RECENT TRENDS IN JAPANESE TRADE AND CAPITAL FLOW—JAPAN VS WESTERN EUROPE AND ASIA*,†

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Abstract. The purpose of this paper is to give an overwiew of recent trends in Japanese trade and capital flow, particularly how currency appreciation against the dollar after 1985 has affected her economic relationship with Western Europe and Asia. Paper concludes that driving force for promoting closer economic relationship between Japan vs Western Europe and Asia was internationalization of Japanese business activity. Japanese firms were investing more in Western Europe and Asia than before. They were also bringing in more imports to Japan from both regions. Also paper found that regional advantage of Japan being located in fast growing Asian region attracted more capital from Western Europe to Japan.

1. INTRODUCTION

Internationalization of Japanese business activity was the driving force for building Japan's closer economic relationship with Western Europe and Asia. From the early 1980s, Japanese firms started to invest abroad more than ever before. Appreciation of the yen against major currencies, especially the dollar from September, 1985 had pushed such trend further. Japanese direct investment was $14.25 billion in 1986 and $18.35 in 1987, reaching the record high level.

Since currencies in most of Asian countries were more or less pegged to the dollar, Japanese firms found it more advantageous to shift some of their production facilities to Asian countries to produce parts for their own assembly lines and also to export to the third country market. Their investments were moving away from textiles and other traditional fields to auto, auto parts and electronics in Asian NICs that were acquiring more sophisticated industrial skills.

Prime motive of Japanese firms to invest in Western Europe in the early 1980s was to protect their market shares that were threatened by introduction of various import restrictive measures. In auto industry, many Japanese manufacturers

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† Western Europe includes Belgium, France, Denmark, Greece, Ireland, Italy, Netherlands, Portugal, Spain, U.K., West Germany, Iceland, Norway, Sweden, Swiss, Finland, Austria and Yugoslavia unless footnoted. Southeast Asia includes Thailand, Singapore, Malaysia, Philippines, Indonesia, Korea, Taiwan, Hong Kong, Cambodia, Burma. Asia includes Southeast Asia plus India, Pakistan, Sri Lanka, Afganistan and Nepal unless footnoted.

started local production through joint ventures with European partners. Their production plans included not only import substitution of Japanese cars but to export their products to the world market. Currency factor was also important in promoting Japanese investment to Europe. By starting European production, Japanese firms tried to hedge against the fluctuation of the yen against the dollar.

Such Japanese investment in Western Europe and Asia influenced Japanese trade relationship with countries in both regions. Since Japanese investment in both regions increased in auto, electrical and electronic products that consist of large number of assembly parts and varied end-products, opening up of Japanese plants in these regions created new import demand for equipments and assembly parts. For example, Japanese investment in autos tended to depress imports of finished cars on the one hand but to increase imports of intermediate assembly parts on the other.[1]

Present paper first gives an overview of the driving forces that promoted internationalization of Japanese business activity in the 1980s. Then it proceeds to analyse the factors that affected Japanese investment to Western Europe and to Asia in particular. Discussion on perspective outcomes of changes in trade relationship between Japan vs Western Europe and Asia following increased Japanese investment to both regions are taken up in the section that follows. The assessment of Japan's closer economic relationship with Western Europe and Asia and its implication on the future course of economic development of the countries in both regions are given in the concluding remark.

2. OVERVIEW OF JAPANESE TRADE AND INVESTMENT IN THE 1980s

By the mid-1980s, Japan became one of the major suppliers of long-term capital to the world.[2] In macroeconomic terms, it may be said that, Japan was running a huge current account surplus because her domestic saving far exceeded domestic investment. As a result, excess supply of funds was flowing into international capital market. Although capital outflow to international financial market in securities accounted for the major part of long-term capital outflow, Japanese direct investment reached record high in 1987 as mentioned earlier.[3]

[1] See Sazanami, Urata and Hamaguchi (1987) for the details.

[2] Japan's share in world total direct investment between 1980 to 1984 (flow base) was 12.1% preceded only by the U.S., 18.2% and the U.K., 18%. (Economic Planning Agency "Whitepaper on Ecooperation, 1986. Page 116)

[3] There are three sources of information on Japanese direct investment. These three differ in definition, thus, also in figures. The Ministry of Finance data on direct investment is based on report and their figures for the fiscal year are usually much larger than Bank of Japan's Balance of Payment Statistics which are based on annual transactions. The Ministry of International Trade and Industry also publishes more detailed information on foreign affiliates based on a questionnaire titled *Gaishi Kei Kigyo no Keiei Doko* annually. Also, MITI has started to publish *Kaigai Toshi Tokei Soran* that gives information on Japan's direct investment abroad including reinvestment activities.

