DIRECT INVESTMENT IN THE 1990s

by

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The Role of Japanese Foreign Direct Investment in the 1990s

Introduction[1]

Business operations have generally become more internationalized in the last decades. There has also been a widening of the national origin of so-called multinational enterprises, which own and control productive assets in more than one country. Such firms used to emanate almost entirely from Western Europe and North America. Now, the dominance of westerners is challenged particularly by the rise of Japanese multinationals, which rapidly expand their activities in all major markets. Their efforts are not reciprocated by western firms, but the Japanese home market remains relatively untouched by foreign-based corporations. In fact, the Japanese are becoming dominant in East Asia as a whole, which is the fastest growing region in the world.

It is tricky to evaluate the prospects for Japanese direct investment for a number of reasons. Firstly, the internationalization of Japanese industry is a fairly recent phenomenon, and there are still limited and unsatisfactory data. Secondly, the geographical pattern of Japanese direct investment differs from that which originates in western countries. Thirdly, the competitiveness of Japanese industry is related to the special features of the Japanese home market, which has implications for its internationalization. Fourthly, the asymmetries which characterize the Japanese trade and investment flows are becoming a delicate matter from a political view point. The international interactions of Japanese firms, at home and abroad, now seem interrelated with the development of the whole trading system.

1 Financial support from the Swedish Research Council for the Humanities and Social Sciencies is gratefully acknowledged.

In order to assess the role of Japanese direct investment in the 1990s, this study surveys its driving forces in the past, and discusses factors which are expected to influence the future development. This is not only a question of macro economic influences, but also of business management, and even the adaptability of the Japanese society. We start by reviewing the Japanese success story and some of its global impacts. Thereafter, the expansion of Japanese firms abroad is traced over over time.

The Japanese success story

Any international comparison of income, trade, technological progress or investment immediately discloses the economic rise of East Asia. The Pacific Basin has overtaken the Atlantic Basin as the core of world economic relations, and the Asian Pacific has acquired a greater income than the United States or Europe (Andersson and Linder, 1991). The prime engine of growth in East Asia is, of course, Japan. Table 1 shows that its share of total OECD income has grown more than six times between 1960 and 1990. Compared to the U.S. or OECD Europe, it has increased from less than a tenth of their size to about half.

Some view Japan's success as an outcome of public planning and guidance, particularly by the Ministry of International Trade and Industry (MITI). Although MITI played a major role in the past and still does in some respects, its role is often exaggerated. Rather, the bonds between MITI and private firms reflect more fundamental characteristics of Japan. These also

Table 1. GDP ratios 1960 - 1990

Ratios	1960	1970	1980	1990
Japan/OECD	3.7	7.0	12.7	22.8
Japan/U.S.	7.0	13.0	24.3	44.5
Japan/OECD Europe	9.6	16.3	29.7	55.5

Source: IMF (1991)

show up in the functioning of the factor markets. Life-time employment, seniority wages and firm-specific unions account for stable working conditions and low mobility, which used to be viewed as an obstacle to development. In finance, "main banks" serve as the core of industrial groups, *keiretsu*, supporting long-term projects and acting as lenders of last resort in times of crisis. Cross-owning of equity protects against outsiders, and hostile takeovers are uncommon. Firms are not viewed as "owned" by shareholders, but rather belong to all those which are tied to them for the long term; workers, suppliers, creditors, clients, etc. From a traditional western view, this sets the stage for a strange kind of capitalism.

The Japanese success story can not be understood without consideration to business management and organization, and particularly how information is processed, disseminated and utilized. Information processing and operational activities are closely connected in Japan. There is a good deal of horizontal coordination, and strategic decisions are generally not imposed by top management on the basis of centralized information. Decisions require consensus, and responsibilities are to a great extent delegated to the operational level. Western companies, in contrast, rather rely on centralized decision making, orders are channeled hierarchically "top-down", accounting for many organizational layers and high costs for supervision (cf. Aoki 1988 and 1991).

The differences between Japan and other countries should not be overstated. Far from all Japanese firms practice lifetime employment or main-bank arrangements. Cross-owning of shares exists in western economies as well. Nevertheless, the Japanese economy as a whole forms a special set-up. Japanese organization and management practices are adapted to the stable and long-term relations that characterize the Japanese society in general. This will be further discussed below.

In East Asia, Japan's development is followed most closely by the Asian Newly Industrialized Economies (ANIEs), i.e. the People's Republic of

Korea, Taiwan, Hong Kong and Singapore. Three of the ASEAN4[2] - Malaysia, Thailand and Indonesia - also perform well, especially in exports. The governments play an active role, except for Hong Kong. In Korea and Taiwan (like in Japan), there has been an intervention with private ownership through land reform.[3] Throughout, governments secure macro-economic stability, while prices are less distorted than in other developing countries. Still, private initiatives are the major engines of growth. Incentives for industrial performance supplement moderate protectionism and selective export promotion, achieving neutrality on the whole.

Global impacts

The rise of Japan, and East Asia as a whole, has exerted a global impact in many respects. Both the United States and most European countries have experienced steadily widening trade deficits with Japan for two decades. Some key relations are given in Table 2, which shows the weight of trading partners relative to total exports and imports.[4] Of total U.S. exports, 12.3 per cent went to Japan in 1990, up from 9.4 per cent in 1980. The EC and the U.S. are the largest targets of their respective exports. The U.S. is also the greatest market for exports from Japan and the ANIEs, while both Japan and the ANIEs obtain a greater share of ASEAN4 exports. The share

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2 Of the members in the Association of South East Asian Nations (ASEAN), the concept ASEAN4 leaves out Singapore, which is counted among the ANIEs, and the small sultanate Brunei.

3 Land reform helped to create a class of independent farmers which supported the governments and accounted for social stability. Incidentially, land reform was possible due to the break-down of the old power structures by intervention from outside.

4 It should be noted that comparisons between the EC and the U.S. are distorted by the elimination of trade between the American states, while that between the member countries in the EC is included.

