ISEAS Series on Japan and the Asia-Pacific

JAPAN in EAST ASIA

Trading and Investment Strategies

WENDY DOBSON

INSTITUTE OF SOUTHEAST ASIAN STUDIES

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The **Institute of Southeast Asian Studies** (ISEAS) was established as an autonomous organization in 1968. It is a regional research centre for scholars and other specialists concerned with modern Southeast Asia, particularly the many-faceted problems of stability and security, economic development, and political and social change.

The Institute is governed by a twenty-two-member Board of Trustees comprising nominees from the Singapore Government, the National University of Singapore, the various Chambers of Commerce, and professional and civic organizations. A ten-man Executive Committee oversees day-to-day operations; it is chaired by the Director, the Institute's chief academic and administrative officer.

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The economic dynamism of East Asia is one of the great transforming features of the post-Cold War world. Spontaneous and often unilateral reductions of barriers to both trade and investment by governments in the region have been important determinants of this dynamism, along with inflows since the mid-1980s, of large amounts of Japanese investment relative to the sizes of the host economies.

This study examines the growth of Japanese trade with and investment in the region in the light of particular concerns voiced by some North Americans. They recognize the economic potential of the transformation and wish to contribute to, and benefit from, the opportunities afforded by rapid economic growth. But concerns abound about potential implications of differences in business systems and the role of governments in economic development. The purpose of this study is to cast light on, rather than add heat to, these concerns.

In carrying out this study, I benefited greatly from the contributions of many people though the observations and conclusions contained herein are my own responsibility. The late Professor Kernial Sandhu, then Director of the Institute for Southeast Asian Studies, offered to host a seminar with scholars from the region, which took place in Singapore on 29–30 September 1992. ISEAS was also my host during the month spent revising the manuscript in response to the suggestions and discussion at that seminar.

I am particularly indebted to Kernial Sandhu for his encouragement and enthusiasm about this project, which is dedicated to his memory. His untimely death means the region has lost a great intellectual entrepreneur who will be greatly missed by people all over the world. I am grateful, too, to Dr Lee Tsao Yuan, Deputy Director of the Institute for Policy Studies and Dr Chia Siow Yue, National University of Singapore, for assistance during that visit, and to the staff of the Institute.

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Dedicated to the memory of
Professor K.S. Sandhu
Director of ISEAS, 1972–1992

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I
INTRODUCTION

Amid concerns about slow growth and lagging competitiveness in many western industrial economies, the remarkable dynamism of the East Asian economies has attracted interest in the reasons for, and implications of, their economic success. Because of the diversity of economic structures and relationships in the region there are many different definitions of East Asia. This study applies the term to the four newly industrializing economies (NIEs) – Hong Kong, Korea, Singapore and Taiwan – and the ASEAN-4 – Indonesia, Malaysia, Philippines and Thailand. Although China is fast emerging as a major force, it is not included because of data problems. Recent inflows of Japanese investment to these economies, evident in the regional distributions of accumulated investment in Table 1, have drawn particular attention. Political initiatives to promote closer regional economic ties have evoked concerns that growing Japanese trade and investment implies the formation of a self-sufficient bloc.

TABLE 1
Regional Shares of Stocks of U.S. and Japanese Outward Investment, 1990

	U.S. Outward FDI[a]	*Japanese Outward FDI*[b]
Canada	16	2
North America	–	44
Europe	48	19
NIEs and ASEAN-4	6	14
Japan	5	–
ROW	25	21
TOTAL	100	100

See Appendix A for a comparison of data sources.

[a] SOURCE: U.S. Department of Commerce. *Survey of Current Business*, Aug. 1991, pp. 104 and 105.

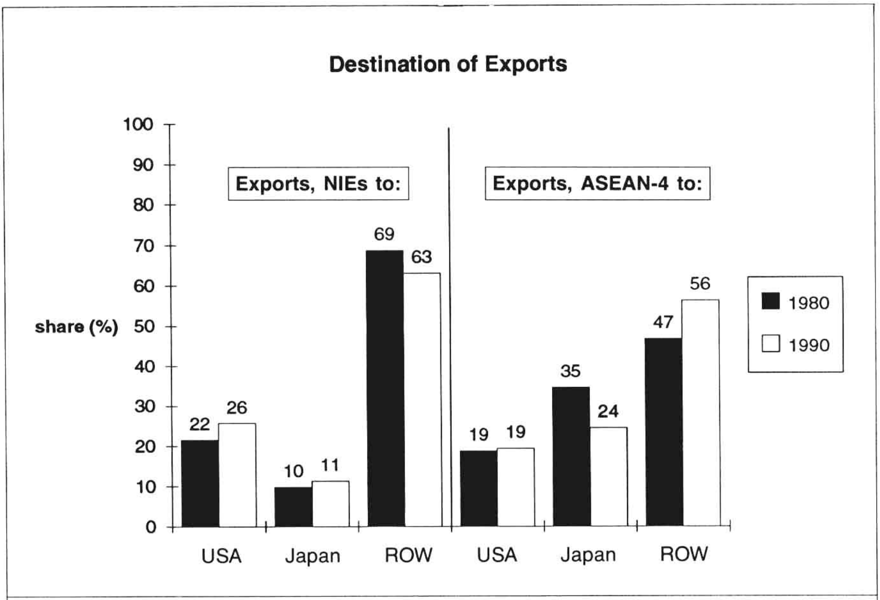
[b] Accumulated outflows, 1951–1990. SOURCE: Ministry of Finance, Dec. 1991. *Zaisei Kinyu Geppo*, pp. 31–35.

