Japanese Foreign Direct Investment in Europe
in a comparative perspective

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I certify that this thesis is my own work and that all sources have been acknowledged.

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Abbreviations and Notes

APEC- Asia Pacific Economic Cooperation
ASEAN - Association of South East Asian Nations
EC - European Community
EEC - European Economic Community
EU - European Union
FDI - Foreign Direct Investment
JFY - Japanese Fiscal Year (April to March)
JETRO - Japanese External Trade Organisation
NIEs - Newly Industrialised Economies

All amounts are given in US dollars
Amounts of investment are those quoted by the Japanese Ministry of Finance and may differ from other sources.
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Chapter 1. Introduction

Japanese foreign direct investment (FDI) in Europe has undergone significant change in the last decade. Between 1985 and 1990, the stock of Japanese FDI directed to Europe increased more than five times, and the annual flow of new investment grew from about $2 billion to over $14 billion. Europe's share of Japan's total FDI also increased substantially. However, with the end of the 'bubble economy', new investment in Europe fell sharply.

The purpose of this thesis is to analyse the trends in Japanese FDI in Europe in the context of Japanese FDI worldwide. The thesis will analyse the reasons for and implications of these trends. In addition, attention will be given to the attitudes towards this investment and the resulting conflicts, and prospects for the future.

Chapter 2 provides the theoretical basis for this analysis. It provides a definition of direct investment, and an outline of the reasons why a business might invest and the necessary conditions for investment to be profitable. The explanation of the factors which determine the direction of direct investment is used later in the thesis to analyse the geographical distribution of Japan's FDI. Chapter 2 also gives a general discussion of the advantages and disadvantages of FDI for the host country. This discussion is subsequently used as background for the analysis of conflicting attitudes towards Japanese FDI in Europe.

Many of the reasons for the boom and subsequent decline of Japanese FDI in Europe coincide with the reasons for the similar pattern in total Japanese FDI. Therefore, the
trends in Japanese FDI in Europe need to be examined in the context of changes in Japanese FDI worldwide. Chapter 3 provides this context.

Until the 1970s, Japanese FDI was limited as a result of strict government controls and a shortage of capital with balance of payments deficits the norm. The late 1970s brought the liberalisation of capital markets and an increasingly international orientation for Japanese firms. With ever increasing trade surpluses, the Japanese sought to correct the imbalance with capital outflow, and Japan became the world's largest capital exporter (until 1993 when it slipped back to third position).

The increase in total Japanese FDI was particularly remarkable in the period between 1986 and 1991. As a result, the topic was the subject of much attention and mixed emotions from politicians, the media and academics alike. With the end of the 'bubble economy', investment has returned to more normal levels.

Coinciding with the increase in the total amount of Japanese FDI, there have been clear shifts in the geographical and sectoral patterns of that investment. Particularly noticeable in recent years have been the increasing amount and proportion directed toward industrialised countries, reflecting what Balassa and Noland\(^1\) claim to be "changing motivations". Japanese FDI in Europe needs to be considered in the context of these changing motivations and investment in industrialised countries. Some of the reasons for the investment boom in Europe are common to the United States and Australia.

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However, Japanese FDI in Europe has increased more rapidly than that in other industrialised countries indicating that there are some factors unique to Europe. There has been significant discussion of these factors. One of the most important is the establishment of the European Union (EU) (previously known as the European Community (EC)) and the single European market. To provide the background to this analysis, Chapter 4 briefly outlines the history and development of the EU. It also outlines the political and economic relationships between Europe and Japan. These have had important influences on the amount of Japanese FDI directed to Europe.

Chapter 5 draws on the context provided by the earlier chapters to analyse the shifts in Japanese FDI to Europe and the reasons for those movements. It also analyses the distribution of Japanese investment in Europe with respect to countries and sectors. These distributions are analysed in the context of the 'intra-regional division of labour' model as discussed by Morris-Suzuki in Morris2. This analysis also provides clear illustration of the factors influencing the direction of Japanese FDI, as discussed in Chapter 2.

Chapter 5 also examines the widely contrasting attitudes and policies toward Japanese FDI from different countries and groups within Europe. These result from the conflicting advantages and disadvantages that FDI brings to the host countries. The contrasting positions within Europe have provided new conflicts both between and within the countries of the EU.

The topic of Japanese FDI in Europe is of interest to other industrialised countries for two main reasons. First, there are similarities and differences between the problems and conflicts facing the Europeans with regard to Japanese FDI, and the situation in other industrialised countries. An analysis of European conflicts provides the basis to compare and contrast.

Second, Japanese FDI in Europe has important implications for other industrialised countries, particularly the United States. The Americans are competing for Japanese investment headed to Europe. They are also facing increased competition, both at home and in third markets, from European-produced, Japanese-owned exports.

The story of Japanese investment in Europe provides an interesting setting for the growing Asian economies that in the coming decades will follow Japan's footsteps in pushing into the European market. Both the Asian countries and the Europeans have lessons to learn from the EU-Japan relationship.

Chapter 6 considers the future prospects for Japanese FDI in Europe in the context of changes in FDI worldwide. Specific attention is given to European unification and the problems that have arisen, the proposed expansion of the EU, and the effect of these factors on Japanese FDI in Europe. Future prospects for Japanese investment are of vital importance to the economies of western Europe still coming out of recession, and to the countries of Eastern Europe who hope that Japanese FDI will provide the catalyst for growth.

This thesis directs most of its attention to Japanese investment in the EU. However, the EU is a rapidly changing entity. Its size, form and motivations are very different to those of the original six that signed the Treaty of Rome in 1957 and formed the European
Economic Community (EEC). Many countries have applied for membership or are undertaking internal debate to determine if joining the Union is appropriate. Therefore, in addition to analysing Japanese FDI in the EU, a wider view of Europe is taken to give consideration to Japanese investment in the other nations of western Europe. In some cases, the terms EU and Europe are used interchangeably.

The third level of interest is in the countries of Eastern Europe and the former Soviet Union. While these countries have expressed interest in joining the Union, the chances of this in the short term are remote. Their economies and societies are very different to those of the rest of Europe, and they are in the process of difficult restructuring. However, there is potential for strong growth in Japanese FDI to these countries, and Chapter 6 gives some consideration to the prospects for Japanese investment there.
Chapter 2. Characteristics of Foreign Direct Investment

2.1 Definition of direct investment

Foreign investment is generated by a surplus of savings over investment, or equivalently the difference between exports (and other current receipts) and imports (and other current payments). This surplus results in an outflow of capital. Foreign investment can take one of two forms - portfolio or direct investment.

Portfolio investment is that in which the ownership of assets is transferred. This includes, for example, investment in public issues of shares and debentures. Portfolio investment tends to be more volatile than direct investment in response to economic conditions.

Direct investment is defined as that which transfers control of the use of assets. It is investment in branches and subsidiaries. It can take the form of acquisition of securities, provision of loans or the establishment and expansion of overseas branches. Direct investment flows can be independent of overall capital flows. "Direct investment requires more intimate contact and knowledge than portfolio investment." For this reason it has tended to be concentrated in countries that have similar economic and social conditions to those from where the investment originated. Otherwise a large investment in knowledge is required.³

This thesis will concentrate on Japanese direct investment in Europe.

2.2 Reasons for direct investment

The reasons for a business deciding to invest in another country can be divided into 'supply' (push) reasons and 'market' (pull) reasons.

The 'supply' reasons include
- ensuring a supply of, or influencing the price of, a raw material;
- taking advantage of cheaper factors (for example labour and land) in the host country;
- avoiding internal pressures such as pollution controls; and
- avoiding the cost of transporting raw materials.

The 'market' reasons include
- securing or expanding a market for their goods in the host country. In some cases it is perceived that there is a need to produce in a market to sell in that market;
- the need to deal with market oriented trade friction; and
- acting in response to export oriented industrialisation policies or import substitution policies.4

Supply-oriented investment generally takes place in developing economies while market-oriented investment is generally concentrated in industrialised economies. However, this division is not exclusive. With regard to Europe (especially western Europe), factors of production are not particularly cheap and there is not a wealth of raw materials. Therefore, Japanese firms investing in Europe will do so for 'market' reasons rather than 'supply' reasons. These reasons are discussed in detail in Chapter 5.

4 Morris, op. cit., pp. 32-34 and 40.
Sekiguchi describes the two major economic hypotheses on direct investment.\textsuperscript{5} The first is the monopolistic power or industrial organisation hypothesis, developed by Hymer and Kindleberger, and independently by Caves. Under this hypothesis, monopolistic or oligopolistic firms transplant production processes across national boundaries by taking advantage of their technological superiority and/or their influence on financial markets. Although some of the investment undertaken by the largest Japanese companies fits this model, the monopolistic power hypothesis does not explain FDI by small and medium-sized Japanese manufacturers.

The managerial resources hypothesis is based on Penrose's growth theory of firms and was developed by Komiya and Fayerweather. Under this hypothesis, the set of technologies in production, marketing and organisation are defined as "managerial resources" and direct investment is seen as a process of international reallocation of these resources. The managerial resources hypothesis can better explain FDI by small competitive firms, but does not exclude the influence of monopolistic elements on competition.

2.3 Conditions for direct investment

When setting up a business overseas, an investor faces locational disadvantages in the establishment and operation of the business compared to the local producers. These include

- higher costs and language barriers related to gaining information on
  - the institutional framework,

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- the legal system,
- market structure, and
- consumer tastes in the host country;

• communication costs between the subsidiary and headquarters;
• problems gaining adequate human resources; and
• discrimination against foreign firms by the host government in public procurement.

On the other hand, for foreign investment to be viable, the investor must hold some net comparative advantage over the local producers. The advantages a business may hold include

• superior management techniques;
• technological expertise;
• brand-names;
• access to productive inputs (for example, a raw material source);
• access to markets of importing countries (as the result of long-term contracts or historical ties); and
• sources of cheaper capital in its home country.6

The relative strength of these advantages and disadvantages will determine whether a business invests and will affect the total amount of direct investment. The greatest disadvantages that Japanese firms investing in Europe face are information and communication costs, and language barriers. On the other hand, the main advantages they hold are superior management techniques, technological expertise and brand names.

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Other factors that influence the total amount of Japanese FDI, including that to Europe are

- the strength of the currency relative to the currency of host countries. A strong currency makes acquisition costs cheaper for the investor.
- the economic situation in Japan. This will determine the availability of funds and the confidence to invest.
- the economic situation of the world as a whole. If growth is high, confidence to invest will reflect this; and
- the freedom of capital markets in Japan. Legislation can restrict the level of capital flows or affect the 'cost' of funds.

2.3 Factors determining the direction of direct investment

Certain factors increase (or decrease) the profitability of direct investment. These will determine where investment is directed. Sometimes these factors are important individually, but usually a firm will make its investment decisions based on a combination of a host country's advantages and disadvantages. Bownas identified six factors.\(^7\)

The first of these determining factors is the size and density of the market and the rate of growth. If there is a large and concentrated potential market and buoyant demand, the expected benefits will help to overcome the risks of embarking into 'unknown territory'. This is particularly important for manufacturing investment.

Countries in Asia, and to a lesser extent the United States, are good examples of large, densely-populated, growing markets. As for Europe, although in total it has a large and wealthy market, it faces the disadvantage of having a multitude of countries with different languages, cultures and standards (although this is being rectified somewhat through European Union). Recession has also dampened consumer demand.

Second, investors will look to countries which have economic and political stability. Since investment often requires long-term commitment before gains will be realised, a country which has high economic variability or which is susceptible to radical shifts in the political situation will be less attractive. This will be more important the higher the fixed costs or the longer the production process.

Industrialised countries, including those in western Europe, clearly provide higher levels of economic and political stability than the developing economies. One of the greatest disadvantages facing Eastern Europe when trying to attract foreign investment is the instability there.

Third, low comparative costs in the host country are important. Many firms begin production offshore solely to overcome rising production costs in their own country. These rising costs usually take the form of the increasing price of labour or land. It is also important for the labour to be not only cheap, but of high quality. It may be that a host country has abundant supplies of raw materials, and by producing in that country, the costs of transport can be overcome. Another motivation for offshore production is to overcome political pressure for decreased levels of pollution.