Table 2. Distribution of exports and imports between regions

a) Exports by destination, 1980, 1985 and 1990 (per cent)

importer / exporter	USA	JAPAN	EC	ANIEs	ASEAN4	YEARS
USA		9.4	26.7	6.8	2.8	<-1980
		10.3	22.4	7.7	2.1	<-1985
		12.3	24.9	10.4	2.7	<-1990
JAPAN	24.5		14.0	14.9	7.0	<-1980
	37.6		11.9	12.8	4.2	<-1985
	31.7		18.8	19.8	7.7	<-1990
EC	5.6	1.0	55.7	1.2	0.7	<-1980
	10.1	1.2	54.5	1.6	0.7	<-1985
	7.0	2.1	60.4	2.1	0.9	<-1990
ANIEs	24.8	10.1	16.4	9.2	10.7	<-1980
	42.1	11.2	12.4	10.2	8.6	<-1985
	29.7	12.2	16.6	12.9	9.5	<-1990
ASEAN4	18.8	34.5	13.6	18.0	3.1	<-1980
	19.8	31.0	11.8	20.0	4.5	<-1985
	19.3	24.4	15.8	21.4	4.2	<-1990

b) Imports by destination, 1980, 1985 and 1990 (per cent)

exporter / importer	USA	JAPAN	EC	ANIEs	ASEAN4	YEARS
USA		12.8	15.6	7.1	2.6	<-1980
		20.8	20.3	11.9	3.2	<-1985
		18.0	18.5	12.2	3.6	<-1990
JAPAN	17.4		5.9	5.2	14.0	<-1980
	20.0		7.2	7.6	12.9	<-1985
	22.5		15.0	11.1	10.4	<-1990
EC	8.6	2.5	49.4	1.7	1.0	<-1980
	8.0	3.4	52.9	1.8	1.1	<-1985
	7.4	4.3	57.9	2.6	1.1	<-1990
ANIEs	17.6	23.4	9.8	7.1	11.0	<-1980
	17.2	22.8	10.6	8.9	9.6	<-1985
	17.1	22.9	11.7	12.2	7.9	<-1990
ASEAN4	16.2	24.2	13.5	13.6	4.0	<-1980
	16.1	23.3	14.5	16.5	6.0	<-1985
	12.9	25.9	15.0	19.1	3.9	<-1990

Source: MITI (1992)

of exports going to the U.S. decreased in the late 1980s, however, while the EC grew in importance. The EC's share of Japanese imports also increased conspicuously, although at a low level. Except for this, the expansion of the ANIEs' share of imports within the East Asian region is most noteworthy. The share of imports provided by Japan and ASEAN4 were rather unchanged in the late 1980s.

The Japanese financial institutions became major actors in the eurodollar markets in the 1970s. Low capital standards and dividend pressure made it possible for them to focus on size and market share, and interest rate regulations at home allowed them to arbitrage on price or with respect to risk (Dufey, 1990). They were further supported by high savings at home, the current account surplus and the appreciation of the yen from 1985. Borrowing short term and lending long term, the Japanese banks shifted from a position behind the American banks in 1983 - measured in international assets - to about three times their size in 1990. At present, falling prices on previously overvalued equity and real estate cause trouble at home. They are also hampered by the capital requirements levied by the Bank of International Settlements (BIS). It remains to be seen whether the difficulties are temporary or represent a more permanent change in the prospects of Japanese financial institutions.

The Japanese success in trade and portfolio investment first seemed unmatched in direct investment. Until the late 1970s, it made up only about 1 per cent of total fixed capital formation, compared to 3 per cent in Germany or 4.5 per cent in the U.S. Direct investment constitutes not primarily a transfer of capital, but of firm-specific factors related to technology and skills in organization, management, distribution and so forth (Dunning, 1977; Caves, 1982). A bundle of factors is provided with remains under the control of the investor, who also retains the risk of failure. Direct investment requires that it is better to transfer a firm's specific assets to another location than to keep them at home and trade with other firms through arm's length contracts. There must also be locational factors which make internalization of the assets in the specific host country desirable. The special features of the Japanese home market, which is the basis for the

Japanese business organization and style of management, used to be viewed as an obstacle to operations abroad.

Expansion in East Asia

Motivated by the desire to reduce risks by acquiring control of raw materials, Japanese companies started to invest in Southeast Asia at an early stage. This contributed to fueling the military aggression of the Japanese in the first part of this century, which lays outside the range of this study.

Like other peoples, the Japanese consequently started operations abroad in the neighbouring countries which are the closest both in terms of geographical and cultural distance. In contrast to the other major home countries of multinational firms, however, Japan is located in Asia. As its direct investment started to grow for real in the 1970s and 1980s, it still had to compete with the already established industrial powers. The Europeans had been large in natural resources and trade since the days of colonization, especially in Indonesia, Malaysia and Singapore. The Americans had dominated since the Second World War, focusing on the same countries, as well as on the Philippines and Taiwan.

By 1979, the Japanese presence could match the other industrial countries in most of East and Southeast Asia. The third column in Table 8.3 compares the share of Japanese direct investment with the total stock in each major host country. The exact percentages should not be taken too seriously, since data on total and Japanese investment are not available from the same source.[5] In particular, total investments are underestimated as certain flows are not included. One example is U.S. investment in petroleum in Indonesia, and another Chinese capital flowing particularly to Hong Kong and Singapore.

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5 In general, data on direct investment are highly uncertain, and vary between sources.

The broad trends of Japanese direct investment, and its varying degree of significance, are still clear from Table 3. In three countries (Thailand, Indonesia and Korea), the Japanese share amounted to two thirds or more of the total in 1979. In Hong Kong and Singapore, it was about one third. The Japanese share was a little above one quarter in the Philippines, while Malaysia is the only major host country in the region where it was insignificant. In South Asia, on the other hand, there was no Japanese direct investment.

In the 1980s, there has been a drastic increase in Japanese direct investment in East Asia. Between 1979 and 1989, the stock relative to GDP at least doubled in two of the ANIEs and in all four countries in ASEAN. The largest changes took place in Thailand (from 1.2 to 5.1 per cent), Hong Kong (4.2 to 17.3 per cent), Singapore (7.6 to 22.2 per cent) and Malaysia (2.4 to 6.7 per cent). Advanced sectors were now becoming important destinations. The absolute flows were still larger in sectors based on low technology and skill-intensity, but the relative increase was greater in advanced sectors in the 1980s (Andersson and Linder, 1991).