The microeconomic importance of such large capital outflow is that direct investment implies shift in production location from Japan to other countries. Thus, it will ultimately alter the amount as well as commodity composition of trade between Japan and her trading partners. Japan will build closer economic ties with particular regions or countries that host more Japanese investment.

Patterns of Japanese direct investment have always been closely linked with her industrial structure. To give a few examples, the purpose of government sponsored resource development projects in the 1950s[4] was to assure supply of natural resources, so vital in building such heavy industries as iron and steel. Heavy investment to nearby Asian countries in the early 1970s reflected the gradual erosion of Japanese comparative advantage in labor intensive industries due to rise in wage cost. Rise in domestic wages plus appreciation of the yen had prompted Japanese firms to start their production in these countries that were promoting import substitution behind their protected markets. Japan's interests in resource development were revived after the first oil crisis and its aftermath.

In the early 1980s, interests of Japanese firms in investing abroad appeared to have shifted more from acquiring resources and utilizing low wage labor to preserving market outlets for manufactured exports and participating in financial operation in industrial countries. Here again, such changes reflected the adjustment of Japanese industries to change in prices of primary products and to intensified trade friction with her major trading partners. The U.S. and Western Europe tried to raise their import barriers against major Japanese exports by introducing voluntary exports restraints and other non-tariff barriers. Japan also invested more to Asian NICs who were rapidly catching up in producing sophisticated industrial products.

During the 1970s, Japanese industries were moving away from production of resource intensive products as aluminum and steel, because high domestic energy cost was depriving their competitive strength. They started to produce those products that resource content of final products were small, namely machineries. These changes in industrial production altered Japanese commodity composition of trade. The exports showed increased concentration in few items such as autos, electronics and electrical products on the one hand while import demand for raw materials and fuels gradually decreased. Although rise in crude oil prices in the late 1970s had more than offset the decline in volume of imports of mineral fuels and contributed to increase total imports, value of imports of fuels started to decline in the early 1908s when oil price started to fall. This decline in fuel imports added to the increase in Japan's trade surplus.

The large multilateral as well as bilateral trade surplus (see Table 1) had strained Japanese economic relationship with her major trading partners. For example, EC Ministerial Council had repeatedly expressed their concern on Japanese huge current account surplus as a factor endangering the function of present world

[4] Among such projects were Alaska Pulp Co., 1953-; Usiminas Siderurgi cas de Minas Gerais, S. A. 1965-; Arabian Oil Co., 1956-; Arabian Oil Co., 1957; and North Sumatra Oil Development Co., 1960.

TABLE 1. JAPANESE BALANCE OF PAYMENTS IN 1982, 1986 AND 1987*
(in billion U.S. $)

	1982	1986	1987
Current balance	6.85	85.85	87.02
Trade balance	18.08	92.83	96.39
Exports	137.67	205.59	224.61
Imports	119.58	112.76	128.22
Services	−9.85	−4.93	−5.70
Transfers	−1.38	−2.05	−3.67
Long-term capital**	−14.97	−131.46	−136.53
Direct investment	−4.10	−14.25	−18.35
Trade credits	−3.25	1.87	0.54
Loans	−8.08	−9.32	−16.21
Securities	2.12	−101.43	−93.83
Short-term capital	−1.58	−1.61	23.87
Errors & omission	4.73	2.46	−3.89
Overall balance	−4.97	−44.77	−29.55

Source: Bank of Japan "Balance of Payment Monthly."
* preliminary ** include long-term capital other than direct investment, trade credits, loans and securities.

trading system and pushed Japan to take import liberalization measures.[5] Also, as bilateral trade imbalance between EC and Japan had expanded, they introduced a series of selective import restrictive measures against Japan.

Japanese government responded to these claims by agreeing to introduce export moderation system covering major export items as VTR, color TV, passenger cars and some machine tools with EC in 1983. It is well known that severe trade friction between Japan and her major trading partner, the U.S., on industry specific issues as steel, color TV and autos since the mid-1970s had led to introduction of voluntary export restriants in these industries.

The request from Asian countries to Japan ranged from expanding the generalized system of preference ceilings and reducing tariff barriers on agriculture and food (ASEAN countries) to further imporving market access and to reduce their bilateral trade imbalances with Japan (Asian NICs, particularly Korea).

Japan also hastened to remove trade barriers even on much disputed agricultural food items. The forces that supported policy stances for promoting Japanese trade liberalization were not only her trading partners but some domestic groups. The gradual tariff reduction on processed foods had squeezed profit margin of domestic food manufacturer who had to rely on high priced agricultural products supported by the government. Continuation of agricultural protection was against the interest of these food manufacturer. Also increase in importance of city electorate whose interests were against high food price was slowly changing

[5] Occasions as June 19, 1985 and March 10, 1986 for example.