These factors tend to relate to developing economies, particularly those within Asia. Although Europe has high quality labour, costs of production are high and it has few
natural resources. Nonetheless, some countries and regions of Europe are cheap relative to others. This is particularly the case for Eastern Europe.

Fourth, an investor will look for a well-developed industrial infrastructure in related industries. These may include the production of inputs, or transport and distribution facilities. Industrialised countries, and particularly western Europe, rate highly in this category.

Fifth, an investor will be influenced by the attitudes to investment in the host country, both from the government and the public. Specific investment incentives such as tax concessions will provide measurable benefits. However, a welcoming attitude from both the government and the public will also be an important factor. This is closely related to the strength of bilateral relations between the investing and the host countries.

As discussed in Chapter 4, the relationship between Japan and Europe has not been particularly strong. Some countries in Europe, especially the United Kingdom, have welcomed and encouraged Japanese FDI. However, the variation in attitudes among the different countries is large and the conflicts between them can be counterproductive for Europe as a whole.

Sixth, as outlined earlier in this chapter, because direct investment requires intimate knowledge and contact, it is usual for investors to look to investing in countries with similar economies and societies to their own. This helps to reduce the risks involved in embarking on direct investment, and to decrease the need for investment in knowledge. Language barriers are some of the greatest obstacles to an enterprise expanding production overseas. Similar societies allow for a smoother production process, especially with regard to relationships between management and workers. Similar
societies also allow a manufacturing firm to adapt its product to the new market more easily.

Asian countries tend to have cultures closer to Japan than western nations. Therefore European countries do not rate highly in this category. Because English is the most widely spoken foreign language in Japan, English-speaking countries are relatively popular with Japanese investors. It is partly for this reason that Japanese FDI in Europe has been concentrated in the United Kingdom. This will be discussed further in Chapter 5.

Finally, exogenous factors, such as the establishment of a trading bloc like the EU, may encourage firms to begin production within the bloc so as to establish access to a (potential) closed market. When protection reaches a critical level, firms begin to substitute direct investment in subsidiaries for exports to overcome import barriers. This also gives the firm a higher profile within the trading bloc.\(^8\) This will be discussed in more detail in Chapter 5.

2.4 Advantages and disadvantages for the host country

For the host country, there are various advantages and disadvantages of direct investment. These give rise to conflicting attitudes towards it. As will be discussed later, such attitudes have caused friction between countries within Europe.

One of the advantages of Japanese FDI in Europe (and elsewhere) is that it provides funds required for investment in capital goods, leading to a greater productive capacity

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\(^8\) Heitger and Stehn, *op. cit.*, p. 7.
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and a higher growth performance. This is particularly important if the host country has problems generating capital from within. The setting up of new industries or companies leads to higher employment. Foreign investment can also lead to increased transfers of technology through research and development projects, and to new marketing links. If domestic industries can observe and learn from investing companies they can achieve improvements in quality and management techniques, including industrial relations.

Foreign investment encourages local firms to have an outward orientation, leading to greater opportunities for trade, investment and the influence of new ideas. At a more abstract level, foreign investment provides a way for countries to expand communication, understanding and cooperation.

Investment in particular industries can have special advantages. For example, increased foreign investment in the tourism industry is likely to be followed by increased international tourist flows. There is also the provision of new and more diversified facilities from which domestic tourists can gain benefit.

Conversely, foreign investment does have disadvantages for the host country. The main one is that the investors may drive domestic competitors out of the market, especially through dumping, and thus be able to exploit their monopoly position in the longer term.

Although investment leads to increased employment, in many cases employment of local personnel may be limited as the companies merely bring workers from their home.

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10 ibid, p. 45.
country. Similarly, local industries will not be able to reap the benefits of increased production, sales and employment if the overseas companies establish so-called 'screwdriver operations'. These are merely assembly operations where the investing companies import all the parts from home using little or no local content.\textsuperscript{11}

Many national and state governments have introduced legislation to combat the disadvantages of foreign investment, both real and perceived. It should be noted that while there are disadvantages of foreign investment and some of the concerns are justified, in many cases the alarmist sentiments are unwarranted and merely the result of media hype and prejudices. For example, in the United States, it has been stated that foreign investment (referring particularly to Japanese) poses an "economic threat against national security".\textsuperscript{12} Similar claims have been made in Europe. More attention will be given to the attitudes towards Japanese investment in Europe in Chapter 5.


\textsuperscript{12} JETRO (d), JETRO white paper on world direct investments: new phase in foreign investments and strategic alliances: summary, Tokyo, 1989, p. 4.
Chapter 3. Trends in Japanese Foreign Direct Investment worldwide

In order to analyse the changes in Japanese FDI in Europe, it is necessary to consider the world situation in which these changes took place. This chapter provides that context by examining how total Japanese FDI has changed in terms of amount, geographical and sectoral distribution, and the reasons for these changes.

3.1 Trends in the amount of Japanese direct investment

Until the 1970s, Japan had persistent trade deficits and there was a shortage of capital in Japan. The government placed strict limits on flows of investment, both in and out of the country, and as a result there was almost complete reinvestment in domestic industries. As a result, Japanese FDI was limited until the 1970s. In 1970, the cumulative value of FDI was just US$3.6 billion. Since that time however, there has been a phenomenal increase in Japanese FDI, both in terms of amount and as a percentage of Japan's gross domestic product.

Table 1 and Figure 1 illustrate the changes in the flow and stock of Japanese FDI since 1970. The annual flow of new Japanese FDI was $3.3 billion in 1975 and increased gradually to $12.2 billion in 1985. The next four years brought a boom in total Japanese FDI and the annual flow grew rapidly to a peak of $67.5 billion in 1989. Recession in Japan resulted in a slump in new FDI in the early 1990s, and the amount of new FDI fell each year to $34.1 billion in 1992, before a slight recovery in 1993. Mirroring the

13 Garnaut, op. cit., p. 88.

changes in the flow of FDI, the stock of Japanese FDI increased steadily from $3.6 billion in 1970 to $83.7 billion in 1985. It then rose dramatically to $253 billion in 1989 when Japan was the world's largest capital exporter. Through the 1990s, the increase in the stock of Japanese FDI has been more gradual. At the end of March 1994, total stock was $422.6 billion. The reasons for these changes are discussed below.

Figure 2 charts the percentage annual changes (compared with the previous year) in stocks and flows of Japanese FDI from 1973 to 1992. From this graph we can make a number of important observations. Firstly, the changes in the flow of Japanese FDI (indicated by the bars) are extremely variable. This serves to emphasise the volatile nature of direct investment (as discussed in Chapter 2), and due to this volatility, it is not constructive to try to identify trends in this series. On the other hand, the changes in the stock of Japanese investment (indicated by the line), which is the more relevant variable, show more consistent and interpretable trends. The stock of Japanese FDI increased strongly in the early 1970s with a peak in 1973. This was followed by a steady, but annually relatively small, increase between the late 1970s and the mid 1980s, with a small peak in 1981. There was a major boom in the second half of the 1980s when both the stock and flow of Japanese FDI increased at an unprecedented rate. In the early 1990s, although the stock of Japanese FDI continued to grow, the rate of change was much slower than in the previous five years.

Let us consider the reasons for the strong growth in Japanese FDI in the early 1970s and the smaller boom in the early 1980s.

In the late 1960s and early 1970s, the Japanese government began to liberalise the capital markets by raising the ceiling on the asset size of overseas investment. The growth in the stock of FDI at that time would have been a response to that liberalisation, with firms
adjusting upwards for the restrictions previously imposed. Coinciding with the liberalisation and as one of the factors leading to it, Japan began to show an ever-increasing trade surplus accompanied by a surplus of savings over investment at this time. This resulted in an increasing supply of capital and the imbalance was corrected by increasing capital outflow, leading to increasing amounts of FDI. Despite the easing of restrictions on Japanese capital movements, the rigidities in the international capital markets allowed a situation of cheaper capital in Japan and other parts of North Asia to persist through the 1970s and 1980s.

Through the 1970s, Japan also began to embark on a process of internationalisation, broadening its horizons in an effort to become recognised as a world power. This led firms to have an outward orientation and to look to the advantages of foreign investment. They also gained overseas experience and a knowledge of international business strategies. Concurrently, national income and production levels in the countries with which Japan conducted most of its trade began to increase substantially, encouraging direct investment.\(^{15}\)

The main reason for the increase in Japanese FDI in the 1970s and 1980s was the appreciation of the yen. The booms in direct investment have generally coincided with periods in which the value of the yen was high relative to other currencies, particularly with revaluation in 1985. An appreciation of the yen makes Japanese exports less competitive as the relative costs of production in Japan increase. Japanese businesses adopted various strategies to overcome this reduced competitiveness. They rationalised and improved productive efficiency, or diversified to produce products with a higher level of profitability. The third corporate strategy that businesses adopted to overcome

\(^{15}\) Balassa and Noland, *op. cit.*, p. 112.
an appreciation of the yen was globalisation. Firms either formed alliances with foreign firms or invested directly, shifting their operations offshore to take advantage of lower production costs.\textsuperscript{16} A strong yen also made the cost of investing to Japanese businesses lower.

The other international factor that must be considered in this period is the effect of the oil crises of 1973 and 1978. Unlike the other factors described above, at the time of the oil crises there tended to be a smaller increase in Japanese foreign investment stocks. With the instability of the world situation and especially concern about Japan's resource needs, firms ("guided" by the government) were more cautionary in their stance and limited their FDI. Investment in this period was directed towards resource security for this reason.

Figure 3, which magnifies part of Figure 1, graphs the annual flow of Japanese FDI between 1983 and 1993 to illustrate the boom and then the slump. As outlined previously, the rapid increase in Japanese FDI began in the second half of the 1980s. Between 1983 and 1989, the flow of investment showed none of the volatility expressed in the previous 15 years, but rather continual annual increases. The amount of investment almost doubled from $12.2 billion in 1985 to $22.3 billion in 1986 and then increased by almost 50 per cent each year to a peak of $67.5 billion in 1989. Between 1986 and 1990, the cumulative value of Japanese FDI almost tripled from $106 billion to $311 billion, making Japan the world's largest source of international capital at that time.\textsuperscript{17}


\textsuperscript{17} JETRO (a), \textit{1993 White Paper: Kaigai Chokusetsu Toshi (Overseas Direct Investment)"}, Tokyo, 1993, p. 522.
Chapter 3

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The Japanese External Trade Organisation (JETRO) cites several general factors that contributed to this boom. The strong appreciation of the yen following the Plaza agreement of 1985 doubled the purchasing power of the yen. This decreased acquisition costs in other countries while at the same time decreasing the profitability of Japanese-produced exports, and made investment overseas more attractive to Japanese firms. Coupled with this, the 'bubble economy' provided a surplus of funds making borrowing easier for firms. It also served to inflate the price of real estate in Japan (while overseas land prices tended to fall) which made production in Japan more expensive and at the same time made both production and investment in real estate overseas more attractive. Japan's labour costs were expensive relative even to western countries, let alone the developing ones. This provided further incentive for off-shore production to reduce input costs.18 There was also an improvement in the capacity of Japanese financial institutions to act as go-betweens in merger and acquisition deals.19

As discussed in Bergsten and Noland, the increasing number of Japanese firms investing overseas provided the impetus for other firms to undertake FDI. Not only were the firms pressured to keep up with their rivals in terms of business performance, many had to follow their investing trading partners to maintain business.20

The good economic conditions in Japan in the second half of the 1980s provided a confident atmosphere. There was continued relaxation of regulations in the financial sector and firms continued to adopt globalisation and global localisation strategies as a means to increase profitability. These strategies are detailed later in this chapter.

18 ibid.

19 JETRO (d), op. cit., p. 7.

20 Bergsten and Noland, op. cit., p. 279.
Despite the high value of the yen, the large deficits on the current account continued, and investment was seen as a strategy to avoid trade friction in the US and in Europe. This will be discussed in more detail in Chapter 5, as will changes attributable to specific regional factors, such as European unification.