Foreign investment may not be the primary factor behind growth in East Asia. Japan itself, like Korea, used to be restrictive against foreign investors. Given adequate domestic policies, however, external capital appears to have made a positive contribution in several countries. In particular, this seems to apply to the internationalization of business *within* East Asia. Of the total capital inflows, neither development assistance nor borrowing have been exceptionally extensive. There has been considerably more emphasis on direct investment than in other developing countries, however. According to Naya (1990), direct investment has contributed to the growth of exports, but the policies of the host countries have been crucial for this impact. Balassa (1991) argues for positive effects on investment efficiency, income and savings as well.

With the product-cycle theory, Vernon (1966) highlighted that direct investment channels factors of production within firms. New goods are developed in industrial centres, and transferred to countries with lower

Table 3. Total and Japanese direct investment

Countries	Total direct investment: Stock in percent of GDP 1979	Japanese direct investment: Stock in per cent of GDP 1979	Percent of total stock in 1979	Stock in per cent of GDP 1989	Percent inc. in Japanese d.i./GDP 1979 - 1989
EAST ASIA					
ANIEs					
Korea	2.8	1.8	64	2.1	17
Taiwan	n.a.	0.8	n.a.	1.8	125
Singapore	24.9	7.6	35	22.2	192
Hong Kong	11.1	4.2	38	17.3	348
ASEAN					
Malaysia	17.0	2.4	12	6.7	179
Thailand	1.7	1.2	80	5.1	325
Philippines	6.0	1.6	27	3.2	100
Indonesia	8.3	5.4	65	11.8	118
China	0.0	0.0	-	0.6	-
SOUTH ASIA					
Bangladesh	0.1	0.0	0	0	0
India	1.9	0.0	0	0	0
Pakistan	3.8	0.0	0	0	0
Sri Lanka	3.1	0.0	0	0	0

Source: Calculations on the basis of The World Bank (1990), The Asian Development Bank (1990), UNCTC (1983) and The Ministry of Finance (1991).

labour costs when technologies have become standardized. Japanese researchers have argued for a special Japanese product life cycle (Ozawa, 1979; Kojima and Ozawa, 1984). Japanese firms transform western technologies to a format which effectively exploits the working conditions in developing countries. This way, Japanese firms would have stepped up the international division of labour. The concept of "the Flying Wild Geese" is a popular methafor for the development process resulting from the mobility and flexibility of private business in the East Asian region. Growth has been spread by the systematic exploitation of differences in factor costs as well as natural resources. Following the "leading goose" in a wide formation, the individual countries move up the industrial ladder after each other, chasing those ahead as changing factor price relations alter comparative advantages (cf. Shinohara, 1972).

The ultimate effects of direct investment depend on how the factors transferred abroad interact with the productive apparatus of the host country. The host country generally gains due to investors' inability to capture all rents that arise from their activities, which spill over to domestic agents through wages, taxes, sharper competition, etc. There may also be negative effects, especially when direct investment is motivated by barriers to trade, such as the establishment of monopolies, suppression of domestic entrepreneurs, and an anti-competitive bias of technology. Losses may also stem from the depletion of natural resources or negative external effects on the environment. It is well-known, for example, that direct investment may be welfare-reducing given distortive incentives. Such incentives may stem from politically motivated objectives on the part of the host country regime, which do not reflect the welfare of the population.

The economic dominance of Japan also creates a fear of dependency in East Asia, and resentment of the cultural influence it may inflict. According to some, Japanese direct investment brings economic and political suppression, and depletes the resource basis of poor Asian countries (cf. Nester, 1990). For example, Japanese companies demanding logs for construction at home are leading the way towards a swift destruction of the native forests in Southeast Asia. After the Philippines have been entirely deforested, and exports have plummeted, the focus in now on the eastern states of Malaysia. In Sarawak, where the indigenous peoples have resisted in vain, Kumazaki (1992) reports that as much as 500,000 hectares may now be logged annually, which would mean that practically all virgin forest will be gone by the mid 1990s. Precious commercial as well as non-commercial values are squandered for all future. The producer countries obtain only a fraction of the gains from the exploitation, which is much less than what could be achieved through the build-up of local processing industry (ITTO, 1991).

The local authorities bear the utter responsibility for such mismanagement of resources, since they arrange with the short-term concessions which deprive foreign and domestic firms of the incentives to care for long-term management. Still, it will eventually damage the interests of the Japanese themselves, as countries experience that potentially rich resources are gone. Okita (1990) has suggested that Japan should adopt a leading role in promoting environmentally sound development in poorer countries.

Irrespective of their impacts on the host economies, Japanese companies have managed to exploit business opportunities in East Asia, cutting their own costs for labour and raw materials. By moving the source of exports from Japan to other Asian countries, they may also have mildered the demand for protectionism in western countries. The fear that Japan would become "deindustrialized" due to the emigration of industries to countries with lower production costs, is now more or less gone. It has become evident that crucial, advanced activities do not leave Japan (cf. Shinohara, 1989). By expanding operations throughout East Asia, Japanese companies have grown stronger and acquired more international experience, however. This way, they have paved the way for continued internationalization.