TABLE 2. JAPAN'S RATIO OF MANUFACTURED GOODS IN TOTAL IMPORTS*

(%)

	Total manufactured goods	Chemicals	Machineries	Others
1983	27.2	5.7	8.2	13.3
1984	29.8	6.1	8.9	14.8
1985	31.0	6.2	9.6	15.2
1986	41.8	7.7	11.6	22.5
1987**	43.5	7.9	12.8	23.1

* Based on Economic Planning Agency estimations in "Nahon Keizai no Genkyo" 1988.
** Preliminary for Jan.–Nov., seasonally adjusted.

political balance in favor of the groups that supported the liberalization.

It is very difficult to make precise assessment of how these trade policy changes have affected Japanese trade flow in the early 1980s. But at least on import side, removal of trade barriers had increased the market responsiveness of Japanese demand to change in relative price of imports against domestic goods. The ratio of manufactured goods in total imports which was 27.2% in 1983 increased to 31.0% in 1985. The rise in such ratio accelerated after large appreciation of the yen against the dollar till it reached 43.8% in 1987 (see Table 2). Increase in imports in 1987 from the previous year was most pronounced in textiles (52%), machineries (30%) and chemicals (22%). As a region, imports from Southeast Asia showed the largest increase which raised its share in Japanese imports to 25.8% (see Table 5). Japanese market was receiving more imported manufactured goods than ever before, in such commodities as textiles and electric machinery from Southeast Asia and autos from Western Europe. The effectiveness of export restrictive measures as VERs in the U.S. or export moderation scheme in EC to restrain Japanese exports to these countries were quite limited in the short-run. Even after the appreciation of yen by 30% to 40% against the dollar since September 1985, Japan's export volume in 1986 increased in general machinery (3.4%) and precision machinery (1.3%) and decreased very moderately in electrical machinery (−2.9%) and transport machinery (−4.8%). However, these export restrictive measures affected the investment behavior of Japanese firms because they felt it difficult to further expand their exports to both regions.

Indeed, Japanese firms were investing more in manufacturing industries in industrial countries in the early 1980s. Japanese investment to industrial countries traditionally was directed primarily in commerce sector to promote trade by establishing sales agents for exports or by putting up subsidiaries to merchandise resources and resource related imports. But introduction of industry specific trade restrictive measures in the U.S. and in EC led Japanese firms to open subsidiary plants or to start joint ventures in order to assemble final products in these countries.

Another notable change that took place between 1982 and 1987 in Japanese direct investment was an increase in investment in finance and insurance. The large portion of Japanese capital outflow during this period was in securities (see Table 1). Increasing number of Japanese financial institutions started to open branch offices and subsidiaries abroad, as they found promising profit opportunities by operating in international security markets.

After the yen appreciation in 1985, further important changes were taking place. Japanese manufacturers who saw the advantage in shifting their production location to nearby Asian countries whose currencies were more or less pegged to the dollar were strengthening their cooperative relationship with companies in these countries through joint venture, production consignment and licensing agreement.

The outcome of such changes in Japanese investment pattern on trade flows is yet to be seen. But undoubtedly these changes will affect the future courses of Japan's economic relationship with her trading partners.

3. DRIVING FORCES FOR PROMOTING JAPANESE DIRECT INVESTMENT TO WESTERN EUROPE AND ASIA

The shift in Japanese industrial specialization away from resource intensive industries to auto, electronics and electric machineries had reduced the importance of resource related investment projects. This change favored investment in Western Europe because investment in Western Europe was primarily in manufacturing and services. The share of Europe in total Japanese direct investment increased from 11.4% in 1982 to 19.7% in 1987. The influence of the change in Japanese industrial investment to Asia was mixed. Japanese investment to Asian NICs (Hong Kong, Korea, Taiwan and Singapore) increased relatively more than her investment to resource rich ASEAN countries (Malaysia, Indonesia and the Philippines). Since resource development projects in Indonesia accounted for almost half of Japanese direct investment in Asia till the end of the 1970s, the decline in importance of resource and resource related projects in the early 1980s had reduced the share of Asia in Japan's total direct investment to 14.6% in 1987 from 17.9% in 1982 (see Table 3).

Number of factors contributed to the increase in Japan's direct investment in Western Europe. There was a gradual decline in European currencies against the yen which reduced wage cost in Europe relative to Japan. Even when Japanese firms found wage in Europe much higher than the wage in developing countries, they favored political stability and less regulatory industrial policy in Europe. Also, well developed European infrastructure was another factor that attracted Japanese investment to Europe.

