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Characteristics and Performance*

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**JAPANESE INVESTMENT IN TRANSITIONAL ECONOMIES:
CHARACTERISTICS AND PERFORMANCE**

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The benefits and disadvantages of having foreign firms participate in host economies has been a subject of much deliberation among academics, public policy makers and practitioners (e.g., Lall 1993; Harrison 1994). With the rise in foreign direct investment (FDI) in the 1980s and the 1990s, this debate is particularly salient. FDI can have a number of effects on host economies (see Graham and Krugman 1990 for a discussion). These effects are brought on by the direct participation of the subsidiaries of foreign firms in economic activity in the host economy.

In some cases, an explicit goal of a firm's FDI is to bring about organizational change, such as in the case when a foreign investment is used as the vehicle for technology transfer (Siddharthan and Safarian 1997). In other cases, organizational change is not an explicit goal, but it is an externality of the investment. By participating directly in the host country's economy, the foreign firm makes a number of connections with local firms: its subsidiaries hire local employees and it interacts with local firms that serve either as buyers and suppliers. As well, the foreign firm generates spillovers of the tacit and explicit knowledge embodied in organizations as management skills and technology (Arrow 1962).

These connections between the foreign subsidiary and the host economy increase the scope for change because local organizations can acquire new knowledge of technology and management from interacting directly with foreign enterprises. Consequently, multinational enterprises can become agents for change within transitional economies via their investment activity (Harianto and Safarian 1997), but the opportunities for change are delimited by the magnitude and form of investment (Anand and Delios 1996). To determine the scope for organizational change, and the contribution of the second largest group of foreign investors to transitional economies, this paper

Along with this growth, decline and resurgence in Japanese investment levels in the 1980s and 1990s, has come a change in the direction of investment outflows. North America and Europe (partly because of the creation of the European Union) were major recipients of Japanese investment in the 1980s. However, Asia has attracted increasingly larger shares of Japanese FDI through the first half of the 1990s. By 1991, Japanese investment in Asia exceeded that in North America and Europe combined. In the five years following, each year Asia received at least half and up to three quarters (in 1995) of Japanese investment outflows (Table 1).¹ Part of the region's increased attractiveness for Japanese foreign investors can be attributed to the liberalization of foreign trade and increased opportunities for investment in transitional economies such as China and Viet Nam. However, the opening up of many formally centrally planned economies in the CEE to the active participation of foreign investors in their economies has not resulted in similar increases in Japanese foreign investment inflows. This divergence in FDI flows is discussed more in the next section.

----- Insert Table 1 here -----

The Location of Japanese Foreign Direct Investment

Among large centrally planned economies, China was the first (in 1978) to institute policy reforms aimed at attracting more inward foreign investment. Since the institution of the 1979 Joint Venture Law in China, and the establishment of the first Sino-foreign joint venture in 1980, FDI in China grew steadily in the 1980s and rapidly through the 1990s. Initially, most of the investment took the form of joint ventures located in Special Economic Zones (SEZs) and the Opening Coastal Cities (OCCs). For example, Beamish and Wang (1989) reported that 65 percent of foreign investment in China was located in SEZs and OCCs. To the mid-1990s, investments

of CEE countries for foreign investors resembled the African continent, one of the regions with the least foreign investment, more so than East and Southeast Asian countries.

The data on individual subsidiary formation, as a measure of FDI outflows, illustrates trends similar to the aggregate data on FDI monetary flows. Even though Japanese investors established twice the number of subsidiaries in the CEE as compared to Africa in the 1988-1996 period, investment in the CEE amounted to just 1.33 percent of total Japanese subsidiary establishment.

For the nine-year period depicted in Table 2, the rates of subsidiary formation in the CEE and in Viet Nam were similar. However, investment in the CEE slowed in the 1994-1996 period, while it accelerated in Viet Nam. Moreover, Japanese firms were much less active in the CEE and Viet Nam compared to the largest transitional economy, China.

While Japanese firms were initially slow to establish operations in China in the 1980s, the early and mid-1990s saw rapid growth in Japanese investment activity in China. In particular, as the amount of overall Japanese investment began to return to late 1980 levels in the mid-1990s, China was the location for one out of every three new subsidiaries formed in the 1994-1996 period.