The internationalization of the 1980s

Japanese direct investment has expanded dramatically in the last decade. In 1989, the share relative to total domestic capital formation surpassed 6 per cent in Japan - more than for any other major country. The explanation is partly to be found in general changes in business conditions. Technological progress in communication, information processing, financial systems and transportation has upgraded the organizational and managerial capabilities of enterprises. As national barriers have become less important, it has become more difficult to sustain competitiveness on the basis of operations in a single nation, or even a single region. As Japanese firms used to lay behind in internationalization, the changing circumstances have forced them to quickly expand their international operations in order to catch up. In addition, there have been other factors which are specific for the Japanese case. Changes within Japan itself, or in Japan's relations with *other* countries, can be regarded as "push" factors. The following partly interrelated developments belong in this category:

1) *Financial deregulation and integration*. The overhaul of Japan's foreign exchange law in 1980, and liberalization in general, has enabled Japanese financial institutions to expand activities worldwide, including the undertaking and servicing of direct investment. Financial deregulation in the United States and the United Kingdom, and the Euro-currency and Euro-bond markets also provided opportunities for Japanese financial institutions to absorb short-term borrowing and convert it to long-term lending and investment. Most went into U.S. securities in the early 1980s, while direct investment became particularly attractive towards the end of the decade.
2) *Current account surpluses* , especially after 1983, have spurred capital outflows. The need to reduce the political strains, mainly with the U.S., has induced direct investment for production in importing countries or exports from third countries, such as the ANIEs.
3) *Currency alignments*. An appreciating yen vis-à-vis the dollar has favored production by Japanese companies abroad from 1985 onwards.
4) *Raising costs* of labor, land and other inputs in Japan. Robotization and up-grading of technology have limited the impact, but it has become relatively more favorable to move especially labor-intensive production to countries with lower costs.

In addition to these factors, there has been a series of shifts in the source of competitiveness for Japanese industry. Abegglan and Stalk (1985) mention the following industrial stages: low wages, high-volume large-scale facilities, focused production, and high flexibility. These shifts, together with an increased ability to adapt management practices and the organization in general, have made the Japanese more capable to operate in more advanced economies, including the U.S. and Europe as well as Asia.

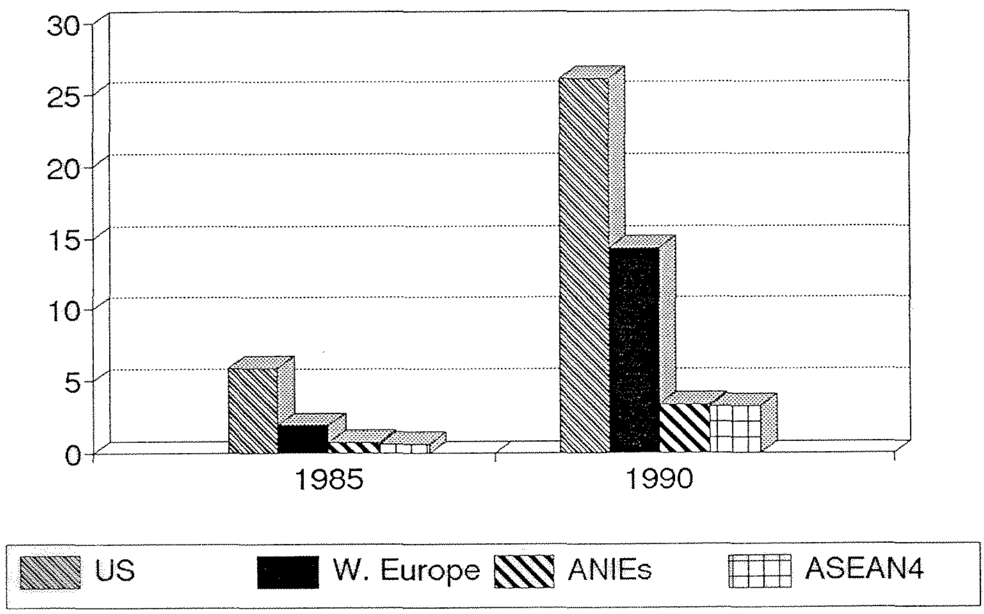
Thus, the composition of Japanese direct investment has changed markedly in the 1980s, both in terms of sectors and regions. The sectorial focus has moved from mining, natural-resource related investment and manufacturing, towards finance, real estate, transportation, commerce and services. The geographical orientation has shifted away from developing to developed countries. East Asia, which consists of newly industrialized rather than traditional developing economies, represents the only major destination in the Third World. Again, investment in research and development, and the enhancement of crucial information networks, remains concentrated in Japan. Local assembly and the support of sales in foreign markets have become highly efficient, however. Foreign subsidiaries have relied on complete control by the parent company, and have generally had a high import propensity.

Figure 1 compares the flows of Japanese and U.S. direct investment to the most important regions in 1985 and 1990. The Japanese flow was roughly on par with the American in the mid 1980s. In 1990, the U.S. was far behind. As seen from the stock data in Figure 2, the Japanese investments were much more diversified geographically. Only in Western Europe was the U.S. slightly ahead. Of course, this also applies to some other regions which are not considered here, such as Latin America.

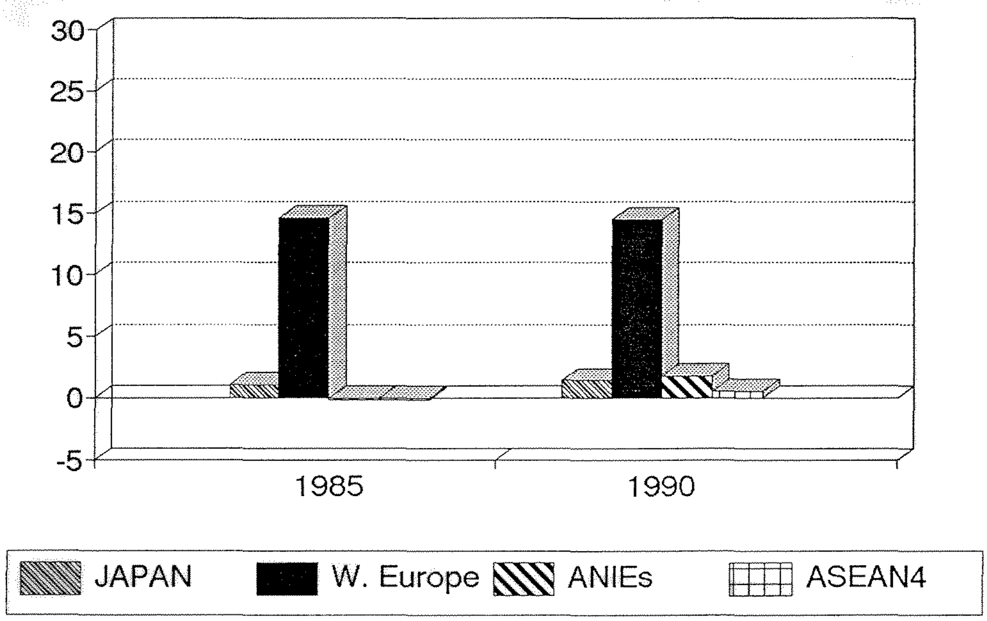
Figure 3 illustrates the increase in Japanese direct investment across regions between 1985 and 1990. Japan advanced in all major markets, and the most in the EC. The American investments, by contrast, increased much less in Japan. This asymmetry is still characteristic for the Japanese exchange with practically all western countries. As of 1989, the stock of American direct investment in Japan was only 7.4 per cent of the stock of Japanese direct investment in the U.S., and the direct investment from the EC in Japan only about 6 per cent of the Japanese direct investment in the EC. The European firms are also much less active than the Japanese or American in the rest of East Asia. The next section considers factors which have exerted a major influence on the development in the different regions.