In part of Western Europe, government officials were quite enthusiastic in inviting Japanese firms that would bring in new technologies and managerial skills to their countries. They also welcomed Japanese direct investment which would

TABLE 3. JAPANESE DIRECT INVESTMENT TO THE WORLD, EUROPE[1] AND ASIA[2] 1982, 1985 AND 1987. FISCAL YEAR APRIL/MARCH

(in million $)

	1982			1985			1987		
	World	Europe	Asia	World	Europe	Asia	World	Europe	Asia
Total investment	7,703	878	1,384	12,218	1,930	1,436	33,364	6,576	4,868
% in world total	100	11.4	17.9	100	15.8	11.7	100	19.7	14.6
Manufacture	2,076	139	544	2,353	323	460	7,832	851	1,679
1. foods	78	1	9	89	12	33	328	19	142
2. textile	67	5	40	28	8	9	206	35	28
3. wood and pulp	76	—	10	14	—	4	317	1	13
4. chemicals	322	39	132	133	14	39	910	121	246
5. iron and other metals	468	7	144	385	37	26	786	13	306
6. general machinery	164	12	52	352	25	76	687	87	102
7. electric machinery	267	53	43	513	48	52	2,421	179	467
8. transport machinery	439	18	47	627	120	151	1,473	299	206
9. others	195	4	67	211	59	60	703	99	169
Primary industry	747	—	265	653	1	329	652	5	276
1. agriculture and forestry	40	—	9	12	—	2	97	—	15
2. fishery	22	—	7	43	—	10	44	—	21
3. mining	685	—	249	598	1	317	511	5	240
Others	4,881	738	575	9,213	1,607	646	24,429	5,402	2,866
1. construction	44	9	20	95	2	31	87	1	16
2. commerce	1,899	340	81	1,549	410	136	2,269	500	212
3. finance and insurance	533	258	39	3,805	953	168	10,673	4,532	378
4. services	702	10	292	665	111	194	2,780	192	684
5. n.e.c.[3]	1,703	121	143	3,099	131	117	8,620	177	1,576

(1) includes Eastern Europe: Eastern Europe accounted for 1.99% of accumulated total to Europe at end 1985.

(2) includes China: China accounted for 1.43% of accoumulated total to Asia at end 1985.

(3) includes transportation, real estate and others n.e.c.

Source: Ministry of Finance "Bureau of International Finance Yearbook" and "Zaisei Kinyu Tokei Gepo."

TABLE 4. JAPANESE FIRMS* IN WESTERN EUROPE BY INDUSTRY AND BY COUNTRY (MANUFACTURING ONLY) AS OF JANUARY, 1987

Industry	Country								
	U.K.	France	West Germany	Netherlands	Belgium	Ireland	Spain	Others	Total
Food	2	5	1				1		9
Textites	1	2				2		3	8
Wood and wood products									
Pulp and paper	1								1
Publishing and printing					1				1
Chemicals	3	3	1	8	3	1	3	4	26
Medicine			2			1	2		5
Petroleum and coal									
Rubber	1	3	2					1	7
Ceramics and stone				1	2	1	1	1	6
Non-ferrous metals	1	1					1	1	4
Metal products	3	1		2	2		2	2	12
General machinery	9	3	6	2			1		21
Electronics and electric	20	5	20	1	3	5	7	2	63
Transport machinery	5	2		2	1		7	5	22
Precision machinery	1	1	3	2	2			2	11
Others	6	6	10	2	4		2	10	40
n.e.c.		1					2	3	6
Total	53	33	45	20	18	10	29	34	242

* Japanese holdings exceeding 10%.

Source: JETRO "Oushu ni Okeru Nihon Kigyo no Keiei no Jittai" (Managements of Japanese firms in Western Europe) May, 1987.

provide employment to local workers. At EC-Japan Conference on Industrial Co-operation,[6] the importance of building closer economic ties between Japan and EC through two-way investment or co-operation in research and technology was repeatedly emphasized.

Among Japanese industries that had accumulated industrial and managerial skills and extended their industrial activities in Western Europe were autos, electronics and electrical machinery in manufacturing and finance and insurance in services. In 1987, two thirds of Japanese direct investment in manufacturing industry to Western Europe was in general, electric and transport machineries (see Table 4). Many products from these industries faced trade moderation or monitoring scheme that restricted imports from Japan. Although Western European demand for electronics and office machineries was strong, European manufacturers were not necessarily keeping up to meet their domestic demand. Japanese firms finding that they could not further expand their exports, started local production of color TV, VTR, electronic typewriter and more recently, copy machines.