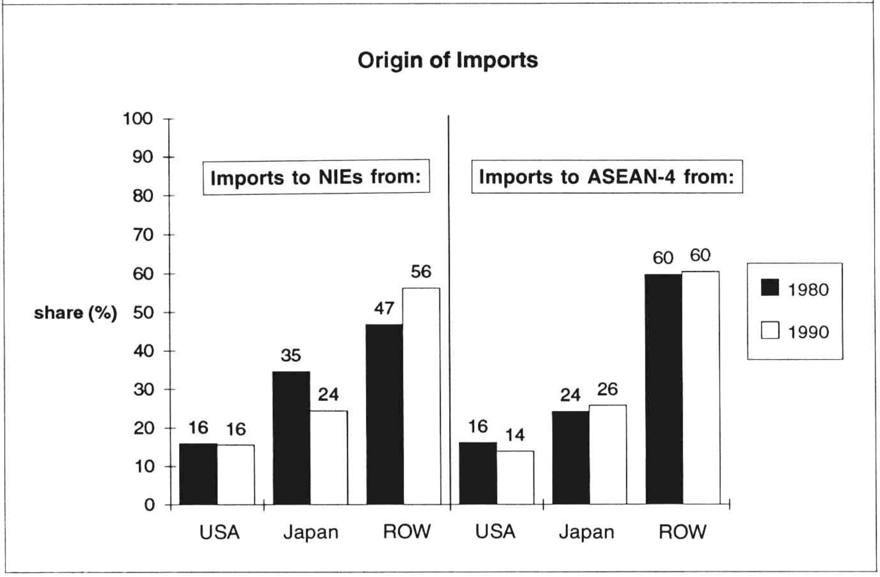
What validity is there to these concerns? The region's continued dependence on western export markets is evident in Chart 1 and implies the region is some distance from self-sustaining economic growth. Implicit in such concerns are differences in frameworks, assumptions and interpretations. For example, some analysts assert that characteristics of the Japanese market, which make it difficult for foreigners to penetrate, also play a role in the possible creation of exclusionary production networks in East Asia.[1] Others observe that U.S.-Japanese economic rivalry is being carried into the region.[2]

Such assertions build on the U.S. literature on Japanese trade and investment that accentuates its asymmetrical characteristics. Japanese foreign direct investment (FDI) outflows have grown rapidly. By 1989 the stock of outward investment stood at US$ 156 billion and accounted for 11 per cent of the world total.[3] Yet Japan has not been a major recipient of FDI; its stock of inward FDI in 1989 was US$28 billion.[4] While it has been a large exporter of manufactures, it has not been a large importer of these products.[5] Many non-Japanese complain about the difficulties of selling to Japan. These perceptions are then generalized beyond the Japanese market, particularly to the East Asian economies, as recipients of the recent wave of Japanese investment.

Explanations of these asymmetries, especially by North Americans, generate considerable disagreement. Some analysts draw on comparisons with other western economies at comparable stages of development and on recognition of Japan's lack of natural resources and relative geographic isolation – until its Asian neighbours began to develop.[6] Indeed, Japan's share of overseas production in manufacturing is still only around 6 per cent compared to 17 and 20 per cent for U.S. and German firms, respectively (Julius 1991, p. 8). Clearly, the rapid surge in outward investment since the mid-1980s is a stock adjustment which has a long way yet to go. Others accentuate the uniqueness and "differentness" of Japanese institutions, particularly the role of government and the organizational features of *keiretsu* – networks of firms linked together by cross-shareholdings and by long-term repetitive relationships between suppliers and customers. There are also the non-arm's-length relationships, and the idea that Japan pursues a different form of capitalism.[7] If *keiretsu* relationships are being replicated abroad in key industries in which firms from many nations are now com-

CHART 1
Direction of Trade, ASEAN and NIEs with USA, Japan and Rest of the World, 1980 and 1990
(Shares, per cent)





NOTE: NIEs does not include Taiwan.

SOURCE: IMF, *Direction of Trade Statistics Yearbook*, various years.

peting, then U.S. firms stand to lose out on potential growth opportunities, particularly in a rapidly-growing region like East Asia.