Figure 1: Flows of Japanese and U.S. foreign direct investment in 1985 and 1990, in billion USD

Japanese case



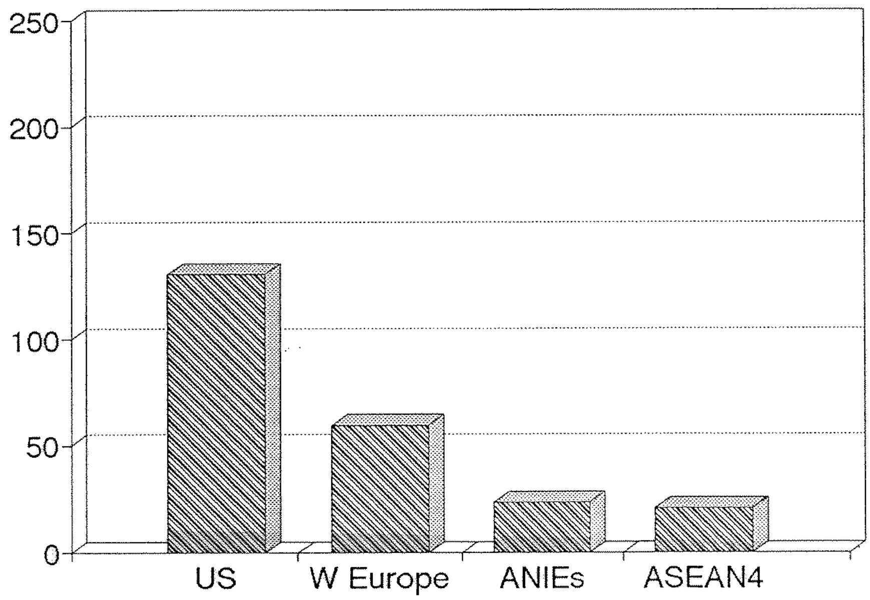
U.S. case



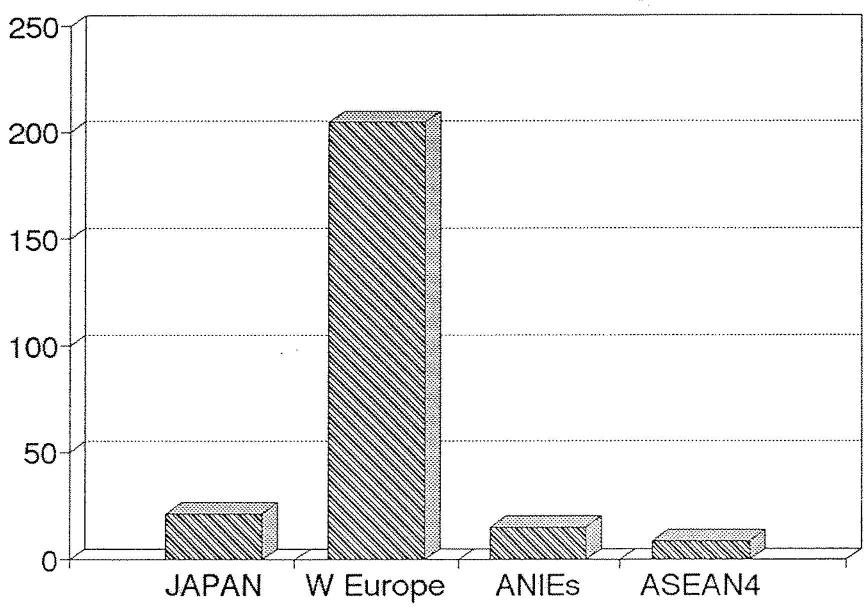
Source: Ministry of Finance (1991) and Survey of Current Business (1987 and 1992)

Figure 8.2: Stocks of Japanese and U.S. foreign direct investment in 1990, in billion USD

Japanese case

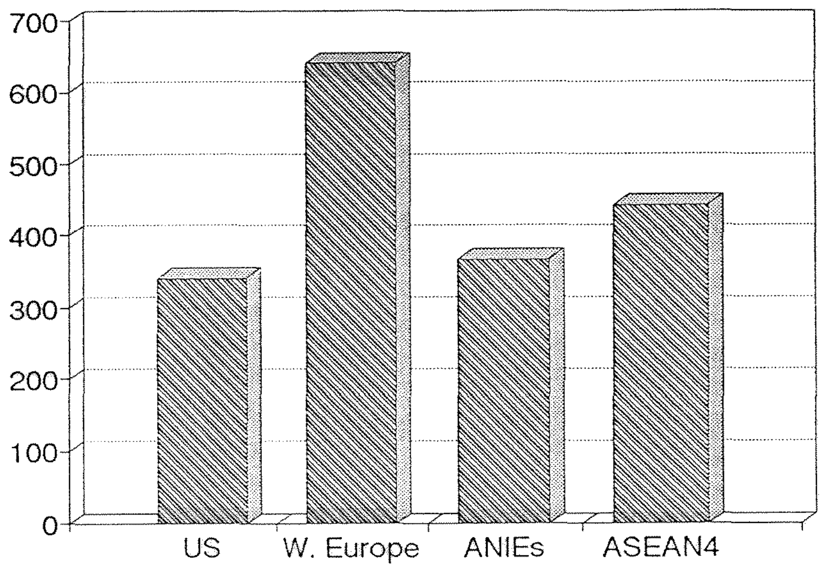


U.S. case



Source: Ministry of Finance (1991) and Survey of Current Business (1992)

Figure 3: Increase of Japanese foreign direct investment, flow base 1985-1990, in per cent



SOURCE: Ministry of Finance (1991)

Regional factors

Why have the Japanese firms invested in specific regions in the 1980s? Most of the "pull" factors in *East Asia* have already been mentioned. They can be summed up as follows:

1) Favorable *macro-economic conditions*, including high growth and moderate inflation.