With the collapse of the 'bubble economy' and with sustained recession in Japan, there was a sharp fall in the annual flow of Japanese FDI. Referring again to Figure 3, from 1990 until 1992 there were continued decreases in the amount of new Japanese FDI. From the peak in 1989 of $67.5 billion, Japanese FDI fell to $57 billion in 1990, $42 billion in 1991 and $34 billion in 1992. Japan has lost its mantle as the world's largest source of FDI, slipping back to third behind the USA and France. 21 The number of cases of direct investment fell from 6589 in 1989 to 4564 in 1991. 22

The reasons for this fall are closely linked to the end of the 'bubble economy' in Japan and recessions both in Japan and worldwide. Funds began to dry up and the performance of transnational companies on the Tokyo stock exchange plummeted, thus decreasing the funds available for foreign investment. Banks balance sheets worsened. With the worldwide recession and increased competition from European and American producers, as well as increased labour costs and interest payments, FDI proved to be less profitable. Firms took a more cautionary stance towards overseas investment. 23 In addition, by that

22 JETRO (a), op. cit., p. 60.
23 ibid., pp. 76-82.
time most major companies had already made substantial investments and inroads into the American and European markets.\textsuperscript{24}

Despite the fact that flows of Japanese FDI decreased dramatically in the early 1990s, the amount of investment remained higher than the flows prior to the boom. It could be suggested that the amounts of FDI in the late 1980s were ‘abnormal’ and that since that time investment has returned to a more normal pattern. In 1993, the amount of new Japanese FDI was $36.02 billion, an increase of 5.5 per cent and the first increase since 1989. There is also optimism that this trend will continue.\textsuperscript{25} Further discussion of reasons for the increase in 1993 and an analysis of future prospects is given in Chapter 6.

### 3.2 Sectoral distribution

In 1960, 50.6 per cent of Japanese FDI was in the primary sector, 27.4 per cent in manufacturing industries and 22 per cent in tertiary industries. By 1985, the sectoral distribution had changed dramatically with resources accounting for 16.1 per cent of the total, manufacturing 30.2 per cent and tertiary industries 53.7 per cent.\textsuperscript{26} Table 3 and Figure 5 show the changes in the world sectoral distribution of Japan's FDI since 1983. An interesting observation is that the composition of Japanese FDI by sector was similar at the beginning and end of the decade (1983-1993), but was considerably different during the period of the 'bubble economy'.


\textsuperscript{25} Australia-Japan Economic Institute, \textit{Economic Bulletin}, Volume 2 No 6, June 1994, p. 3.

\textsuperscript{26} Morris, \textit{op. cit.}, p. 19.
The share of Japanese FDI in manufacturing industries is small by world standards. As shown in Figure 5(a), investment in manufacturing industries has been fairly stable in the last decade, consistently accounting for 25 to 30 per cent of total Japanese FDI. The exception was in the period between 1985 and 1987 when there was a sharp fall in the share directed towards these industries. In 1993, manufacturing made up 30.9 per cent of the total with electrical equipment, chemicals and machinery the main beneficiaries. Investment in the production of transport equipment (mainly cars), while still strong, showed a significant decrease.

Between 1951 and 1992 cumulative investment in manufacturing industries was 26.5 per cent, showing that the trend has been a slight increase in the share directed to these industries. In 1993, this sector had a growth of 10.7 per cent, the highest for many years. This trend is largely the result of the strong yen as firms have had to make decisions to move their operations offshore to maintain competitiveness. The share directed toward manufacturing has increased as a result of a shift away from certain non-manufacturing industries, as described below.

As shown in Figure 5(a), non-manufacturing industries have typically accounted for 65 to 70 per cent of Japanese direct investment, except between 1985 and 1987 when their share reached as much as 80 per cent. In 1993, non-manufacturing industries accounted for 68.4 per cent of Japanese FDI.

27 JETRO (d), op. cit., p. 8. In 1987, 4% of the total output of Japanese firms was produced overseas compared to 20% of US and West German production. Morris, op. cit., p. 22.

28 Australia-Japan Economic Institute, op. cit., p. 8.

29 ibid., p. 6.

The distribution of investment within the non-manufacturing industries has undergone interesting changes. This is illustrated by Figure 5(b). The proportion directed to resources and agriculture has shown a tendency to decrease, falling from 5.3 per cent of the total in 1985 to 1.9 per cent in 1987, despite rebounding a little since then. The share directed to transport has decreased significantly. Investment in the banking and insurance industries led the boom in non-manufacturing investment between 1985 and 1987, but their share has fallen significantly to pre-boom levels since then. However, as trade and investment in other industries increase, there is likely to be renewed interest in the banking sector as Japanese firms move to service the other industries. The proportion of Japanese FDI going to real estate reached a peak of 21.4 per cent in 1991, as Japanese land prices soared and foreign land remained relatively cheap. However, it fell back a little in 1992 and 1993 as the effects of the collapse of the 'bubble economy' were felt and Japanese land prices returned to more reasonable levels. The share directed to service industries has shown a strong upward trend.

Non-manufacturing investment in 1993 is characterised by an even spread between industries, rather than the dominance by banking or real estate that was evident in previous years. In addition, this distribution closely reflects the long term cumulative shares of the various industries. This indicates that the pattern has returned to a more stable state.

The difference between manufacturing and non-manufacturing investment, and the total is the amount directed to establishment of branches of a company.
Figure 6 shows the sectoral distribution of Japanese FDI divided by region in 1991. Clearly, the sectoral distribution of Japanese FDI in different regions varies greatly depending on the regions' sectoral biases and comparative advantages, as outlined in Chapter 2. Both North America and Europe have a ratio of manufacturing to non-manufacturing investment of three to seven, similar to the ratio of the total. Latin America and Oceania have a strong bias toward non-manufacturing industries and Asia has a relative bias toward manufacturing industries. The reasons for these biases are discussed below in conjunction with the reasons affecting the geographic distribution. It is difficult to draw conclusions about the Middle East and Africa with such a small amount of investment and just one year's data.

### 3.3 Geographic distribution

In addition to the increasing amount of Japanese FDI since the 1970s, there have been significant changes in the geographical pattern of this investment. Figure 4 shows the distribution of Japanese FDI by area in 1983 and 1993, while Figure 3 and Table 2 give an indication of how the distribution has changed in the last decade. Although there is inherent volatility in the distribution, some strong trends are evident.

The most evident trend is that, coinciding with the boom in Japanese FDI, there was a shift from investment in developing countries to industrialised economies. In 1983, investment directed to industrialised countries (largely North America, Europe and Oceania) accounted for far less than half of all Japanese FDI. At the height of the boom, in 1989 and 1990, the share of Japanese FDI to these countries was more than 80 per cent. With the fall in the amount of FDI in the last two years, there has been a parallel fall in the share going to industrialised countries. However, it remains at a strong level.
Conversely, the share directed toward developing economies was strong until the early 1980s, then suffered a fall, and has recently begun to show signs of recovery.

Considering the regions individually, the percentage directed toward North America increased substantially from 20 per cent in 1974 to a peak of 50.2 per cent in 1989. Investment to North America peaked somewhat earlier than in the other industrialised countries, and has since fallen to 42.4 per cent of the total in 1993. The share directed to Europe increased from 8.6 per cent in 1978 to more than 25 per cent in 1992, but, as with North America, has decreased since then. This trend is discussed in more detail in Chapter 5. The share directed to Oceania (largely Australia and New Zealand) also increased rapidly, from 1.5 per cent in 1984 to 7.9 per cent in 1991.

Asia was the leading regional destination for Japanese FDI between 1974 and 1981, but was overtaken by the US, and more recently, Europe. In the last decade, the percentage of Japanese FDI directed toward Asia decreased from 22.7 per cent in 1983 to 10 per cent in 1986 and remained at around that level until the early 1990s, when there was a significant increase to 18.4 per cent of the total in 1993.

Latin America suffered a large fall in its share of Japanese FDI from a substantial 23.1 per cent in 1983 (more than any region except North America) to 6.4 per cent in 1990. The share to the Middle East and Africa, also decreased to very small levels in the late 1980s.

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Chapter 3

Trends in Japanese FDI worldwide

After the United States (40.9 per cent), the leading recipient countries of Japanese FDI in 1993 were the United Kingdom (7.0 per cent), the Netherlands (6.1 per cent), Australia (5.3 per cent) and China, the big improver, with 4.7 per cent of the total.32

The corporate strategies of Japanese firms and the policies of the government in the 1970s were largely determined by Japan's trade and resource procurement needs.33 For this reason, Japan's early direct investments, concentrated in the ASEAN countries and in Latin America, were important in ensuring a constant and stable supply of natural resources, largely minerals, to fuel Japan's growing industrial machine. A large proportion of these resources came from Indonesia and Australia (50% of the total between 1968 and 1977).34 Japan was also looking to secure export markets for its capital goods and this resulted in direct investment in manufacturing industries in the developing economies.35

As wages and other production costs (such as rent) in Japan began to rise and pressure was brought to bear on the manufacturing companies by anti-pollution groups, these firms looked to shifting labour-intensive industries, such as the manufacture of cars, electronics and textiles, offshore. There were further incentives after the appreciation of the yen in 1985 made such options even cheaper.

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32 Australia-Japan Economic Institute, op. cit., p. 4.


In order to combat the rising cost of producing in Japan, there was an increase in investment in the Newly Industrialising Economies (NIEs) of Northeast Asia, such as South Korea, Singapore, Hong Kong and Taiwan. In the NIEs, labour costs were relatively low, and these countries were close to Japan both geographically and culturally, thus reducing establishment and operating costs. However, as the NIEs themselves began to show economic strength in the 1970s and 1980s, they lost some of their 'locational advantages' for Japanese FDI as the wage costs in these countries began to rise relative to the rest of the world and thus the profitability was reduced.

ASEAN countries, especially Malaysia, Thailand and Indonesia, continued to be appealing, with their low labour costs, geographic proximity, and large supply of natural resources. It was cheaper to produce close to the source of raw materials, especially those that were expensive to transport to Japan to process (such as metals and timber). As China's market has been liberalised, it has become a favoured destination for Japanese FDI with a large market, geographic and cultural proximity and an abundant, cheap labour supply.

At the same time as the NIEs began to show economic strength, the Japanese economy began to lose its comparative advantage in labour-intensive industries and there was a shift to capital-intensive and technological industries. This allowed greater scope for investment in developed economies, including Europe. The liberalisation of international capital markets allowed Japanese financial institutions to operate overseas. There was also significant investment in real estate, especially as the cost of land in Japan soared during the 'bubble economy' years. As Japanese income levels have risen, there has been an increase in the number of Japanese tourists venturing overseas and Japanese

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36 Garnaut, op. cit., p. 88.
companies have set up operations overseas to service these visitors. There has also been a tendency for Japanese businesses to counteract rising protectionist sentiments in the West (especially in the United States and Europe) and protect their market share by investing in local industries and thus overcoming import barriers.

Morris portrays the pattern of Japanese FDI as a two stage process - globalisation and global localisation.\(^{37}\) The globalisation stage took place up to the mid 1980s. Japanese companies set up manufacturing operations overseas in a basic form largely to overcome rising costs in Japan. Control remained completely with the parent company in Japan. The overseas operations were just at the final assembly stage with little local content or R&D conducted at the plant. This investment was concentrated in developing economies.

In the second stage, global localisation, the companies 'deepen' their investment, becoming insiders in the destination market. They shift their offshore operations from assembly to full manufacture by transferring decision making and R&D functions and increasing local content by using local suppliers. Global localisation became important in the late 1980s and 1990s at the same time as investment in industrialised countries, including European ones, became more dominant.

This shift from globalisation to global localisation is market driven. Companies see it as necessary to produce within the market to which they wish to sell. This facilitates increased responsiveness to market changes. In a consumer driven market, it is necessary for producers to adapt quickly to demand changes. In such a situation, a subsidiary must be able to adjust without having to turn to the headquarters for managerial advice.

parts or new product developments. The shift from globalisation to global localisation is closely related to the increased investment in industrialised countries which is both a cause and an effect.

In contrast to Europe, the United States has been a popular destination for Japanese capital exports. This is because the conditions there coincide largely with those described in Chapter 2 as making investment more profitable. For example, it has a large and relatively buoyant market. The political and economic situation is stable. Raw materials and land are abundant and there is a strong industrial infrastructure. Labour, while not particularly cheap, is of high quality. The close relationship between the United States and Japan provides a solid base for both trade and investment. The Japanese have a good knowledge of the American economy and society, a legacy of America's occupation of Japan after the war and of a continuing security and political role. With English as the spoken language, the Japanese feel far more comfortable than in countries where other languages are dominant.