----- Insert Table 2 here -----

Clearly, countries of the CEE have accounted for a small share of worldwide investment in the 1990s, and an even smaller share of Japanese investment. This raises the question, Why have Japanese firms established so few subsidiaries in the CEE? Parts of the answer to this question rest in the motivations for Japanese investment and other parts in factors specific to the CEE, such as the region's geographical, historical and cultural connections to Japan.

Resource Seeking. Even with the rapid economic growth that had occurred, China, as well as Viet Nam, continued as favorable locations for labor-intensive production because of the low cost of labor. Manufacturing wage rates in Viet Nam averaged US\$0.24/hour in 1994, which was about two-thirds the rate in China (US\$0.37/hour). Meanwhile, Russia's 1995 mean hourly manufacturing labor cost was more than double that of China, and the Czech Republic's was five times as great (Goddard 1997).

While the wage rate in China as a whole was low in comparison to CEE countries, and much lower than that in many other East and Southeast Asian countries (labor costs in manufacturing in Singapore, Malaysia and Thailand were five to fifteen times greater), the cost of labor exhibited considerable variance across regions. The relatively affluent Eastern coastal provinces (e.g., Jiangsu, Zhejiang) had a higher cost of labor in the mid-1990s than the less affluent interior provinces. For example, in January 1997, the cost to employ a sales manager in Chongqing or Chengdu in Sichuan province was 60 percent of that in Guangzhou, Guangdong and 40 percent of the cost in Shanghai (Goddard 1997). Aside from the lower cost of labor, much of China's natural resource wealth is also found in the Interior Provinces.

Even with the natural resource wealth of the interior of China, and the potential for sourcing lower cost labor, investment remained concentrated in the Eastern coastal provinces. This trend was initiated in part by the attraction of the SEZs, and by the presence of a large, affluent population (the aforementioned market seeking motive). In fact, there is little evidence that Japanese multinationals have altered raw material sourcing strategies in response to the new sourcing opportunities present in large countries such as China and Russia. To illustrate this point, Japan's

trading-related investments (Toyo Keizai 1997). Consequently, with the relative lack of trading subsidiaries of Japanese firms in the CEE, there was not a strong supporting network of trading services necessary to reinforce the investments of manufacturing firms in the CEE.

Investment in support services (financial services, retail establishments such as restaurants, travel services, business consulting) are undertaken when a sufficient mass of manufacturing subsidiaries from the home country have been established in the host country. While manufacturing services still account for upwards of 80 percent of FDI in China, a substantive amount of support services-related FDI has been made in cities such as Dalian (mostly restaurants and retail establishments) and Shanghai (financial services). In the CEE, FDI in support services has been less frequent, although in countries such as Russia and Hungary, which were the largest recipients of Japanese FDI among CEE countries, 25 to 40 percent of subsidiaries operated in support services.

Factors Specific to CEE countries

History, Geography and Culture. Perhaps even more important than the lack of trading and support services-related subsidiaries as an attraction for potential manufacturing investments, is the lack of a trading and investment history between Japan and the CEE. Japanese firms sent 1.1 percent of all exports to the CEE in the first five years of 1990 (UNCTAD 1996). Weak trading relations, and sporadic investment activity in the past, suggest that Japanese firms have a lack of familiarity with the region. In contrast, Japanese firms have a richer history of economic involvement in Asia and China. For example, Japanese textile manufacturers made direct investments in the eastern coastal provinces in China in the late 1920s and early 1930s. As well, the north-eastern Chinese coastal city, Dalian, was a major recipient of Japanese FDI prior to the

more widespread and encompassed by greater uncertainty, particularly when other options existed (e.g., China).

An additional difference in economic transformation concerns the interaction between foreign investors and state-owned enterprises. Reforms in the CEE were oriented at the privatization of existing state enterprises. While China's economy also was saddled with a large number of state-owned enterprises, the direction of reforms in China was more towards encouraging the establishment of new enterprises. This aspect of the reforms relates to Japanese firms directly because these firms have a well-observed preference, as compared to US firms, for establishing greenfield operations over acquisitions (Beamish, Delios and Lecraw 1997). Hence, the privatization phenomenon, which may have successfully stimulated European and US-based firms to invest in the CEE, was not as relevant to Japan-based investors. The nature of Japanese investment in individual countries in the CEE is discussed more in the following section.