2) Sound *economic policies*, particularly open trade regimes and low taxes. In parts of ASEAN, trade barriers have also attracted import-substituting direct investment.

3) The ANIES and ASEAN-countries have had their *currencies* more or less pegged to the dollar, which made operations in these countries more attractive for Japanese firms when the yen appreciated in the mid 1980s.

4) *Political stability*, including a high priority for economic development at the national level.

5) *Institutional and cultural conditions*, creating a work-ethic which could readily be taken advantage of by the Japanese.

In the *United States*, the overvalued dollar might have been expected to discourage direct investment in the early 1980s. However, "pull" factors have turned out to be considerably more powerful. One was the spurt of consumption coupled with the need of Japanese sellers to establish a local presence in order to serve consumers effectively. Another was that the U.S. twin deficits tapped the American economy of financial resources, which made investment projects price-worthy in spite of the high dollar. In fact, it was the Japanese capital which enabled the dollar to remain strong and interest rates to remain moderate in the U.S. In the late 1980s, however, the growing Japanese presence has increasingly turned into a source of political friction. The American public has not appreciated the sell-out of domestic trading marks, and prefers to put the blame on Japanese buyers rather than U.S. polices and priorities.

Following the ending of the "cold war", many Japanese fear that they will be the target of the 1990s for Americans in search of foreign scapegoats for domestic problems. This may turn into a major "push" effect away from the U.S. So far, Japanese firms have responded by "blending" the nationality of their products. More input is acquired locally, alliances are formed with domestic firms, and the interests of local communities are carefully assessed. To give one example, many Japanese cars made by Japanese-owned manufacturers are now more "American" in terms of content than many cars made by American-owned manufacturers. Japanese subsidiaries are actually among the largest U.S. exporters to Japan. Nevertheless, Japanese firms have generally a higher import propensity than the average firms in the U.S., and tensions remain. Comparing the investment flows in both directions, Encarnation (1992) points out that Japanese parent companies tend to exert more control. American parent companies hold smaller positions in their Japanese subsidiaries, which contributes to less imports.

Europe has evolved as a major alternative destination for Japanese investors. This applies particularly to the European Community (EC), which contains the largest markets. The geographical and sectorial distribution of the Japanese investments in Europe are in Table 4 given for the cumulative flow 1951-1989. Of the total Japanese direct investment in Europe between 1951 and 1989, more than two-thirds occurred in the last three years. As can be seen, the Japanese firms are widely spread across countries and sectors. As in Southeast Asia, there is a clear connection between activities and locations. For example, Britain, Luxemburg and the Netherlands attracted a relatively large amount in banking and insurance, Germany in commerce and manufacturing, and France in real estate and manufacturing. Within manufacturing, France has relatively most investment in machinery and food, and Germany in chemicals and electrical machinery. On the whole, Britain remains the dominating destination both in manufacturing and non-manufacturing. JETRO (1990) reports that the distribution system, infrastructure, quality of labour and language are the most important locational factors for Japanese firms in Europe. In Spain and Portugal, Japanese firms are attracted by low labour costs.

The attractiveness of the markets in the EC grows with the establishment of the Single Market. Through this, the EC is scrapping all interior barriers to flows of capital, labour, goods and services. Through advantages to scale and, particularly, stiffer competition, the aim is to strengthen the competitiveness of European firms. At the same time, it becomes less complicated for foreign firms to operate in Europe. JETRO (1990) reports that the size of a country's domestic market is now a relatively unimportant locational factor for Japanese direct investment in the EC. Broadly speaking, half the output is sold on the home country's market, and the other half in the rest of the EC. Exports back home are rare.

Another factor which spurs direct investment is uncertainty regarding the external policy of the EC. The worries of a "Fortress Europe" are amplified by the frequent use of non-tariff barriers to imports, such as anti-dumping proceedings and voluntary export restraints. It is clear that such measures are used against competitive foreign firms when there are well organized Community-firms whose interests are threatened (Messerlin, 1989). In the event of higher external barriers, it becomes even more important for firms based in other countries to be present in the EC and establish themselves as insiders. Responding to the invasion of Japanese firms, some member countries in the EC have adopted "local content rules", which require that a

Table 4: Geographical and sectorial distribution of Japanese direct investment in Europe, 1951-1989 (cumulative)
In per cent. The total is given in billion USD.

	England	France	Germany	Netherlands	Luxemburg
Food	0.6	4.6	0.2	0.4	0.0
Chemicals	0.6	1.3	10.9	2.7	0.0
Machinery	3.2	8.0	4.0	2.5	0.3
Elec. mach.	4.9	4.1	9.9	4.8	0.0
Transp. mach.	2.9	1.8	0.7	1.5	0.0
Manufac. total	14.4	29.3	28.9	15.0	0.4
Commerce	7.8	21.1	39.6	12.0	0.0
Bank & Ins.	52.3	10.0	13.2	50.4	96.3
Service	2.7	10.2	2.3	9.9	0.3
Real Estate	10.7	16.8	0.6	11.9	0.4
Total (bill. USD)	15.8	2.9	3.4	10.1	5.4
Share*	35.1	6.4	7.7	22.4	12.0

* In per cent of all Japanese direct investment in Europe
Source: Ministry of Finance (1990).

certain share of total input is provided by domestic firms. The aim appears sometimes to have been a greater dispersion of rents locally, and sometimes a weakened effectiveness for the Japanese investors.