This chapter has provided the context from which to extend analysis of Japanese FDI in Europe. Many of the factors considered above have affected Japanese FDI in Europe. However, there are other factors specific to Europe that will be examined in detail in the following chapters.
Chapter 4. Japan’s relationship with the European Union

One of the main reasons for the increased share of Japanese FDI directed to Europe is the establishment and development of the EU. The scope of this thesis does not permit a complete description and analysis of the history of the European Union, which is covered in much detail elsewhere. However, in order to provide the necessary background for the analysis in Chapter 5, this chapter outlines the main points. Further, the relationship between Europe and Japan, and the trade friction between them are important factors affecting Japanese FDI to Europe. This chapter, therefore, provides an outline of the political and economic relations and trade friction between the EU and Japan and provides background for the following chapter.

4.1 Brief history of the European Union

The European Economic Community (later to become the European Community and now referred to as the European Union) was established in 1957 by the Treaty of Rome with the original six member nations being France, Germany, Luxembourg, Italy, the Netherlands and Belgium. The reason for such regional integration was to allow the countries to take advantage of economies of scale and increase trade and co-operation within the region, so that they could be competitive with the United States, and ironically, Japan. It has also been suggested that by having these nations economically reliant on one another, they are less likely to initiate intra-European conflicts. There have been

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Japan's relationship with the European Union

four enlargements of the Community with Britain, Ireland and Denmark joining in 1973, Greece in 1981, Spain and Portugal in 1986, and Austria, Sweden and Finland in 1995. The combined population of the 15 nations is about 373 million people.

Integration has taken place gradually, firstly with the elimination of internal tariff barriers, then free movement of resources including labour, and monetary union in the late 1970s. The Maastrict Treaty, signed in 1992 and entered into force on November 1 1993 following ratification by all signatories in national referenda, provides for closer European union. It complements the initiative of the Single European Market with free circulation of goods, capital, services and people. Development of Economic and Monetary Union (EMU), including a single currency, establishment of a central bank and harmonisation of economic policies, is aimed for by 1999. As discussed in Chapter 5, it is these developments that have accelerated the growth of Japanese FDI in the EU.

EU countries are required to move towards 'conditions for economic convergence' by decreasing inflation rates and budget deficits. It is also hoped to develop a Common Foreign and Security Policy, and more integrated policies in areas such as justice, social policy and home affairs. However, there have been problems in European integration which may stifle Japanese FDI. These are discussed in Chapter 6.

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41 The first Danish referendum in June 1992 produced a "no" vote. A second referendum in May 1993 produced a majority of "yes" votes after EC Government leaders granted Denmark special status which does not bind it to the main Treaty objectives of a single currency, common defence and immigration policies and European citizenship.

European report, Nos. 1833 (February 6 1993) and 1860 (May 20 1993).

The membership applications of Austria, Sweden and Finland were approved by the European Parliament, and following positive outcomes in national referenda, they joined on January 1 1995.\footnote{The European Parliament also approved Norway's application to join the EU. However, the Norwegian people declined the opportunity in a national referendum on 28 November 1994.} It is also envisaged that in the longer term (although probably not until next century) the membership of the community could be extended to include countries of Eastern Europe, such as Poland, Hungary and the Czech Republic.\footnote{“Survey: The European Community”, p. 19.} A larger market will be even more enticing for Japanese investors. A more diversified community, including the lower-cost countries of Eastern Europe, would also provide Japanese investors with better opportunities for intra-regional division of labour. These issues are discussed further in Chapter 6.

The EU constitutes the world's biggest and most powerful trading region\footnote{GDP in 1993: EU - US$6415 billion
USA - US$6387 billion

International Monetary Fund, \textit{International Financial Statistics Yearbook}, Washington, DC, 1993.}, and following the accession of the three new members in 1995, has a combined GDP of almost US$7 billion. Since the late 1980s, the EU has been plagued by low growth rates\footnote{Real GDP growth in the EU in 1991 was 1.3\%. \textit{JETRO} (a), \textit{op. cit.}, p. 263.} and unemployment of over 10 per cent.\footnote{The rate of unemployment in the EU has risen without interruption for the past four years, peaking at 11 per cent in April and May 1994. The seasonally adjusted figures for July 1994 show a slight decrease to 10.8 per cent. At that time, unemployment levels were significantly higher in some countries as shown below:}

<table>
<thead>
<tr>
<th>Country</th>
<th>Unemployment Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spain</td>
<td>22.1%</td>
</tr>
<tr>
<td>Ireland</td>
<td>17.6%</td>
</tr>
<tr>
<td>Italy</td>
<td>12.0%</td>
</tr>
<tr>
<td>France</td>
<td>11.3%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>9.7%</td>
</tr>
<tr>
<td>UK</td>
<td>9.3%</td>
</tr>
<tr>
<td>Germany</td>
<td>6.3%</td>
</tr>
<tr>
<td>Portugal</td>
<td>6.1%</td>
</tr>
</tbody>
</table>
Fears of the EU becoming an impenetrable 'fortress' with high tariff barriers have been expressed by other countries, and this is perceived to be one of the main reasons for high levels of Japanese investment in Europe, as discussed in Chapter 5. EU officials have argued strongly against this criticism claiming that "the unified market's goal is to form a freer broad economic bloc which should prove equally beneficial to its members and the rest of the world".48

4.2 Japan's political and economic relationship with Europe

Although the relationship between Europe and Japan dates back to the thirteenth century, traditionally it has been relatively weak. In a world of trilateral economic power, that is the US, Europe and Japan, the links between Japan and the US and Europe and the US are relatively strong, while the relationship between Japan and Europe remains the weak link. It has been described as a relationship marked by misunderstanding, preconceptions and stereotypes. As described in Chapter 2, a strong relationship between countries and a good knowledge of each other facilitates investment flows. Conversely, the weak relationship between Japan and Europe has not provided a strong basis for Japanese FDI in Europe.

The Japanese borrowed industrial expertise and technology, and political, legal and educational systems from the Europeans, as a means of modernising their economy in the

<table>
<thead>
<tr>
<th>Country</th>
<th>Unemployment Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>10.9%</td>
</tr>
<tr>
<td>Belgium</td>
<td>9.9%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>3.2%</td>
</tr>
<tr>
<td>Greece</td>
<td>n.a.</td>
</tr>
</tbody>
</table>


48 JETRO (d), *op. cit.*, p. 4.
nineteenth century, and have always been keen to copy aspects of European culture and society. However, the Japanese fascination with Europe was not reciprocated. To Europeans, Japan has been a small country on the other side of the world, culturally, historically and politically different. European images of Japan have, for a long time, been based on the 'yellow peril' and on the influx of low quality Japanese goods made with cheap labour in the 1930s. While it was the Americans that forced the opening of Japan, European interests in Asia were largely centred on China, India, and Persia. This lack of interest persisted until the economic success of Japan in the 1960s and 1970s forced the Europeans to take notice.

In the post-war period, both Europe and Japan were in ruins, and the main priority was reconstruction. Little attention was shown on either side towards developing relationships between them. In the 1950s and 1960s, the Europeans were primarily interested in internal political unity. "The intervening years of neglect have taken heavy toll in terms of the [EU's] ability to formulate coherent policies relating to Japan."49 By the time the Europeans became conscious of the Japanese economic miracle, it was too late to form a close trading relationship and take advantage of a ready and growing Japanese market. The legacy of this neglect remains with a weak intensity of trade as described later in this chapter.

There was also a lack of unity from the EU as a group, with, instead, a wide range of policy responses and bilateral agreements between individual members and Japan. No common commercial or industrial policy towards Japan was concluded.50 This lack of


unity has allowed the different countries in Europe to develop their own approaches
towards Japanese trade and investment, and has caused conflict within Europe, as
discussed in Chapter 5.

On the part of Japan, diplomatic efforts towards Europe in the early post-war period
were sporadic and not particularly assertive. Japan's foreign policy was focussed on the
United States and within the Asia-Pacific region as economic and strategic interests were
centred there. No formal framework for cooperation or alliance, such as NATO or the
US-Japan Security Treaty, was ever concluded between Europe and Japan.

The relationship improved somewhat in the 1970s with the establishment of the unofficial
Trilateral Commission to set up a structure for the exchange of ideas about co-operation
between the US, western Europe and Japan. There have also been increased political
contacts and annual high level consultations. However, "such encounters have usually
ended with platitudinous statements and promises designed not to offend anyone rather
than substantial outcomes".51

The situation of misunderstanding was not helped by such comments as the description of
the Japanese in a 1979 EC memorandum as "workaholics living in rabbit hutchess" or de
Gaulle's description of Prime Minister Ikeda as "a transistor salesman".52 A survey in
1993 showed that 90 per cent of Europeans still thought that Japanese-EU cooperation
and consultation were not well reported or understood.53

51 ibid., p. 93.
52 ibid, p. 17.
53 "Europeans want Japan to do more, poll finds", The Japan Times, 3 July 1993, p. 2.

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In response to the lack of understanding, in July 1994, the European Commission produced a paper entitled *Towards a new Asia Strategy* to define an overall policy approach toward Asia. It calls for increased co-ordination of EU policies, the strengthening of the EU's presence in Asia and a higher European profile. A range of measures are in place in order to strengthen the bilateral ties between Japan and the EU, including the Trade Assessment Mechanism, export promotion initiatives, industrial cooperation, education programs for the EU business community, ongoing regulatory dialogue, the Trade Cooperation Commission and the ongoing rounds of bilateral and multilateral discussions.

Economically, the relationship between Japan and Europe has also been weak. It is in the area of trade that most friction between Japan and the EU has arisen. Japan and Europe are not natural trading partners and the flow of trade between them, relative to their economic size and trade with other countries and regions, reflects this. In order to illustrate the weak trading relationship between Japan and Europe compared to their relationships with North America, Corbett calculated the 'Intensity of Trade Index' between Japan and the EEC (as it was in 1975), Japan and North America, and North America and the EEC. The 'Intensity of Trade Index' measures the strength of trade flows between two countries or regions, relative to their world shares of exports and imports. The formula is given in Appendix A. Corbett's analysis clearly showed that the trade between North America and Japan was very intense with indices of 1.47 and 1.22. Trade between the EEC and North America was not as strong at 0.31 and 0.50. The weakest link was between Japan and the EEC; the indices were only 0.29 and 0.11.54

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54 Corbett, *op. cit.*, p. 16.
I have attempted to update these indices to 1992, calculating them using the same formula as Corbett did, and including the intensity of trade indices for Australian exports to Japan and Japanese exports to Australia. It should be noted, however, that the form of the EU has changed since Corbett did her study, and the results should be considered in that light. The results of the calculations showed some interesting results and are presented in Appendix A.

The intensity of trade between the EU and Japan (in both directions) has increased substantially since 1975. The intensity index for Japanese imports from the EU doubled between 1975 and 1992, moving from 0.11 to 0.22, while the intensity of trade from Japan to the EU increased from 0.29 to 0.46. Nevertheless, the low values of these indices indicate that trade between the EU and Japan remains weak compared to their trade with the rest of the world. The trade relationship between Japan and the US remained intense, and the indices increased for trade in both directions to 1.62 and 1.41.

The intensity of trade between the EU and North America actually decreased for trade in both directions and the intensity of trade index for North American exports to the EU (0.40) fell below the equivalent index for Japanese exports to the EU. The high indices for Australia-Japan trade, and particularly for Australian exports to Japan (4.12), illustrate the highly complementary trading relationship (in contrast to the EU-Japan relationship) and the significance of our trade flows relative to Australia's and Japan's world trading positions.

The weakness of the trading relationship between Japan and the EU is not surprising. They have similar economic structures - both are industrialised, market-based economies with a relative lack of natural resources - and therefore they tend to produce the same types of goods. This is illustrated by the fact that in 1993, manufactured products
Chapter 4  

Japan’s relationship with the European Union

accounted for 99% of EU imports from Japan and 83% of exports.55 As a result they are competitors in both product and factor markets, rather than complementing each other as Australia and Japan do. There is also the problem of geographical separation, which results in high transport and transaction costs. In addition, semi-natural cultural and historical barriers (as described above) tend to impede trade.