Japanese firms first started off as assembly makers, relying heavily on parts imported from Japan. For example, local content of Nissan Motors' British plant at initial stage was mere 40%. But plans are reported that British part makers alone or jointly with Japanese part makers will supply more parts to Nissan Motors to raise local content to 60%–80% in the future.[7] Similar trends are observed in European electronic part makers to supply more parts to Japanese assembly plants in Europe. Such trend will eventually increase local content of Japanese assembly makers and increase local employment. Japanese direct investment to EC in manufacturing was providing 76,000 jobs as of March, 1987.[8] If locational advantage of supplying parts within EC than shipping all the way from Japan will promote Japanese direct investment of part makers, their investment to Europe will follow investment of assembly makers and further increase total Japanese investment to European countries.

Japanese direct investment to Asia showed a radical shift from traditional pattern in the mid-1980s. Investment in resources and resource based manufacturing, such as wood, iron and steel, and other metals lost their importance. Asian manufacturing industries that attracted more Japanese direct investment were machinery industries, particularly electric machineries (see Table 3).

The changes in industrial composition of Japanese direct investment to Asia reflected the changes in motives of Japanese firms to invest in Asia. Primary purpose of Japanese manufacturing firms in establishing Asian subsidiaries in the past was to undertake production behind the trade barriers that intended to promote import substitution in these countries. In 1983, Japanese manufacturing firms in Asia shipped 66.9% of their output to local market, 22.3% to the third

[6] First conference took place in November 1983.
[7] JETRO (1987) page 8.
[8] MITI: "Whitepaper on Trade" (1987) page 405.

country and 10.8% to Japan. Such regional composition of sales differed markedly from American manufacturing firms which shipped only 39.0% to local market, but 37.5% to the third country market and 23.5% to the U.S..[9] In other words, American firms invested in Asia primarily to export. Particularly such tendency became more pronounced toward the end of the 1970s when the dollar had appreciated against other major currencies. Currency appreciation had promoted American firms to increase their offshore production in Asia. U.S. subsidiaries in Asia became important sources of supply for electronic parts and consumer electric appliances to parent companies. Until the mid-1980s, Japanese firms in Asia that had higher export ratio to output were in resource or resource based manufacturing industries, namely, nonferrous metals, wood and wood products, and fishery.

As Japanese electronic, electric machinery and autos gained their competitive strength in the world market, they started to internationalized their production operation. They found Asian countries, notably Asian NICs that acquired more sophisticated industrial skills, attractive countries to shift some of their production processes located in Japan. Asian NICs in their part were just finishing up their import substitution stages and moving into export promotion stage. Most of the countries in the region now allow 100% foreign holdings for export oriented undertakings. These basic conditions that favored export oriented investment projects in Asian NICs and in some ASEAN countries plus appreciation of the yen against the dollar since September, 1985 increased Japanese investment to these countries further.

In 1986 and 1987, Japanese firms intensified their corporate ties with Asian counterparts by providing additional capital, new license agreements and starting joint ventures. New Japanese investments in manufacturing industry to Asia during January to August 1986 concentrated in auto, electronic and electrical industry (62% of total cases) and in Asian NICs (77.5% of total cases).[10] A number of plans were reported by major Japanese firms in electronic, electric and auto industries to expand their production in Asian subsidiaries to ship more to the third country markets, or to supply new parts demanded by parent companies in Japan or by subsidiaries in the U.S..[11] Also, some of Japanese firms in electric industries were shifting production of lower priced brands to their Asian subsidiary plants.[12]

It is important to note that recent appreciation of the yen against the dollar has altered investment flows not ony between the U.S. and Japan but also between Japan and Asia. And behind this were improved competitiveness of Asian

[9] MITI: "Whitepaper on Economic Cooperation" (1987) page 126; Figure 2-2-8.

[10] MITI: "Whitepaper on Economic Cooperation" (1987) page 125; Figure 2-2-7.

[11] MITI: "Whitepaper on Economic Cooperation" (1987) page 128; Figure 2-2-9.

[12] Typical such examples might be the following case. The leading electric and electronic maker Matsushita announced that they would stop producing sound machinery priced below $100. Also Aiwa had shifted 50% of radio cassette production to their plants in Singapore. (Economic Institute, Kikai Shinko Kyokai (1987) page 49)

countries in producing sophisticated manufactured products.

Emergence of Asia as the fastest growing industrial centers of the world is also affecting foreign investment into Japan. Indeed, one of the most important reasons for U.S. and European firms to invest in Japan was its locational advantage in Asia.[13] European direct investment to Japan accounts for one third of total number of investment in manufacturing. Chemicals including medicine and general machinery were two major industries that attracted European capital in the early 1980s. Another important development in recent European direct investment to Japan was increase in investment by auto makers to promote sales by establishing their own distribution channels. The rise in Japanese income and standards of living are diversifying demand for autos. The improvement of sales network and afterservices that will respond promptly to Japanese demand are necessary confition for expanding auto sales in Japan. Particularly, efforts of European auto makers seem to be showing good results in expanding European auto exports to Japan from the mid-1980s.