The view one takes with respect to these questions is important, particularly for third countries in North America and Europe. If one believes Japan, or Japanese firms, are following an exclusionary strategy in East Asia, then seeking to invest in, and trade with, these economies would entail more risk than if economic developments were largely accounted for by the operation of market forces. In effect, one would conclude that being efficient would be insufficient to ensure success. Similarly, the relevance of these debates to the economist is not whether Japan is different or unique, but the economic efficiency of Japanese agents; the impact of their behaviour on global welfare; and the long-run sustainability of their behaviour.

Thus, the questions posed in this book are the following: What are the reasons for the recent growth of Japanese trade with, and investment in, the East Asian economies? How do these reasons compare with prevailing theories of trade and investment? With U.S. behaviour? What are the implications of Japanese patterns for third countries and for the future of the systems of international trade and finance?

The central analytical issue is: Why and how do firms produce abroad? The essence of FDI is the transfer within the firm of firm- and industry-specific assets such as technology, managerial, marketing and organizational knowhow that are necessary to compete with local producers in host countries. Dunning's (1980) "eclectic" paradigm of international production is perhaps the best model to capture these features of FDI behaviour. Dunning identifies three factors which influence a firm's decision to carry out FDI:

1. ownership (O) advantages, such as economies of scale, other technological advantages, or management skills which enable the firm to recover the costs of investing abroad;
2. location (L) factors which contribute to the decision to employ ownership advantages to produce abroad; these factors may be risks and barriers in export markets or the availability of lower-cost labour or natural resources; and
3. internalization (I) factors which determine that foreign production occurs through FDI, that is, within the firm. Firms decide to create

> an internal market among parent and affiliates or subsidiaries in order to control key sources of competitiveness or to reduce the risks that the firm might lose control of such intangible factors as knowledge and technology.

Dunning's work is part of the transactions cost literature which originated with Hymer (1976), Kindleberger (1969), Caves (1982), Rugman (1980), among others. Firms in oligopolistic industries, characterized by knowledge and financial advantages, produce abroad rather than export their products or license their technologies. As we see in Table 2, more than 40 per cent of global merchandise trade takes place in industries with these characteristics. Yet as Komiya (1991, p. 144) argues, between a fifth and a third of Japanese global FDI flows have been accounted for by independent small and medium-sized firms (SMEs) without oligopolistic characteristics. Similarly, much Taiwanese investment in neighbouring economies is undertaken by small and medium-sized enterprises (SMEs) in highly-competitive industries. These realities suggest the need for a less restrictive transactions framework, such as Dunning's, which acknowledges firm- and industry-specific assets associated with economies of scale, as well as locational advantages associated with relative factor scarcities, and home and host government policies.

TABLE 2
Shares of Product Groups in
World Merchandise Exports, 1990

Product group	*Value ($)*	*Share (%)*
Machinery and transport equipment (nes)	1,237	35.2
(of which office machines and telecommunications equipment)	303	8.5
(Automotive products)	322	9.0
Chemicals	298	8.5
Iron & steel	109	3.0
TOTAL		46.7

SOURCE: GATT, *International Trade 1990–91*, Volume II.

The role of home and host governments as locational influences on FDI are a major focus of this study. Conceptually, incorporating them into the analysis is motivated by two approaches. The first is the concept of long-run dynamic comparative advantage and Schumpeterian innovation (Yoshitomi 1991), where technical change results from the deliberate efforts of firms. Innovating firms can reap at least temporary monopoly gains from such innovation until imitation by rivals, resulting from intense competition, drains away excess profits.

The second approach is that of strategic trade theory, which in contrast, applies industrial organization models of imperfect competition to trade. In this framework, oligopolistic rents accrue to manufacturing firms due to barriers to entry and externalities arising from innovation. Governments have incentives to intervene in ways that shift rents to home firms, or in instances of FDI, to intervene to shift benefits from foreign-owned firms to the domestic economy. Thus, emerging manufacturing industries using advanced technology become strategic sectors in which capital and labour can earn significantly higher returns. The Japanese Government recognized this, says Krugman (1986), and used policy tools to nurture industry and shield it from foreign competition.

The distinctions between dynamic comparative advantage and the new trade theory are part of an international policy debate about strategic industries – industries which governments identify and promote on the grounds of serving national interests – but for which there are various identifying criteria. One criterion for identifying strategic industries is those in which the long-term availability of products and technologies is considered crucial to the national interest; another criterion is those industries characterized by dynamic increasing returns; a third criterion is those in which there are regional or national externalities which have a significant impact on growth through backward and forward linkages in material and knowledge (Stevens 1991, p. 98).

The organization of this study reflects the importance of such strategic factors as determinants of trade and investment. Chapter 2 focuses on the home environments of Japanese firms. Economic performance and policy have been important influences on the development of ownership and internalization advantages of Japanese firms.