The natural and semi-natural barriers are exacerbated by the imposition of tariff and non-tariff barriers on both sides. Protection remains the greatest stumbling block to a more fruitful relationship. The weak political and economic relationships between Japan and Europe have not provided a strong basis for Japanese FDI in Europe. Conversely, however, trade friction and protectionism in Europe, either real or anticipated, have been strong catalysts for Japanese FDI, as described below.

4.3 Protection as a stimulus for investment

The cause of most friction is the well-publicised, and large and growing trade surplus that Japan has with the EU. Since 1968, Japan has never had a deficit in its trade with the EU56. It is the rapid increase in the surplus throughout the last two decades, but particularly in the late 1980s and early 1990s, that has been of concern. The surplus grew from $18 billion in 1990 to $28 billion in 1991, and then $31 billion in 1992 before decreasing slightly to $27 billion in 199357. Japan’s trade with the EU since 1986 and the balance of trade is illustrated in Figure 7.


The Japanese have often been criticised for protecting their industries. In the 1950s and 1960s, Japanese manufacturing industries were highly protected by tariffs. These have been removed, but European (and American) exporters claim that Japanese industries remain protected by non-tariff barriers. The Europeans point to Japan's low level of manufactured imports and are looking for those markets to be opened. They claim that Japan has not made an adequate effort to adapt its system for higher imports. The Japanese respond by saying that the Europeans have made little effort to penetrate the Japanese market which has great potential for them, instead being more concerned with internal problems.

On the other hand, European protection against Japanese imports has a long history. It has been present since the pre-war period and intensified in periods of recession in Europe. In recent years, protection has generally taken the form of non-tariff barriers, in particular Quantitative Restrictions (QRs), anti-dumping duties and voluntary export restraints (VERs).

With a large trade deficit with Japan, exacerbated by high unemployment levels and continuing economic woes in Europe in the 1980s (as described earlier in this chapter), criticism of Japan was intense and there was pressure for higher protection levels against Japanese exports. The EU has been frustrated by what it describes as Japan's preferential treatment of the US. European automobile makers and electronics companies are particularly worried about competition from Japanese imports.

These protectionist sentiments have brought about an increase in Japanese FDI in Europe as the Japanese businesses substitute direct investment for trade. Furthermore, with the signing of the Maastrict Treaty and the unification of Europe, many Japanese exporters feared that the EU would become 'Fortress Europe' with higher tariff barriers. Many companies decided to invest in Europe to overcome these barriers. This is discussed further in the next chapter.
Chapter 5. Japanese Foreign Direct Investment in Europe

5.1 Trends in the amount of Japanese direct investment in Europe

As shown in Figure 8 and Table 4, the stock and flow of Japanese investment to Europe was limited until the mid-1980s. In 1985, the flow of new investment was just $1.93 billion and the cumulative amount was $11 billion. However, between 1985 and 1990, there was a significant rise in Japanese investment in Europe, and particularly within the European Union. The flow of investment to Europe peaked in 1989 at $14.8 billion, and remained very strong in 1990, by which time the cumulative amount had reached $59 billion. Along with total Japanese FDI, FDI directed to Europe fell back somewhat in 1991 and 1992. It showed a small rise again in 1993.

As a percentage of the total amount of Japanese FDI, investment to Europe has not increased as rapidly as the absolute amount, indicating that a large part of the increase was in line with increasing Japanese investment worldwide. In addition, the share directed toward Europe is still considerably less than that to North America, and relatively weak given Europe's economic size. Nonetheless, the share of FDI directed toward Europe rose from 8.6 per cent in 1978 to 15.5 per cent in 1986 and 25.1 per cent in 1990, before decreasing slightly in 1991 and 1992. The reasons for the increasing proportion are of interest, and are discussed below.

First let us consider an explanation of the pattern of Japanese investment to Europe.

Relating European factors to the determinants of investment explained in Chapter 2, it is

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59 The amount invested in the United States is about twice that invested in the European Union despite their similar economic size in terms of population and GDP. Heitger and Stehn, op. cit., p. 2.
not surprising that investment to Europe was slow to take off and is not as strong as that to other regions and especially North America. For example, European production costs, especially labour, are high relative to other regions. As discussed in the previous chapter, the economic and political relationships between Japan and the EU collectively, and Japan and most European countries individually, are based on relatively weak foundations. Certainly the relationship between Europe and Japan has been more remote than those between the US and Japan, Australia and Japan, or the EU and the US. In addition, the Japanese have a far more limited knowledge of Europe than they do of the US or their Asia-Pacific neighbours, partly because of the large geographical distance between Europe and Japan. The governments and public of some European countries were at best apathetic of, and at worst less than warm in welcoming, Japanese investment. Although Europe has a large and affluent market, that market has been, at least until recently, more fragmented in terms of economic, industrial and legal systems, languages and consumer tastes.

On the positive side, Europe (like the US) is stable economically and politically, and there is a good industrial infrastructure. However, these positive factors alone were not strong enough to completely outweigh the negative factors described above, and make Japanese FDI in Europe highly profitable.

Various explanations can be given for the rapid increase in both the amount and share of Japanese FDI directed to Europe in the second half of the 1980s. The rising amount has to be considered in the light of rapidly increasing Japanese FDI worldwide, the reasons for which were outlined in Chapter 3. Nonetheless, Europe's share also increased dramatically. Part of this increase was in line with an increasing share of investment directed to industrialised countries. The increasing proportion directed to Europe, North America and Australia was due to four important factors.
• First, as Japan's industrial structure changed from one based on labour-intensive goods to one more reliant on capital-intensive and technological goods, there was less emphasis on investing in low-cost countries. The industrialised countries provided a high quality labour force and research expertise. With an appreciating yen following the Plaza agreement in 1985 and tax incentives in these countries, the cost differential between Japan and the West was eroded and it was relatively cheap for the Japanese to undertake joint ventures or take over existing enterprises.

• Second, there was a close correlation between the share of FDI directed to industrialised countries and the share directed to financial industries. A large part of the increase can be attributed to Japanese service companies venturing overseas to complement Japanese manufacturing companies trading with or investing in these industrialised countries. Increased FDI in the service sectors mirrored the increase in Japanese exports to the industrialised countries. Furthermore, there was significant investment in real estate and the tourism sector as prices in Japan itself became excessive. More Japanese people began to travel overseas during the affluent period in the 1980s.

• Third, as was explained in previous chapters, with increased competition from both local producers and those from third countries, firms found it necessary to produce in the market in order to sell in that market, so as to be responsive to consumer demands.

• Fourth, the Japanese began to substitute direct investment for trade, as protectionist measures (either introduced or threatened) became stronger in Europe and North America. Some of these measures were clearly identifiable, such as quotas; others
were more covert taking the form of local content rules or financial inducement for local content levels. These sentiments were the result of the combination of poor economic conditions in Europe and North America, and a soaring Japanese current account surplus. With the formation and development of the EU, there was great concern in Japan that high trade barriers would be erected. This issue is discussed later in this chapter.

There are important questions to be asked at this point. Was the increasing amount and proportion of Japanese FDI directed to Europe in the late 1980s simply in line with increasing FDI worldwide, and with the increased share directed to industrialised countries? Consequently, is the increase in Europe's share attributable only to the factors described above, or are there factors unique to Europe that have to be considered?

To answer this question, I analysed the increase in FDI to Europe in the boom period relative to the increase in the world and in North America, attempting to show some difference in the change in investment flows to these regions. The results are shown in Appendix B. Between 1986 and 1989, Japanese FDI worldwide increased by 202 per cent. In the same period, investment to North America increased by 225 per cent and that to Europe increased by 327 per cent. The annual increase on the previous year for Europe was far higher than for North America or worldwide in 1987 and 1989, and similar in 1988. The differential between the two industrialised regions and the world figure is in line with the previous observation that more investment was directed to industrialised countries in this period. The fact that the increase in Europe was significantly greater than the increase in North America shows that there must have been some special factors causing a shift towards Europe as an investment destination. I have identified three:
First, by the late 1980s, many Japanese companies had already invested in the US as shown by the earlier peak in North America's share. These companies were facing increased competition in America as American companies began to adopt more efficient production techniques including Japanese methods. There was also increasing criticism and hostility towards the Japanese as the trade surplus ballooned. As a result it is quite plausible to suggest that Japanese companies began to look to new frontiers to set up operations - Europe was the logical choice.

Second, certain governments, especially the British, offered large incentives in the form of subsidies and tax concessions to investing firms, as they began to recognise the benefits of Japanese FDI.

Third, coinciding with the slight shift away from America (we should not overemphasise this - the US is still the largest destination), the Europeans were pushing their way toward a unified market leading up to the signing of the Maastrict Treaty in 1992. This was one of the most important factors in the increased proportion of Japanese investment going to Europe. This is explained in more detail below.

There are two aspects to the unification of Europe that act as determinants for Japanese investment there - factors that caused an increase for a positive reason and those that caused an increase for a negative reason. On the positive side, the creation of a single market partly helped to overcome one of the greatest disadvantages that the Japanese faced investing in European countries individually - the diversity of economic and industrial structures, legal systems, cultures, languages, and consumer tastes. As moves were made to decrease the barriers, to allow free circulation of goods, capital, services and people, to develop more integrated policies with regard to justice, social policy and
home affairs, and even to move towards a single currency, the Japanese began to recognise new advantages of investing in Europe, now a large, wealthy and more homogenous market.\textsuperscript{60} Furthermore, as membership of the Union increases beyond the present time, that market will continue to increase in size.

From the negative side, the moves towards unification increased Japanese fears that there would be a high degree of protectionism in a 'Fortress Europe'. The Japanese were determined to invest within Europe before trade barriers were erected.\textsuperscript{61} Balassa and Noland described FDI as "a means to reduce trade tensions abroad"\textsuperscript{62}.

Heitger and Stehn believe that protection of industries in Europe, both existing and expected, is the main determinant of increased Japanese FDI in Europe. The following is a precis of their analysis.\textsuperscript{63}

As outlined in Chapter 2, when looking to invest overseas, a firm weighs up the disadvantages it faces operating in a foreign country with the firm specific comparative advantages it possesses. If this equation comes out negative, the firm will not invest. A positive outcome is a necessary but not sufficient condition for FDI to occur. The firm could exploit its competitive advantage by producing at home and exporting to foreign markets, or by licensing its brand names, technology or manufacturing and marketing skills. For a firm to choose direct investment, there have to be some net location specific advantages or internalisation advantages. Location specific advantages include lower

\textsuperscript{60} "The Battle for Europe", p. 16.

\textsuperscript{61} Kimura, \textit{op. cit.}

\textsuperscript{62} Balassa and Noland, \textit{op. cit.}, p. 111.

\textsuperscript{63} Heitger and Stehn, \textit{op. cit.}, pp. 3-14.
wages, less regulation, low taxes, relatively low labour costs, or exports impeded by tariffs and non-tariff barriers. They may allow FDI to substitute for trade. Figure 9 illustrates this process.

Heitger and Stehn use this model to analyse the reasons for the rapid rise in Japanese manufacturing FDI to Europe. They point out that there had to be some location specific advantages leading to the rapid increase in Japanese FDI to Europe in the late 1980s. Changes in the institutional setting would have taken place gradually and over time, not quickly enough to cause such a rapid rise. Although some European countries changed their tax systems to promote economic growth, the tax rates in all European countries were still higher than in Japan. Similarly, unit labour costs in Europe were far above Japanese levels.

Therefore, Heitger and Stehn claim that the high level of effective protection in Europe imposed through tariff and non-tariff barriers (voluntary export restraints, quotas, local content rules) was the main determinant of increased Japanese FDI in the late 1980s. (The same logic can be applied to the US, where protectionist sentiments were prominent just before the same attitudes were expressed in Europe, although effective protection levels were not as high.) Furthermore, the changes expected during European unification leading up to the end of the decade make it increasingly attractive for Japanese firms to substitute FDI for exports. They use empirical results to support these assertions.

The conclusion of their analysis was that the more successful is trade liberalisation within the European Union, the greater the incentive for Japanese firms to establish subsidiaries within the EU. This is because greater market integration and internal trade liberalisation is likely to lead to increased trade diversion away from third markets and an increase in
external trade barriers as a result of interest group pressure. With increased effective protection levels, the incentive to choose direct investment increases.