4. OUTCOME OF JAPANESE DIRECT INVESTMENT IN CHANGING TRADE RELATIONSHIP WITH WESTERN EUROPE AND ASIA

Japanese imports from both Southeast Asia and Western Europe showed a phenomenal increase in 1987. It increased by 31% in the former and 25.2% in the latter from the previous year (see Table 5). Increase in Japanese imports was most pronounced in case of imports from Asian NICs (Korea, Taiwan and Hong Kong), major recipients of Japanese direct investment in manufacturing industry in Asia. Imports from these three countries rose by 51.7% in 1987 from 1986.

It became quite evident by 1987 that Japanese direct investment in Asian manufacturing industry to produce low priced range electronic and electric products and some subassembled auto parts for Japanese market was the prime force that led to increase in imports from these countries. Among the items that showed big increases in imports were electric and electronic machineries such as stereo and radio cassettes from Southeast Asia which grew two folds reflecting mainly imports from Singapore and Taiwan. Aiwa and Hitachi, both leading electronic and electric manufacturers, were increasing their purchase from foreign subsidiaries located in these two countries. Also Mitsubishi Autos was importing more parts from their Korean counterpart.

Gradual removal of Japanese tariffs as well as non-tariff barriers and appreciation of the yen against currencies in both Western Europe and Asia provided the basic conditions that favored promotion of exports to Japanese markets from countries in both regions. Also, as for European countries, recent rise in Japanese standard of living promoted the demand for high quality consumer goods from Europe. This was particularly true in case of auto imported from West Germany and apprels imported from Italy.

[13] MITI: "Whitepaper on Trade" (1986) page 235.

TABLE 5. JAPANESE TRADE WITH THE WORLD, WESTERN EUROPE AND ASIA. IMPORTS IN 1982, 1986 AND 1987

	1982			1986			1987		
	World	W. Europe	Asia	World	W. Europe	Asia	World	W. Europe	Asia
Total in billion $	131.9	10.11	29.99	126.4	18.02	29.49	149.39	22.56	38.62
% in world total	100	7.7	22.7	100	14.3	23.3	100	15.1	25.8
Total imports	100	100	100	100	100	100	100	100	100
Raw materials	14.3	3.8	15.3	13.9	3.3	13.5	14.7	3.6	14.3
Mineral fuels	49.7	0.2	53.3	29.2	1.1	34.9	26.2	0.6	28.5
Foods	11.0	11.3	11.2	15.2	9.0	18.0	14.7	9.2	16.8
Manufactured goods	24.9	72.5	19.4	34.8	69.1	31.9	40.5	77.0	40.4
Machinery	6.9	24.7	2.1	11.6	24.7	6.4	12.8	28.4	7.9
Chemicals	5.2	21.7	3.1	7.7	20.0	3.3	7.9	21.1	3.0
Others	12.8	26.1	14.2	15.5	24.4	22.2	19.8	27.5	29.5
Re-imports and special items	—	12.2	0.8	6.9	17.4	1.7	3.6	9.6	—

TABLE 5. JAPANESE TRADE WITH THE WORLD, WESTERN EUROPE AND ASIA. EXPORTS IN 1982, 1986 AND 1987

	1982			1986			1987		
	World	W. Europe	Asia	World	W. Europe	Asia	World	W. Europe	Asia
Total in billion $	138.8	21.57	31.87	209.15	37.48	41.79	229.21	45.15	52.98
% in world total	100	15.5	23.0	100	17.9	20.0	100	19.7	23.1
Total exports	100	100	100	100	100	100	100	100	100
Textiles	4.5	2.4	7.0	3.3	2.2	6.3	3.0	2.0	5.5
General machinery	14.6	11.7	18.4	18.4	19.2	19.3	19.5	20.1	21.0
Electrical machinery	18.6	27.5	17.8	22.4	26.2	25.1	22.2	25.4	25.7
Transport machinery	27.4	27.5	12.2	28.4	26.7	9.2	27.9	28.5	9.8
Precision machinery	4.5	8.9	3.9	5.0	8.5	4.3	5.0	7.7	4.1
Metal products	16.7	5.0	19.0	9.8	2.6	14.0	7.9	2.1	12.7
Chemical products	4.6	3.8	9.0	4.5	4.3	10.0	5.1	4.4	9.9
Foods & material	1.0	13.2	4.6	0.7	10.3	4.3	0.7	0.4	4.3
Others	6.1		8.2	7.5		7.5	8.7	9.3	6.9

Source: Ministry of International Trade and Industry, "Whitepaper on Trade" various issues.