Foreign Direct Investment in CEE

Within the countries of the CEE, Japanese investors have concentrated investments in four nations. Not surprisingly, Russia, as the largest country in the region, has received the greatest amount of investment as measured by a subsidiary count (Table 4). Twenty-nine percent (43 subsidiaries) of Japanese investment in the CEE were located in Russia. Hungary, the Czech Republic, Poland and Romania follow as other countries in which Japanese firms have established more than ten foreign subsidiaries. Other CEE countries in which Japanese firms have invested include Bulgaria, Croatia, Estonia, Slovakia, Slovenia and the Ukraine, although the level of investment is low (four subsidiaries or less).

----- Insert Table 4 here -----

countries of the CEE was repeated in the industrial composition of Japanese investment in the CEE. China and Viet Nam.

Sectoral Patterns in Foreign Direct Investment

In both China and the countries of the CEE, the earliest Japanese investments listed in Toyo Keizai (1997) were made in 1981, while in Viet Nam the oldest subsidiary was founded in 1990. After sporadic and infrequent investment activity in the CEE in the early and mid-1980s, Japanese companies began to invest more heavily in the CEE (principally Russia) in 1989 and 1990 (see Table 2). Sectorally, early investments in the CEE were concentrated in services as Japanese General Trading Companies (GTCs), such as Marubeni and Tomen, and Japanese manufacturing companies, like Minolta and Olympus, began to set up wholesale trading operations in the CEE.

The early pattern of investment in the service sector has continued through the 1990s and, as of 1997, 75 percent of Japanese investments were wholesale trading operations (SIC code 50). Just 19 percent of Japanese subsidiaries operated in manufacturing industries. As well, the manufacturing subsidiaries were found in fields in which Japanese firms have tended to invest more heavily – chemicals, electronics and transportation. With the concentration in the service sector, it is not surprising that GTCs (e.g., Kanematsu, Itochu, Marubeni, Sumitomo) lead the way in terms of the number of investments by individual firms. The dominance of these firms in early Japanese investment activity in the CEE was consistent with investment behavior in developed and developing countries. For example, in the first set of Japanese investments in East and Southeast Asia following World War II, Japanese GTCs had an equity involvement in 50 percent of the subsidiaries established by Japanese firms (Yoshino 1976). However, unlike Japanese investments in the CEE, these subsidiaries were in the manufacturing sector, and the role of GTCs was different.

tended to be located in Special Economic Zones in Shanghai and Guangdong; and ferrous product investments were made in Jiangsu and Liaoning provinces.

In Viet Nam as well, Japanese investment was concentrated in the manufacturing sector. Seventy-one percent of the 106 subsidiaries were engaged in manufacturing; eight percent in primary industries and 21 percent were service-sector subsidiaries. Among manufacturing subsidiaries, the distribution across two-digit SIC industries was uniform. The largest percentage (19 percent) of manufacturing investments were made in the electronics sector, followed by textiles (12 percent) and fabricated metals (10 percent). Regional concentration of industries, and other sector-specific characteristics, were more difficult to determine in the case of Viet Nam because just 106 subsidiaries were established by 1996. Nonetheless, two cities, Ho Chi Min and Hanoi, received 59 percent of the investments made to the end of 1996. Additionally, it appears that Viet Nam has been emerging as an important off-shore manufacturing base for Japanese firms, much as China did ten years earlier.

Characteristics and Performance of Japanese Foreign Direct Investment

Just as the greater incidence of foreign direct investment activity in China created more opportunities for interactions between foreign and domestic organizations, the characteristics of Japanese subsidiaries in China and Viet Nam, as compared to the CEE, were indicative of organizational structures more conducive to transfers of organizational practices. This statement is supported by the analysis in this section in which the characteristics of the subsidiaries established in the three regions are compared. The specific characteristics examined are the entry mode, amount and percent of equity investment, performance and sales, employment and expatriate management practices of Japanese subsidiaries.