Ironically, the European Community was established partly as a response to the emergence of Japan as a world economic power. "Japanese competition has been a major catalyst for the Single Market. Its emergence as the second largest economic force in the world has forced the creation of the Single Market." It seems that its establishment served to strengthen the Japanese resolve to build the relationship with Europe.

Japanese FDI going to Europe in 1991 and 1992 was sluggish in line with the fall in Japanese investment worldwide following the end of the 'bubble economy' and recession in Japan. There was also a shift away from industrialised economies with recessions in those countries. By this stage, many of the large Japanese producers had set up facilities in Europe. Nonetheless, investment in Europe has remained stronger than in the period before the boom.

5.2 Sectoral distribution within Europe

Figure 11(a) shows the composition of Japanese investment in Europe by sector in 1991. By amount, manufacturing investment (28.7 per cent) accounts for slightly less than it did in the whole world in the same year. The transport equipment, electronics and electrical appliance, chemical and machinery industries were dominant. Equivalently, of the 2298 Japanese companies in the EU, 642 were in manufacturing industries, especially chemicals, electronics and machinery. Non-manufacturing investment accounts for

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68.3 per cent of the total. Within this sector, there is a high percentage directed to the banking, finance, insurance and commerce industries. Much of the investment in service and finance industries is complementary with Japanese exports and is to support Japanese industries and customers in Europe. In other words, as exports from Japan to Europe increase, investment in these industries tends to increase.

Figure 11(b) gives an indication of how the sectoral distribution of Japanese FDI to Europe has changed since 1981. The most noticeable difference is that investment in resources has decreased substantially, from 16.8 per cent in 1981 to just 1.8 per cent in 1991. Investment in manufacturing has increased from around 20 per cent in both 1981 and 1985 to almost 30 per cent in 1991, illustrating the effect of global localisation strategies. Investment in services also increased from 63 per cent in 1981 to 72 per cent in 1985, before decreasing a little in 1991. This was in line with increased Japanese exports to Europe, until 1993 when they were dampened by recession and the high value of the yen.

Overseas investment can take the form of wholly-owned subsidiaries, acquisitions, joint ventures or offshore research and development facilities. Most Japanese companies set up in Europe as wholly or principally owned subsidiaries, with fewer as joint-ventures with European businesses. In 1990, over half of Japanese manufacturers in Europe were embarking on sole ventures with 30 per cent as joint ventures and 15 per cent as acquisitions. In Northern Europe, the ratio of sole ventures to joint ventures is much higher. However, in Southern Europe, and particularly Spain, joint ventures tend to

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67 Turner, *op. cit.*, p. 32.
dominate. Morris predicts that as more small and medium sized enterprises embark on foreign investment projects, the number of joint ventures is likely to rise.

5.3 Geographic distribution within Europe

Let us now consider where Japanese investment in Europe is directed, how it has changed and the reasons for these changes. Figure 10 shows the geographical distribution of Japanese FDI in Europe in 1983 and in 1992. The United Kingdom is clearly the most dominant with 41.8 per cent of the Japanese investment in Europe located there. The proportion directed to the Netherlands was also significant with 20.5 per cent of the total. Apart from Germany with 10.9 per cent and France with 6.5 per cent, the shares directed to other countries within the EU are relatively small. An analysis of the distribution of Japanese FDI in Europe compared to the share of European GDP of each country in 1992 (Appendix C) shows that in the UK and the Netherlands, the investment share is significantly stronger than the share of GDP, while in Belgium, Luxembourg and Ireland, investment is only slightly stronger. In Spain, Portugal and Greece, the share of Japanese FDI is slightly less than their share of GDP, while for France, Germany and Italy, the investment share is significantly less than their economic strength.

<table>
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<tr>
<th></th>
<th>sole ventures</th>
<th>joint ventures</th>
<th>acquisitions</th>
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<tbody>
<tr>
<td>Northern Europe</td>
<td>64%</td>
<td>18%</td>
<td>18%</td>
</tr>
<tr>
<td>France</td>
<td>26%</td>
<td>48%</td>
<td>26%</td>
</tr>
<tr>
<td>Southern Europe</td>
<td>19%</td>
<td>65%</td>
<td>16%</td>
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ibid.

Morris, op. cit., p. 209.
From another perspective, of the 2298 Japanese companies operating in the EU in 1991, 772 were in the UK and 210 in the Netherlands. There were 623 companies with operations in Germany, out of proportion with the share of investment directed there, indicating that the operations are clearly of a smaller size. Conversely, operations in the UK tend to be relatively large. The number of companies operating in other EU countries are shown in Table 5.

The proportion of investment going to European countries outside of the EU (including Turkey, Eastern Europe, the former Soviet Union, Scandinavia, Austria and Switzerland) is not large. Switzerland accounts for most of this investment, while investment in most East European countries can be described as minuscule. However, this does underline the potential for increased investment in these countries.

The UK has consistently been a favoured destination for Japanese FDI, and its share of total investment has increased significantly from 1.8 per cent of total Japanese investment in 1973 to 8.6 per cent in 1992. The Netherlands has also consistently taken a large slice, and its share has increased from 1.8 per cent to 4.2 per cent in the same period. In the long term, the share directed to France, Italy and Germany has not changed substantially. An analysis of changes in the distribution since 1987 shows few definite trends, but rather much variation. A large fall in Luxembourg’s share has been offset by slight increases for France, Germany, Spain, Italy and Belgium.

There are five main reasons for the domination by the UK.

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70 JETRO (c), op. cit., p. 7.

71 Heitger and Stehn, op. cit., p. 3 and Ministry of Finance, Japan, op. cit., various editions.
• First, English is the most comfortable foreign language for the Japanese.

• Second, the government of the UK has been very receptive to Japanese investment. This is in contrast to the ambivalence or hostility that has been shown by other European countries. Attracting foreign investment has been high on the British political agenda since 1979 and the Invest in Britain Bureau, as well as regional, county and district promotion agencies have made energetic attempts to encourage Japanese manufacturing plants in Britain. Many of these agencies now have representatives located in Japan. The British government has also provided substantial financial inducement for Japanese investment.\textsuperscript{72}

• Third, because Britain is the financial centre of Europe and most Japanese investment has been concentrated in this sector, there has been a tendency to invest in the UK.

• Fourth, the UK has relatively cheap labour costs, especially compared with Germany\textsuperscript{73}, and the workers tend to be of high quality. In addition, with high levels of unemployment in some regions, labour has been abundant.

• Finally, the UK's wider industrial policy, increasingly neo-liberal \textit{laissez faire}, has made it easier for Japanese producers to enter the market place.

\textsuperscript{72} Morris, \textit{op. cit.}, pp. 14-15.

\textsuperscript{73} In 1987, one Japanese producer said that it was paying double the wage rates to its West German shop floor workers compared to its Welsh employees. \textit{ibid.}, p. 199.
Chapter 5

Japanese FDI in Europe

Investment in the Netherlands and Luxembourg has been out of proportion with their size (although the latter has suffered a large decrease). This is because they are also financial centres and in the case of Holland, English is widely understood.

Investment in France, Italy and Germany is small relative to their economic size and is partly due to the language barriers; but in the case of France and Italy, also the less than welcoming response. The number of cases of investment in Germany is large, but the plants tend to be smaller and the amount of FDI is not large. On the positive side, Germany has good industrial infrastructure, a good industrial relations system, a high quality labour force and a central geographic position in Europe. However, these positive factors are outweighed by the high cost of labour, a shortage of labour and strong domestic competition.74 In 1988, Turner found that investment in Germany was largely in the distribution sector.75

France with a large market, a central location and average labour costs has the potential to attract more Japanese investment. Turner’s study found that investment in manufacturing in France was strong relative to other European destinations.76

Spain has been the main base for investment in the manufacturing sector due to its low costs of production and its high levels of protection.77 However, Spain and the other low cost countries within the EU do not command as large a share of Japanese FDI in Europe as might be expected. This is because their languages and cultures are not well

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74 ibid.
75 Turner, op. cit., p. 31.
76 ibid.
77 Morris, op. cit., p. 200.
understood by Japanese investors, they are not central players in the EU, and their markets are not as wealthy as those of northern Europe. The industrial infrastructure and quality of labour are less developed than those in the UK. However, the figures are somewhat deceiving. Spain does claim a large and growing share of manufacturing investment. Because manufacturing investment forms a minor part of the Japanese FDI in Europe, its share seems relatively small.

Other low cost countries in Europe (particularly those in Eastern Europe) have not been popular destinations for Japanese FDI largely because they are not members of the EU. In selling products made in these countries to the countries of the EU, the Japanese investors face the same tariffs and quotas as the rest of the world. Therefore there is no advantage in producing in Eastern Europe rather than South East Asia or South America where labour costs are also low. Eastern Europe also faces the problems of economic and political instability, and labour unaccustomed to the capitalist system. However, as Eastern Europe becomes more closely integrated with the countries of the EU, it will be a more popular destination for Japanese FDI. This is discussed further in Chapter 6.

5.4 Intra-regional and intra-country division of labour

Morris-Suzuki uses the 'intra-regional division of labour' model to describe the sectoral and geographic distribution of Japanese FDI in Asia. This model can also be applied to Japanese FDI in Europe.

The division of labour is represented by a pyramidal structure with several levels. Company operations in Japan are at the apex of the pyramid. At this level are the


78 ibid., p. 10.
company headquarters and management operations, research and development activities and production of high value added goods. At the base of the pyramid are the offshore manufacturing facilities of standardised and low value added goods. Initially South Korea, Singapore and Taiwan occupied this position. However, as these economies have developed and production costs have increased, a three tier structure has developed, with Japan at the top, the NIEs on the second rung producing advanced manufactures, and the ASEAN countries at the base.

The Asian region provides the best illustration of intra-regional division of labour. A similar pattern has developed in Europe, although it is not as well defined. Germany, with high costs of production, is targeted for more advanced manufactures and distribution. The lower cost countries of Spain, Portugal, Ireland and the UK form the base of the pyramid with manufacture of electronics and automobiles concentrated in these places. As the EU grows and comes to include countries of Eastern Europe, another tier will form. Just as Japanese investment in different sectors is directed to different regions of the world depending on their advantages and disadvantages, the diversified nature of the EU gives Japanese investors the opportunity to exploit the comparative advantages of the different countries.

Taking the 'intra-regional division of labour' model to its extreme, within the countries of Europe, certain regions have been more effective at attracting foreign investment. In the UK, peripheral regions, especially Wales, Scotland and north-east England, tend to dominate. These regions have cheap abundant labour and the regional governments provide incentives and guidance.

With about five per cent of the UK's population, Wales attracted one third of all UK inward investment projects from Japan in 1993/94. The Welsh economy, traditionally
reliant on coal and steel, is shifting its focus to consumer electronics and service industries. With a well educated, flexible, hard-working, yet cheap labour force, Wales provides a relatively profitable investment destination within the UK and hence within the EU.

In Germany and Spain there are clear locational patterns related to the factors that typify and motivate investment, such as the type of production and the availability of labour. Investment in France is not as concentrated as in other countries, but again depends on the availability of labour and government incentives.79

5.5 Attitudes to direct investment in Europe and problems

Japanese investment in Europe has clearly brought several advantages to the countries involved, but on the other hand has been widely criticised. Similarly, while the governments of some countries, particularly France, have been vocal in their opposition to Japanese investment, other countries, and even regions within France, are competing among themselves to attract Japanese funds. Japanese investment in Europe is less than that in the US, and American investment in Europe is still greater than Japanese investment80. Similarly, Japanese manufacturing companies in the EU still employ only 100,000 people in total, only slightly more than the European workforce of IBM.81 It is the rapid acceleration of Japanese investment, the dominance of Japanese companies in certain sectors, such as electronics and cars, and the success of these companies, that worries European industrialists and politicians.