Although Japanese imports of manufactured goods increased from Southeast Asia and from Western Europe in 1986 and in 1987, they were far from sufficient to reduce the bilateral trade imbalances between Japan and both regions. Japanese trade surplus with Southeast Asia increased from $12.30 billion in 1986 to $14.36 billion in 1987. Also similar surplus with Western Europe increased from $19.46 billion in 1986 to $22.59 billion in 1987 (see Table 5).

Aside from the well known J-curve effect which inflates value of exports in dollar terms when currency appreciates against the dollar, a number of reasons can be pointed out for the increase in Japanese trade surpluses against Western Europe and Asia. First of all, demand for Japanese exports remained strong in both Asia and Western Europe despite the currency appreciation. Japanese exports to Western Europe were concentrated in a number of few items by the mid-1980s. In 1986, exports of five items, autos, computer, VTR tape recorder, TV & radio and copy machine accounted for 39.8% of Japanese exports to EC.

Almost all of these items faced some sorts of import restriction schemes in Western Europe, including antidumping tariffs on copy machine introduced by EC in August, 1986. As noted in the previous section, such restriction had prompted Japanese auto, electronic and electric manufacturers to open assembly plants in Western Europe. However, their European plants relied heavily on imported parts shipped from Japan.

Whether this increase in imports of Japanese parts to Western Europe is a transitional phenomenon is yet to be seen. Some Japanese autopart makers are following assembly makers in increasing investment to Western Europe as expansion of Japanese assembly production would lead to increase in local demand for accessories and parts. Also increase in the number of Japanese autos in Europe will create new demand for parts needed for the repair. In case of electronic and electric manufacturer, there were firms like Matsushita in West Germany who invited their own part makers to supply parts to the assembly plants. If local content ratio of assembly makers in Western Europe will rise in the future, increase in exports from Japan will be moderated. But for the time being restriction on Japanese exports of end-products was increasing her exports of parts to Western Europe.

The rate of increase in Japanese exports of parts for general machinery, autos and electronics and electric machinery in the 1980s was even greater in case of Asian NICs compared to Western European experiences. The increase was not hampered by the appreciation of the yen in 1985 but it even accelerated in 1986. The Asian NICs in their effort to move out from being traditional supplier of textiles and other labor intensive manufactured goods to producer of more sophisticated goods as consumer electronics and electric machineries had promoted technological transfers centered on assembly technology. Thus they had built their assembly industries—auto, color TV and more recently VTRs—which rely heavily on imported parts from Japan. Especially for parts that require higher industrial skills in product design and quality, this was true.

Thus even after the yen had appreciated substantially in 1986 making imports from Japan more expensive, Asian NICs increased their imports from Japan. In other words, imported parts from Japan were so vital in producing their end products such as autos, color TV and VTR. As Asian NICs' exports to the U.S. boomed in 1986 reflecting their advantage in having more stable exchange rates against the dollar compared to the yen, it increased imports from Japan to supply parts needed for the production. A typical such examples were large increase in Japanese exports of semi-conductor and integrated circuits to Asian NICs in 1986. Volume of Japanese exports to Asian NICs increased by 58.5% in semi-conductor and 49% in integrated circuits in 1986 from the previous year. In case of autos, one finds a strong correlation between Korean exports of finished cars to the world and Japanese exports of auto parts to Korea.[14]

Outcome of Japanese direct investment in changing trade flows between Western Europe and Asia will pose very interesting question on whether movement of capital promotes trade flows or substitute them. The Japanese direct investment in resources and resource-based manufacturing industry evidently promoted trade since capital was used to develop resources that were shipped to Japan. The purpose of Japanese direct investment to Western Europe and Asia prompted by import restrictive measures by the former and import substitution policies by the latter was intended to substitute imports from Japan by their local production. Thus one would expect decline in trade. However, import restriction on finished products was increasing subassembled part imports from Japan in both Western Europe and Asia. Whether direct investment by part makers will follow assembly makers and increase local production of parts which will eventually substitute imports from Japan in both finished products and parts are not clear yet. If substitution occurs, then direct investment will reduce trade. But if Japanese industrial operation in Western Europe and Asia contributes to promote industrial competitiveness and increase their exports, Japanese investment will have trade promotive effect in part of Western Europe and Asia. Truth of the matter probably rests someway in between. At least, one can conclude that decision of the firms in picking production sites give profound influence on trade flow and thus on how economic activities are transmitted between different countries.