Independent of region, when making an investment in a trading subsidiary, Japanese firms have tended to assume higher levels of ownership. This trend is evident in this sample when mean ownership levels in the manufacturing and trading sectors were compared. The mean equity possessed by Japanese firms in manufacturing subsidiaries was slightly more than 50 percent, and in wholesale trading subsidiaries it was nearly 70 percent. The 70 percent holding was close to the average equity possessed by Japanese investors in foreign subsidiaries situated in the CEE.

A second trend common to the three regions was the propensity for later investors to assume a larger equity share than early investors. For subsidiaries established before 1989, when Japanese firms were making their initial forays into China, the mean equity share possessed was 45 percent. In the CEE, it was 52 percent. Over time, in the CEE and China, Japanese investors generally took a greater equity share in more newly established subsidiaries. Hence, there was a positive relationship between the date of subsidiary establishment and the equity share of Japanese investors (see Figure 1).

----- Insert Figure 1 here -----

Part of this trend was related to reduced restrictions on ownership positions in the CEE, China and Viet Nam, and, along with this liberalization, was a concurrent experience effect (e.g., Johanson and Vahlne 1977). The experience effect refers to the positive relationship observed between a firm's level of experience in a region and its ownership level in its foreign subsidiaries (as in Figure 1). As investors obtain more experience in a host country, there is a concomitant increase in knowledge of the host country environment. The increase in host country knowledge leads to a reduction in the need for the equity participation of local firms as a means of securing local

performance. Fifty-three percent of Japanese subsidiaries in China were profitable, while 22 percent of subsidiaries operated at a loss. For subsidiaries in the CEE, 50 percent were profitable and 36 percent reported a loss. The performance in Viet Nam was the lowest in the three regions, with mean profitability standing at 1.76 (where loss responses were coded as 1, break-even as 2 and gain as 3).

----- Insert Table 6 here -----

The relatively higher performance of Japanese subsidiaries in China can be attributed to at least three factors. First, the economy in China has been expanding at a much faster rate than Viet Nam and the CEE as a region, and faster than individual economies within the CEE. Consequently, the environment in which Japanese subsidiaries were operating in China was more munificent, and individual subsidiaries were more likely to be operating profitably in a rapidly growing economy.

Second, the experience of Japanese firms within China was much greater. Japanese firms have a longer history of economic involvement in China. For example, there was a considerable volume of foreign direct investment in the textile sector in the Eastern coastal provinces of China by Japanese firms in the early 1930s. In the same time period, Heilongjiang (then an occupied colony of Japan called Manchukuo) received much investment in the mining, transportation, communication and chemical industries (Ozawa 1979). Following this early pattern, the decades of the 1980s and 1990s have seen the resumption of Japanese investment activity in China. Consequently, local competence in China should be greater than that in Viet Nam and the CEE.

Third, investment in China was concentrated in the manufacturing sector whereas investment in the CEE was mostly in trading subsidiaries. As a business dependent on large sales volumes, the

were employed in a typical Japanese subsidiary in China, and about 2.56 were found in each subsidiary in Viet Nam. However, in subsidiaries in the countries of the CEE, expatriate employment was less and averaged 1.5 expatriates per subsidiary (see Table 7).

----- Insert Table 7 here -----

The difference in expatriate employment levels was partly a function of the smaller size (lower total employment) of subsidiaries in the CEE, as compared to those in China. But this explanation does not hold in the comparison to the Vietnamese case. To control for the confounding effects of subsidiary size, a ratio of expatriate employees in each subsidiary can be calculated.² The ratio of expatriates (the percent of employees that are expatriates) is reported in the fourth and fifth columns of Table 7. According to the two methods used to calculate relative expatriate employment, the highest ratio of expatriate employment is in Viet Nam, in which the mean expatriate employment ratio across Japanese subsidiaries was 9.33 (or 2.61 for expatriate employment calculated as a mean of sample means). The mean expatriate employment ratio across Japanese subsidiaries in China (5.53) was substantially less than that in Viet Nam, but greater than that in the CEE (4.68).