79 ibid., pp. 201-2.
80 “The Battle for Europe”, p. 17.
81 Morris, op. cit., p. 196.
Japanese investment in Europe has been a politically sensitive topic. Particularly vocal against Japanese investment was former French Prime Minister Edith Cresson who said "The Japanese have a strategy of world conquest. They have finished with their job in the US. Now they're about to devour Europe". Many European companies have had to merge or have been squeezed out altogether because of Japanese FDI. Local content was the main focus of debate in the late 1980s. Strict local content rules have been imposed, as well as quotas and anti-dumping measures. For example, anti-dumping duties have been imposed on electronic typewriters and copiers due to concerns about the local content ratio. Governments have also given grants to European industries for research and development to make them more competitive. The French and Italians have been particularly against Japanese investment, although with a slowdown in the rate of increase of investment, these criticisms seem to have decreased in both frequency and vigour. Germany feels it can hold its own against the Japanese and there is less opposition in that country.

On the other hand, Britain and Ireland have not only welcomed Japanese investment, but encouraged it. With recession and unemployment levels as high as 17 per cent in those countries, cash and technology are urgently needed. Japanese FDI is seen by the UK government as potentially the most dynamic and influential source of international investment. Economists believe that Japanese manufacturing skill will diffuse into European industry. Some think that Japanese investment is crucial to Britain's

82 "The Battle for Europe", p. 16.
83 ibid., p. 17.
84 ibid.
manufacturing future. National and regional governments offer incentives in the form of tax concessions and direct grants.

For example, the Welsh Development Agency has made a concerted effort to attract overseas investment and develop industrial infrastructure. Senior government officials have visited Japan soliciting inward investment for Wales.

Britain's attitude has brought criticism from others in Europe who see it as an 'aircraft carrier' for Japanese attacks. For example, the local content of Nissan cars made in the UK has been under review and has resulted in a series of trade rows between the UK, France and Italy. The difficulty is that once a car is made in the EU, it can, in theory, be sold without barriers in other EU countries, thus avoiding quotas in those with more protective policies. However, even in France, the most critical of all countries in the EU, the lure of Japanese money has been too hard to resist, and local authorities have looked to encourage Japanese investment.

With the different countries having conflicting attitudes and the regions and countries competing for funds, the Japanese have been able to pay one off against the other. Thus, it has been difficult for the EU to develop a common policy, thereby compounding the problem.

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87 ibid., p. 21.
88 This was particularly noticeable at the 1993 Global Business Opportunities Convention (GBOC) held in Osaka, October 12-14. Many of the participants were there solely to encourage Japanese investment and appeared to spend a lot of money to try to achieve this through promotional material, offices in Japan, and various tax concessions and grants offered to investors. There were stands from The Netherlands, Ireland, The Northern Development Board (UK), regions of France, Spain, Belgium, and Portugal.
In its report on trade and economic relations between the EC and Japan in December 1992, the Committee on External Economic Relations stated the Commission's view on Japanese direct investment in the Union as follows:

Japanese direct investment in the EC can make a useful contribution to industrial development and renewal provided that it is sufficiently integrated into the economic fabric of the Community and leads to
i) the net creation of new jobs;
ii) the progressive 'Europeanisation' of management; and
iii) not merely the selective transfer of items of research and development to Europe, but ultimately also the establishment of autonomous, innovatory R&D centres in Europe, directed not only to regional but also to world markets.89

This view clearly reflects concerns of various members of the Union, and implicitly is encouraging global localisation of Japanese production in Europe. The report goes on to recommend that "member states should follow a common line towards the issue of inward investment"90, recognising that one of the Union's greatest problems has been that the different members have been competing among themselves for Japanese funds with no common policy aims.

The alarmist sentiments and criticism of Japanese investment in Europe has been a result of the large and rapid increase in the amount of Japanese FDI, extensive media coverage, much of it negative and focussing on certain sectors such as real estate, and the expansion of Japan's economic presence. In order to overcome these negative attitudes, successful Japanese companies have attempted to strengthen relations with the local communities by localising manufacturing resources, such as using more locally produced parts and

89 Moorhouse, J., Report of the Committee on External Economic Relations on trade and economic relations between the EC and Japan, December 1992, p. 11.

90 ibid., p. 12.
employing local workers, and by having Japanese personnel fulfil social obligations and
do volunteer work. To fully overcome the problem, it will be necessary to disseminate to
the public, information on the benefits of foreign investment.

Not only are European companies finding it difficult to export to Japan and finding they
have to compete with Japanese companies on their own territory, but it is difficult for
them to invest within Japan. This is illustrated clearly in Table 6. While cumulative
Japanese FDI amounted to $422.6 billion in 1993, the cumulative value of foreign direct
investment in Japan was just $29.9 billion.\(^{91}\) (European investment is about 30 per cent
of this amount.) Of this, 65 per cent was in the manufacturing sector with the remaining
35 per cent in non-manufacturing industries. There is significant investment in
technology and in research and development.

FDI in Japan is unlikely to be profitable because of high production costs, and language
and cultural barriers. Additionally, Japan has no special natural resources, industrial
biases (such as the financial sector in the UK, Luxembourg and the Netherlands) or
tourism hot spots (like Australia). Nonetheless, the sheer size of the imbalance makes the
European companies critical.

JETRO identifies "gaps in perception" as one of the main causes of the small level of
foreign investment in Japan. Given the perceived barriers to trade with Japan, perhaps
foreign companies should follow Japan’s lead and look to increasing their investment in
Japan as a strategy for overcoming these barriers. These companies need to seek
reciprocal access through bilateral and regional diplomacy. The challenge is to overcome
the language and cultural barriers, and the high costs of production. This will not be an

easy task. Another possibility, and one that Australia is pursuing aggressively, is for European companies to use Australia as a base from which to launch their businesses into Asia.

Japan needs to improve both the investment environment and its image as a good place to invest. It is part of JETRO’s work to do this. Just as the Japanese need not only to open their markets but also to show the world they are open, they need to encourage foreign investment. If they do not, the result will be increasing hostility as they attempt to increase their investment offshore. The Japanese government recognises this and has been trying to reduce the imbalance by offering foreign firms tax incentives and low interest, long-term finance through the Japanese Development Bank and the Export-Import Bank of Japan.92

The increased Japanese investment has also had implications for American companies in Europe. Not only have they had to compete with Japanese companies at home, but they now face Japanese competition in a traditionally strong base.93
Chapter 6. Prospects for Japanese FDI in the EU and Eastern Europe

6.1 Recessions and recovery, and prospects for Japan’s FDI

Figures 1 and 3 showed the rapid rise of Japanese investment both in the world generally, but more particularly in Europe, until 1990. In the following three years there were successive falls in these flows as a result of the collapse of the 'bubble economy' and a sustained (and for the Japanese, deep) recession. Nonetheless, the amount of investment was still relatively strong and above pre-boom levels. It is the heady days of the late 1980s that should be seen as ‘irregular’; present levels are more sustainable.

In 1993, Japanese FDI increased for the first time since 1989. The amount of $36.02 billion was an increase of 5.5 per cent on the previous year. Increases were registered in the United States, Europe and Asia. The Australia-Japan Economic Institute identified the renewed appreciation of the yen as the primary cause. The appreciation of the yen has been "prolonged and significant", negatively affecting the competitiveness of Japanese manufacturing industries and increasing the incentive for such companies to transplant operations offshore to more competitive locations. It is this factor that clearly explains both the increased investment in the electrical equipment and general machinery sectors, and in that directed to China.94

The economic recovery in Europe and the US has been an important factor in the increasing Japanese FDI in the tertiary sector. In particular, investment in finance grew as a result of increased investments by clients in other industries and as a result of increased trade to these industrialised regions.

94 Australia Japan Economic Institute, op. cit., p. 2.
This increase has happened despite corporate profitability in Japan remaining low. As Japanese companies fully recover from the collapse of the financial and real estate sectors, they are likely to be more willing to invest overseas. The Australia Japan Economic Institute predicts that Japanese FDI will increase again next year as a result of increased corporate profitability and several other factors. They point out that "depreciation of the yen is unlikely; prospects for the stock market are brighter than in the past three years; low inflation is keeping interest rates steady; high economic growth is continuing in Asia, accelerating in the US and reappearing in parts of Europe; and the financial sectors will have to step up their investment to keep up with their customers in the production sectors".95

Access Economics forecast in 1991 that Japanese FDI is likely to continue at a high level even if the surplus of savings over investment declines, because of the low percentage of Japanese investment in overseas manufacturing and changing economic structure in Japan.96

JETRO predicts that

- there is unlikely to be a large outflow of capital from Japan, especially in the traditionally strong sectors such as electronics and automobiles, due to the increased competitiveness of western companies and the increased costs of procuring funds.
- FDI in Europe and the US will be marked by its 'global localisation' strategies. For example, more R&D facilities are being shifted offshore.

95 ibid., p. 3.
investment by small and medium sized enterprises will be strong due to labour shortages and increasing wages in Japan, movements overseas by parent companies, and internationalisation strategies driven by reverse imports.

investment in Asia will continue to increase rapidly, especially in manufacturing sectors and to ASEAN and China, due to increased costs of production in Japan. The 'intra-regional division of labour' will be strengthened as production of low value added products is moved offshore.97

While many of these factors will not be as favourable for Europe as for low cost countries, prospects for Japanese FDI in Europe are still good. Japanese FDI in Europe was $7.9 billion in 1993. This was an increase of 12.4 per cent on the previous year, significantly more than the increase in Japanese FDI world-wide. Europe's share also increased, rising to 22 per cent. It is unlikely that investment will quickly return to the heights of the 'bubble economy' years. However, the amount of new investment is significantly more than investment in the pre-boom years. A noticeable trend is that Japanese businesses are now far more discerning with their money and less likely to invest indiscriminately. In some cases, the main Japanese contributions are confidence and technology rather than large injections of cash.98

It has been suggested that Japanese investment in Europe will remain steady, with adequate opportunity for small and medium-sized producers to set up overseas. With political and monetary union scheduled for 1999, there could be another boom around that time as the union is more strongly cemented.99 The decision to base the European

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97 JETRO (a), op. cit., pp. 82-89.


99 Kimura, op. cit.
central bank in Germany could see Japanese investment there increase, given the high proportion of investment in the financial sectors. It will be interesting to follow changes in the amount of new and existing Japanese FDI in Europe and strategies adopted by companies, both external and internal.

6.2 Problems with European unification and expansion

European unification has not proceeded at all smoothly, with continuing conflict between member countries on the form of future cooperation. Particularly important were the refusal of Denmark to agree to the Maastricht Treaty in a national referendum in June 1992 (although a second referendum produced agreement after Denmark was granted special status - see Footnote 41), and the collapse of the European Monetary System in 1993. Thus, the whole situation is far less certain than it was at the time of Maastricht, and this could negatively impact on Japanese FDI.

The EU has been expanding and diversifying in terms of the types of social and economic structures and level of economic development of the countries involved and, as discussed below, this trend is likely to continue. This has provoked discussion as to how the Union should be progressed. As External Economic Relations Commissioner Brittan said, "You can't run a community of twenty or more in the same way you run a community of six." With countries already as heterogeneous as Germany and Spain and the Union likely to be more diverse in the future, it is recognised that some sort of 'variable speed' approach needs to be adopted. Countries would move at different paces towards common objectives and eventual convergence. Such a concept has already found its recognition in the Maastricht Treaty itself, with provisions for EMU to come into effect for a core group, with the rest to follow.
Chapter 6 Prospects and Eastern Europe

Statements made by French Prime Minister Balladur and a discussion paper by the Christian Democrats Party in Germany have provoked much debate and some criticism. The German paper suggested that a hard core of Germany, France and the Benelux countries proceed faster than the rest. This resulted in protests from some of those not nominated for the fast track (especially the UK, Spain and Italy).\(^\text{100}\)

A diversified EU actually holds attractions for Japanese investors. They would be able to exploit the specific advantages of each country, as shown in the ‘intra-regional division of labour model’ in Chapter 5.

6.3 Eastern Europe and an expanded EU

The creation of a single European market has proved to be attractive to other European nations in respect to their participation in the EU. As mentioned earlier, Sweden, Finland and Austria joined the Union in 1995. Other countries have expressed an interest in taking part. As yet the European Commission is adopting a ‘wait and see’ approach. However, for political and security reasons, it is expected that in the next ten to fifteen years the Union could be expanded to include the countries of Eastern Europe (Poland, Hungary, the Czech Republic, Slovakia, Romania and Bulgaria), some former Soviet Republics (Slovenia and the three Baltic States) and Mediterranean countries (Cyprus and Malta).