5. IMPLICATIONS OF CLOSER JAPANESE ECONOMIC RELATIONSHIPS WITH WESTERN EUROPE AND ASIA TO FUTURE SOCIO-ECONOMIC DEVELOPMENT IN BOTH REGIONS

In the 1980s, Japan was starting to build closer economic relationships with Western Europe and Asia through direct investment, particularly in such industries as fast growing electronics and electric machinery, autos and financial services. Japanese firms who accumulated industrial and managerial skills in these

[14] MITI: "Whitepaper on Trade" (1987) page 115; Figure 2-1-22.

fields shifted their industrial locations abroad whenever they found it necessary.

The increased competitiveness of Asian NICs had prompted Japanese investment to these countries to overcome rapid rise in the value of yen after September 1985. The prime motive of such investment was to export to the third country markets and also to supply their own demand in Japan. Evidently Japanese firms were moving away from their traditional pattern of production, namely importing raw materials and carrying out all the fabrication processes within Japan to importing subassembled parts from abroad to produce final products. Behind these changes were gradual removal of Japanese tariffs and non-tariff barriers, rise in domestic wages and accumulated know-how for foreign operation by Japanese companies.

If such need to change Japanese industrial structure to become more 'Harmonious' stressed in Maekawa Report[15] implied Japan should accommodate more manufactured imports so that their growth can benefit her trading partners by transmitting demand, then the recent trend seems to be heading in the right direction. Further improvement of market access to Japan and keeping the yen at the current appreciated level will be correct policy prescription to this end.

Japanese advantage in being located near the fast growing Southeast Asian countries was one of the important reasons for attracting more foreign investment into Japan. The plans for cooperation between VW group in West Germany and Nissan Motors included production for increasing exports to Southeast Asia. Another important trend in investment to Japan from Western Europe was to set up sales distributor and after-service network. These efforts undoubtedly have contributed to the expansion of auto imports from Europe.

Although the bilateral trade imbalances between Japan vs Western Europe and Asia are still quite substantial, new tide for more trade through manufactured imports started to emerge from the mid-1980s. The trend will benefit Western European countries and Asian NICs and few others in Asia. However, since such changes in Japanese trade reflected the shift in her industry away from resource intensive sectors to sophisticated manufactured goods, policy measures in both Japan and Asian countries may need to promote economic relationships with countries in Asia influenced adversely by the change.

One of the major obstacles for Japanese direct investment to Asian countries aside from NICs are their lack of infrastructure including supply of eligible labor for manufacturing operation. Also foreign exchange regulations on remittance, local content regulation and high tariffs on imports discourage investment to these countries.

[15] "Report of the Advisory Group on Economic Structural Adjustment for International Harmony" known as "Maekawa Report" submitted to Prime Minister Nakasone in 1986, recommended; 1. Expanding domestic demand; 2. Transformation to an internationally harmonious industrial structure; 3. Further improving market access and encouraging import of manufactured goods; 4. Stabilization of exchange rates and liberalization and internationalization of financial and capital markets; 5. Promotion of international cooperation and Japan's contribution to the world economy commensurate with its international status; 6. On fiscal and monetary policy management.

Japanese efforts to increase government aid to enhance the basic infrastructure necessary for industrialization will help to develop closer economic ties with some Asian countries affected adversely by recent shifts in Japanese specialization. But one has to bear in mind that Japanese surplus in current account is mainly a result of excess saving over investment in the private sector. The government deficits in Japan and the support for balanced fiscal policy stances, even when government aids are favorably treated in the budget are limiting the extensive use of government oriented capital flow for international economic cooperation. Thus recent investment promotive measures such as "May six package" in Indonesia (1986, May) or relaxing the foreign stock holding regulation in export oriented industries in Malaysia[16] are promising moves to invite Japanese capital. The importance of having more direct investment is not limited to alleviate the capital shortages in the host countries. Their products will have better access to the foreign market through marketing channels of the parent companies. Through these interdependent channels of sales that unite countries in different regions, economic activities are transmitted between Japan, Western Europe and Asia.

Of course the countries are prone to get adverse effects from joining these interdependent channels. Domestic industry may face more instability when government of trading partner takes tight monetary of fiscal policies. Exchange rate fluctuation may be another factor that brings in the instability. However, the fact remains that in the world economy where improvement in information and communication networks unites countries in different regions together, firms tend to pick most attractive location for production. Their production brings in capital, technological and managerial skils and provides employment to local workers. These factors all contribute to economic growth of the countries. And to this end internationalized activities of Japanese firms may help to promote economic-growth in Asia and in Western Europe.

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[16] MITI: "Whitepaper on Economic Cooperation" (1987) in page 54 stresses that these change may promote investment to ASEAN countries.

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