On the whole, however, the member countries of the EC are welcoming to foreign direct investment. Rather than restraining it, they bargain to obtain investment, and offer incentives. This can be expected to continue, and even more so if the Community adopts external barriers which make Japanese goods scarce, and even more demanded by consumers. At the same time, those countries which do not obtain investment turn hostile towards it. Compare with the struggle between Britain on the one hand, and France and Italy on the other, concerning the rights of Japanese auto-manufacturers in Europe. Like in the U.S., Japanese firms are spurred to build alliances with locals to secure market access.

In finance and insurance, Japanese direct investment originally served domestic industrial partners abroad (Coulbeck, 1984). Small and medium-sized manufacturing firms are now following their larger core firms into the European Community, which further raises the motivation of Japanese banks to have a strong presence. Except for integration of normal funding activities and improved fund management, operations in Europe involve multi-currency transactions and exploitation of differences in national tax rates. There is also a considerable element of control consoliation. In addition to these factors, American and Japanese banks have increased their number of subsidaries due to the Second Banking Directive, which takes effect January 1 1993.[6] In this field, however, the importance of customized relations makes it necessary to build allicances with incumbent institutions in order to reach the bulk of the market. This has turned out to be difficult, and Japanese banks are not expected to expand further in Europe in the near future (Shigehara 1990; Feldman, 1990).

The prospects of a Monetary Union in the EC may create new attractions in Europe, since this would do away with the excessive transaction costs between European currencies. It is still too early to judge the importance of this factor, however. Considerable impediments remain before a monetary union can be established. Hardly any of the member countries fulfill the conditions for joining it, set up by themselves. A fundamental question, still unanswered, is under what circumstances the heterogeneous European Community constitutes an optimal currency area. If a common currency would be adopted too early, it might cause further instability and lead to protectionist policies for purposes of adjustment.

In the rest of Europe, the Japanese investment has been modest so far. Certain countries are now actively seeking to attract it. Too small domestic markets will probably prevent most countries in Western Europe from obtaining any major investments as long as they remain outside the EC.

6 After this date, foreign banks will be able to open new subsidiaries only if the laws of their home countries meet the "reciprocity requirement" that is stated by the Second Banking Directive.

There are some exceptions. In Sweden and Switzerland, the prevalence of technologically advanced and internationally experienced domestic corporations may attract activities which benefit from technological spillovers. Sweden enjoys an additional advantage in its relatively low costs for qualified labour, but suffers from an adverse geographic location. The East European countries enjoy low costs but the political situation is still highly uncertain, and the domestic markets are small. Japanese investors are most interested in those which are located close to the EC and have a good chance to acquire access to the Single Market. The main countries in this category are probably Poland and Hungary, and perhaps what will be left of Checkoslovakia.

International interactions

As seen above, there have been many simultaneous developments spurring Japanese firms to go abroad in the 1980s. Some have pushed activities out of Japan, others have pulled them into certain regions. Step by step, the traditionally perceived barriers to operations abroad seem to have been overcome. But does this mean that the Japanese expansion abroad will continue? As stated above, the efficiency of Japanese firms partly build on the special characteristics of their home market. Before predicting the role of Japanese direct investment in the 1990s, we need to further consider the international interactions of the Japanese.

The Japanese spurt in exports and investments overseas can be well explained by traditional economic factors, such as terms of trade changes, savings behaviour, etc. The reason for the limited Japanese imports and inward investments is less well understood (Saxonhouse and Stern, 1989; Krugman, 1987). The prices of western goods tend to be high in Japan, while volumes are small. Still, studies have mostly found normal responses among Japanese consumers to changes in the price of western goods (Lawrence, 1987). Thus, western goods seem to face invisible barriers to entry which cause a mark-up on prices.

It has already been noted that Japan is characterized by "closer" interactions between economic counterparts than is common in the West. Japan has less developed external markets, but emphasizes structures and incentives within existing configurations. Enterprises are able to rely more on subcontractors, distributors and other partner firms, externalizing any activities which are not immediately relevant for the essence of their organizations (Clark et al., 1987; Asanuma, 1988). Asanuma (1989) and Hoshi et al. (1990) have demonstrated benefits in terms of risk-diversification, complementarity of assets and the enhancement of human skills from such interconnected relationships. Western firms, by contrast, seek to handle risk-sharing, moral hazard and adverse selection through internalization in the form of vertical integration.

The differences also show up in the organization of research and development (R&D). Similar to multinational firms based in other countries, such as most American, German, British or Swedish ones, the Japanese concentrate R&D to their home country. Freeman (1987) speaks of the national system of innovation as the network of private and public institutions which foster and diffuse technologies. Imai (1990) demonstrates how the Japanese system emphasizes "learning by using" through close interactions between the producers of new technology and those units which are concerned with processing and marketing. Innovations occur because different stages of production overlap, and through an extensive sharing of information within the system. In electrical engineering, Wakasugi (1990) concludes that Japanese technological progress stems from the close coordination of R&D departments with other divisions.

Imai (1991) notes that the Japanese system of overlapping between research and marketing causes difficulties for international interactions. Partnerships with westerners, which do not apply such overlapping, become asymmetric. The speed of the diffusion of knowledge is greater on the Japanese side, where overlapping with other units is a critical element. The western side finds that Japanese partners do not adhere to their alliances, and mutual trust is difficult to establish. Hamel et al. (1986) conclude that the Japanese enjoy an advantage in partnerships with westerners. To the extent that this creates a barrier for interactions between the Japanese and westerners, it appears to work differently in Japan and in the West.

Looking at inter-company relations, Japanese firms in Japan can be said to focus on complementarity with particular partner firms, while western firms in the West enhance efficiency irrespectively of their partner firms. Given that Japan and the West can be characterized as two separate equilibria in this sense, there is an asymmetry in the behaviour of western firms in Japan and Japanese firm in the West (Andersson, 1992a,b). Japanese firms are motivated to adapt to western business practices in the West, but western firms in Japan experience a dynamic inconsistency in their optimal plans. Ex ante the formation of a partnership, they prefer the Japanese way. Ex post, however, they prefer the western way, thereby enhancing their own capabilities and avoiding that investment is sunk in the Japanese market. In case future behaviour can not be committed, Japanese firms will then join partnerships with westerners at home only when they can control volumes, prices and information flows. The Japanese are able to enter the West, but western firms have trouble in Japan, and the prices of western goods remain high.