Such an expanded market would make Europe all the more inviting for Japanese investment. These countries would also provide Japanese investors with a low-cost

region within the EU in which to produce. Thus an expansion of the EU is likely to produce an increase in the share of Japanese FDI directed to Europe.

With the collapse of the Soviet Union and the opening of Central and Eastern European countries, it was expected that their new market economies would attract investment flows, especially from Japan. Eastern Europe desperately needs investment funds as a means to reform its markets. The countries of Eastern Europe (especially Hungary, Poland, the Czech Republic and Bulgaria) and the former Soviet Union have launched activities to attract western capital investment as a means of modernising their economies. They have done this by relaxing tight controls on foreign capital inflows, reforming laws on joint ventures and making it possible for 100 per cent ownership by foreign companies. There have been some joint ventures with Japan. However, the Japanese, along with other investing countries, have been slow and unwilling to establish production bases in Eastern Europe (except in natural resource sectors). Reasons given include inadequate communication infrastructure, environmental problems, labour unfamiliar with the free market system, controls on the movement of foreign companies, continuing societal and economic confusion. In addition, the Japanese are not yet convinced of the attractiveness of the markets given the risks involved in foreign investment.

Nonetheless, there are cases if Japanese investment in Eastern Europe. For example, Suzuki began production in Hungary in 1992. Although Japanese FDI is unlikely to

101 JETRO (d), op. cit., p. 12.
102 Flows of investment to Eastern Europe were $5 billion in 1993. Brenchley, op. cit.
103 Kimura, op. cit.
104 JETRO (a), op. cit., p. 265.
increase quickly, because the countries of Eastern Europe are enthusiastic for Japanese funds there is likely to be steady growth in the near future, and undoubtedly great potential in the longer term. This potential competition for investment funds worries the struggling members of the EU, such as Spain, Portugal and Greece.\textsuperscript{105}

6.4 Conclusion

In conclusion, Japanese investment in Europe grew rapidly in the late 1980s in line with the growth of Japanese FDI worldwide. Until that time, FDI in Europe was limited because the characteristics of the market and industrial structure made it less profitable and more risky than other destinations. Once the Japanese had made inroads into the American market and the Europeans began to encourage FDI, Europe became a more popular destination. However, the most important factor in the rapid growth was the formation of a single market and moves toward complete economic integration. Not only did the standardisation make it easier for the Japanese to do business, but there were fears that a protectionist 'Fortress Europe' would develop in response to rising trade deficits with Japan. This catalysed Japanese investment activities to establish themselves inside the barriers.

The situation has created conflict in Europe with, on the one hand, the need for Japanese funds and expertise, and on the other, fears that local industries will be eliminated completely. At the height of the boom in the late 1980s, there was extreme criticism by some in Europe not only of the Japanese, but also the governments of other member nations which openly encouraged Japanese FDI. However, this criticism seems to have lessened somewhat in the last eighteen months with a fall in the rate of investment. With the collapse of the 'bubble economy', Japanese firms do not have the funds to invest as

\textsuperscript{105} ibid., p. 264.
widely overseas. Hence, there has been a decrease in the level of FDI generally, as well as in Europe. Although many of the large companies have already set up in Europe, there is significant scope for the expansion of small and medium-sized enterprises. If unification proceeds smoothly leading up to 1999, and particularly if the membership of the EU is expanded, Japanese FDI is likely to remain strong, without reaching the heights of the boom period.
Appendices

Appendix A

Intensity of Trade - Japan, EEC/EU and North America

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<tr>
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<th></th>
<th></th>
<th></th>
</tr>
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</tr>
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<td>0.28</td>
<td></td>
<td></td>
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<tr>
<td>Australia</td>
<td>4.12</td>
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<td></td>
</tr>
</tbody>
</table>

The intensity of trade is measured by the formula:

\[
\frac{(X_{ij}/X_i)}{(M_j/(W-M_i))}
\]

where
- \(X_{ij}\) is country i's exports to country j
- \(X_i\) is country i's total exports
- \(M_j\) is country j's total imports
- \(W\) is world imports
- \(M_i\) is country i's total imports

Appendix B

Changes in Japanese FDI to the world, Europe and North America, 1986-1989

| Year | World | | | Europe | | | North America | |
|------|-------|---|---|-------|---|---|--------|---|---|
|      | Amount | Change | Change | Amount | Change | Change | Amount | Change | Change |
|      | $US m  | on year (%) | 1986-1989 (%) | $US m  | on year (%) | 1986-1989 (%) | $US m  | on year (%) | 1986-1989 (%) |
| 1986 | 22,320 | 3,469 | 3,469 | 3,469 | 3,469 | 3,469 | 10,441 | 10,441 | 10,441 |
| 1987 | 33,364 | 50% | 6,576 | 90% | 6,576 | 90% | 15,357 | 47% | 15,357 |
| 1988 | 47,022 | 41% | 9,116 | 39% | 9,116 | 39% | 22,328 | 45% | 22,328 |
| 1989 | 67,540 | 44% | 203% | 14,808 | 62% | 327% | 33,902 | 52% | 225% |

Appendix C

Comparison of share of Japanese FDI in EU countries with their share of EU GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP 1992 (US$ million)</th>
<th>% of total EU GDP</th>
<th>% of total Japanese FDI in EU, 1992</th>
<th>Difference between share of FDI and share of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>1364</td>
<td>15.2%</td>
<td>44.4%</td>
<td>29.2%</td>
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<tr>
<td>Netherlands</td>
<td>455</td>
<td>5.1%</td>
<td>21.8%</td>
<td>16.7%</td>
</tr>
<tr>
<td>Germany</td>
<td>2519</td>
<td>28.1%</td>
<td>11.6%</td>
<td>-16.5%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>15</td>
<td>0.2%</td>
<td>1.0%</td>
<td>0.8%</td>
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<tr>
<td>France</td>
<td>1844</td>
<td>20.6%</td>
<td>6.9%</td>
<td>-13.7%</td>
</tr>
<tr>
<td>Spain</td>
<td>710</td>
<td>7.9%</td>
<td>5.0%</td>
<td>-2.9%</td>
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<tr>
<td>Belgium</td>
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<td>3.4%</td>
<td>4.2%</td>
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<td>Italy</td>
<td>1470</td>
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<tr>
<td>Ireland</td>
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<td>1.7%</td>
<td>1.0%</td>
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<tr>
<td>Portugal</td>
<td>110</td>
<td>1.2%</td>
<td>0.2%</td>
<td>-1.0%</td>
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<tr>
<td>Greece</td>
<td>109</td>
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<td>-1.2%</td>
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<tr>
<td>Total</td>
<td>8967</td>
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Figure 1: Stock and Flow of Japanese Foreign Direct Investment (JFY1970-JFY1993)
Figure 2: Percentage Change in Stocks and Flows of Japanese FDI (relative to previous year)
Figure 3: Amount of Japanese Foreign Direct Investment, JFY1983-JFY1993

US$ billions

North America  Europe  Asia  Other

Figure 4: Geographic Distribution of Japanese FDI, JFY1983

Geographic Distribution of Japanese FDI, JFY1993
Figure 5(a): Sectoral Distribution of Japanese FDI, JFY1983 - JFY1993

Figure 5(b): Industrial Distribution of Non-manufacturing FDI, JFY1983 - JFY1993
Figure 6: Sectoral Distribution of Japanese FDI by region, JFY 1991

- Oceania
- Africa
- Europe
- Middle East
- Asia
- Latin America
- North America
- Total

Legend:
- Red: Manufacturing
- Blue: Non-Manufacturing
- Yellow: Branch Establishment
Figure 7: Trade between Japan and the European Union, 1978-1993
Figure 8: Japanese FDI in Europe (Amount and per cent of total)

US$ billions


Amount
% of total Japanese FDI
Figure 9: Necessary conditions for foreign direct investment

Foreign firm disadvantages + Firm specific comparative advantages → net negative → No investment

→ net positive

Location specific advantages (eg low wages)
OR
Internalization advantages (eg low tax, labour market constitution, relatively low labour costs, tariffs or NTB)

Export to foreign market or licensing

Foreign direct investment
Figure 10a): Geographic distribution of Japanese FDI to Europe, JFY1983

Figure 10b): Geographic distribution of Japanese FDI to Europe, JFY1992
Figure 11a): Sectoral Distribution of Japanese FDI in Europe, JFY1991

Figure 11b): Sectoral distribution of Japanese FDI to Europe, 1981, 1985 and 1991
Table 1

Flows and Stock of Japanese Foreign Direct Investment, JFY1970 - JFY1993 ($US billion)

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Table 2

Japanese Foreign Direct Investment, by region, JFY1983 - JFY1993
(percentage distribution)

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Table 3

Japanese Foreign Direct Investment, by sector, JFY1983 - JFY1993
(percentage distribution)

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<td>29.4</td>
<td>24.1</td>
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<td>29.5</td>
<td>29.1</td>
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<td>3.8</td>
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<td>19.1</td>
<td>9.8</td>
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<td>5.1</td>
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<td>5.6</td>
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<td>20.7</td>
<td>19.5</td>
<td>21.4</td>
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<td>16.9</td>
<td>15.5</td>
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<td>1.1</td>
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Table 4

Japanese Foreign Direct Investment in Europe, JFY1975 - JFY1993
($US billion and percentage of total Japanese FDI)

<table>
<thead>
<tr>
<th>Year</th>
<th>Flow</th>
<th>Flow percent of total</th>
<th>Stock</th>
<th>Stock percent of total</th>
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</thead>
<tbody>
<tr>
<td>1975</td>
<td>0.34</td>
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<td>n.a</td>
<td>n.a</td>
</tr>
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<td>0.58</td>
<td>12.3%</td>
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<tr>
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<td>0.99</td>
<td>12.2%</td>
<td>7.2</td>
<td>11.7%</td>
</tr>
<tr>
<td>1984</td>
<td>1.94</td>
<td>19.1%</td>
<td>9.1</td>
<td>12.8%</td>
</tr>
<tr>
<td>1985</td>
<td>1.93</td>
<td>15.8%</td>
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</tr>
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<td>1986</td>
<td>3.47</td>
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<td>17.8%</td>
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Table 5

Japanese-affiliated Companies in the EU, August 1991
(number of companies)

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<th>Country</th>
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<tr>
<td>Denmark</td>
<td>27</td>
</tr>
<tr>
<td>Germany</td>
<td>623</td>
</tr>
<tr>
<td>Greece</td>
<td>31</td>
</tr>
<tr>
<td>Spain</td>
<td>133</td>
</tr>
<tr>
<td>France</td>
<td>136</td>
</tr>
<tr>
<td>Ireland</td>
<td>33</td>
</tr>
<tr>
<td>Italy</td>
<td>121</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>20</td>
</tr>
<tr>
<td>Netherlands</td>
<td>210</td>
</tr>
<tr>
<td>Portugal</td>
<td>31</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>772</td>
</tr>
</tbody>
</table>

Total: 2,298

Table 6

Foreign Direct Investment in Japan
($US billion)

<table>
<thead>
<tr>
<th>Year</th>
<th>Flow</th>
<th>Stock</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>2.2</td>
<td>9.6</td>
</tr>
<tr>
<td>1988</td>
<td>3.2</td>
<td>12.8</td>
</tr>
<tr>
<td>1989</td>
<td>2.9</td>
<td>15.7</td>
</tr>
<tr>
<td>1990</td>
<td>2.8</td>
<td>18.5</td>
</tr>
<tr>
<td>1991</td>
<td>4.3</td>
<td>22.8</td>
</tr>
<tr>
<td>1993</td>
<td>n.a.</td>
<td>29.9</td>
</tr>
</tbody>
</table>
Sources for Figures and Tables


Figure 2: own calculations using sources listed for Figure 1.


Figure 6: JETRO (a), *1993 White Paper: Kaigai Chokusetsu Toshi (Overseas Direct Investment)*, Tokyo, 1993.

Figure 7: International Monetary Fund, *Direction of Trade Statistics Quarterly*, Washington DC, June 1994.


Figure 10: Ministry of Finance, Japan, *Financial Statistics of Japan*, Tokyo, various editions.


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