The relatively less intense use of expatriates in the CEE was unexpected given the concentration of investments in the wholesale trading sector. In general, in foreign subsidiaries in this sector, Japanese firms employed a greater ratio of expatriates than subsidiaries established in other service and manufacturing industries (Anand and Delios 1997). If the comparison of Japanese expatriate management practices is restricted to the subsidiaries of GTCs, a similar but more pronounced trend to that in Table 7 is observed. In subsidiaries of Japanese GTCs in China and Viet Nam, one in ten employees was an expatriate, whereas in similar subsidiaries in the CEE

attractive alternative sites for raw materials and production-oriented investments, work in concert to limit the amount of Japanese investment in the CEE.

By contrast, Viet Nam began to attract more attention from Japanese investors, particularly in 1995 and 1996. Rich endowments of natural resources coupled with a low cost of labor and geographic and cultural proximity to Japan, make Viet Nam an attractive site in which to locate manufacturing subsidiaries. Indeed, investment activity in Viet Nam was concentrated in the manufacturing sector and the pattern and intensity of investment to 1996, indicated that this country may receive greater investment flows in the future as other Japanese manufacturing firms seek to re-locate existing, or develop new, overseas manufacturing operations.

The characteristics of Japanese subsidiaries, particularly the lower expatriate employment levels, reflect the lower commitment that Japanese firms have to the CEE as compared to China and Viet Nam. Japanese firms devoted few expatriates to the CEE. This scarce resource (Beamish and Inkpen 1998) has been allocated to China and Viet Nam indicating the importance of the two countries to Japanese firms. The highest ratio of expatriates was observed in Viet Nam perhaps reflecting Japanese firms' commitment to the country and the need to develop new organizational competencies via operational experience.

Together, the lack of investment in the CEE and, when making investments, the lower commitment of Japanese firms to the CEE, imply that the opportunity for change in domestic organizations in the CEE were much less. Foreign direct investment can bring about change when foreign firms interact directly with domestic firms. Change can come from the acquisition of new knowledge about manufacturing techniques, management practices or other forms of

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Table 1
Japanese Foreign Direct Investment by Region: 1988-1996

Region	Year									Total
	1988	1989	1990	1991	1992	1993	1994	1995	1996	
Asia	512 42.3%	562 41.5%	544 39.5%	430 41.4%	453 51.3%	586 66.4%	785 71.6%	1,147 74.6%	708 69.6%	5,727 55.1%
North America	380 31.4%	388 28.6%	364 26.4%	216 20.8%	148 16.8%	119 13.5%	115 10.5%	172 11.2%	146 14.3%	2,048 19.7%
Europe	221 18.3%	290 21.4%	358 26.0%	308 29.7%	204 23.1%	119 13.5%	115 10.5%	144 9.4%	111 10.9%	1,870 18.0%
South America	39 3.2%	38 2.8%	48 3.5%	35 3.4%	42 4.8%	31 3.5%	45 4.1%	41 2.7%	29 2.8%	348 3.4%
Oceania	46 3.8%	66 4.9%	51 3.7%	38 3.7%	31 3.5%	19 2.2%	28 2.6%	19 1.2%	13 1.3%	311 3.0%
Africa/Middle East	12 1.0%	11 0.8%	11 0.8%	11 1.1%	5 0.6%	8 0.9%	8 0.7%	15 1.0%	11 1.1%	92 0.9%
Total	1,210	1,355	1,376	1,038	883	882	1,096	1,538	1,018	10,396

Data source: Toyo Keizai (1997).

Table 3
Economic Indicators in Transitional Economies

Country/Region	GNP / capita (US\$)	GDP growth (%)	Indicators		Population (millions)
			Trade (exports + imports) (US\$ billion)	Trade growth (91-96)	
China (N=2,069)	530	11.6	57.8	17%	1,190.9
Viet Nam (N=120)	190	8.5	2.6	23%	72.5
Russia (N=43)	2,650	-7.9	6.9	(6%)	148.4
Hungary (N=35)	3,840	-1.7	0.4	3%	10.2
Czech Republic (N=24)	3,210	-2.3	0.3	10%	10.3
Poland (N=22)	960	2.9	0.3	(14%)	38.3
Romania (N=11)	1,230	-0.9	0.1	(12%)	22.7

Data source: IMF (1997) and World Bank Atlas (1996).