Based on the study of 700 firms, Odaka (1990) found significant differences in the behaviour of Japanese and foreign-owned firms. For example, Japanese-owned firms base promotion relatively more on long careers within the company, use introductory training for newly employed and replacement as method of lay-off rather than firing workers. In the West, Japanese firms do adjust a good deal of their behaviour - use take-overs, lay off workers, and accept ordinary unions (albeit reluctantly). In other respects, however, they retain crucial elements of their organization, increasing productivity and/or causing problems with local counterparts. For example, typical Japanese management practices have been found to function well among blue-collar workers in European countries, while offices have suffered from lack of communication, which has led to high turnover of employees (Trevor, 1989; Yasui, 1989).

That Japanese firms are able to adjust to "western" standards in the West does not mean that they give up relations with Japanese partners there. We have already noted that both financial institutions and small- and medium-sized Japanese firms follow their industrial relatives to foreign markets. The small Japanese firms are more internationalized than corresponding firms in other countries.[7]

Predictions for the 1990s

It is time to sum up some predictions for the years ahead. We have seen that Japanese direct investment has emerged on a grand scale only lately. The primary motivation has changed from access to raw materials and low wages, to supporting progress in the world's largest and richest markets. Japanese direct investment had to be large in the late 1980s, because the Japanese firms lagged behind in internationalization. As they are now on par with other investors, or even ahead of them, one could expect that the Japanese multinationals would be less aggressive abroad in the 1990s.

This reasoning may be supported by the economic debacle that Japan currently faces at home. As seen in retrospect, Japanese equity was grossly overvalued in the late 1980s. After several years of restraint by the Bank of Japan, the stock exchange is still contracting, real estate has lost value and the financial muscles are weakening in many institutions. Economic growth has slowed and some funds are brought back home to support faltering accounts. Although many crashes may be expected down the road, it is unlikely that the Japanese expansion abroad will be more than temporarily restrained by these events, however. Domestic consumption has gone down, signaling an adjustment on the part of Japanese consumers to a permanently lower level of income. Meanwhile, Japanese exports continue to grow, as does the current account surplus and the capital outflows.

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7 For a comparison of the Japanese and Swedish experience in this respect, see Fredriksson (1992).

On the other hand, there are serious structural problems in the Japanese economy which may show up in the longer run. The aging population may reduce savings, and new generations of Japanese consumers may be more inclined to spend than current ones. Such changes should not be taken for granted. Japan is becoming aware of its low population growth, and of the obvious connection with the obstacles for women to combine family life with a rewarding career. Although a great deal remains to be done, steps are being taken to improve the professional options for women. This may help to restore the birth-rate, as well as expand and improve the work force. When it comes to consumption, long-term planning is deeply rooted in Japanese minds, and it may take a long time for a more spending-oriented attitude to break through.

It should consequently not surprise if the Japanese will, in fact, be able to handle domestic problems such as those mentioned above. With an upper hand in worker motivation and organizational capabilities, Japanese firms will continue to upgrade their technological capabilities, and the demand for their products will grow accordingly. With operations abroad supporting sales, we should expect Japanese direct investment to become increasingly important in the 1990s. In the United States, the flow may still stagnate, as Japanese firms are already well established, and continued expansion may fuel increased tension. On the other hand, Japanese firms will improve their adaption to local requirements, and export more back to Japan.

This suggests that the Japanese multinationals will increase their presence particularly in Europe and the rest of East Asia, which represent the largest other markets in the world. In Europe, one can expect power struggles with local authorities. As already discussed, it is unlikely that Japanese firms will suffer major blows from such battles. The Europeans are struggling with each other to keep their integration process going. Japanese investment projects, with the employment opportunities and tax revenue they bring, will be lucrative prizes for individual countries and regions. Given that Europe becomes more protectionist, the great losers will be developing countries which can not jump across trade barriers, rather than the Japanese. This is not to say that the Japanese will continue to invest heavily in all sectors. They are already well established in finance and insurance, where continued expansion is regarded as difficult.

What remains problematic is the limited success of western firms in the large Japanese home market. Krugman (1984) argues that this enables high profits for Japanese firms at home, allowing them to dump their output in foreign markets.[8] Meanwhile, growing trade deficits are used as an excuse for protectionist measures both in the U.S. and the EC. Voluntary export restraints and antidumping proceedings are not only costly for western consumers, but postpone structural change and lock resources into inefficient operations. The damage to competitiveness is particularly serious in intermediate goods, such as electronics and electrical parts and components. As western firms are lured into believing that they can forego the effort of competing with the Japanese on a truly global scale, the Japanese also strengthen their grip on East Asia, which is the most rapidly developing region in the world. By retaining their dominance in Japan, and achieving it in East Asia, Japanese companies become even more formidable competitors.

The crucial question concerns whether foreign firms will be able to compete with more success in Japan. The declining price level in Japan currently provide foreign firms with a golden opportunity to enter. Previous restrictions limiting the rights to ownership are also gone by now. Some progress has been recorded by foreign firms in the last year, but their efforts continue to be dwarfed by those of the Japanese abroad. Meanwhile, trying to force western goods onto the Japanese through political action, e.g. by guaranteeing a certain share of the computer chip market to foreigners, gives the wrong signals both to the Japanese and to foreigners.

Given the different nature of partnerships and information sharing on the two sides, western firms can succeed in Japan only through commitments to its market, getting to know the consumers and what it takes to succeed there.

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8 That Japanese firms in fact report low profits is irrelevant, as this is motivated by the extremely high profit taxes in Japan.

To neglect this task means to go down a dangerous path. Paradoxically, a continued lack of success for western firms in the Japanese home market will be equally dangerous for Japan itself. Widening trade and investment imbalances will sooner or later become intolerable for western politicians, undermine the world trading system and even the prospects for peace and security. Japan must become aware of these risks, and seriously consider how it can remove unduly obstacles for foreigners. Continued progress for Japanese direct investment in the 1990s and beyond will eventually require that multinationals engage in increased exchange both ways.

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