Note: GDP figures for some CEE countries are estimates (at source) based on NMP (Net Material Product).

Table 5
Japanese Firms' Mode of Entry in Transitional Economies

Country/Region	Entry Mode				All Entries
	Wholly-owned	Joint Venture	Acquisition	Capital Participation	
China	385 19.4%	1,550 78.3%	6 0.3%	39 2.0%	1,980
CEE	54 36.7%	85 57.8%	1 0.7%	7 4.8%	147
Viet Nam	26 21.8%	89 74.9%	1 0.8%	3 2.5%	119
Total	465	1,724	8	49	2,246

Data source: Toyo Keizai (1997).

Note: 97 subsidiaries did not report a mode of entry.

Table 6
Performance of Japanese Subsidiaries in Transitional Economies

Country/Region	Performance			Mean
	Loss	Break-even	Gain	
China	99 21.7%	114 25.0%	243 53.3%	2.32
CEE	8 36.4%	3 15.6%	11 50.0%	2.17
Viet Nam	10 58.8%	1 5.9%	6 35.3%	1.76
Total	117	118	260	2.29

Data source: Toyo Keizai (1997).

Note: 1. 1,848 subsidiaries did not report performance.

2. Means were based on based on the following coding of responses:
 loss = 1; break-even = 2; gain = 3.

Notes

¹ A single data source is used for this account of Japanese foreign investment activity. As the use of a single source, particularly one that was compiled by survey, introduces such possible errors as those of omission (missing investments that were made but not reported), we compare the paper's principal data source Japanese Overseas Investment (published in Japanese), to several other sources of investment activity.

The 1997 edition of this annual sourcebook listed information on more than 18,000 Japanese subsidiaries of 5,000 Japanese firms. Toyo Keizai, a large Japanese publisher of business, economic and statistical information, compiled and published the data found in Japanese Overseas Investment. The subsidiary-level information reported in Japanese Overseas Investments was obtained in a survey of 5,700 listed and unlisted companies in Japan. The response rate to the 1997 survey was 55 percent. Where responses were not received from companies, previous years' data were used and some information was updated using additional sources such as securities reports, telephone interviews and other accounts reported in the media (e.g., newspapers). Although the survey does not include all Japanese companies that have made foreign direct investments (Anderson and Noguchi 1994), for each parent company listed in Japanese Overseas Investments the list of foreign activities tends to be complete. However, some information within each foreign investment listing has a low response rate (specifically, the sales and performance items).

Bodies other than Toyo Keizai compile information on the foreign activities of Japanese firms. The Japanese External Trade Organization (JETRO) routinely conducts surveys of foreign investment and trade activity, but the information collected in these surveys tends to be reported in highly aggregate form in publications such as JETRO's annual white paper on trade and investment. Another drawback of JETRO's survey, like surveys conducted by the Japanese Ministry of International Trade and Tourism (MITI), is that it suffers from lower response rates than Toyo Keizai's survey, and the resultant information is more incomplete (Sachwald 1995). See also Ramstetter (1996) for a comparison of the estimates of Japanese firms' international activity by Toyo Keizai, MITI, Japanese Ministry of Finance (MoF), and Bank of Japan.

Another possible data source for foreign investment activity are government bodies, which report aggregates of FDI flows. These flows can be measured at the inward level, such as for each country in this study, or at the outward level. Outward FDI data for Japan is available from MoF. However, MoF only tracks dollar flows. This tracking method can lead to two biases. First, MoF numbers only account for foreign investments that are financed in Japan. As financing can originate in countries other than Japan, MoF data can be misleading. Second, foreign investment may be routed through one country (where a finance subsidiary is located), to its ultimate destination in another country. Consequently, reported destinations for foreign investment flows can be inaccurate (Sachwald, 1995). Finally, government-level data is subject to a number of other biases that make its use suspect (see Vernon 1997).

² The mean percentage of expatriates in each industry was calculated as a ratio of the mean values for total employment and expatriate employment (i.e., an average of the two averages); and as a sample mean calculated from each subsidiary's mean expatriate employment percentage. The latter calculation reports a higher mean because many small trading subsidiaries have high ratios of expatriates (50 percent or more of employees are expatriates).